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IFAC welcomes any comments you may have regarding this handbook. Comments may be sent to the address above or emailed to publicsectorpubs@ifac.org.

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2006 IFAC HANDBOOK OF INTERNATIONAL PUBLIC SECTOR ACCOUNTING STANDARDS BOARD PRONOUNCEMENTS

Scope of the Handbook

This Handbook brings together for continuing reference background information about the International Federation of Accountants (IFAC) and the currently effective pronouncements on Public Sector issued by IFAC as of January 1, 2006. . In this handbook, the text of pronouncements that become effective at a date after January 1, 2006 has been shaded.

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CHANGES OF SUBSTANCE FROM THE 2005 HANDBOOK

Pronouncements Issued by the International Public Sector Accounting Standards Board

This handbook contains references to the Public Sector Committee (the Committee, or the PSC) of IFAC. Effective November 10, 2004, the International Public Sector Accounting Standards Board (IPSASB) of IFAC replaced the PSC.

This Handbook contains references to the International Auditing Practices Committee (IAPC) of IFAC. Effective April 1, 2002, the International Auditing and Assurance Standards Board (IAASB) of IFAC replaced the IAPC.

This Handbook also contains references to the International Accounting Standards Committee (IASC). As of April 1, 2002, International Financial Reporting Standards (previously referred to as International Accounting Standards) are issued by the International Accounting Standards Board (IASB).

Please Note: As of this printing, the IASB Publications Department is located at 30 Cannon Street, London EC4M 6XH, United Kingdom.

E-mail: publications@iasb.org.uk
Internet: http://www.iasb.org.uk

Amendments

The Public Sector Committee's Guideline No. 1, "Financial Reporting by Government Business Enterprises" has been withdrawn as of November 2002.

Pronouncements Issued by the International Ethics Standards Board for Accountants

Additions

During 2005 the International Ethics Standards Board for Accountants (IESBA) issued a revised *Code of Ethics for Professional Accountants* (the Code) establishing a conceptual framework for all professional accountants to ensure compliance with the five fundamental principles of professional ethics. The revised Code is effective on June 30, 2006. Section 290 is applicable to assurance engagements when the assurance report is dated on or after June 30, 2006. Earlier application is encouraged.

Recent Exposure Drafts

The IESBA has issued as exposure draft proposing a revision to the network firm definition contained in Section 290.

INTERNATIONAL PUBLIC SECTOR ACCOUNTING STANDARDS BOARD -INTERIM TERMS OF REFERENCE

(Approved November 2004)

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INTERNATIONAL PUBLIC SECTOR ACCOUNTING STANDARDS BOARD

Interim Terms of Reference

Purpose of the International Public Sector Accounting Standards Board

1. The mission of the International Federation of Accountants (IFAC), as set out in its constitution, is "to serve the public interest, IFAC will continue to strengthen the worldwide accountancy profession and contribute to the development of strong international economies by establishing and promoting adherence to high-quality professional standards, furthering the international convergence of such standards and speaking out on public interest issues where the profession's expertise is most relevant.". In pursuing this mission, the IFAC Board has established the International Public Sector Accounting Standards Board (IPSASB) to develop high–quality accounting standards for use by public sector entities around the world in the preparation of general purpose financial statements. In this regard:

    - the term "public sector" refers to national governments, regional (e.g., state, provincial, territorial) governments, local (e.g., city, town) governments and related governmental entities (e.g., agencies, boards, commissions and enterprises); and

    - general purpose financial statements refers to financial statements issued for users that are unable to demand financial information to meet their specific information needs.

2. The IFAC Board has determined that designation of the IPSASB as the responsible body for the development of such standards, under its own authority and within its stated terms of reference, best serves the public interest in achieving this aspect of its mission.

3. The IPSASB functions as an independent standard-setting body under the auspices of IFAC. It achieves its objectives by:

    - Issuing International Public Sector Accounting Standards (IPSASs);

    - Promoting their acceptance and the international convergence to these standards; and

    - Publishing other documents which provide guidance on issues and experiences in financial reporting in the public sector.

Appointment of Members

4. The members of the IPSASB are appointed by the Board of IFAC. The IPSASB comprises 15 members, 13 of whom are nominated by the member bodies of IFAC and two of whom are appointed as public members. Public members may be nominated by any individual or organization.

5. Candidates put forward are considered for appointment by the IFAC Nominating Committee. The selection process is based on the best person for the job. In recommending appointments to the Board, the Nominating Committee seeks to ensure that the IPSASB comprises a membership which possesses appropriate technical expertise, knowledge of institutional arrangements encompassed by its constituency, technical proficiencies of users, preparers and auditors, and a broad geographical spread.

6. IPSASB members are appointed for an initial term of three years which may be renewed for further three-year terms. Appointments will be made annually in such a way that one-third of the members shall be rotated each year. Continuous service on the Board by the same person shall be limited to two consecutive three-year terms, unless that member is appointed to serve as Chair for a further term. The members of the IPSASB will be primarily engaged in the public sector. For voting purposes, each IPSASB member has one vote.

7. Each member of the IPSASB may be joined at the meeting table by one technical advisor who will have the full privilege of the floor but will not be entitled to vote.

8. The IPSASB may appoint as observers, representatives of appropriate organizations that have a strong interest in financial reporting in the public sector, provide ongoing input to the work of the IPSASB and have an interest in endorsing and supporting IPSASs. These observers will have the privilege of the floor but will not be entitled to vote. They will be expected to possess the technical skills to participate fully in the IPSASB discussions and to attend IPSASB meetings regularly to maintain an understanding of current issues. The IPSASB will review the composition and role of observers on an annual basis.

Nature, Scope and Authority of Pronouncements

9. The IPSASB has been given the authority, on behalf of the Board of IFAC, to issue:

   - International Public Sector Accounting Standards (IPSASs) as the standards to be applied by members of the profession in the preparation of general purpose financial statements of public sector entities. The IPSASB adopts a "due process" for the development of

IPSASs which provides all interested parties with the opportunity to provide input to the standards development process.

- Studies to provide advice on financial reporting issues in the public sector. They are based on study of the best practices and most effective methods for dealing with the issues being addressed.
- Occasional Papers and Research Reports to provide information that contributes to the body of knowledge about public sector financial reporting issues and developments. They are aimed at providing new information or fresh insights and generally result from research activities such as: literature searches, questionnaire surveys, interviews, experiments, case studies and analysis.

10. In developing its standards, the IPSASB seeks input from its consultative group and considers and makes use of pronouncements issued by:

    (a) The International Accounting Standards Board (IASB) to the extent they are applicable to the public sector;

    (b) National standard-setters, regulatory authorities and other authoritative bodies;

    (c) Professional accounting bodies; and

    (d) Other organizations interested in financial reporting in the public sector.

    The IPSASB will ensure that its pronouncements are consistent with those of IASB to the extent those pronouncements are applicable and appropriate to the public sector.

11. The objective of the IPSASB Consultative Group is to provide a forum in which the IPSASB can consult with representatives of different groups of constituents to obtain input and feedback on its work program, project priorities, major technical issues, due process and activities in general. The Consultative Group does not vote on International Public Sector Accounting Standards or other documents issued by the IPSASB.

12. The IPSASB cooperates with national standard-setters in preparing and issuing Standards to the extent possible, with a view to sharing resources, minimizing duplication of effort and reaching consensus and convergence in standards at an early stage in their development. It also promotes the endorsement of IPSASs by national standard-setters and other authoritative bodies and encourages debate with users, including elected and appointed representatives; Treasuries, Ministries of Finance and similar authoritative bodies; and practitioners throughout the world to identify user needs for new standards and guidance.

Working Procedures

13. The IPSASB issues exposure drafts of all proposed standards for public comment. In some cases, the IPSASB may also issue an Invitation to Comment prior to the development of an Exposure Draft. This provides an opportunity for those affected by IPSASB pronouncements to provide input and present their views before the pronouncements are finalized and approved. The IPSASB considers all comments received on Invitations to Comment and Exposure Drafts in developing an IPSAS.

14. Each IPSASB meeting requires the presence, in person or by simultaneous telecommunications link, of at least ten appointed members.

15. Each member of the IPSASB has one vote. An affirmative vote of at least two-thirds of the voting rights of the IPSASB is necessary to approve Invitations to Comment, Exposure Drafts and IPSASs. An IPSASB member may authorize an individual present at an IPSASB meeting to vote on behalf of the member.

16. IPSASB meetings to discuss the development, and to approve the issuance, of standards or other technical documents are open to the public. Agenda papers, including minutes of the meetings of the IPSASB, are published on the IPSASB's website.

17. IPSASB publishes an annual report outlining its work program, its activities and the progress made in achieving its objectives during the year.

18. IFAC will review the effectiveness of the IPSASB's processes at least every three years.

Language

19. The approved text of a pronouncement is that published by IPSASB in the English language. Member bodies of IFAC are authorized to prepare, after obtaining IFAC approval, translations of such pronouncements at their own cost, to be issued in the language of their own countries as appropriate.

INTERNATIONAL FEDERATION OF ACCOUNTANTS

The Organization

The International Federation of Accountants (IFAC) is the worldwide organization for the accountancy profession. Founded in 1977, its mission is "to serve the public interest, IFAC will continue to strengthen the worldwide accountancy profession and contribute to the development of strong international economies by establishing and promoting adherence to high-quality professional standards, furthering the international convergence of such standards, and speaking out on public interest issues where the profession's expertise is most relevant."

IFAC's governing bodies, staff and volunteers are committed to the values of integrity, transparency and expertise. IFAC also seeks to reinforce professional accountants' adherence to these values, which are reflected in the IFAC *Code of Ethics for Professional Accountants.*

Primary Activities

Serving the Public Interest

IFAC provides leadership to the worldwide accountancy profession in serving the public interest by:

- Developing, promoting and maintaining global professional standards and a *Code of Ethics for Professional Accountants* of a consistently high quality;
- Actively encouraging convergence of professional standards, particularly auditing, assurance, ethics, education and financial reporting standards;
- Seeking continuous improvements in the quality of auditing and financial management;
- Promoting the values of the accountancy profession to ensure that it continually attracts high caliber entrants;
- Promoting compliance with membership obligations; and
- Assisting developing and emerging economies, in cooperation with regional accounting bodies and others, in establishing and maintaining a profession committed to quality performance and in serving the public interest.

Contributing to the Efficiency of the Global Economy

IFAC contributes to the efficient functioning of the international economy by:

- Improving confidence in the quality and reliability of financial reporting;
- Encouraging the provision of high-quality performance information (financial and non-financial) within organizations;

- Promoting the provision of high-quality services by all members of the worldwide accountancy profession; and
- Promoting the importance of adherence to the *Code of Ethics for Professional Accountants* by all members of the accountancy profession, including members in industry, commerce, the public sector, the not-for-profit sector, academia, and public practice.

Providing Leadership and Spokesmanship

IFAC is the primary spokesperson for the international profession and speaks out on a wide range of public policy issues, especially those where the profession's expertise is most relevant, as well as on regulatory issues related to auditing and financial reporting. This is accomplished in part through outreach to numerous organizations that rely on or have an interest in the activities of the international accountancy profession.

Membership

IFAC is comprised of 163 member bodies from every part of the globe, representing more than 2.5 million accountants in public practice, business and industry, the public sector and education. No other accountancy body in the world and few other professional organizations have the broad-based international support that characterizes IFAC.

IFAC's strengths derive not only from its international representation, but also from the support and involvement of its individual member bodies, which are themselves dedicated to promoting integrity, transparency, and expertise in the accountancy profession, as well as from the support of regional accountancy bodies.

Standard-Setting Initiatives

IFAC has long recognized the need for a globally harmonized framework to meet the increasingly international demands that are placed on the accountancy profession, whether from the business, public sector or education communities. Major components of this framework are the IFAC *Code of Ethics for Professional Accountants*, International Standards on Auditing (ISAs), International Education Standards and International Public Sector Accounting Standards (IPSASs).

IFAC standard-setting boards, described below, follow a due process that supports the development of high-quality standards in the public interest in a transparent, efficient, and effective manner. These standard-setting boards all have Consultative Advisory Groups, which provide public interest perspectives, and include public members.

IFAC's Public Interest Activity Committees (PIACs) – the International Auditing and Assurance Standards Board, International Accounting Education Standards Board, International Ethics Standards Board for Accountants and the Compliance

Advisory Panel – are subject to oversight by the international Public Interest Oversight Board (PIOB) for the accountancy profession (see below).

The terms of reference, due process and operating procedures of the IFAC standard-setting boards are available from the IFAC website at http://www.ifac.org.

IFAC actively supports convergence to ISAs and other standards developed by the IFAC standard-setting boards and the International Accounting Standards Board.

Auditing and Assurance Services

The International Auditing and Assurance Standards Board (IAASB) develops ISAs and International Standards on Review Engagements (ISREs), which deal with the audit and review of historical financial statements; and International Standards on Assurance Engagements (ISAEs), which deal with assurance engagements other than the audit or review of historical financial information. The IAASB also develops related practice statements. These standards and statements serve as the benchmark for high-quality auditing and assurance standards and statements worldwide. They outline basic principles and essential procedures for auditors and other professional accountants, giving them the tools to cope with the increased and changing demands for reports on financial information, and provide guidance in specialized areas.

In addition, the IAASB develops quality control standards for firms and engagement teams in the practice areas of audit, assurance and related services.

The pronouncements issued by the IAASB are contained in the 2006 edition of IFAC's *Handbook of International Auditing, Assurance, and Ethics Pronouncements* and are also available from the IFAC website at http://www.ifac.org.

Ethics

The *Code of Ethics for Professional Accountants*, developed by IFAC's International Ethics Standards Board for Accountants (formerly the Ethics Committee), establishes ethical requirements for professional accountants and provides a conceptual framework for all professional accountants to ensure compliance with the five fundamental principles of professional ethics. These principles are integrity, objectivity, professional competence and due care, confidentiality, and professional behavior. Under the framework, all professional accountants are required to identify threats to these fundamental principles and, if there are threats, apply safeguards to ensure that the principles are not compromised. A member body of IFAC or firm may not apply less stringent standards than those stated in the Code.

Public Sector

The International Public Sector Accounting Standards Board (IPSASB) develops IPSASs which set out the requirements for financial reporting by governments and other public sector entities. The IPSASs represent international best practice in financial reporting by public sector entities. They apply to general purpose financial statements prepared under the accrual basis of accounting and the cash basis of

accounting, as specified. In many jurisdictions, the application of the requirements of IPSASs will enhance the accountability and transparency of the financial reports prepared by governments and their agencies.

The IPSASB also issues non-authoritative documents which provide guidance on the migration from the cash to the accrual basis of financial reporting, outline country experiences in financial reporting by governments and deal with specific financial reporting issues in the public sector.

French and Spanish translations of the IPSASs are also available for download from the IFAC website.

Education

Working to advance accounting education programs worldwide, IFAC's International Accounting Education Standards Board (IAESB) (formerly the Education Committee) develops International Education Standards, setting the benchmarks for the education of members of the accountancy profession. All IFAC member bodies are required to comply with these standards, which address the education process leading to qualification as a professional accountant as well as the ongoing continuing professional development of members of the profession. The IAESB also develops other guidance to assist member bodies and accounting educators to implement and achieve best practice in accounting education.

This handbook does not contain the International Education Standards, which are available from the IFAC website at http://www.ifac.org.

Support for Professional Accountants in Business

Both IFAC and its member bodies face the challenge of meeting the needs of an increasing number of accountants employed in business and industry, the public sector, education and the not-for-profit sector. These accountants now comprise more than 50 percent of the membership of IFAC member bodies. IFAC's Professional Accountants in Business (PAIB) Committee develops guidance to assist member bodies in addressing a wide range of professional issues, encourages and supports high-quality performance by PAIBs and strives to build public awareness and understanding of the work they provide.

Small- and Medium-Sized Practices

IFAC is also focused on providing best practice guidance to another growing constituency: small- and medium-sized practices (SMPs). IFAC's SMP Committee (formerly the SMP Permanent Task Force) develops papers on topics of global concern and provides input in the development of international standards and on the work of the IFAC standard-setting boards. The committee also investigates ways in which IFAC, together with its member bodies, can respond to the needs of accountants operating in small and medium enterprises and practices.

Developing Nations

IFAC's Developing Nations Committee (formerly the Developing Nations Permanent Task Force) supports the development of the accountancy profession in all regions of the world by representing and addressing the interests of developing nations and by providing guidance to strengthen the accountancy profession worldwide. The committee also seeks resources and development assistance from member bodies and other organizations on their behalf.

IFAC Member Body Compliance Program

As part of the Member Body Compliance Program, IFAC members and associates (mostly national professional institutes) are required to demonstrate how they have use their best endeavors, subject to national laws and regulations, to implement the standards issues by IFAC and the International Accounting Standards Board. The program, which is overseen by IFAC's Compliance Advisory Panel, also seeks to determine how member bodies have met their obligations with respect to quality assurance and investigation and disciplinary programs for their members as set out in IFAC's Statements of Membership Obligations (SMOs). The SMOs serve as the foundation of the Compliance Program and provide clear benchmarks to current and potential member bodies to assist them in ensuring high-quality performance by professional accountants.

This handbook does not contain the SMOs, which are available from the IFAC website at http://www.ifac.org.

Regulatory Framework

In November 2003, IFAC, with the strong support of member bodies and international regulators, approved a series of reforms to increase confidence that the activities of IFAC are properly responsive to the public interest and will lead to the establishment of high-quality standards and practices in auditing and assurance.

The reforms provide for the following: more transparent standard-setting processes, greater public and regulatory input into those processes, regulatory monitoring public interest oversight, and ongoing dialogue between regulators and the accountancy profession. This is accomplished through the following structures:

Public Interest Oversight Board (PIOB)—Established in February 2005, the PIOB oversees IFAC's standard-setting activities in the areas of auditing and assurance, ethics – including independence – and education, as well as the IFAC Member Body Compliance Program. The PIOB is comprised of eight representatives and two observer members nominated by international regulators and institutions.

Monitoring Group (MG)—The MG comprises international regulators and related organizations. Its role is to update the PIOB regarding significant events in the regulatory environment. It is also the vehicle for dialogue between regulators and the international accountancy profession.

IFAC Regulatory Liaison Group (IRLG)—The IRLG includes the IFAC President, Deputy President, Chief Executive, the Chairs of the IAASB, the Transnational Auditors Committee and the Forum of Firms, and up to four other members designated by the IFAC Board. It works with the MG and addresses issues related to the regulation of the profession.

IFAC Structure and Operations

Governance of IFAC rests with its Board and Council. The IFAC Council comprises one representative from each member body. The Board is a smaller group responsible for policy setting. As representatives of the worldwide accountancy profession, Board members take an oath of office to act with integrity and in the public interest.

IFAC is headquartered in New York City and is staffed by accounting and other professionals from around the world.

IFAC Website

IFAC makes its guidance widely available by enabling individuals to freely download all publications from its website (http://www.ifac.org) and by encouraging its member bodies, regional accountancy bodies, standard setters, regulators and others to include links from their own websites, or print materials, to the publications on IFAC's website. The IFAC Policy Statement, *Permissions Policy for Publications Issued by the International Federation of Accountants,* outlines its policy with regard to copyright.

IFAC recognizes that it is important that preparers and users of financial statements, auditors, regulators, lawyers, academia, students, and other interested groups in non-English speaking countries have access to its standards in their native language. The IFAC Policy Statement, *Translation of Standards and Guidance Issued by the International Federation of Accountants,* outlines its policy with regard to translation of its standards.

This handbook does not contain these policy statements. However, they are available from the IFAC website at http://www.ifac.org. The website also features additional information about IFAC's structure and activities.

PREFACE TO INTERNATIONAL PUBLIC SECTOR ACCOUNTING STANDARDS

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PREFACE TO INTERNATIONAL PUBLIC SECTOR ACCOUNTING STANDARDS

Introduction

1. This Preface to the International Public Sector Accounting Standards (IPSASs) sets out the objectives and operating procedures of the International Public Sector Accounting Standards Board (IPSASB) and explains the scope and authority of the IPSASs. The Preface should be used as a reference for interpreting invitations to comment, discussion documents, exposure drafts and standards approved and published by the IPSASB.

2. The mission of the International Federation of Accountants (IFAC), as set out in its constitution, is "to serve the public interest, strengthen the accountancy profession worldwide and contribute to the development of strong international economies by establishing and promoting adherence to high-quality professional standards, furthering the international convergence of such standards, and speaking out on public interest issues where the profession's expertise is most relevant." In pursuing this mission, IFAC established the IPSASB.

3. The IPSASB (formerly Public Sector Committee (PSC)) is a Board of IFAC formed to develop and issue under its own authority International Public Sector Accounting Standards (IPSASs). IPSASs are high quality global financial reporting standards for application by public sector entities other than Government Business Enterprises (GBEs).

4. The IPSASB's Consultative Group is appointed by the IPSASB. The Consultative Group is a non-voting group. It provides a means by which the IPSASB can consult with and seek advice as necessary from a broad constituent group. The Consultative Group is chaired by the Chair of the IPSASB. The Consultative Group is primarily an electronic forum. However, regional chapters of the Consultative Group meet with the IPSASB in conjunction with any IPSASB meetings in their region. All Consultative Group members are invited to these meeting. In addition, a full meeting of all members of the Consultative Group may be held if considered necessary.

Objective of the IPSASB

5. The objective of the IPSASB is to serve the public interest by developing high quality public sector financial reporting standards and by facilitating the convergence of international and national standards, thereby enhancing the quality and uniformity of financial reporting throughout the world. The IPSASB achieves its objectives by:

    - Issuing International Public Sector Accounting Standards (IPSASs);

- Promoting their acceptance and the international convergence to these standards; and
- Publishing other documents which provide guidance on issues and experiences in financial reporting in the public sector.

6. The IPSASs are the authoritative requirements established by the IPSASB. Apart from developing IPSASs, the IPSASB issues other non-authoritative publications including studies, research reports and occasional papers that deal with particular public sector financial reporting issues.

Membership of the IPSASB

7. The members of the IPSASB are appointed by the IFAC Board to serve on the IPSASB. The IPSASB comprises 15 members, 13 of whom are nominated by member bodies of IFAC and two of whom are public members. Public members may be nominated by any individual or organization. In addition, a limited number of observers from bodies that have an interest in public sector financial reporting are appointed to IPSASB. These observers have the privilege of the floor but are not entitled to vote.

IPSASB Meetings

8. Each IPSASB meeting requires a quorum of at least ten appointed members, in person or by simultaneous telecommunications link.
9. IPSASB meetings to discuss the development and to approve the issuance of IPSASs or other papers are open to the public. Agenda papers, including the minutes of the meetings of the IPSASB, are published on the IPSASB's web site.

Scope and Authority of International Public Sector Accounting Standards

10. The IPSASB develops IPSASs which apply to the accrual basis of accounting and IPSASs which apply to the cash basis of accounting.
11. IPSASs set out recognition, measurement, presentation and disclosure requirements dealing with transactions and events in general purpose financial statements.
12. The IPSASs are designed to apply to the general purpose financial statements of all public sector entities. Public sector entities include national governments, regional governments (for example, state, provincial, territorial), local governments (for example, city, town) and their component entities (for example, departments, agencies, boards, commissions), unless otherwise stated. The Standards do not apply to Government Business Enterprises. Government Business Enterprises apply International Financial Reporting Standards (IFRSs) which are issued by the International

Accounting Standards Board (IASB). IPSASs include a definition of Government Business Enterprises.

13. Any limitation of the applicability of specific IPSASs is made clear in those standards. IPSASs are not meant to apply to immaterial items.

General Purpose Financial Statements

14. Financial statements issued for users that are unable to demand financial information to meet their specific information needs are general purpose financial statements. Examples of such users are citizens, voters, their representatives and other members of the public. The term "financial statements" used in this Preface and in the standards covers all statements and explanatory material which are identified as being part of the general purpose financial statements.

15. When the accrual basis of accounting underlies the preparation of the financial statements, the financial statements will include the statement of financial position, the statement of financial performance, the cash flow statement and the statement of changes in net assets/equity. When the cash basis of accounting underlies the preparation of the financial statements, the primary financial statement is the statement of cash receipts and payments.

16. In addition to preparing general purpose financial statements, an entity may prepare financial statements for other parties (such as governing bodies, the legislature and other parties who perform an oversight function) who can demand financial statements tailored to meet their specific information needs. Such statements are referred to as special purpose financial statements. The IPSASB encourages the use of IPSASs in the preparation of special purpose financial statements where appropriate.

IPSASs for the Accrual and Cash Bases

17. The IPSASB develops accrual IPSASs that:

    - Are converged with International Financial Reporting Standards (IFRSs) issued by the International Accounting Standards Board (IASB) by adapting them to a public sector context when appropriate. In undertaking that process, the IPSASB attempts, wherever possible, to maintain the accounting treatment and original text of the IFRSs unless there is a significant public sector issue which warrants a departure; and

    - Deals with public sector financial reporting issues that are either not comprehensively dealt with in existing IFRSs or for which IFRSs have not been developed by the IASB.

18. As many accrual-based IPSASs are based on IFRSs, the IASB's "Framework for the Preparation and Presentation of Financial Statements" is a relevant reference for users of IPSASs

19. The IPSASB has also issued a comprehensive Cash Basis IPSAS that includes mandatory and encouraged disclosures sections.

Moving from the Cash Basis to the Accrual Basis

20. The Cash Basis IPSAS encourages an entity to voluntarily disclose accrual-based information, although its core financial statements will nonetheless be prepared under the cash basis of accounting. An entity in the process of moving from cash accounting to accrual accounting may wish to include particular accrual-based disclosures during this process. The status (for example, audited or unaudited) and location of additional information (for example, in the notes to the financial statements or in a separate supplementary section of the financial report) will depend on the characteristics of the information (for example, reliability and completeness) and any legislation or regulations governing financial reporting within a jurisdiction.

21. The IPSASB also attempts to facilitate compliance with accrual-based IPSASs through the use of transitional provisions in certain standards. Where transitional provisions exist, they may allow an entity additional time to meet the full requirements of a specific accrual-based IPSAS or provide relief from certain requirements when initially applying an IPSAS. An entity may at any time elect to adopt the accrual basis of accounting in accordance with IPSASs. At this point, the entity shall apply all the accrual-based IPSASs and could choose to apply any transitional provisions in an individual accrual-based IPSAS.

22. Having decided to adopt accrual accounting in accordance with IPSASs, the transitional provisions would govern the length of time available to make the transition. On the expiry of the transitional provisions, the entity shall report in full in accordance with all accrual-based IPSASs.

23. International Public Sector Accounting Standard (IPSAS) 1, "Presentation of Financial Statements" includes the following requirement:

    "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 Standards."

24. IPSAS 1 also requires disclosure of the extent to which the entity has applied any transitional provisions.

Authority of International Public Sector Accounting Standards

25. Within each jurisdiction, regulations may govern the issue of general purpose financial statements by public sector entities. These regulations may be in the

form of statutory reporting requirements, financial reporting directives and instructions, and/or accounting standards promulgated by governments, regulatory bodies and/or professional accounting bodies in the jurisdiction concerned.

26. The IPSASB believes that the adoption of IPSASs, together with disclosure of compliance with them will lead to a significant improvement in the quality of general purpose financial reporting by public sector entities. This, in turn, is likely to lead to better informed assessments of the resource allocation decisions made by governments, thereby increasing transparency and accountability.

27. The IPSASB acknowledges the right of governments and national standard-setters to establish accounting standards and guidelines for financial reporting in their jurisdictions. Some sovereign governments and national standard-setters have already developed accounting standards that apply to governments and public sector entities within their jurisdiction. IPSASs may assist such standard-setters in the development of new standards or in the revision of existing standards in order to contribute to greater comparability. IPSASs are likely to be of considerable use to jurisdictions that have not yet developed accounting standards for governments and public sector entities. The IPSASB strongly encourages the adoption of IPSASs and the harmonization of national requirements with IPSASs.

28. Standing alone, neither the IPSASB nor the accounting profession has the power to require compliance with IPSASs. The success of the IPSASB's efforts is dependent upon the recognition and support for its work from many different interested groups acting within the limits of their own jurisdiction.

Due Process

29. The IPSASB adopts a due process for the development of IPSASs that provides the opportunity for comment by interested parties including IFAC member bodies, auditors, preparers (including finance ministries), standard-setters, and individuals. The IPSASB also consults with its Consultative Group on major projects, technical issues, and work program priorities.

30. The IPSASB's due process for projects normally, but not necessarily, includes the following steps:

    - Study of national accounting requirements and practice and an exchange of views about the issues with national standard-setters;
    - Consideration of pronouncements issued by:
        - the International Accounting Standards Board (IASB);
        - National standard-setters, regulatory authorities and other authoritative bodies;

  - Professional accounting bodies; and
  - Other organizations interested in financial reporting in the public sector;

- Formation of steering committees (SCs), project advisory panels (PAPs) or subcommittees to provide input to the IPSASB on a project;
- Publication of an exposure draft for public comment usually for at least 4 months. This provides an opportunity for those affected by the IPSASB's pronouncements to present their views before the pronouncements are finalized and approved by the IPSASB. The exposure draft will include a basis for conclusion;
- Consideration of all comments received within the comment period on discussion documents and exposure drafts, and to make modifications to proposed standards as considered appropriate in the light of IPSASB's objectives; and
- Publication of an IPSAS which includes a basis for conclusions that explains the steps in the IPSASB's due process and how the IPSASB reached its conclusions.

Steering Committees, Project Advisory Panels and Subcommittees

31. The IPSASB may delegate the responsibility for carrying out the necessary research and for preparing exposure drafts of proposed Standards and guidelines or drafts of studies to steering committees, subcommittees or individuals.

32. Steering Committees, Project Advisory Panels and subcommittees are chaired by a member of the IPSASB, but can include persons who are not members of the IPSASB or of a member body of IFAC.

Approval arrangements

33. The draft of a standard, duly revised after the exposure period, is submitted to the IPSASB for approval. If approved by the IPSASB, it is issued as an IPSAS and becomes effective from the date specified in the standard. On occasion, where there are significant unresolved issues associated with an exposure draft, the IPSASB may decide to re-expose a proposed standard.

34. For the purposes of approving an invitation to comment, exposure draft or a standard, an affirmative vote of at least two-thirds of the voting rights of the IPSASB is required. Each IPSASB member represented on the IPSASB has one vote.

Language

35. The approved text of a pronouncement is that published by IPSASB in the English language. Member bodies of IFAC are authorized to prepare, after obtaining IFAC approval, translations of such pronouncements at their own cost, to be issued in the language of their own countries as appropriate.

Introduction to the International Public Sector Accounting Standards

The International Federation of Accountants' International Public Sector Accounting Standards Board (IPSASB) develops accounting standards for public sector entities referred to as International Public Sector Accounting Standards (IPSASs). The IPSASB recognizes the significant benefits of achieving consistent and comparable financial information across jurisdictions and it believes that the IPSASs will play a key role in enabling these benefits to be realized. The IPSASB strongly encourages governments and national standard-setters to engage in the development of its Standards by commenting on the proposals set out in these Exposure Drafts.

The IPSASB issues IPSASs dealing with financial reporting under the cash basis of accounting and the accrual basis of accounting. The accrual basis IPSASs are based on the International Financial Reporting Standards (IFRSs), issued by the International Accounting Standards Board (IASB) where the requirements of those Standards are applicable to the public. They also deal with public sector specific financial reporting issues that are not dealt with in IFRSs.

The adoption of IPSASs by governments will improve both the quality and comparability of financial information reported by public sector entities around the world. The IPSASB recognizes the right of governments and national standard-setters to establish accounting standards and guidelines for financial reporting in their jurisdictions. The IPSASB encourages the adoption of IPSASs and the harmonization of national requirements with IPSASs. Financial statements should be described as complying with IPSASs only if they comply with all the requirements of each applicable IPSAS.

IPSAS 1—PRESENTATION OF FINANCIAL STATEMENTS

Acknowledgment

This International Public Sector Accounting Standard is drawn primarily from International Accounting Standard (IAS) 1, "Presentation of Financial Statements" 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 International Accounting Standards (IASs) issued by the IASC remain in force until they are amended or withdrawn by the IASB. Extracts from IAS 1 are reproduced in this publication of the Public Sector Committee of the International Federation of Accountants with the permission of IASB.

The approved text of the IASs is that published by IASB in the English language, and copies may be obtained directly from IASB Publications Department, 7th floor, 166 Fleet Street, London EC4A 2DY, United Kingdom.

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May 2000

IPSAS 1—PRESENTATION OF FINANCIAL STATEMENTS

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Comparison with IAS 1

The standards, which have been set in bold type, should be read in the context of the commentary paragraphs in this Standard, which are in plain type, and in the context of the "Preface to International Public Sector Accounting Standards." International Public Sector Accounting Standards are not intended to apply to immaterial items.

Objective

The objective of this Standard is to prescribe the manner in which general purpose financial statements should be presented in order to ensure comparability both with the entity's own financial statements of previous periods and with the financial statements of other entities. To achieve this objective, this Standard sets out overall considerations for the presentation of financial statements, guidance for their structure, and minimum requirements for the content of financial statements prepared under the accrual basis of accounting. The recognition, measurement and disclosure of specific transactions and other events are dealt with in other International Public Sector Accounting Standards.

Scope

1. **This Standard should be applied in the presentation of all general purpose financial statements prepared and presented under the accrual basis of accounting in accordance with International Public Sector Accounting Standards.**

2. General purpose financial statements are those intended to meet the needs of users who are not in a position to demand reports tailored to meet their specific information needs. Users of general purpose financial statements include taxpayers and ratepayers, members of the legislature, creditors, suppliers, the media, and employees. General purpose financial statements include those that are presented separately or within another public document such as an annual report. This Standard does not apply to condensed interim financial information.

3. This Standard applies 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.

4. **This Standard applies to all public sector entities other than Government Business Enterprises.**

5. Government Business Enterprises (GBEs) are required to comply with International Accounting Standards (IASs) issued by the International Accounting Standards Committee. The Public Sector Committee's Guideline No. 1, "Financial Reporting by Government Business Enterprises" notes that IASs are relevant to all business enterprises, regardless of whether they are in the private or public sector. Accordingly,

Guideline No. 1 recommends that GBEs should present financial statements that conform, in all material respects, to IASs.

Definitions

6. **The following terms are used in this Standard with the meanings specified:**

<u>Accounting policies</u> are the specific principles, bases, conventions, rules and practices adopted by an entity in preparing and presenting financial statements.

<u>Accrual basis</u> means 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.

<u>Assets</u> are resources controlled by an entity as a result of past events and from which future economic benefits or service potential are expected to flow to the entity.

<u>Associate</u> is an entity in which the investor has significant influence and which is neither a controlled entity nor a joint venture of the investor.

<u>Borrowing costs</u> are interest and other expenses incurred by an entity in connection with the borrowing of funds.

<u>Cash</u> comprises cash on hand and demand deposits.

<u>Cash equivalents</u> 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.

<u>Cash flows</u> are inflows and outflows of cash and cash equivalents.

<u>Consolidated financial statements</u> are the financial statements of an economic entity presented as those of a single entity.

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

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

(b) **Can be sold, exchanged, transferred or redeemed.**

Control is the power to govern the financial and operating policies of another entity so as to benefit from its activities.

Controlled entity is an entity that is under the control of another entity (known as the controlling entity).

Controlling entity is an entity that has one or more controlled entities.

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

Economic entity means a group of entities comprising a controlling entity and one or more controlled entities.

Equity method is 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.

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

Exchange difference is the difference resulting from reporting the same number of units of a foreign currency in the reporting currency at different exchange rates.

Extraordinary items are 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.

Fair value is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.

A financial asset is 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.**

Foreign currency is a currency other than the reporting currency of an entity.

Foreign operation is 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.

Fundamental errors are 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.

Government Business Enterprise means an entity that has all the following characteristics:

(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.**

Joint venture is a binding arrangement whereby two or more parties are committed to undertake an activity which is subject to joint control.

Liabilities are present obligations of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits or service potential.

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.

Minority interest is 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.

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

Net surplus/deficit comprises the following components:

(a) **Surplus or deficit from ordinary activities; and**

(b) **Extraordinary items.**

Ordinary activities are 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.

Qualifying asset is an asset that necessarily takes a substantial period of time to get ready for its intended use or sale.

Reporting currency is the currency used in presenting the financial statements.

Reporting date means the date of the last day of the reporting period to which the financial statements relate.

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

Surplus/deficit from ordinary activities is the residual amount that remains after expenses arising from ordinary activities have been deducted from revenue arising from ordinary activities.

Economic Entity

7. The term "economic entity" is used in this Standard to define, for financial reporting purposes, a group of entities comprising the controlling entity and any controlled entities.

8. Other terms sometimes used to refer to an economic entity include "administrative entity," "financial entity," "consolidated entity" and "group."

9. 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.

Future Economic Benefits or Service Potential

10. 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 Standard uses the term "future economic benefits or service potential" to describe the essential characteristic of assets.

Government Business Enterprises

11. 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.

Net Assets/Equity

12. "Net assets/equity" is the term used in this Standard 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.

Purpose of Financial Statements

13. Financial statements are a structured representation of the financial position of and the transactions undertaken by an entity. The objectives of general purpose financial statements are to provide information about the financial position, performance and cash flows of an entity that is useful to a wide range of users in making and evaluating decisions about the allocation of resources. Specifically, the objectives of general purpose financial reporting in the public sector should be to provide information useful for decision-making, and to demonstrate the accountability of the entity for the resources entrusted to it by:

    (a) Providing information about the sources, allocation and uses of financial resources;

    (b) Providing information about how the entity financed its activities and met its cash requirements;

    (c) Providing information that is useful in evaluating the entity's ability to finance its activities and to meet its liabilities and commitments;

    (d) Providing information about the financial condition of the entity and changes in it; and

    (e) Providing aggregate information useful in evaluating the entity's performance in terms of service costs, efficiency and accomplishments.

14. General purpose financial statements can also have a predictive or prospective role, providing information useful in predicting the level of resources required for continued operations, the resources that may be generated by continued operations, and the associated risks and uncertainties. Financial reporting may also provide users with information:

    (a) Indicating whether resources were obtained and used in accordance with the legally adopted budget; and

    (b) Indicating whether resources were obtained and used in accordance with legal and contractual requirements, including financial limits established by appropriate legislative authorities.

15. To meet these objectives, the financial statements provide information about an entity's:

    (a) Assets;

    (b) Liabilities;

    (c) Net assets/equity;

    (d) Revenue;

(e) Expenses; and

(f) Cash flows.

16. Whilst the information contained in financial statements can be relevant for the purpose of meeting the objectives in paragraph 13, it is unlikely to enable all these objectives to be met. This is likely to be particularly so in respect of entities whose primary objective may not be to make a profit, as managers are likely to be accountable for the achievement of service delivery as well as financial objectives. Supplementary information, including non-financial statements, may be reported alongside the financial statements in order to provide a more comprehensive picture of the entity's activities during the period.

Responsibility for Financial Statements

17. The responsibility for the preparation and presentation of financial statements varies within and across jurisdictions. In addition, a jurisdiction may draw a distinction between who is responsible for preparing the financial statements and who is responsible for approving or presenting the financial statements. Examples of people or positions who may be responsible for the preparation of the financial statements of individual entities (such as government departments or their equivalent) include the individual who heads the entity (the permanent head or chief executive) and the head of the central finance agency (or the senior finance official, such as the controller or accountant-general).

18. The responsibility for the preparation of the consolidated financial statements of the government as a whole usually rests jointly with the head of the central finance agency (or the senior finance official, such as the controller or accountant-general) and the finance minister (or equivalent).

Components of Financial Statements

19. **A complete set of financial statements includes the following components:**

(a) **Statement of financial position;**

(b) **Statement of financial performance;**

(c) **Statement of changes in net assets/equity;**

(d) **Cash flow statement; and**

(e) **Accounting policies and notes to the financial statements.**

20. The components listed in paragraph 19 are referred to by a variety of names both within and across jurisdictions. The statement of financial position may also be referred to as a balance sheet or statement of assets and

liabilities. The statement of financial performance may also be referred to as a statement of revenues and expenses, an income statement, an operating statement, or a profit and loss statement. The notes to the financial statements may include items referred to as "schedules" in some jurisdictions.

21. The financial statements provide users with information about an entity's resources and obligations at the reporting date and the flow of resources between reporting dates. This information is useful for users making assessments of an entity's ability to continue to provide goods and services at a given level, and the level of resources that may need to be provided to the entity in the future so that it can continue to meet its service delivery obligations.

22. Public sector entities are typically subject to budgetary limits in the form of appropriations or budget authorizations (or equivalent), which may be given effect through authorizing legislation. General purpose financial reporting by public sector entities may provide information on whether resources were obtained and used in accordance with the legally adopted budget. Where the financial statements and the budget are on the same basis of accounting, this Standard encourages the inclusion in the financial statements of a comparison with the budgeted amounts for the reporting period. Reporting against budgets may be presented in various different ways, including:

    (a) The use of a columnar format for the financial statements, with separate columns for budgeted amounts and actual amounts. A column showing any variances from the budget or appropriation may also be presented, for completeness; and

    (b) A statement by the individual(s) responsible for the preparation of the financial statements that the budgeted amounts have not been exceeded. If any budgeted amounts or appropriations have been exceeded, or expenses incurred without appropriation or other form of authority, then details may be disclosed by way of footnote to the relevant item in the financial statements.

23. Entities are encouraged to present additional information to assist users in assessing the performance of the entity, and its stewardship of assets, as well as making and evaluating decisions about the allocation of resources. This additional information may include details about the entity's outputs and outcomes in the form of performance indicators, statements of service performance, program reviews and other reports by management about the entity's achievements over the reporting period.

24. Entities are also encouraged to disclose information about compliance with legislative, regulatory or other externally-imposed regulations. When information about compliance is not included in the financial statements, it may be useful for a note to refer to any documents that include that information. Knowledge of non-compliance is likely to be relevant for accountability purposes and may affect a user's assessment of the entity's performance and direction of future operations. It may also influence decisions about resources to be allocated to the entity in the future.

Overall Considerations

Fair Presentation and Compliance with International Public Sector Accounting Standards

25. **Financial statements should present fairly the financial position, financial performance and cash flows of an entity. The appropriate application of International Public Sector Accounting Standards, with additional disclosures when necessary, results, in virtually all circumstances, in financial statements that achieve a fair presentation.**

26. **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.**

27. **Inappropriate accounting treatments are not rectified either by disclosure of the accounting policies used, or by notes or explanatory material.**

28. **In the extremely rare circumstances when management concludes that compliance with a requirement in a Standard would be misleading, and therefore that departure from a requirement is necessary to achieve a fair presentation, an entity should disclose:**

    (a) **That management has concluded that the financial statements fairly present the entity's financial position, financial performance and cash flows;**

    (b) **That it has complied in all material respects with applicable International Public Sector Accounting Standards except that it has departed from a Standard in order to achieve a fair presentation;**

    (c) **The Standard from which the entity has departed, the nature of the departure, including the treatment that the Standard would**

require, the reason why that treatment would be misleading in the circumstances, and the treatment adopted; and

(d) **The financial impact of the departure on the entity's net surplus or deficit, assets, liabilities, net assets/equity, and cash flows for each period presented.**

29. Financial statements may be described as being "based on" or "complying with the significant requirements of," or "in compliance with the accounting requirements of" International Public Sector Accounting Standards. There may be no further information, although it is clear that significant disclosure requirements, if not accounting requirements, are not met. Such statements are misleading because they detract from the reliability and understandability of the financial statements.

30. In order to ensure that financial statements that claim compliance with International Public Sector Accounting Standards will meet the standards required by users internationally, this Standard includes an overall requirement that financial statements should give a fair presentation, guidance on how the fair presentation requirement is met, and further guidance for determining the extremely rare circumstances when a departure is necessary. It also requires prominent disclosure of the circumstances surrounding a departure. However, where an entity adopts International Public Sector Accounting Standards, the existence of conflicting national requirements (for example, where financial reporting requirements set by the government conflict with these Standards) is not, in itself, sufficient to justify a departure in financial statements that claim compliance with International Public Sector Accounting Standards.

31. Departures from the requirements of an International Public Sector Accounting Standard in order to comply with statutory/legislative financial reporting requirements in a particular jurisdiction do not constitute departures necessary to achieve fair presentation as outlined in paragraph 28. If such departures are material an entity cannot claim to be complying with International Public Sector Accounting Standards.

32. In virtually all circumstances, a fair presentation is achieved by compliance in all material respects with applicable International Public Sector Accounting Standards. A fair presentation requires:

(a) Selecting and applying accounting policies in accordance with paragraph 37;

(b) Presenting information, including accounting policies, in a manner which provides relevant, reliable, comparable and understandable information; and

(c) Providing additional disclosures when the requirements in International Public Sector Accounting Standards are insufficient to enable users to understand the impact of particular transactions or events on the entity's financial position and financial performance.

33. In extremely rare circumstances, application of a specific requirement in an International Public Sector Accounting Standard might result in misleading financial statements. This will be the case only when the treatment required by the Standard is clearly inappropriate and thus a fair presentation cannot be achieved either by applying the Standard or through additional disclosure alone. Departure is not appropriate simply because another treatment would also give a fair presentation.

34. When assessing whether a departure from a specific requirement in International Public Sector Accounting Standards is necessary, consideration is given to:

(a) The objective of the requirement and why that objective is not achieved or is not relevant in the particular circumstances; and

(b) The way in which the entity's circumstances differ from those of other entities which follow the requirement.

35. Because the circumstances requiring a departure are expected to be extremely rare and the need for a departure will be a matter for considerable debate and subjective judgment, it is important that users are aware that the entity has not complied in all material respects with International Public Sector Accounting Standards. It is also important that they are given sufficient information to enable them to make an informed judgment on whether the departure is necessary and to calculate the adjustments that would be required to comply with the Standard.

36. **When, in accordance with specific provisions in that Standard, an International Public Sector Accounting Standard is applied before its effective date, that fact should be disclosed.**

Accounting Policies

37. **Management should select and apply an entity's accounting policies so that the financial statements comply with all the requirements of each applicable International Public Sector Accounting Standard. Where there is no specific requirement, management should develop policies to ensure that the financial statements provide information that is:**

(a) **Relevant to the decision-making needs of users; and**

(b) **Reliable in that they:**

(i) **Represent faithfully the financial performance and financial position of the entity;**

(ii) **Reflect the economic substance of events and transactions and not merely the legal form;**

(iii) **Are neutral, that is, free from bias;**

(iv) **Are prudent; and**

(v) **Are complete in all material respects.**

38. **If one or more alternative accounting policies (benchmark or allowed alternative) are available under an International Public Sector Accounting Standard, an entity should choose and apply consistently one of those policies unless the Standard specifically requires or permits categorization of items (transactions, events, balances, amounts, etc.) for which policies are to be chosen. If a Standard requires or permits separate categorization of items, a single accounting policy should be selected and applied consistently to each category.**

39. **Once an initial policy has been selected, a change in accounting policy should only be made in accordance with International Public Sector Accounting Standard (IPSAS) 3, "Net Surplus or Deficit for the Period, Fundamental Errors and Changes in Accounting Policies" and applied to all items or categories of items in the manner specified in paragraph 38.**

40. Accounting policies are the specific principles, bases, conventions, rules and practices adopted by an entity in preparing and presenting financial statements.

41. The quality of information provided in financial statements determines the usefulness of the financial statements to users. Paragraph 37 requires the development of accounting policies to ensure that the financial statements provide information that meets a number of qualitative characteristics. Appendix 2 to this Standard summarizes the qualitative characteristics of financial reporting.

42. In the absence of a specific International Public Sector Accounting Standard, management uses its judgment in developing an accounting policy that provides the most useful information to users of the entity's financial statements. In making this judgment, management considers:

(a) The requirements and guidance in International Public Sector Accounting Standards dealing with similar and related issues;

(b) The definitions, recognition and measurement criteria for assets, liabilities, revenue and expenses described in other publications of the International Federation of Accountants—Public Sector Committee; and

(c) Pronouncements of other standard setting bodies and accepted public or private sector practices to the extent, but only to the extent, that these are consistent with (a) of this paragraph. For example, pronouncements of the International Accounting Standards Committee (IASC), including the "Framework for the Preparation and Presentation of Financial Statements," International Accounting Standards and interpretations issued by the IASC's Standing Interpretations Committee.

Going Concern

43. **When preparing financial statements an assessment of an entity's ability to continue as a going concern should be made. This assessment should be made by those responsible for the preparation of the financial statements. Financial statements should be prepared on a going concern basis unless there is an intention to liquidate the entity or to cease operating, or if there is no realistic alternative but to do so. When those responsible for the preparation of the financial statements are aware, in making their assessment, of material uncertainties related to events or conditions which may cast significant doubt upon the entity's ability to continue as a going concern, those uncertainties should be disclosed. When the financial statements are not prepared on a going concern basis, that fact should be disclosed, together with the basis on which the financial statements are prepared and the reason why the entity is not considered to be a going concern.**

44. Financial statements are normally prepared on the assumption that the entity is a going concern and will continue in operation and meet its statutory obligations for the foreseeable future. In assessing whether the going concern assumption is appropriate, those responsible for the preparation of the financial statements take into account all available information for the foreseeable future, which should be at least, but is not limited to, twelve months from the approval of the financial statements.

45. The degree of consideration depends on the facts in each case, and assessments of the going concern assumption are not predicated on the solvency test usually applied to business enterprises. There may be circumstances where the usual going concern tests of liquidity and solvency appear unfavorable, but other factors suggest that the entity is nonetheless a going concern. For example:

(a) In assessing whether a government is a going concern, the power to levy rates or taxes may enable some entities to be considered as a going concern even though they may operate for extended periods with negative net assets/equity; and

(b) For an individual entity, an assessment of its statement of financial position at the reporting date may suggest that the going concern assumption is not appropriate. However, there may be multi-year funding agreements, or other arrangements, in place that will ensure the continued operation of the entity.

46. The determination of whether the going concern assumption is appropriate is primarily relevant for individual entities rather than for a government as a whole. For individual entities, in assessing whether the going concern basis is appropriate, those responsible for the preparation of the financial statements may need to consider a wide range of factors surrounding current and expected performance, potential and announced restructurings of organizational units, estimates of revenue or the likelihood of continued government funding, and potential sources of replacement financing before it is appropriate to conclude that the going concern assumption is appropriate.

Consistency of Presentation

47. **The presentation and classification of items in the financial statements should be retained from one period to the next unless:**

(a) **A significant change in the nature of the operations of the entity or a review of its financial statement presentation demonstrates that the change will result in a more appropriate presentation of events or transactions; or**

(b) **A change in presentation is required by an International Public Sector Accounting Standard.**

48. A significant acquisition or disposal, or a review of the financial statement presentation, might suggest that the financial statements should be presented differently. For example, an entity may dispose of a savings bank that represents one of its most significant controlled entities and the remaining economic entity conducts mainly administrative and policy advice services. In this case, the presentation of the financial statements based on the principal activities of the economic entity as a financial institution is unlikely to be relevant for the new economic entity.

49. Only if the revised structure is likely to continue, or if the benefit of an alternative presentation is clear, should an entity change the presentation of its financial statements. When such changes in presentation are made, an

entity reclassifies its comparative information in accordance with paragraph 62. Where an entity has adopted International Public Sector Accounting Standards, a change in presentation to comply with national requirements is permitted as long as the revised presentation is consistent with the requirements of this Standard.

Materiality and Aggregation

50. **Items that are material by virtue of their nature should be presented separately in the financial statements. Items that are material by virtue of their size but which have the same nature may be aggregated. Immaterial amounts should be aggregated with amounts of a similar nature or function and need not be presented separately.**

51. Financial statements result from processing large quantities of transactions that are structured by being aggregated into groups according to their nature or function. The final stage in the process of aggregation and classification is the presentation of condensed and classified data that form line items either on the face of the financial statements or in the notes. If a line item is not individually material, it is aggregated with other items either on the face of the financial statements or in the notes. An item that is not sufficiently material to warrant separate presentation on the face of the financial statements may nevertheless be sufficiently material that it should be presented separately in the notes.

52. In this context, information is material if its non-disclosure could influence the decision-making and evaluations of users about the allocation and stewardship of resources, and the performance of the entity, made on the basis of the financial statements. Materiality depends on the size and nature of the item judged in the particular circumstances of its omission. In deciding whether an item or an aggregate of items is material, the size and nature of the item are evaluated together. Depending on the circumstances, either the size or the nature of the item could be the determining factor. For example, individual revenues or receipts with the same nature and function are aggregated even if the individual amounts are large. However, large items which differ in nature or function are presented separately.

53. The principle of materiality provides that the specific disclosure requirements of International Public Sector Accounting Standards need not be met if the resulting information is not material.

Offsetting

54. **Assets and liabilities should not be offset except when offsetting is required or permitted by another International Public Sector Accounting Standard.**

55. **Items of revenue and expense should not be offset except when, and only when:**

    (a) **An International Public Sector Accounting Standard requires or permits it; or**

    (b) **Gains, losses and related expenses arising from the same or similar transactions and other events are not material. Such amounts should be aggregated in accordance with paragraph 50.**

56. It is important that both assets and liabilities, and revenue and expenses, when material, are reported separately. Offsetting in either the statement of financial performance or the statement of financial position, except when offsetting reflects the substance of the transaction or event, detracts from the ability of users to understand the transactions undertaken and to assess the future cash flows of the entity. The reporting of assets net of valuation allowances, for example obsolescence allowances on inventories and doubtful debts allowances on receivables, is not offsetting.

57. Revenue relating to exchange transactions is measured at the fair value of consideration received or receivable, taking into account the amount of any trade discounts and volume rebates allowed by the entity. An entity undertakes, in the course of its ordinary activities, other transactions which do not generate revenue but which are incidental to the main revenue generating activities. The results of such transactions are presented, when this presentation reflects the substance of the transaction or event, by netting any revenue with related expenses arising on the same transaction. For example:

    (a) Gains and losses on the disposal of non-current assets, including investments and operating assets, are reported by deducting from the proceeds on disposal the carrying amount of the asset and related selling expenses;

    (b) Expenses that are reimbursed under a contractual arrangement with a third party (for example, a sub-letting agreement) are netted against the related reimbursement; and

    (c) Extraordinary items may be presented net of related taxation and minority interest, where appropriate, with the gross amounts shown in the notes.

58. In addition, gains and losses arising from a group of similar transactions are reported on a net basis, for example foreign exchange gains and losses and gains and losses arising on financial instruments held for trading purposes.

Such gains and losses are, however, reported separately if their size, nature or incidence is such that separate disclosure is required by IPSAS 3.

59. The offsetting of cash flows is dealt with in IPSAS 2, "Cash Flow Statements."

Comparative Information

60. **Unless an International Public Sector Accounting Standard permits or requires otherwise, comparative information should be disclosed in respect of the previous period for all numerical information in the financial statements, except in respect of the financial statements for the reporting period to which this Standard is first applied. Comparative information should be included in narrative and descriptive information when it is relevant to an understanding of the current period's financial statements.**

61. In some cases narrative information provided in the financial statements for the previous period(s) continues to be relevant in the current period. For example, details of a legal dispute, the outcome of which was uncertain at the last reporting date and is yet to be resolved, are disclosed in the current period. Users benefit from knowing that the uncertainty existed at the last reporting date, and the steps that have been taken during the period to resolve the uncertainty.

62. **When the presentation or classification of items in the financial statements is amended, comparative amounts should be reclassified, unless it is impracticable to do so, to ensure comparability with the current period, and the nature, amount of, and reason for any reclassification should be disclosed. When it is impracticable to reclassify comparative amounts, an entity should disclose the reason for not reclassifying and the nature of the changes that would have been made if amounts were reclassified.**

63. Circumstances may exist when it is impracticable to reclassify comparative information to achieve comparability with the current period. For example, data may not have been collected in the previous period(s) in a way which allows reclassification, and it may not be practicable to recreate the information. In such circumstances, the nature of the adjustments to comparative amounts that would have been made are disclosed. IPSAS 3 contains guidance on the adjustments required to comparative information following a change in accounting policy that is applied retrospectively.

Structure and Content

Introduction

64. This Standard requires certain disclosures on the face of the financial statements, requires other line items to be disclosed either on the face of the financial statements or in the notes, and sets out recommended formats as an appendix to the Standard which an entity may follow as appropriate in its own circumstances.

65. This Standard uses the term disclosure in a broad sense, encompassing items presented on the face of each financial statement as well as in the notes to the financial statements. Disclosures required by other International Public Sector Accounting Standards are made in accordance with the requirements of those Standards. Unless this or another Standard specifies to the contrary, such disclosures are made either on the face of the relevant financial statement or in the notes.

Identification of Financial Statements

66. **Financial statements should be clearly identified and distinguished from other information in the same published document.**

67. International Public Sector Accounting Standards apply only to the financial statements, and not to other information presented in an annual report or other document. Therefore, it is important that users are able to distinguish information that is prepared using International Public Sector Accounting Standards from other information which may be useful to users but is not the subject of Standards.

68. **Each component of the financial statements should be clearly identified. In addition, the following information should be prominently displayed, and repeated when it is necessary for a proper understanding of the information presented:**

    (a) **The name of the reporting entity or other means of identification;**

    (b) **Whether the financial statements cover the individual entity or the economic entity;**

    (c) **The reporting date or the period covered by the financial statements, whichever is appropriate to the related component of the financial statements;**

    (d) **The reporting currency; and**

    (e) **The level of precision used in the presentation of figures in the financial statements.**

69. The requirements in paragraph 68 are normally met by presenting page headings and abbreviated column headings on each page of the financial statements. Judgment is required in determining the best way of presenting such information. For example, when the financial statements are read electronically, separate pages may not be used; the above items are then presented frequently enough to ensure a proper understanding of the information given.

70. Financial statements are often made more understandable by presenting information in thousands or millions of units of the reporting currency. This is acceptable as long as the level of precision in presentation is disclosed and relevant information is not lost.

Reporting Period

71. **Financial statements should be presented at least annually. When, in exceptional circumstances, an entity's reporting date changes and annual financial statements are presented for a period longer or shorter than one year, an entity should disclose, in addition to the period covered by the financial statements:**

    (a) **The reason for a period other than one year being used; and**

    (b) **The fact that comparative amounts for certain statements such as the statement of financial performance, changes in net assets/equity, cash flows and related notes are not comparable.**

72. In exceptional circumstances an entity may be required to, or decide to, change its reporting date, for example in order to align the reporting cycle more closely with the budgeting cycle. When this is the case, it is important that users are aware that the amounts shown for the current period and comparative amounts are not comparable and that the reason for the change in reporting date is disclosed. A further example is where, in making the transition from cash to accrual accounting, an entity changes the reporting date for entities within the economic entity to enable the preparation of consolidated financial statements.

73. Normally, financial statements are consistently prepared covering a one year period. However, some entities prefer to report, for example, for a 52 week period for practical reasons. This Standard does not preclude this practice, as the resulting financial statements are unlikely to be materially different to those that would be presented for one year.

Timeliness

74. The usefulness of financial statements is impaired if they are not made available to users within a reasonable period after the reporting date. An entity should be in a position to issue its financial statements within six

months of the reporting date. Ongoing factors such as the complexity of an entity's operations are not sufficient reason for failing to report on a timely basis. More specific deadlines are dealt with by legislation and regulations in many jurisdictions.

Statement of Financial Position

The Current/Non-current Distinction

75. **Each entity should determine, based on the nature of its operations, whether or not to present current and non-current assets and current and non-current liabilities as separate classifications on the face of the statement of financial position. Paragraphs 79 to 88 of this Standard apply when this distinction is made. When an entity chooses not to make this classification, assets and liabilities should be presented broadly in order of their liquidity.**

76. **Whichever method of presentation is adopted, an entity should disclose for each asset and liability item that combines amounts expected to be recovered or settled both before and after twelve months from the reporting date, the amount expected to be recovered or settled after more than twelve months.**

77. When an entity supplies goods or services within a clearly identifiable operating cycle, separate classification of current and non-current assets and liabilities on the face of the statement of financial position provides useful information by distinguishing the net assets that are continuously circulating as working capital from those used in the entity's long-term operations. It also highlights assets that are expected to be realized within the current operating cycle, and liabilities that are due for settlement within the same period.

78. Information about the maturity dates of assets and liabilities is useful in assessing the liquidity and solvency of an entity. Guidance on the disclosure of the maturity dates of financial assets and financial liabilities can be found in International Accounting Standard (IAS) 32, "Financial Instruments: Disclosure and Presentation." Financial assets include trade and other receivables and financial liabilities include trade and other payables. Information on the expected date of recovery and settlement of non-monetary assets and liabilities such as inventories and provisions is also useful whether or not assets and liabilities are classified between current and non-current.

Current Assets

79. **An asset should be classified as a current asset when it:**

    (a) **Is expected to be realized in, or is held for sale or consumption in, the normal course of the entity's operating cycle; or**

    (b) **Is held primarily for trading purposes or for the short-term and expected to be realized within twelve months of the reporting date; or**

    (c) **Is cash or a cash equivalent asset.**

    All other assets should be classified as non-current assets.

80. This Standard uses the term "non-current assets" to include intangible, operating and financial assets of a long-term nature. It does not prohibit the use of alternative descriptions as long as their meaning is clear.

81. The operating cycle of an entity is the time taken to convert inputs or resources into outputs. For instance, governments transfer resources to public sector entities so that they can convert those resources into goods and services, or outputs, to meet the government's desired social, political and economic outcomes.

82. Current assets include taxes receivable, user charges receivable, fines and regulatory fees receivable, inventories and accrued investment revenue that are either realized, consumed or sold, as part of the normal operating cycle even when they are not expected to be realized within twelve months of the reporting date. Marketable securities are classified as current assets if they are expected to be realized within twelve months of the reporting date; otherwise they are classified as non-current assets.

Current Liabilities

83. **A liability should be classified as a current liability when it:**

    (a) **Is expected to be settled in the normal course of the entity's operating cycle; or**

    (b) **Is due to be settled within twelve months of the reporting date.**

    All other liabilities should be classified as non-current liabilities.

84. Current liabilities can be categorized in a similar way to current assets. Some current liabilities, such as government transfers payable and accruals for employee and other operating costs, form part of the working capital used in the normal operating cycle of the entity. Such operating items are classified as current liabilities even if they are due to be settled after more than twelve months from the reporting date.

85. Other current liabilities are not settled as part of the current operating cycle, but are due for settlement within twelve months of the reporting date. Examples are the current portion of interest-bearing liabilities, bank overdrafts, dividends payable, income taxes and other non-trade payables. Interest-bearing liabilities that provide the financing for working capital on a long-term basis, and are not due for settlement within twelve months, are non-current liabilities.

86. **An entity should continue to classify its long-term interest-bearing liabilities as non-current, even when they are due to be settled within twelve months of the reporting date if:**

    (a) **The original term was for a period of more than twelve months;**

    (b) **The entity intends to refinance the obligation on a long-term basis; and**

    (c) **That intention is supported by an agreement to refinance, or to reschedule payments, which is completed before the financial statements are approved.**

    The amount of any liability that has been excluded from current liabilities in accordance with this paragraph, together with information in support of this presentation, should be disclosed in the notes to the statement of financial position.

87. Some obligations that are due to be repaid within the next operating cycle may be expected to be refinanced or "rolled-over" at the discretion of the entity and, therefore, are not expected to use current working capital of the entity. Such obligations are considered to form part of the entity's long-term financing and should be classified as non-current. However, in situations in which refinancing is not at the discretion of the entity (as would be the case if there were no agreement to refinance), the refinancing cannot be considered automatic and the obligation is classified as current unless the completion of a refinancing agreement before approval of the financial statements provides evidence that the substance of the liability at the reporting date was long term.

88. Some borrowing agreements incorporate undertakings (covenants) by the borrower which have the effect that the liability becomes payable on demand if certain conditions related to the borrower's financial position are breached. In these circumstances, if the conditions have been breached, the liability is classified as non-current only when:

    (a) The lender has agreed, prior to the approval of the financial statements, not to demand payment as a consequence of the breach; and

(b) It is not probable that further breaches will occur within twelve months of the reporting date.

Information to be Presented on the Face of the Statement of Financial Position

89. **As a minimum, the face of the statement of financial position should include line items which present the following amounts:**

(a) **Property, plant and equipment;**

(b) **Intangible assets;**

(c) **Financial assets [excluding amounts shown under (d), (f) and (h)];**

(d) **Investments accounted for using the equity method;**

(e) **Inventories;**

(f) **Recoverables from non-exchange transactions, including taxes and transfers;**

(g) **Receivables from exchange transactions;**

(h) **Cash and cash equivalents;**

(i) **Taxes and transfers payable;**

(j) **Payables under exchange transactions;**

(k) **Provisions;**

(l) **Non-current liabilities;**

(m) **Minority interest; and**

(n) **Net assets/equity.**

90. **Additional line items, headings and sub-totals should be presented on the face of the statement of financial position when an International Public Sector Accounting Standard requires it, or when such presentation is necessary to present fairly the entity's financial position.**

91. This Standard does not prescribe the order or format in which items are to be presented. Paragraph 89 simply provides a list of items that are so different in nature or function that they deserve separate presentation on the face of the statement of financial position. Illustrative formats are set out in Appendix 1 to this Standard. Adjustments to the line items above include the following:

(a) Line items are added when another International Public Sector Accounting Standard requires separate presentation on the face of

the statement of financial position, or when the size, nature or function of an item is such that separate presentation would assist in presenting fairly the entity's financial position; and

(b) The descriptions used and the ordering of items may be amended according to the nature of the entity and its transactions, to provide information that is necessary for an overall understanding of the entity's financial position.

92. The line items listed in paragraph 89 are broad in nature and need not be limited to items falling within the scope of other Standards. For example, the line item intangible assets includes goodwill and assets arising from development costs.

93. The judgment on whether additional items are separately presented is based on an assessment of:

(a) The nature and liquidity of assets and their materiality, leading, in most cases, to the separate presentation of goodwill and assets arising from development costs, monetary and non-monetary assets and current and non-current assets;

(b) Their function within the entity, leading, for example, to the separate presentation of operating and financial assets, inventories, receivables and cash and cash equivalent assets; and

(c) The amounts, nature and timing of liabilities, leading, for example, to the separate presentation of interest-bearing and non-interest-bearing liabilities and provisions, classified as current or non-current as appropriate.

94. Assets and liabilities that differ in nature or function are sometimes subject to different measurement bases. For example certain classes of property, plant and equipment may be carried at cost, or at revalued amounts. The use of different measurement bases for different classes of assets suggests that their nature or function differs and therefore that they should be presented as separate line items.

Information to be Presented either on the Face of the Statement of Financial Position or in the Notes

95. **An entity should disclose, either on the face of the statement of financial position or in the notes to the statement of financial position, further sub-classifications of the line items presented, classified in a manner appropriate to the entity's operations. Each item should be sub-classified, when appropriate, by its nature, and amounts payable to and receivable from the controlling entity, fellow controlled entities and associates and other related parties should be disclosed separately.**

96. The detail provided in sub-classifications, either on the face of the statement of financial position or in the notes depends on the requirements of International Public Sector Accounting Standards and the size, nature and function of the amounts involved. The factors set out in paragraph 93 are also used to decide the basis of sub-classification. The disclosures will vary for each item, for example:

    (a) Tangible assets should be classified by class in accordance with any appropriate standards that address accounting for property, plant and equipment;

    (b) Receivables are analyzed between amounts receivable from user charges, taxes and other non-reciprocal revenues, other members of the economic entity, receivables from related parties, prepayments, and other amounts;

    (c) Inventories are sub-classified in accordance with appropriate standards that address accounting for inventories, into classifications such as merchandise, production supplies, materials, work in progress and finished goods;

    (d) Taxes and transfers payable are analyzed between tax refunds payable, transfers payable, and amounts payable to other members of the economic entity;

    (e) Provisions are analyzed showing separately provisions for employee benefit costs and any other items classified in a manner appropriate to the entity's operations; and

    (f) Components of net assets/equity are analyzed showing separately contributed capital, accumulated surpluses and deficits and any reserves.

97. **When an entity has no share capital, it should separately disclose the following, either on the face of the statement of financial position or in the notes:**

    (a) **Net assets/equity, showing separately:**

        (i) **Contributed capital, being the cumulative total at the reporting date of contributions from owners, less distributions to owners;**

        (ii) **Accumulated surpluses or deficits;**

        (iii) **Reserves, including a description of the nature and purpose of each reserve within net assets/equity; and**

        (iv) **Minority interests; and**

(b) **The amount of a distribution (other than the return of capital) proposed or declared after the reporting date but before the financial statements were authorized for issue.**

98. Many public sector entities will not have share capital but the entity will be controlled exclusively by another public sector entity. The nature of the government's interest in the net assets/equity of the entity is likely to be a combination of contributed capital and the aggregate of the entity's accumulated surpluses or deficits and reserves—which reflect the net assets/equity attributable to the entity's operations.

99. In some cases, there may be a minority interest in the net assets/equity of the entity. For example, at whole-of-government level, the economic entity may include a Government Business Enterprise that has been partly privatized. Accordingly, there may be private shareholders who have a financial interest in the net assets/equity of the entity.

100. **When an entity has share capital, in addition to the disclosures in paragraph 97, it should disclose the following, either on the face of the statement of financial position or in the notes:**

(a) **For each class of share capital:**

(i) **The number of shares authorized;**

(ii) **The number of shares issued and fully paid, and issued but not fully paid;**

(iii) **Par value per share, or that the shares have no par value;**

(iv) **A reconciliation of the number of shares outstanding at the beginning and at the end of the year;**

(v) **The rights, preferences and restrictions attaching to that class, including restrictions on the distribution of dividends and the repayment of capital;**

(vi) **Shares in the entity held by the entity itself or by controlled entities or associates of the entity; and**

(vii) **Shares reserved for issuance under options and sales contracts, including the terms and amounts;**

(b) **A description of the nature and purpose of each reserve within net assets/equity;**

(c) **The amount of dividends that were proposed or declared after the reporting date but before the financial statements were authorized for issue; and**

(d) **The amount of any cumulative preference dividends not recognized.**

Statement of Financial Performance

Information to be Presented on the Face of the Statement of Financial Performance

101. **As a minimum, the face of the statement of financial performance should include line items which present the following amounts:**

    (a) **Revenue from operating activities;**

    (b) **Surplus or deficit from operating activities;**

    (c) **Finance costs;**

    (d) **Share of net surpluses or deficits of associates and joint ventures accounted for using the equity method;**

    (e) **Surplus or deficit from ordinary activities;**

    (f) **Extraordinary items;**

    (g) **Minority interest share of net surplus or deficit; and**

    (h) **Net surplus or deficit for the period.**

    Additional line items, headings and sub-totals should be presented on the face of the statement of financial performance when required by an International Public Sector Accounting Standard, or when such presentation is necessary to present fairly the entity's financial performance.

102. In the context of the statement of financial performance, operating activities refers to those activities which an entity carries out in order to achieve its primary objectives. Revenues and expenses arising from operating activities are distinguished from those arising from holding assets or financing an entity's operations. For example, a local government's operations may include the generation of revenue from property taxes and the incurrence of expenses such as wages, depreciation and consumables. Other items such as finance costs and gains and losses on the sale of property, plant and equipment are generally incidental to the local government's primary objectives and therefore outside its operating activities.

103. The effects of an entity's various activities, transactions and other events differ in terms of their impact on its ability to meet its service delivery obligations, and the disclosure of the elements of performance assists in an understanding of the performance achieved and in predicting future results.

Additional line items are included on the face of the statement of financial performance and the descriptions used and the ordering of items are amended when this is necessary to explain the elements of performance. Factors to be taken into consideration include materiality and the nature and function of the various components of revenue and expenses. Revenue and expense items are offset only when the criteria in paragraph 55 are met.

Information to be Presented either on the Face of the Statement of Financial Performance or in the Notes

104. **An entity should present, either on the face of the statement of financial performance or in the notes to the statement of financial performance, a sub-classification of total revenue, classified in a manner appropriate to the entity's operations.**

105. **An entity should present, either on the face of the statement of financial performance or in the notes to the statement of financial performance, an analysis of expenses using a classification based on either the nature of expenses or their function within the entity, as appropriate.**

106. Entities are encouraged to present the analysis in paragraph 105 on the face of the statement of financial performance.

107. Expense items are further sub-classified in order to highlight the costs and cost recoveries of particular programs, activities or other relevant segments of the reporting entity. This information may be provided in one of two ways.

108. The first analysis is referred to as the nature of expense method. Expenses are aggregated in the statement of financial performance according to their nature, (for example depreciation, purchases of materials, transport costs, wages and salaries), and are not reallocated amongst various functions within the entity. This method is simple to apply in many smaller entities because no allocations of operating expenses between functional classifications are necessary. An example of a classification using the

Revenue from operating activities		X
Salaries and employee benefits	X	
Depreciation and amortization expense	X	
Other operating expenses	X	
Total expenses		(X)
Surplus from operating activities		X

nature of expense method is as follows:

109. The second analysis, referred to as the functional method of expense classification, classifies expenses according to the program or purpose for which they were made. This presentation often provides more relevant information to users than the classification of expenses by nature, although the allocation of expenses to functions can be arbitrary and involves considerable judgment. An example of the functional method of expense classification is as follows:

Total revenue	X
Expenses:	
Health expenses	(X)
Education expenses	(X)
Other expenses	(X)
Surplus/(deficit)	X

110. The expenses associated with the main functions undertaken by the entity are shown separately. In this example, the entity has functions relating to the provision of health and education services. The entity would present expense line items for each of these functions.

111. **Entities classifying expenses by function should disclose additional information on the nature of expenses, including depreciation and amortization expense, salaries and employee benefits, and finance costs.**

112. The choice of analysis between the functional method and the nature of expense method depends on both the historical and regulatory factors and the nature of the organization. Both methods provide an indication of the costs which might be expected to vary, directly and indirectly, with the outputs of the entity. Because each method of presentation has its merits for different types of entities, this Standard provides a choice between classifications based on what fairly presents the elements of an entity's performance.

113. **When an entity provides a dividend to its owners and has share capital, it should disclose, either on the face of the statement of financial performance or in the notes, the amount of dividends per share, declared or proposed, for the period covered by the financial statements.**

Changes in Net Assets/Equity

114. **An entity should present, as a separate component of its financial statements, a statement showing:**

(a) **The net surplus or deficit for the period;**

(b) **Each item of revenue and expense, which, as required by other standards, is recognized directly in net assets/equity, and the total of these items; and**

(c) **The cumulative effect of changes in accounting policy and the correction of fundamental errors dealt with under the benchmark treatments in IPSAS 3.**

115. **In addition, an entity should present, either within this statement or in the notes:**

(a) **Contributions by owners and distributions to owners, in their capacity as owners;**

(b) **The balance of accumulated surpluses or deficits at the beginning of the period and at the reporting date, and the movements for the period; and**

(c) **To the extent that components of net assets/equity are separately disclosed, a reconciliation between the carrying amount of each component of net assets/equity at the beginning and the end of the period, separately disclosing each movement.**

116. 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.

117. The overall change in net assets/equity represents the total net surplus/deficit for the period, other revenues and expenses recognized directly as changes in net assets/equity, together with any contributions by, and distributions to, owners in their capacity as owners.

118. Contributions by, and distributions to, owners include transfers between two entities within an economic entity (for example, a transfer from a government, acting in its capacity as owner, to a government department). Contributions by owners, in their capacity as owners, to controlled entities are recognized as a direct adjustment to net assets/equity only where they explicitly give rise to residual interests in the entity in the form of rights to net assets/equity.

119. IPSAS 3 requires all items of revenue and expense recognized in a period to be included in the determination of net surplus or deficit for the period unless an International Public Sector Accounting Standard requires or permits otherwise. Other Standards require certain items, such as revaluation surpluses and deficits and certain foreign exchange differences, to be recognized directly as changes in net assets/equity along with capital

transactions with and distributions to the entity's owners. Since in assessing the changes in an entity's financial position between two reporting dates it is important to take into consideration all items which contribute to the change in position, this Standard requires a separate component of the financial statements which highlights both an entity's net surplus/deficit for the period and those items that have been recognized directly in net assets/equity during the period.

120. The requirements in paragraphs 114 and 115 may be met by using a columnar format which reconciles the opening and closing balances of each element within net assets/equity, including all items listed in paragraphs 114 and 115. Paragraph 114 also requires a sub-total of all items of revenue and expense, which, as required by other Standards, have been recognized directly in net assets/equity.

Cash Flow Statement

121. IPSAS 2 sets out requirements for the presentation of the cash flow statement and related disclosures. It states that cash flow information is useful in providing users of financial statements with a basis to assess the ability of the entity to generate cash and cash equivalents, and the needs of the entity to utilize those cash flows.

Notes to the Financial Statements

Structure

122. **The notes to the financial statements of an entity should:**

(a) **Present information about the basis of preparation of the financial statements and the specific accounting policies selected and applied for significant transactions and other events;**

(b) **Disclose the information required by international public sector accounting standards that is not presented elsewhere in the financial statements; and**

(c) **Provide additional information which is not presented on the face of the financial statements but that is necessary for a fair presentation.**

123. **Notes to the financial statements should be presented in a systematic manner. Each item on the face of the statement of financial performance, statement of financial position and cash flow statement should be cross-referenced to any related information in the notes.**

124. Notes to the financial statements include narrative descriptions or more detailed schedules or analyses of amounts shown on the face of the

statement of financial performance, statement of financial position, cash flow statement and statement of changes in net assets/equity, as well as additional information such as contingent liabilities and commitments. They include information required and encouraged to be disclosed by International Public Sector Accounting Standards, and other disclosures necessary to achieve a fair presentation.

125. Notes are normally presented in the following order, which assists users in understanding the financial statements and comparing them with those of other entities:

(a) Statement of compliance with International Public Sector Accounting Standards (see paragraph 26);

(b) Statement of the measurement basis (bases) and accounting policies applied;

(c) Supporting information for items presented on the face of each financial statement in the order in which each line item and each financial statement is presented; and

(d) Other disclosures, including:

(i) Contingencies, commitments and other financial disclosures; and

(ii) Non-financial disclosures.

126. In some circumstances, it may be necessary or desirable to vary the ordering of specific items within the notes. For example, information on interest rates and fair value adjustments may be combined with information on maturities of financial instruments although the former are statement of financial performance disclosures and the latter relate to the statement of financial position. Nevertheless, a systematic structure for the notes is retained as far as practicable.

127. Information about the basis of preparation of the financial statements and specific accounting policies may be presented as a separate component of the financial statements.

Presentation of Accounting Policies

128. **The accounting policies section of the notes to the financial statements should describe the following:**

(a) **The measurement basis (or bases) used in preparing the financial statements;**

(b) **The extent to which the entity has applied any transitional provisions in any international public sector accounting standard; and**

(c) **Each specific accounting policy that is necessary for a proper understanding of the financial statements.**

129. In addition to the specific accounting policies used in the financial statements, it is important for users to be aware of the measurement basis (bases) used (historical cost, current cost, realizable value, fair value or present value) because they form the basis on which the whole of the financial statements are prepared. When more than one measurement basis is used in the financial statements, for example when certain items are revalued, it is sufficient to provide an indication of the categories of assets and liabilities to which each measurement basis is applied.

130. 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. The accounting policies that an entity might consider presenting include, but are not restricted to, the following:

(a) Revenue recognition

(b) Consolidation principles, including controlled entities

(c) Investments

(d) Recognition and depreciation/amortization of tangible and intangible assets

(e) Capitalization of borrowing costs and other expenditure:

  (i) Inventories held for sale

  (ii) Other qualifying assets

(f) Construction contracts

(g) Investment properties

(h) Financial instruments and investments

(i) Leases

(j) Research and development costs

(k) Inventories:

  (i) Held for resale

  (ii) For consumption

(l) Provisions

(m) Employee benefit costs

(n) Foreign currency translation and hedging

(o) Definition of segments and the basis for allocation of costs between segments

(p) Inflation accounting

(q) Government grants

131. Each entity considers the nature of its operations and the policies which the user would expect to be disclosed for that type of entity. For example, public sector entities would be expected to disclose an accounting policy for recognition of taxes, donations and other forms of non-reciprocal revenue. When an entity has significant foreign operations or transactions in foreign currencies, disclosure of accounting policies for the recognition of foreign exchange gains and losses and the hedging of such gains and losses would be expected. In consolidated financial statements, the policy used for determining goodwill and minority interest is disclosed.

132. An accounting policy may be significant even if amounts shown for current and prior periods are not material. It is also appropriate to disclose an accounting policy for each policy not covered by existing International Public Sector Accounting Standards, but selected and applied in accordance with paragraph 37.

Other Disclosures

133. **An entity should disclose the following if not disclosed elsewhere in information published with the financial statements:**

(a) **The domicile and legal form of the entity, and the jurisdiction within which it operates;**

(b) **A description of the nature of the entity's operations and principal activities;**

(c) **A reference to the relevant legislation governing the entity's operations; and**

(d) **The name of the controlling entity and the ultimate controlling entity of the economic entity (where applicable).**

Transitional Provisions

134. **All provisions of this Standard should be applied from the date of first adoption of this Standard, except in relation to items which have not been recognized as a result of transitional provisions under another International Public Sector Accounting Standard. The disclosure**

provisions of this Standard would not be required to apply to such items until the transitional provision in the other International Public Sector Accounting Standard expires.

135. Notwithstanding the existence of transitional provisions under another International Public Sector Accounting Standard, entities that are in the process of adopting the accrual basis of accounting for financial reporting purposes are encouraged to comply in full with the provisions of that other Standard as soon as possible.

Effective Date

136. **This International Public Sector Accounting Standard becomes effective for annual financial statements covering periods beginning on or after July 1, 2001. Earlier application is encouraged.**

137. When an entity adopts the accrual basis of accounting, as defined by International Public Sector Accounting Standards, for financial reporting purposes, subsequent to this effective date, this Standard applies to the entity's annual financial statements covering periods beginning on or after the date of adoption.

Appendix 1

Illustrative Financial Statement Structure

This appendix is illustrative only and does not form part of the standards. The purpose of the appendix is to illustrate the application of the standards and to assist in clarifying their meaning.

The Standard sets out the components of financial statements and minimum requirements for disclosure on the face of the statement of financial position and the statement of financial performance as well as for the presentation of changes in net assets/equity. It also establishes further items that may be presented either on the face of the relevant financial statement or in the notes.

The purpose of this appendix is to provide examples of the ways in which the requirements for the presentation of the statement of financial performance, statement of financial position and changes in net assets/equity might be presented in the primary financial statements. The order of presentation and the descriptions used for line items should be changed where necessary in order to achieve a fair presentation in each entity's particular circumstances. For example, line items of a public sector entity such as a defense department are likely to be significantly different from those for a central bank. The financial statements have been prepared for a national government and the statement of financial performance (by function) illustrates the functions of government classifications used in the Government Finance Statistics. These functional classifications are unlikely to apply to all public sector entities. Refer to this Standard for an example of more generic functional classifications for other public sector entities.

Public Sector Entity-Statement of Accounting Policies (Extract)

Reporting entity

These financial statements are for a public sector entity (national government of Country A). The financial statements encompass the reporting entity as specified in the relevant legislation (Public Finance Act 20XX). This comprises:

- Central government ministries; and
- Government Business Enterprises.

Basis of preparation

The financial statements comply with International Public Sector Accounting Standards for the accrual basis of accounting. The measurement base applied is historical cost adjusted for revaluations of assets.

The financial statements have been prepared on a going concern basis and the accounting policies have been applied consistently throughout the period.

Public Sector Entity — Statement of Financial Position as of 31 December 20X2 (In Thousands of Currency Units)

	20X2	20X2	20X1	20X1
ASSETS				
Current assets				
Cash and cash equivalents	X		X	
Receivables	X		X	
Inventories	X		X	
Prepayments	X		X	
Investments	X		X	
		X		X
Non-current assets				
Receivables	X		X	
Investments	X		X	
Other financial assets	X		X	
Infrastructure, plant and equipment	X		X	
Land and buildings	X		X	
Intangible assets	X		X	
Other non-financial assets	X		X	
		X		X
Total assets		X		X
LIABILITIES				
Current liabilities				
Payables	X		X	
Short-term borrowings	X		X	
Current portion of borrowings	X		X	
Provisions	X		X	
Employee benefits	X		X	
Superannuation	X		X	
		X		X
Non-current liabilities				
Payables	X		X	
Borrowings	X		X	
Provisions	X		X	
Employee benefits	X		X	
Superannuation	X		X	
		X		X
Total liabilities		X		X
Net assets		X		X

NET ASSETS/EQUITY				
Capital contributed byother government entities	X		X	
Reserves	X		X	
Accumulated surpluses/(deficits)	X		X	
		X		X
Minority interest		X		X
Total net assets/equity		X		X

Public Sector Entity—Statement of Financial Performance for the Year Ended 31 December 20X2 (Illustrating the Classification of Expenses by Function)

(In thousands of currency units)

	20X2	**20X1**
Operating revenue		
Taxes	X	X
Fees, fines, penalties and licenses	X	X
Revenue from exchange transactions	X	X
Transfers from other government entities	X	X
Other operating revenue	X	X
Total operating revenue	X	X
Operating expenses		
General public services	X	X
Defense	X	X
Public order and safety	X	X
Education	X	X
Health	X	X
Social protection	X	X
Housing and community amenities	X	X
Recreational, cultural and religion	X	X
Economic Affairs	X	X
Environmental protection	X	X
Total operating expenses	X	X
Surplus/(deficit) from operating activities	X	X
Finance costs	(X)	(X)
Gains on sale of property, plant and equipment	X	X
Total non-operating revenue (expenses)	(X)	(X)

Surplus/(deficit) from ordinary activities	X	X
Minority interest share of surplus/(deficit)[1]	(X)	(X)
Net surplus/(deficit) before extraordinary items	X	X
Extraordinary items	(X)	(X)
Net surplus/(deficit) for the period	X	X

1 The minority interest share of the surplus/(deficit) from ordinary activities includes the minority interest share of extraordinary items. The presentation of extraordinary items net of minority interest is permitted by paragraph 57(c) of International Public Sector Accounting Standard (IPSAS) 1, “Presentation of Financial Statements.” Disclosure of the minority interest share of extraordinary items is shown in the notes to the financial statements.

Public Sector Entity—Statement of Financial Performance for the Year Ended 31 December 20X2 (Illustrating the Classification of Expenses by Nature)

(In Thousands of Currency Units)

	20X2	20X1
Operating revenue		
Taxes	X	X
Fees, fines, penalties and licenses	X	X
Revenue from exchange transactions	X	X
Transfers from other government entities	X	X
Other operating revenue	X	X
Total operating revenue	X	X
Operating expenses		
Wages, salaries and employee benefits	X	X
Grants and other transfer payments	X	X
Supplies and consumables used	X	X
Depreciation and amortization expense	X	X
Other operating expenses	X	X
Total operating expenses	X	X
Surplus/(deficit) from operating activities	X	X
Finance costs	(X)	(X)
Gains on sale of property, plant and equipment	X	X
Total non-operating revenue (expenses)	(X)	(X)
Surplus/(deficit) from ordinary activities	X	X
Minority interest share of surplus/(deficit)[2]	(X)	(X)
Net surplus/(deficit) before extraordinary items	X	X
Extraordinary items	(X)	(X)
Net surplus/(deficit) for the period	X	X

[2] The minority interest share of the surplus/(deficit) from ordinary activities includes the minority interest share of extraordinary items. The presentation of extraordinary items net of minority interest is permitted by paragraph 57(c) of IPSAS 1, "Presentation of Financial Statements." Disclosure of the minority interest share of extraordinary items is shown in the notes to the financial statements.

Public Sector Entity—Statement of Changes in Net Assets/Equity for the Year Ended 31 December 20X2

(In Thousands of Currency Units)

	Contributed Capital	**Revaluation Reserve**	**Translation Reserve**	**Accumulated Surpluses/ (Deficits)**	**Total**
Balance at 31 December 20X0	X	X	(X)	X	X
Changes in accounting policy	(X)			(X)	(X)
Restated balance	X	X	X	X	X
Surplus on revaluation of property		X			X
Deficit on revaluation of investments		(X)			(X)
Currency translation differences			(X)		(X)
Net gains and losses not recognized in the statement of financial performance		X	(X)		X
Net surplus for the period				X	X
Balance at 31 December 20X1	X	X	(X)	X	X
Deficit on revaluation of property		(X)			(X)
Surplus on revaluation of investments		X			X
Currency translation differences			(X)		X
Net gains and losses not recognized in the statement of financial performance		(X)	(X)		(X)
Net deficit for the period				(X)	(X)
Balance at 31 December 20X2	X	X	(X)	X	X

Appendix 2

Qualitative Characteristics of Financial Reporting

Paragraph 37 of this Standard requires the development of accounting policies to ensure that the financial statements provide information that meets a number of qualitative characteristics. This appendix summarizes the qualitative characteristics of financial reporting.

Qualitative characteristics are the attributes that make the information provided in financial statements useful to users. The four principal qualitative characteristics are understandability, relevance, reliability and comparability.

Understandability

Information is understandable when users might reasonably be expected to comprehend its meaning. For this purpose, users are assumed to have a reasonable knowledge of the entity's activities and the environment in which it operates, and to be willing to study the information.

Information about complex matters should not be excluded from the financial statements merely on the grounds that it may be too difficult for certain users to understand.

Relevance

Information is relevant to users if it can be used to assist in evaluating past, present or future events or in confirming, or correcting, past evaluations. In order to be relevant, information must also be timely.

Materiality

The relevance of information is affected by its nature and materiality.

Information is material if its omission or misstatement could influence the decisions of users or assessments 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 its omission or misstatement. Thus, materiality provides a threshold or cut-off point rather than being a primary qualitative characteristic which information must have if it is to be useful.

Reliability

Reliable information is free from material error and bias, and can be depended on by users to represent faithfully that which it purports to represent or could reasonably be expected to represent.

Faithful Representation

For information to represent faithfully transactions and other events, it should be presented in accordance with the substance of the transactions and other events, and not merely their legal form.

Substance Over Form

If information is to represent faithfully the transactions and other events that it purports to represent, it is necessary that they are accounted for and presented in accordance with their substance and economic reality and not merely their legal form. The substance of transactions or other events is not always consistent with their legal form.

Neutrality

Information is neutral if it is free from bias. Financial statements are not neutral if the information they contain has been selected or presented in a manner designed to influence the making of a decision or judgment in order to achieve a predetermined result or outcome.

Prudence

Prudence is the inclusion of a degree of caution in the exercise of the judgments needed in making the estimates required under conditions of uncertainty, such that assets or revenue are not overstated and liabilities or expenses are not understated.

However, the exercise of prudence does not allow, for example, the creation of hidden reserves or excessive provisions, the deliberate understatement of assets or revenue, or the deliberate overstatement of liabilities or expenses, because the financial statements would not be neutral and, therefore, not have the quality of reliability.

Completeness

The information in financial statements should be complete within the bounds of materiality and cost.

Comparability

Information in financial statements is comparable when users are able to identify similarities and differences between that information and information in other reports.

Comparability applies to the:

- Comparison of financial statements of different entities; and
- Comparison of the financial statements of the same entity over periods of time.

An important implication of the characteristic of comparability is that users need to be informed of the policies employed in the preparation of financial statements, changes to those policies and the effects of those changes.

Because users wish to compare the performance of an entity over time, it is important that financial statements show corresponding information for preceding periods.

Constraints on Relevant and Reliable Information

Timeliness

If there is an undue delay in the reporting of information it may lose its relevance. To provide information on a timely basis it may often be necessary to report before all aspects of a transaction are known, thus impairing reliability. Conversely, if reporting is delayed until all aspects are known, the information may be highly reliable but of little use to users who have had to make decisions in the interim. In achieving a balance between relevance and reliability, the overriding consideration is how best to satisfy the decision-making needs of users.

Balance Between Benefit and Cost

The balance between benefit and cost is a pervasive constraint. The benefits derived from information should exceed the cost of providing it. The evaluation of benefits and costs is, however, substantially a matter of judgment. Furthermore, the costs do not always fall on those users who enjoy the benefits. Benefits may also be enjoyed by users other than those for whom the information was prepared. For these reasons, it is difficult to apply a benefit-cost test in any particular case. Nevertheless, standard-setters, as well as those responsible for the preparation of financial statements and users of financial statements, should be aware of this constraint.

Balance Between Qualitative Characteristics

In practice a balancing, or trade-off, between qualitative characteristics is often necessary. Generally the aim is to achieve an appropriate balance among the characteristics in order to meet the objectives of financial statements. The relative importance of the characteristics in different cases is a matter of professional judgment.

Comparison with IAS 1

International Public Sector Accounting Standard (IPSAS) 1, "Presentation of Financial Statements," is drawn primarily from International Accounting Standard (IAS) 1, "Presentation of Financial Statements." The main differences between IPSAS 1 and IAS 1 are as follows:

- Commentary additional to that in IAS 1 has been included in IPSAS 1 to clarify the applicability of the standards to accounting by public sector entities for example, discussion on the application of the going concern concept has been expanded.
- IAS 1 allows the presentation of either a statement showing all changes in net assets/equity, or a statement showing changes in net assets/equity other than those arising from capital transactions with owners and distributions to owners in their capacity as owners. IPSAS 1 requires the presentation of a statement showing all changes in net assets/equity.
- IPSAS 1 uses different terminology, in certain instances, from IAS 1. The most significant examples are the use of the terms "entity," "revenue," "statement of financial performance," "statement of financial position" and "net assets/equity" in IPSAS 1. The equivalent terms in IAS 1 are "enterprise," "income," "income statement," "balance sheet" and "equity."
- The definition of the term "extraordinary item" differs from that used in IAS 8, "Net Profit or Loss for the Period, Fundamental Errors and Changes in Accounting Policies." The definition includes an additional criterion, namely that the items be "outside the control or influence of the entity" (paragraph 6).
- IPSAS 1 contains a different set of definitions of technical terms from IAS 1 (paragraph 6).
- IPSAS 1 contains a transitional provision allowing the non-disclosure of items which have been excluded from the financial statements due to the application of a transitional provision in another IPSAS (paragraph 134).

IPSAS 1 contains a summary of qualitative characteristics (based on the IASC framework) in Appendix 2.

IPSAS 2—CASH FLOW STATEMENTS

Acknowledgment

This International Public Sector Accounting Standard is drawn primarily from International Accounting Standard (IAS) 7, "Cash Flow Statements" 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 IASC. The International Accounting Standards (IASs) issued by IASC remain in force until they are amended or withdrawn by IASB. Extracts from IAS 7 are reproduced in this publication of the Public Sector Committee of the International Federation of Accountants with the permission of IASB.

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May 2000

IPSAS 2—CASH FLOW STATEMENTS

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The standards, which have been set in bold type, should be read in the context of the commentary paragraphs in this Standard, which are in plain type, and in the context of the "Preface to International Public Sector Accounting Standards." International Public Sector Accounting Standards are not intended to apply to immaterial items.

Objective

The cash flow statement identifies the sources of cash inflows, the items on which cash was expended during the reporting period, and the cash balance as at the reporting date. Information about the cash flows of an entity is useful in providing users of financial statements with information for both accountability and decision making purposes. Cash flow information allows users to ascertain how a public sector entity raised the cash it required to fund its activities and the manner in which that cash was used. In making and evaluating decisions about the allocation of resources, such as the sustainability of the entity's activities, users require an understanding of the timing and certainty of cash flows. The objective of this Standard is to require the provision of information about the historical changes in cash and cash equivalents of an entity by means of a cash flow statement which classifies cash flows during the period from operating, investing and financing activities.

Scope

1. **An entity which prepares and presents financial statements under the accrual basis of accounting should prepare a cash flow statement in accordance with the requirements of this Standard and should present it as an integral part of its financial statements for each period for which financial statements are presented.**

2. Information about cash flows may be useful to users of an entity's financial statements in assessing the entity's cash flows, assessing the entity's compliance with legislation and regulations (including authorized budgets where appropriate) and for making decisions about whether to provide resources to, or enter into transactions with an entity. They are generally interested in how the entity generates and uses cash and cash equivalents. This is the case regardless of the nature of the entity's activities and irrespective of whether cash can be viewed as the product of the entity, as may be the case with a public financial institution. Entities need cash for essentially the same reasons, however different their principal revenue producing activities might be. They need cash to pay for the goods and services they consume, to meet ongoing debt servicing costs, and, in some cases, to reduce levels of debt. Accordingly, this Standard requires all entities to present a cash flow statement.

3. **This Standard applies to all public sector entities other than Government Business Enterprises.**

4. Government Business Enterprises (GBEs) are required to comply with International Accounting Standards (IASs) issued by the International Accounting Standards Committee. The Public Sector Committee's Guideline No.1, "Financial Reporting by Government Business Enterprises" notes that IASs are relevant to all business enterprises, regardless of whether they are in the private or public sector. Accordingly, Guideline No. 1 recommends that GBEs should present financial statements that conform, in all material respects, to IASs.

Benefits of Cash Flow Information

5. Information about the cash flows of an entity is useful in assisting users to predict the future cash requirements of the entity, its ability to generate cash flows in the future and to fund changes in the scope and nature of its activities. A cash flow statement also provides a means by which an entity can discharge its accountability for cash inflows and cash outflows during the reporting period.

6. A cash flow statement, when used in conjunction with other financial statements, provides information that enables users to evaluate the changes in net assets/equity of an entity, its financial structure (including its liquidity and solvency) and its ability to affect the amounts and timing of cash flows in order to adapt to changing circumstances and opportunities. It also enhances the comparability of the reporting of operating performance by different entities because it eliminates the effects of using different accounting treatments for the same transactions and other events.

7. Historical cash flow information is often used as an indicator of the amount, timing and certainty of future cash flows. It is also useful in checking the accuracy of past assessments of future cash flows.

Definitions

8. **The following terms are used in this Standard with the meanings specified:**

   Accrual basis means 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 the accrual basis are assets, liabilities, net assets/equity, revenue and expenses.

Assets are resources controlled by an entity as a result of past events and from which future economic benefits or service potential are expected to flow to the entity.

Associate is an entity in which the investor has significant influence and which is neither a controlled entity nor a joint venture of the investor.

Cash comprises cash on hand and demand deposits.

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.

Cash flows are inflows and outflows of cash and cash equivalents.

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

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

(b) **Can be sold, exchanged, transferred or redeemed.**

Control is the power to govern the financial and operating policies of another entity so as to benefit from its activities.

Controlled entity is an entity that is under the control of another entity (known as the controlling entity).

Controlling entity is an entity that has one or more controlled entities.

Cost method is 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.

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

Economic entity means a group of entities comprising a controlling entity and one or more controlled entities.

Equity method is 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.

Exchange rate is the ratio for exchange of two currencies.

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

Extraordinary items are 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.

Financing activities are activities that result in changes in the size and composition of the contributed capital and borrowings of the entity.

Foreign currency is a currency other than the reporting currency of an entity.

Government Business Enterprise means an entity that has all the following characteristics:

(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.**

Investing activities are the acquisition and disposal of long-term assets and other investments not included in cash equivalents.

Investor in a joint venture is a party to a joint venture and does not have joint control over that joint venture.

Joint venture is a binding arrangement whereby two or more parties are committed to undertake an activity which is subject to joint control.

Liabilities are present obligations of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits or service potential.

Minority interest is 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.

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

Net surplus/deficit comprises the following components:

(a) **Surplus or deficit from ordinary activities; and**

(b) **Extraordinary items.**

Operating activities are the activities of the entity that are not investing or financing activities.

Proportionate consolidation is 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.

Reporting currency is the currency used in presenting the financial statements.

Reporting date means the date of the last day of the reporting period to which the financial statements relate.

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

Surplus/deficit from ordinary activities is the residual amount that remains after expenses arising from ordinary activities have been deducted from revenue arising from ordinary activities.

Cash and Cash Equivalents

9. Cash equivalents are held for the purpose of meeting short-term cash commitments rather than for investment or other purposes. For an investment to qualify as a cash equivalent it must be readily convertible to a known amount of cash and be subject to an insignificant risk of changes in value. Therefore, an investment normally qualifies as a cash equivalent only when it has a short maturity of, say, three months or less from the date of acquisition. Equity investments are excluded from cash equivalents unless they are, in substance, cash equivalents.

10. Bank borrowings are generally considered to be financing activities. However, in some countries, bank overdrafts which are repayable on demand form an integral part of an entity's cash management. In these circumstances, bank overdrafts are included as a component of cash and cash equivalents. A characteristic of such banking arrangements is that the bank balance often fluctuates from being positive to overdrawn.

11. Cash flows exclude movements between items that constitute cash or cash equivalents because these components are part of the cash management of an entity rather than part of its operating, investing and financing activities. Cash management includes the investment of excess cash in cash equivalents.

Economic Entity

12. The term "economic entity" is used in this Standard to define, for financial reporting purposes, a group of entities comprising the controlling entity and any controlled entities.

13. Other terms sometimes used to refer to an economic entity include "administrative entity," "financial entity," "consolidated entity" and "group."

14. 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.

Future Economic Benefits or Service Potential

15. 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 Standard uses the term "future economic benefits or service potential" to describe the essential characteristic of assets.

Government Business Enterprises

16. 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.

Net Assets/Equity

17. "Net assets/equity" is the term used in this Standard 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.

Presentation of a Cash Flow Statement

18. **The cash flow statement should report cash flows during the period classified by operating, investing and financing activities.**

19. An entity presents its cash flows from operating, investing and financing activities in a manner which is most appropriate to its activities. Classification by activity provides information that allows users to assess the impact of those activities on the financial position of the entity and the amount of its cash and cash equivalents. This information may also be used to evaluate the relationships among those activities.

20. A single transaction may include cash flows that are classified differently. For example, when the cash repayment of a loan includes both interest and capital, the interest element may be classified as an operating activity and the capital element is classified as a financing activity.

Operating Activities

21. The amount of net cash flows arising from operating activities is a key indicator of the extent to which the operations of the entity are funded:

    (a) By way of taxes (directly and indirectly); or

    (b) From the recipients of goods and services provided by the entity.

    The amount of the net cash flows also assists in showing the ability of the entity to maintain its operating capability, repay obligations, pay a dividend to its owner and make new investments without recourse to external sources of financing. The consolidated whole-of-government operating cash flows provide an indication of the extent to which a government has financed its current activities through taxation and charges. Information about the specific components of historical operating cash flows is useful, in conjunction with other information, in forecasting future operating cash flows.

22. Cash flows from operating activities are primarily derived from the principal cash-generating activities of the entity. Examples of cash flows from operating activities are:

    (a) Cash receipts from taxes, levies and fines;

    (b) Cash receipts from charges for goods and services provided by the entity;

    (c) Cash receipts from grants or transfers and other appropriations or other budget authority made by central government or other public sector entities;

    (d) Cash receipts from royalties, fees, commissions and other revenue;

    (e) Cash payments to other public sector entities to finance their operations (not including loans);

    (f) Cash payments to suppliers for goods and services;

    (g) Cash payments to and on behalf of employees;

    (h) Cash receipts and cash payments of an insurance entity for premiums and claims, annuities and other policy benefits;

    (i) Cash payments of local property taxes or income taxes (where appropriate) in relation to operating activities;

    (j) Cash receipts and payments from contracts held for dealing or trading purposes;

    (k) Cash receipts or payments from discontinuing operations; and

(l) Cash receipts or payments in relation to litigation settlements.

Some transactions, such as the sale of an item of plant, may give rise to a gain or loss which is included in the determination of net surplus or deficit. However, the cash flows relating to such transactions are cash flows from investing activities.

23. An entity may hold securities and loans for dealing or trading purposes, in which case they are similar to inventory acquired specifically for resale. Therefore, cash flows arising from the purchase and sale of dealing or trading securities are classified as operating activities. Similarly, cash advances and loans made by public financial institutions are usually classified as operating activities since they relate to the main cash-generating activity of that entity.

24. In some jurisdictions, governments or other public sector entities will appropriate or authorize funds to entities to finance the operations of an entity and no clear distinction is made for the disposition of those funds between current activities, capital works and contributed capital. Where an entity is unable to separately identify appropriations or budgetary authorizations into current activities, capital works and contributed capital, the appropriation or budget authorization should be classified as cash flows from operations and this fact should be disclosed in the notes to the financial statements.

Investing Activities

25. The separate disclosure of cash flows arising from investing activities is important because the cash flows represent the extent to which cash outflows have been made for resources which are intended to contribute to the entity's future service delivery. Examples of cash flows arising from investing activities are:

(a) Cash payments to acquire property, plant and equipment, intangibles and other long-term assets. These payments include those relating to capitalized development costs and self-constructed property, plant and equipment;

(b) Cash receipts from sales of property, plant and equipment, intangibles and other long-term assets;

(c) Cash payments to acquire equity or debt instruments of other entities and interests in joint ventures (other than payments for those instruments considered to be cash equivalents or those held for dealing or trading purposes);

(d) Cash receipts from sales of equity or debt instruments of other entities and interests in joint ventures (other than receipts for those

instruments considered to be cash equivalents and those held for dealing or trading purposes);

(e) Cash advances and loans made to other parties (other than advances and loans made by a public financial institution);

(f) Cash receipts from the repayment of advances and loans made to other parties (other than advances and loans of a public financial institution);

(g) Cash payments for futures contracts, forward contracts, option contracts and swap contracts except when the contracts are held for dealing or trading purposes, or the payments are classified as financing activities; and

(h) Cash receipts from futures contracts, forward contracts, option contracts and swap contracts except when the contracts are held for dealing or trading purposes, or the receipts are classified as financing activities.

When a contract is accounted for as a hedge of an identifiable position, the cash flows of the contract are classified in the same manner as the cash flows of the position being hedged.

Financing Activities

26. The separate disclosure of cash flows arising from financing activities is important because it is useful in predicting claims on future cash flows by providers of capital to the entity. Examples of cash flows arising from financing activities are:

(a) Cash proceeds from issuing debentures, loans, notes, bonds, mortgages and other short or long-term borrowings;

(b) Cash repayments of amounts borrowed; and

(c) Cash payments by a lessee for the reduction of the outstanding liability relating to a finance lease.

Reporting Cash Flows from Operating Activities

27. **An entity should report cash flows from operating activities using either:**

(a) **The direct method, whereby major classes of gross cash receipts and gross cash payments are disclosed; or**

(b) **The indirect method, whereby net surplus or deficit is adjusted for the effects of transactions of a non-cash nature, any deferrals or accruals of past or future operating cash receipts or**

payments, and items of revenue or expense associated with investing or financing cash flows.

28. Entities are encouraged to report cash flows from operating activities using the direct method. The direct method provides information which may be useful in estimating future cash flows and which is not available under the indirect method. Under the direct method, information about major classes of gross cash receipts and gross cash payments may be obtained either:

    (a) From the accounting records of the entity; or

    (b) By adjusting operating revenues, operating expenses (interest and similar revenue, and interest expense and similar charges for a public financial institution) and other items in the statement of financial performance for:

        (i) Changes during the period in inventories and operating receivables and payables;

        (ii) Other non-cash items; and

        (iii) Other items for which the cash effects are investing or financing cash flows.

29. Entities reporting cash flows from operating activities using the direct method are also encouraged to provide a reconciliation of the surplus/deficit from ordinary activities with the net cash flow from operating activities. This reconciliation may be provided as part of the cash flow statement or in the notes to the financial statements.

30. Under the indirect method, the net cash flow from operating activities is determined by adjusting net surplus or deficit from ordinary activities for the effects of:

    (a) Changes during the period in inventories and operating receivables and payables;

    (b) Non-cash items such as depreciation, provisions, deferred taxes, unrealized foreign currency gains and losses, undistributed surpluses of associates, and minority interests;

    (c) All other items for which the cash effects are investing or financing cash flows; and

    (d) The impact of any extraordinary items which are classified as operating cash flows.

Reporting Cash Flows from Investing and Financing Activities

31. **An entity should report separately major classes of gross cash receipts and gross cash payments arising from investing and financing activities, except to the extent that cash flows described in paragraphs 32 and 35 are reported on a net basis.**

Reporting Cash Flows on a Net Basis

32. **Cash flows arising from the following operating, investing or financing activities may be reported on a net basis:**

    (a) **Cash receipts collected and payments made on behalf of customers, taxpayers or beneficiaries when the cash flows reflect the activities of the other party rather than those of the entity; and**

    (b) **Cash receipts and payments for items in which the turnover is quick, the amounts are large, and the maturities are short.**

33. Paragraph 32(a) refers only to transactions where the resulting cash balances are controlled by the reporting entity. Examples of such cash receipts and payments include:

    (a) The collection of taxes by one level of government for another level of government, not including taxes collected by a government for its own use as part of a tax sharing arrangement;

    (b) The acceptance and repayment of demand deposits of a public financial institution;

    (c) Funds held for customers by an investment or trust entity; and

    (d) Rents collected on behalf of, and paid over to, the owners of properties.

34. Examples of cash receipts and payments referred to in paragraph 32(b) are advances made for, and the repayment of:

    (a) The purchase and sale of investments; and

    (b) Other short-term borrowings, for example, those which have a maturity period of three months or less.

35. **Cash flows arising from each of the following activities of a public financial institution may be reported on a net basis:**

    (a) **Cash receipts and payments for the acceptance and repayment of deposits with a fixed maturity date;**

(b) **The placement of deposits with and withdrawal of deposits from other financial institutions; and**

(c) **Cash advances and loans made to customers and the repayment of those advances and loans.**

Foreign Currency Cash Flows

36. **Cash flows arising from transactions in a foreign currency should be recorded in an entity's reporting currency by applying to the foreign currency amount the exchange rate between the reporting currency and the foreign currency at the date of the cash flow.**

37. **The cash flows of a foreign controlled entity should be translated at the exchange rates between the reporting currency and the foreign currency at the dates of the cash flows.**

38. Cash flows denominated in a foreign currency are reported in a manner consistent with IPSAS 4, "The Effects of Changes in Foreign Exchange Rates." This permits the use of an exchange rate that approximates the actual rate. For example, a weighted average exchange rate for a period may be used for recording foreign currency transactions or the translation of the cash flows of a foreign controlled entity. IPSAS 4 does not permit the use of the exchange rate at reporting date when translating the cash flows of a foreign controlled entity.

39. Unrealized gains and losses arising from changes in foreign currency exchange rates are not cash flows. However, the effect of exchange rate changes on cash and cash equivalents held or due in a foreign currency is reported in the cash flow statement in order to reconcile cash and cash equivalents at the beginning and the end of the period. This amount is presented separately from cash flows from operating, investing and financing activities and includes the differences, if any, had those cash flows been reported at end of period exchange rates.

Extraordinary Items

40. **The cash flows associated with extraordinary items should be classified as arising from operating, investing or financing activities as appropriate, and separately disclosed.**

41. The cash flows associated with extraordinary items are disclosed separately as arising from operating, investing or financing activities in the cash flow statement, to enable users to understand their nature and effect on the present and future cash flows of the entity. These disclosures are in addition to the separate disclosures of the nature and amount of extraordinary items in the statement of financial performance required by IPSAS 3, "Net

Surplus or Deficit for the Period, Fundamental Errors and Changes in Accounting Policies."

Interest and Dividends

42. **Cash flows from interest and dividends received and paid should each be disclosed separately. Each should be classified in a consistent manner from period to period as either operating, investing or financing activities.**

43. The total amount of interest paid during a period is disclosed in the cash flow statement whether it has been recognized as an expense in the statement of financial performance or capitalized in accordance with the allowed alternative treatment in IPSAS 5, "Borrowing Costs."

44. Interest paid and interest and dividends received are usually classified as operating cash flows for a public financial institution. However, there is no consensus on the classification of these cash flows for other entities. Interest paid and interest and dividends received may be classified as operating cash flows because they enter into the determination of net surplus or deficit. Alternatively, interest paid and interest and dividends received may be classified as financing cash flows and investing cash flows respectively, because they are costs of obtaining financial resources or returns on investments.

45. Dividends paid may be classified as a financing cash flow because they are a cost of obtaining financial resources. Alternatively, dividends paid may be classified as a component of cash flows from operating activities in order to assist users to determine the ability of an entity to make these payments out of operating cash flows.

Taxes on Net Surplus

46. **Cash flows arising from taxes on net surplus should be separately disclosed and should be classified as cash flows from operating activities unless they can be specifically identified with financing and investing activities.**

47. Public sector entities are generally exempt from taxes on net surpluses. However, some public sector entities may operate under tax equivalent regimes where taxes are levied in the same way as they are on private sector entities.

48. Taxes on net surplus arise from transactions that give rise to cash flows that are classified as operating, investing or financing activities in a cash flow statement. While tax expense may be readily identifiable with investing or

financing activities, the related tax cash flows are often impracticable to identify and may arise in a different period from the cash flows of the underlying transaction. Therefore, taxes paid are usually classified as cash flows from operating activities. However, when it is practicable to identify the tax cash flow with an individual transaction that gives rise to cash flows that are classified as investing or financing activities the tax cash flow is classified as an investing or financing activity as appropriate. When tax cash flows are allocated over more than one class of activity, the total amount of taxes paid is disclosed.

Investments in Controlled Entities, Associates and Joint Ventures

49. When accounting for an investment in an associate or a controlled entity accounted for by use of the equity or cost method, an investor restricts its reporting in the cash flow statement to the cash flows between itself and the investee, for example, to dividends and advances.

50. An entity which reports its interest in a jointly controlled entity using proportionate consolidation, includes in its consolidated cash flow statement its proportionate share of the jointly controlled entity's cash flows. An entity which reports such an interest using the equity method includes in its cash flow statement the cash flows in respect of its investments in the jointly controlled entity, and distributions and other payments or receipts between it and the jointly controlled entity.

Acquisitions and Disposals of Controlled Entities and Other Operating Units

51. **The aggregate cash flows arising from acquisitions and from disposals of controlled entities or other operating units should be presented separately and classified as investing activities.**

52. **An entity should disclose, in aggregate, in respect of both acquisitions and disposals of controlled entities or other operating units during the period, each of the following:**

    (a) **The total purchase or disposal consideration;**

    (b) **The portion of the purchase or disposal consideration discharged by means of cash and cash equivalents;**

    (c) **The amount of cash and cash equivalents in the controlled entity or operating unit acquired or disposed of; and**

    (d) **The amount of the assets and liabilities other than cash or cash equivalents recognized by the controlled entity or operating unit acquired or disposed of, summarized by each major category.**

53. The separate presentation of the cash flow effects of acquisitions and disposals of controlled entities and other operating units as single line items, together with the separate disclosure of the amounts of assets and liabilities acquired or disposed of, helps to distinguish those cash flows from the cash flows arising from the other operating, investing and financing activities. The cash flow effects of disposals are not deducted from those acquisitions.

54. The aggregate amount of the cash paid or received as purchase or sale consideration is reported in the cash flow statement net of cash and cash equivalents acquired or disposed of.

55. Assets and liabilities other than cash or cash equivalents of a controlled entity or operating unit acquired or disposed of are only required to be disclosed where the controlled entity or unit had previously recognized those assets or liabilities. For example, where a public sector entity which prepares reports under the cash basis is acquired by another public sector entity, the acquiring entity would not be required to disclose the assets and liabilities (other than cash and cash equivalents) of the entity acquired as that entity would not have recognized non-cash assets or liabilities.

Non-cash Transactions

56. **Investing and financing transactions that do not require the use of cash or cash equivalents should be excluded from a cash flow statement. Such transactions should be disclosed elsewhere in the financial statements in a way that provides all the relevant information about these investing and financing activities.**

57. Many investing and financing activities do not have a direct impact on current cash flows although they do affect the capital and asset structure of an entity. The exclusion of non-cash transactions from the cash flow statement is consistent with the objective of a cash flow statement as these items do not involve cash flows in the current period. Examples of non-cash transactions are:

    (a) The acquisition of assets through the exchange of assets, the assumption of directly related liabilities or by means of a finance lease; and

    (b) The conversion of debt to equity.

Components of Cash and Cash Equivalents

58. **An entity should disclose the components of cash and cash equivalents and should present a reconciliation of the amounts in its cash flow**

statement with the equivalent items reported in the statement of financial position.

59. In view of the variety of cash management practices and banking arrangements around the world and in order to comply with IPSAS 1, "Presentation of Financial Statements," an entity discloses the policy which it adopts in determining the composition of cash and cash equivalents.

60. The effect of any change in the policy for determining components of cash and cash equivalents, for example, a change in the classification of financial instruments previously considered to be part of an entity's investment portfolio, is reported in accordance with IPSAS 3.

Other Disclosures

61. **An entity should disclose, together with a commentary by management in the notes to the financial statements, the amount of significant cash and cash equivalent balances held by the entity that are not available for use by the economic entity.**

62. There are various circumstances in which cash and cash equivalent balances held by an entity are not available for use by the economic entity. Examples include cash and cash equivalent balances held by a controlled entity that operates in a country where exchange controls or other legal restrictions apply when the balances are not available for general use by the controlling entity or other controlled entities.

63. Additional information may be relevant to users in understanding the financial position and liquidity of an entity. Disclosure of this information, together with a description in the notes to the financial statements, is encouraged and may include:

    (a) The amount of undrawn borrowing facilities that may be available for future operating activities and to settle capital commitments, indicating any restrictions on the use of these facilities;

    (b) The aggregate amounts of the cash flows from each of operating, investing and financing activities related to interests in joint ventures reported using proportionate consolidation; and

    (c) The amount and nature of restricted cash balances.

64. Where appropriations or budget authorizations are prepared on a cash basis, the cash flow statement may assist users in understanding the relationship between the entity's activities or programs and the government's budgetary information. Refer to IPSAS 1 for a brief discussion of the comparison of actual and budgeted figures.

Effective Date

65. **This International Public Sector Accounting Standard becomes effective for annual financial statements covering periods beginning on or after July 1, 2001. Earlier application is encouraged.**

66. When an entity adopts the accrual basis of accounting, as defined by International Public Sector Accounting Standards, for financial reporting purposes, subsequent to this effective date, this Standard applies to the entity's annual financial statements covering periods beginning on or after the date of adoption.

Appendix

Cash Flow Statement (For an Entity Other Than a Financial Institution)

This appendix is illustrative only and does not form part of the standards. The purpose of this appendix is to illustrate the application of the standards to assist in clarifying their meaning.

Direct Method Cash Flow Statement (paragraph 27(a))

Public Sector Entity—Consolidated Cash Flow Statement for Year Ended 31 December 20X2 (In Thousands of Currency Units)

	20X2	**20X1**
CASH FLOWS FROM OPERATING ACTIVITIES		
Receipts		
Taxation	X	X
Sales of goods and services	X	X
Grants	X	X
Interest received	X	X
Other receipts	X	X
Payments		
Employee costs	(X)	(X)
Superannuation	(X)	(X)
Suppliers	(X)	(X)
Interest paid	(X)	(X)
Other payments	(X)	(X)
Net cash flows from operating activities	X	X
CASH FLOWS FROM INVESTING ACTIVITIES		
Purchase of plant and equipment	(X)	(X)
Proceeds from sale of plant and equipment	X	X
Proceeds from sale of investments	X	X
Purchase of foreign currency securities	(X)	(X)
Net cash flows from investing activities	(X)	(X)

CASH FLOWS FROM FINANCING ACTIVITIES		
Proceeds from borrowings	X	X
Repayment of borrowings	(X)	(X)
Distribution/dividend to government	(X)	(X)
Net cash flows from financing activities	X	X
Net increase/(decrease) in cash and cash equivalents	X	X
Cash and cash equivalents at beginning of period	X	X
Cash and cash equivalents at end of period	X	X

Notes to the Cash Flow Statement

(a) Cash and Cash Equivalents

Cash and cash equivalents consist of cash on hand and balances with banks and investments in money market instruments. Cash and cash equivalents included in the cash flow statement comprise the following statement of financial position amounts:

	20X2	20X1
Cash on hand and balances with banks	X	X
Short-term investments	X	X
	X	X

The entity has undrawn borrowing facilities of X, of which X must be used on infrastructure projects.

(b) Property, Plant and Equipment

During the period, the economic entity acquired property, plant and equipment with an aggregate cost of X of which X was acquired by means of capital grants by the national government. Cash payments of X were made to purchase property, plant and equipment.

(c) Reconciliation of Net Cash Flows from Operating Activities to Net Surplus/(Deficit) from Ordinary Activities (in thousands of currency units)

	20X2	20X1
Surplus/(deficit) from ordinary activities	X	X
Non-cash movements		
Depreciation	X	X
Amortization	X	X
Increase in provision for doubtful debts	X	X
Increase in payables	X	X
Increase in borrowings	X	X
Increase in provisions relating to employee costs	X	X
(Gains)/losses on sale of property, plant and equipment	(X)	(X)
(Gains)/losses on sale of investments	(X)	(X)
Increase in other current assets	(X)	(X)
Increase in investments due to revaluation	(X)	(X)
Increase in receivables	(X)	(X)
Extraordinary item[1]	(X)	–
Net cash flows from operating activities	X	X

1 This extraordinary item falls within the definition of operating activities.

Indirect Method Cash Flow Statement (paragraph 27(b))

Public Sector Entity—Consolidated Cash Flow Statement for Year Ended 31 December 20X2 (In Thousands of Currency Units)

	20X2	20X1
CASH FLOWS FROM OPERATING ACTIVITIES		
Surplus/(deficit) from ordinary activities	X	X
Non-cash movements		
Depreciation	X	X
Amortization	X	X
Increase in provision for doubtful debts	X	X
Increase in payables	X	X
Increase in borrowings	X	X
Increase in provisions relating to employee costs	X	X
(Gains)/losses on sale of property, plant and equipment	(X)	(X)
(Gains)/losses on sale of investments	(X)	(X)
Increase in other current assets	(X)	(X)
Increase in investments due to revaluation	(X)	(X)
Increase in receivables	(X)	(X)
Extraordinary item	(X)	–
Net cash flows from operating activities	X	X
CASH FLOWS FROM INVESTING ACTIVITIES		
Purchase of plant and equipment	(X)	(X)
Proceeds from sale of plant and equipment	X	X
Proceeds from sale of investments	X	X
Purchase of foreign currency securities	(X)	(X)
Net cash flows from investing activities	(X)	(X)
CASH FLOWS FROM FINANCING ACTIVITIES		
Proceeds from borrowings	X	X
Repayment of borrowings	(X)	(X)
Distribution/dividend to government	(X)	(X)

Notes to the Cash Flow Statement

(a) Cash and Cash Equivalents

Cash and cash equivalents consist of cash on hand and balances with banks and investments in money market instruments. Cash and cash equivalents included in the cash flow statement comprise the following statement of financial position amounts:

	20X2	**20X1**
Cash on hand and balances with banks	X	X
Short-term investments	X	X
	X	X

The entity has undrawn borrowing facilities of X, of which X must be used on infrastructure projects.

(b) Property, Plant and Equipment

During the period, the economic entity acquired property, plant and equipment with an aggregate cost of X of which X was acquired by means of capital grants by the national government. Cash payments of X were made to purchase property, plant and equipment.

Comparison with IAS 7

International Public Sector Accounting Standard (IPSAS) 2, "Cash Flow Statements," is drawn primarily from International Accounting Standard (IAS) 7, "Cash Flow Statements." The main differences between IPSAS 2 and IAS 7 are as follows:

- Commentary additional to that in IAS 7 has been included in IPSAS 2 to clarify the applicability of the standards to accounting by public sector entities.
- IPSAS 2 uses different terminology, in certain instances, from IAS 7. The most significant examples are the use of the terms "entity," "revenue," "statement of financial performance," "statement of financial position" and "net assets/equity" in IPSAS 2. The equivalent terms in IAS 7 are "enterprise," "income," "income statement," "balance sheet" and "equity."
- IPSAS 2 contains a different set of definitions of technical terms from IAS 7 (paragraph 8).
- In common with IAS 7, IPSAS 2 allows either the direct or indirect method to be used to present cash flows from operating activities. Where the direct method is used to present cash flows from operating activities, IPSAS 2 encourages disclosure of a reconciliation of net surplus from ordinary activities to operating cash flows in the notes to the financial statements (paragraph 29).
- The Appendix to IPSAS 2 does not include an illustration of a Cash Flow Statement for a financial institution.

IPSAS 3—NET SURPLUS OR DEFICIT FOR THE PERIOD, FUNDAMENTAL ERRORS AND CHANGES IN ACCOUNTING POLICIES

Acknowledgment

This International Public Sector Accounting Standard is drawn primarily from International Accounting Standard (IAS) 8, "Net Profit or Loss for the Period, Fundamental Errors and Changes in Accounting Policies" 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 IASC. The International Accounting Standards (IASs) issued by IASC remain in force until they are amended or withdrawn by IASB. Extracts from IAS 8 are reproduced in this publication of the Public Sector Committee of the International Federation of Accountants with the permission of IASB.

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IPSAS 3—NET SURPLUS OR DEFICIT FOR THE PERIOD, FUNDAMENTAL ERRORS AND CHANGES IN ACCOUNTING POLICIES

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The standards, which have been set in bold type, should be read in the context of the commentary paragraphs in this Standard, which are in plain type, and in the context of the "Preface to International Public Sector Accounting Standards." International Public Sector Accounting Standards are not intended to apply to immaterial items.

Objective

The objective of this Standard is to prescribe the classification, disclosure and accounting treatment of certain items in the financial statements so that all entities prepare and present these items on a consistent basis. This enhances comparability both with the entity's financial statements of previous periods and with the financial statements of other entities.

Accordingly, this Standard requires the classification and disclosure of extraordinary items and the separate disclosure of certain items in the financial statements. It also specifies the accounting treatment for changes in accounting estimates, changes in accounting policies and the correction of fundamental errors.

The disclosure of extraordinary items in the cash flow statement is required by International Public Sector Accounting Standard (IPSAS) 2, "Cash Flow Statements."

Scope

1. **An entity which prepares and presents financial statements under the accrual basis of accounting should apply this Standard in presenting surplus or deficit from ordinary activities and extraordinary items in the statement of financial performance and in accounting for changes in accounting estimates, fundamental errors and changes in accounting policies.**

2. This Standard deals with, among other things, the disclosure of certain items of net surplus or deficit for the period. These disclosures are made in addition to any other disclosures required by other International Public Sector Accounting Standards, including IPSAS 1, "Presentation of Financial Statements."

3. The tax effects of extraordinary items, fundamental errors and changes in accounting policies are not considered in this Standard as they are not relevant for many public sector entities. International Accounting Standard (IAS) 12, "Income Taxes" contains guidance on the treatment of tax effects. Where IAS 12 refers to unusual items, this should be read as extraordinary items as defined in this Standard.

4. **This Standard applies to all public sector entities other than Government Business Enterprises.**

5. Government Business Enterprises (GBEs) are required to comply with International Accounting Standards (IASs) issued by the International Accounting Standards Committee. The Public Sector Committee's Guideline No. 1, "Financial Reporting by Government Business Enterprises" notes that IASs are relevant to all business enterprises, regardless of whether they are in the private or public sector. Accordingly, Guideline No. 1 recommends that GBEs should present financial statements that conform, in all material respects, to IASs.

Definitions

6. **The following terms are used in this Standard with the meanings specified:**

   Accounting policies are the specific principles, bases, conventions, rules and practices adopted by an entity in preparing and presenting financial statements.

   Accrual basis means 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.

   Assets are resources controlled by an entity as a result of past events and from which future economic benefits or service potential are expected to flow to the entity.

   Borrowing costs are interest and other expenses incurred by an entity in connection with the borrowing of funds.

   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.

   Cash flows are inflows and outflows of cash and cash equivalents.

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

   (a) **Conveys entitlement both to distributions of future economic benefits or service potential by the entity during its life, such**

distributions being at the discretion of the owners or their representatives, and to distributions of any excess of assets over liabilities in the event of the entity being wound up; and/or

(b) **Can be sold, exchanged, transferred or redeemed.**

Control is the power to govern the financial and operating policies of another entity so as to benefit from its activities.

A discontinued operation[1] 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.

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

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

Extraordinary items are 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.

Financing activities are activities that result in changes in the size and composition of the contributed capital and borrowings of the entity.

Foreign entity is a foreign operation, the activities of which are not an integral part of those of the reporting entity.

Foreign operation is 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.

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1 IFAC PSC has not yet addressed the issue of discontinuing operations, which was previously included within International Accounting Standard (IAS) 8 (Revised 1993), "Net Profit/Loss for the Period, Fundamental Errors and Changes in Accounting Policies" and which is now the subject of a separate Standard, International Accounting Standard (IAS) 35, "Discontinuing Operations."

Fundamental errors are 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.

Government Business Enterprise means an entity that has all the following characteristics:

(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.**

Liabilities are present obligations of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits or service potential.

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

Net surplus/deficit comprises the following components:

(a) **Surplus or deficit from ordinary activities; and**

(b) **Extraordinary items.**

Operating activities are the activities of the entity that are not investing or financing activities.

Ordinary activities are 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.

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

Surplus/deficit from ordinary activities is the residual amount that remains after expenses arising from ordinary activities have been deducted from revenue arising from ordinary activities.

Future Economic Benefits or Service Potential

7. 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 Standard uses the term "future economic benefits or service potential" to describe the essential characteristic of assets.

Government Business Enterprises

8. 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. 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.

Net Assets/Equity

9. "Net assets/equity" is the term used in this Standard 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.

Net Surplus or Deficit for the Period

10. **All items of revenue and expense recognized in a period should be included in the determination of the net surplus or deficit for the period unless an International Public Sector Accounting Standard requires or permits otherwise.**

11. Normally, all items of revenue and expense recognized in a period are included in the determination of the net surplus or deficit for the period. This includes extraordinary items and the effects of changes in accounting

estimates. However, circumstances may exist when certain items may be excluded from net surplus or deficit for the current period. This Standard deals with two such circumstances: the correction of fundamental errors and the effect of changes in accounting policies.

12. Other International Public Sector Accounting Standards deal with items which may meet definitions of revenue or expense but which are usually excluded from the determination of net surplus or deficit. Examples include a revaluation surplus on physical assets (which are accounted for in accordance with appropriate standards on property, plant and equipment) and gains and losses arising on the translation of the financial statements of a foreign entity (see IPSAS 4, "The Effects of Changes in Foreign Exchange Rates)."

13. **The net surplus or deficit for the period comprises the following components, each of which should be disclosed on the face of the statement of financial performance:**

    (a) **Surplus or deficit from ordinary activities; and**

    (b) **Extraordinary items.**

Extraordinary Items

14. **The nature and the amount of each extraordinary item should be separately disclosed.**

15. Extraordinary items should be separately disclosed in the statement of financial performance.

16. Extraordinary items should be rare, unusual and material. The disclosure of cash flows associated with extraordinary items within a cash flow statement is required by IPSAS 2. IPSAS 2 outlines the requirements for the disclosure of extraordinary items within a cash flow statement. It requires that the cash flows associated with extraordinary items be classified as arising from operating, investing or financing activities as appropriate, and separately disclosed.

Distinct from Ordinary Activities

17. Virtually all items of revenue and expense included in the determination of net surplus or deficit for the period arise in the course of the ordinary activities of the entity.

18. Whether an event or transaction is clearly distinct from the ordinary activities of the entity is determined by the nature of the event or transaction in relation to the activities ordinarily carried on by the entity rather than by the frequency with which such events are expected to occur.

An event or transaction may be extraordinary for one entity or level of government, but not extraordinary for another entity or level of government because of the differences between their respective ordinary activities. In the context of whole-of-government reporting, extraordinary items will be extremely rare.

Not Expected to Recur in Foreseeable Future

19. The event or transaction should be of a type that would not reasonably be expected to recur in the foreseeable future, taking into account the environment in which the entity operates. The nature of extraordinary items is such that they would not normally be anticipated at the beginning of a reporting period and therefore would not be included in a budget. Inclusion of an item in a budget suggests that the occurrence of the item is foreseen and therefore not extraordinary.

Outside the Control or Influence of the Entity

20. The event or transaction should be outside the control or influence of the entity. An event or transaction is presumed to be outside the control or influence of an entity if the decisions or determinations of the entity do not normally influence the occurrence of that transaction or event. However, a gain or loss arising because of a decision to sell an asset rather than hold the asset is not to be considered extraordinary because the event originated within the entity and was therefore within the control or influence of management.

Examples of Extraordinary Items

21. Examples of extraordinary items should be considered in the context of the entity's operating environment and the level of government within which it operates. Judgment should be exercised in each case. Although an event may meet the definition of an extraordinary item for a particular level of government, for example, local or provincial government, it is unlikely that many events will be extraordinary in the context of a national government.

22. Examples of the costs associated with events or transactions that may, although not necessarily, give rise to extraordinary items for some public sector entities or levels of government are:

    (a) Short-term costs associated with the provision of services to refugees where the need for such services was unforeseen at the beginning of the period, outside the ordinary scope of activities for the entity and outside the control of the entity. If such services were provided for more than one reporting period they would not generally be classified as extraordinary; and

    (b) The costs associated with the provision of services following a natural or man-made disaster, for example, the provision of shelter

to homeless people following an earthquake. In order for a such an event to qualify as an extraordinary event it would need to be of a magnitude that would not normally be expected in either the geographic area in which it occurred or the geographic area associated with the entity, and the provision of emergency services or the restoration of essential services would need to be outside the scope of ordinary activities of the entity concerned. Where an entity has responsibility for providing assistance to those affected by natural disasters then costs associated with this activity would not generally meet the definition of an extraordinary item.

23. By contrast, the following activities, or the prevention of such activities, are generally within the control of an entity and would rarely, if ever, be extraordinary for an entity:

    (a) Gains or losses from exchange of foreign currencies;

    (b) The gain or loss on disposal of an activity of the entity; and

    (c) Restructuring costs.

24. The restructuring of activities is an example of an event which would not normally be extraordinary for either an individual public sector entity or the whole-of-government entity which incorporates that government body. All three criteria within the definition of an extraordinary item must be satisfied before an item can be classified as extraordinary. A restructuring may clearly be distinct from the ordinary activities of the entity. However, at the whole-of-government level, restructuring may occur frequently. More importantly, restructuring is usually within the control or influence of a whole-of-government entity.

Disclosure of Extraordinary Items

25. The disclosure of the nature and amount of each extraordinary item may be made on the face of the statement of financial performance, or in the notes to the financial statements. If disclosure is made in the notes to the financial statements, the total amount of all extraordinary items should be disclosed on the face of the statement of financial performance.

Surplus or Deficit from Ordinary Activities

26. **When items of revenue and expense within surplus or deficit from ordinary activities are of such size, nature or incidence that their disclosure is relevant to explain the performance of the entity for the period, the nature and amount of such items should be disclosed separately.**

27. Although the items described in paragraph 26 are not extraordinary items, the nature and amount of such items may be relevant to users of financial statements. The disclosures may assist users in understanding the financial position and performance of an entity and in making projections about financial position and performance. Disclosure of such information is usually made in the notes to the financial statements.

28. Circumstances which may give rise to the separate disclosure of items of revenue and expense in accordance with paragraph 26 include:

    (a) The write-down of inventories to net realizable value or property, plant and equipment to recoverable amount, as well as the reversal of such write-downs;

    (b) A restructuring of the activities of an entity and the reversal of any provisions for the costs of restructuring;

    (c) Disposals of items of property, plant and equipment;

    (d) Privatizations or other disposals of long-term investments;

    (e) Discontinued operations;

    (f) Litigation settlements; and

    (g) Other reversals of provisions.

29. Where the impact of a government's restructuring has a material impact upon the financial statements, relevant disclosures in relation to the statement of financial performance would include staff expenses such as redundancy or retraining, relocation and refurbishment expenses, and the net surplus or deficit associated with the sale or disposal of assets.

Changes in Accounting Estimates

30. As a result of the uncertainties inherent in delivering services, conducting trading or other activities, many financial statement items cannot be measured with precision but can only be estimated. The estimation process involves judgments based on the latest information available. Estimates may be required, for example, of tax revenue due to government, bad debts arising from uncollected taxes, inventory obsolescence, the useful lives or expected pattern of consumption of economic benefits or service potential of depreciable assets, or the percentage completion of road construction. The use of reasonable estimates is an essential part of the preparation of financial statements and does not undermine their reliability.

31. An estimate may have to be revised if changes occur regarding the circumstances on which the estimate was based or as a result of new information, more experience or subsequent developments. By its nature,

the revision of the estimate does not bring the adjustment within the definitions of an extraordinary item or a fundamental error.

32. Sometimes it is difficult to distinguish between a change in accounting policy and a change in an accounting estimate. In such cases, the change is treated as a change in an accounting estimate, with appropriate disclosure.

33. **The effect of a change in an accounting estimate should be included in the determination of net surplus or deficit in:**

    (a) **The period of the change, if the change affects the period only; or**

    (b) **The period of the change and future periods, if the change affects both.**

34. A change in an accounting estimate may affect the current period only or both the current period and future periods. For example, a change in the estimate of the amount of bad debts affects only the current period and is therefore recognized immediately. However, a change in the estimated useful life or the expected pattern of consumption of economic benefits or service potential of a depreciable asset affects the depreciation expense in the current period and in each period during the remaining useful life of the asset. In both cases, the effect of the change relating to the current period is recognized as revenue or expense in the current period. The effect, if any, on future periods is recognized in future periods.

35. **The effect of a change in an accounting estimate should be included in the same statement of financial performance classification as was used previously for the estimate.**

36. To ensure the comparability of financial statements of different periods, the effect of a change in an accounting estimate for estimates which were previously included in the surplus or deficit from ordinary activities is included in that component of net surplus or deficit. The effect of a change in an accounting estimate for an estimate which was previously included as an extraordinary item is reported as an extraordinary item.

37. **The nature and amount of a change in an accounting estimate that has a material effect in the current period or which is expected to have a material effect in subsequent periods should be disclosed. If it is impracticable to quantify the amount, this fact should be disclosed.**

Fundamental Errors

38. Errors in the preparation of the financial statements of one or more prior periods may be discovered in the current period. Errors may occur as a result of mathematical mistakes, mistakes in applying accounting policies, misinterpretation of facts, fraud or oversights. The correction of these errors is normally included in the determination of net surplus or deficit for the current period.

39. On rare occasions, an error has such a significant effect on the financial statements of one or more prior periods that those financial statements can no longer be considered to have been reliable at the date of their issue. These errors are referred to as fundamental errors. An example of a fundamental error is the omission of a major class of revenue or expense from the financial statements. The correction of fundamental errors that relate to prior periods requires the restatement of the comparative information or the presentation of additional pro forma information.

40. The correction of fundamental errors can be distinguished from changes in accounting estimates. Accounting estimates by their nature are approximations that may need revision as additional information becomes known. For example, the gain or loss recognized on the outcome of a contingency which previously could not be estimated reliably does not constitute the correction of a fundamental error.

Benchmark Treatment

41. **The amount of the correction of a fundamental error that relates to prior periods should be reported by adjusting the opening balance of accumulated surpluses or deficits. Comparative information should be restated, unless it is impracticable to do so.**

42. The financial statements, including the comparative information for prior periods, are presented as if the fundamental error had been corrected in the period in which it was made. Therefore the amount of the correction that relates to each period presented is included within the net surplus or deficit for that period. The amount of the correction relating to periods prior to those included in the comparative information in the financial statements is adjusted against the opening balance of accumulated surpluses or deficits in the earliest period presented. Any other information reported with respect to prior periods, such as historical summaries of financial data, is also restated.

43. The restatement of comparative information does not necessarily give rise to the amendment of financial statements which have been approved by the governing body or registered or filed with regulatory authorities. However, national laws may require the amendment of such financial statements.

44. **An entity should disclose the following:**

    (a) **The nature of the fundamental error;**

    (b) **The amount of the correction for the current period and for each prior period presented;**

    (c) **The amount of the correction relating to periods prior to those included in the comparative information; and**

    (d) **The fact that comparative information has been restated or that it is impracticable to do so.**

Allowed Alternative Treatment

45. **The amount of the correction of a fundamental error should be included in the determination of net surplus or deficit for the current period. Comparative information should be presented as reported in the financial statements of the prior period. Additional pro forma information, prepared in accordance with paragraph 41, should be presented unless it is impracticable to do so.**

46. The correction of the fundamental error is included in the determination of the net surplus or deficit for the current period. However, additional information is presented, often as separate columns, to show the net surplus or deficit of the current period and any prior periods presented as if the fundamental error had been corrected in the period when it was made. It may be necessary to apply this accounting treatment in countries where the financial statements are required to include comparative information which agrees with the financial statements presented in prior periods.

47. **An entity should disclose the following:**

    (a) **The nature of the fundamental error;**

    (b) **The amount of the correction included in each period for which pro forma information is presented and the amount of the correction relating to periods prior to those included in the pro forma information. If it is impracticable to present pro forma information, this fact should be disclosed; and**

    (c) **The amount of any correction recognized in net surplus or deficit for the current period.**

Changes in Accounting Policies

48. Users need to be able to compare the financial statements of an entity over a period of time to identify trends in its financial position, performance and cash flows. Therefore the same accounting policies are normally adopted in each period.

49. **The selection and application of accounting policies are discussed in IPSAS 1. A change from one basis of accounting to another basis of accounting is a change in accounting policy.**

50. **A change in the accounting treatment, recognition or measurement of a transaction or event within a basis of accounting is regarded as a change in accounting policy.**

51. **A change in accounting policy should be made only if required by statute (including a mandatory regulation), or by an accounting standard setting body, or if the change will result in more relevant or reliable information about the financial position, financial performance or cash flows of the entity.**

52. The following are not changes in accounting policies:

    (a) The adoption of an accounting policy for events or transactions that differ in substance from previously occurring events or transactions; and

    (b) The adoption of a new accounting policy for events or transactions which did not occur previously or that were immaterial.

53. The initial adoption of a policy to carry assets at revalued amounts is a change in accounting policy. However, where another appropriate accounting standard establishes requirements for dealing with revaluations in relation to a specific class of assets, such as property, plant and equipment, such changes should be dealt with in accordance with that Standard.

54. A change in accounting policy is applied retrospectively or prospectively in accordance with the requirements of this Standard. Retrospective application results in the new accounting policy being applied to events and transactions as if the new accounting policy had always been in use. Therefore, the accounting policy is applied to events and transactions from the date of origin of such items. Prospective application means that the new accounting policy is applied to the events and transactions occurring after the date of the change. With respect to prospective application, no adjustments relating to prior periods are made either to the opening balance of accumulated surpluses or deficits or in reporting the net surplus or deficit for the current period because existing balances are not recalculated. However, the new accounting policy is applied to existing balances as from the date of the change. For example, an entity may decide to change its accounting policy for borrowing costs and capitalize those costs in conformity with the allowed alternative treatment in IPSAS 5, "Borrowing Costs." Under prospective application, the new policy only applies to

borrowing costs that are incurred after the date of the change in accounting policy.

Adoption of an International Public Sector Accounting Standard

55. **A change in accounting policy which is made on the adoption of an International Public Sector Accounting Standard should be accounted for in accordance with the specific transitional provisions, if any, in that International Public Sector Accounting Standard. In the absence of any transitional provisions, the change in accounting policy should be applied in accordance with the benchmark treatment in paragraphs 59, 60, 63 and 64 or the allowed alternative in paragraphs 65, 67 and 68.**

56. The transitional provisions in an International Public Sector Accounting Standard may require either a retrospective or a prospective application of a change in accounting policy.

57. IPSAS 1 sets out the principles to be applied in the selection and application of accounting policies.

58. When an entity has not adopted a new International Public Sector Accounting Standard which has been published but which has not yet come into effect, the entity is encouraged to disclose the nature of the future change in accounting policy and an estimate of the effect of the change on its net surplus or deficit, financial position, and/or net increase/(decrease) in cash and cash equivalents as appropriate.

Other Changes in Accounting Policies—Benchmark Treatment

59. **A change in accounting policy should be applied retrospectively unless the amount of any resulting adjustment that relates to prior periods is not reasonably determinable.**

60. **Any resulting adjustment should be reported as an adjustment to the opening balance of accumulated surpluses or deficits. Comparative information should be restated unless it is impracticable to do so.**

61. The financial statements, including the comparative information for prior periods, are presented as if the new accounting policy had always been in use. Therefore, comparative information is restated in order to reflect the new accounting policy. The amount of the adjustment relating to periods prior to those included in the financial statements is adjusted against the opening balance of accumulated surpluses or deficits of the earliest period presented. Any other information with respect to prior periods, such as historical summaries of financial data, is also restated.

62. The restatement of comparative information does not necessarily give rise to the amendment of financial statements which have been approved by the governing body or registered or filed with regulatory authorities. However, national laws may require the amendment of such financial statements.

63. **The change in accounting policy should be applied prospectively when the amount of the adjustment to the opening balances required by paragraph 60 cannot be reasonably determined.**

64. **When a change in accounting policy has a material effect on the current period or any prior period presented, or may have a material effect in subsequent periods, an entity should disclose the following:**

    (a) **The reasons for the change;**

    (b) **The amount of the adjustment for the current period and for each period presented;**

    (c) **The amount of the adjustment relating to periods prior to those included in the comparative information; and**

    (d) **The fact that comparative information has been restated or that it is impracticable to do so.**

Other Changes in Accounting Policies—Allowed Alternative Treatment

65. **A change in accounting policy should be applied retrospectively unless the amount of any resulting adjustment that relates to prior periods is not reasonably determinable. Any resulting adjustment should be included in the determination of the net surplus or deficit for the current period. Comparative information should be presented as reported in the financial statements of the prior period. Additional pro forma comparative information, prepared in accordance with paragraph 60, should be presented unless it is impracticable to do so.**

66. Adjustments resulting from a change in accounting policy are included in the determination of the net surplus or deficit for the period. However, additional comparative information is presented, often as separate columns, in order to show the net surplus or deficit and the financial position of the current period and any prior periods presented as if the new accounting policy had always been applied. It may be necessary to apply this accounting treatment in countries where the financial statements are required to include comparative information which agrees with the financial statements presented in prior periods.

67. **The change in accounting policy should be applied prospectively when the amount to be included in net surplus or deficit for the current period required by paragraph 65 cannot be reasonably determined.**

68. **When a change in accounting policy has a material effect on the current period or any prior period presented, or may have a material effect in subsequent periods, an entity should disclose the following:**

    (a) **The reasons for the change;**

    (b) **The amount of the adjustment recognized in net surplus or deficit in the current period; and**

    (c) **The amount of the adjustment included in each period for which pro forma information is presented and the amount of the adjustment relating to periods prior to those included in the financial statements. If it is impracticable to present pro forma information, this fact should be disclosed.**

Effective Date

69. **This International Public Sector Accounting Standard becomes effective for annual financial statements covering periods beginning on or after July 1, 2001. Earlier application is encouraged.**

70. When an entity adopts the accrual basis of accounting, as defined by International Public Sector Accounting Standards, for financial reporting purposes, subsequent to this effective date, this Standard applies to the entity’s annual financial statements covering periods beginning on or after the date of adoption.

Appendix

This appendix is illustrative only and does not form part of the standards. The purpose of this appendix is to illustrate the application of the standards and to assist in clarifying their meaning. Extracts from the financial statements are provided to show the effects on the financial statements of the transactions described in this appendix. These extracts do not necessarily conform with all the disclosure and presentation requirements of other International Public Sector Accounting Standards.

Extraordinary Items

The examples shown below are intended to illustrate the disclosure of extraordinary items in a statement of financial performance. The disclosure of extraordinary items in a cash flow statement is required by IPSAS 2. The classification of an event or transaction as extraordinary is dependent upon the nature of the event and the entity. Events or transactions which may be an extraordinary item for one entity may not be extraordinary for another entity. In particular, few events are likely to be extraordinary at the whole-of-government level.

Public Sector Entity—Statement of Financial Performance (Extract)

	20X2	20X1
Surplus from ordinary activities	7,900	8,400
Extraordinary item — loss on destruction of overseas broadcasting operation (Note 1)	–	(3,150)
Net surplus for the period	7,900	5,250

Extracts from Notes to the Financial Statements

1. On 1 October 20X1, the overseas broadcasting operations of the entity were destroyed by an earthquake. The results of this operation had previously been reported in the “Broadcasting” segment. The loss arising from the earthquake has been accounted for as an extraordinary item as earthquakes are uncommon in this region. The loss arising from the earthquake is the net carrying amount of the assets and liabilities of the operation at the date of the earthquake. The revenues recognized relating to this operation from 1 January 20X1 until 1 October 20X1 were 10,000 and the surplus was 2,000.

Fundamental Errors

During 20X2, the entity discovered that revenue from income taxes was incorrect. Income taxes of 6,500 that should have been recognized in 20X1 were incorrectly omitted from 20X1 and recognized as revenue in 20X2.

The entity's accounting records for 20X2 show revenue from taxation of 60,000 (including the 6,500 taxation which should have been recognized in 20X1), and expenses of 86,500.

In 20X1, the entity reported:

Revenue from taxation	34,000
User charges	3,000
Other operating revenue	30,000
Total revenue	67,000
Expenses	(60,000)
Net surplus	7,000

Public Sector Entity—Statement of Financial Performance under the Benchmark Treatment *(Extract)*

	20X2	20X1 (restated)
Revenue from taxation	53,500	40,500
User charges	4,000	3,000
Other operating revenue	40,000	30,000
Total revenue	97,500	73,500
Expenses	(86,500)	(60,000)
Net surplus	11,000	13,500

Public Sector Entity—Statement of Changes in Net Assets/Equity under the Benchmark Treatment

	20X2	20X1 (restated)
Opening accumulated surpluses as previously reported	17,000	10,000
Correction of fundamental error (Note 1)	6,500	–
Opening accumulated surpluses	23,500	10,000
Net surplus	11,000	13,500
Closing accumulated surpluses	34,500	23,500

Extracts from Notes to the Financial Statements

2. Revenue from taxation of 6,500 was incorrectly omitted from the financial statements of 20X1. The financial statements of 20X1 have been restated to correct this error.

Public Sector Entity—Statement of Financial Performance under the Allowed Alternative Treatment (Extract)

			Pro forma	
	20X2	20X1	20X2 (restated)	20X1 (restated)
Revenue from taxation (Note 1)	60,000	34,000	53,500	40,500
User charges	4,000	3,000	4,000	3,000
Other operating revenue	40,000	30,000	40,000	30,000
Total revenue	104,000	67,000	97,500	73,500
Expenses	(86,500)	(60,000)	(86,500)	(60,000)
Net surplus	17,500	7,000	11,000	13,500

Public Sector Entity—Statement of Changes in Net Assets/Equity under the Allowed Alternative Treatment

			Pro forma	
	20X2	20X1	20X2 (restated)	20X1 (restated)
Opening accumulated surpluses as previously reported	17,000	10,000	17,000	10,000
Correction of fundamental error (Note 1)	–	–	6,500	–
Opening accumulated surpluses as restated	17,000	10,000	23,500	10,000
Net surplus	17,500	7,000	11,000	13,500
Closing accumulated surpluses	34,500	17,000	34,500	23,500

Extracts from Notes to the Financial Statements

3. Revenue from taxation of 6,500 was incorrectly omitted from the financial statements of 20X1. Restated pro forma information for 20X2 and 20X1 is presented as if the error had been corrected in 20X1.

Changes in Accounting Policy

During 20X2, the entity changed its accounting policy with respect to the treatment of borrowing costs that are directly attributable to the acquisition of a hydro-electric power station which is under construction. In previous periods, the entity had capitalized such costs in accordance with the allowed alternative treatment in IPSAS 5. The entity has now decided to expense, rather than capitalize, these costs in order to conform with the benchmark treatment in IPSAS 5.

The entity capitalized borrowing costs of 2,600 during 20X1 and 5,200 in periods prior to 20X1. All borrowing costs incurred in previous years with respect to the acquisition of the power station were capitalized.

The accounting records for 20X2 show surplus from operating activities before interest of 30,000; and interest expense of 3,000 (which relates only to 20X2).

In 20X1, the entity reported:

Surplus from operating activities before interest	18,000
Interest expense	–
Net surplus from ordinary activities	18,000

20X1 opening accumulated surpluses were 20,000 and closing accumulated surpluses were 38,000.

Public Sector Entity—Statement of Financial Performance under the Benchmark Treatment *(Extract)*

	20X2	**20X1 (restated)**
Surplus from operating activities before interest	30,000	18,000
Interest expense	(3,000)	(2,600)
Net surplus from ordinary activities	27,000	15,400

Public Sector Entity—Statement of Changes in Net Assets/Equity under the Benchmark Treatment

	20X2	**20X1 (restated)**
Opening accumulated surpluses as previously reported	38,000	20,000
Change in accounting policy with respect to the capitalization of interest (Note 1)	(7,800)	(5,200)
Opening accumulated surpluses as restated	30,200	14,800
Net surplus	27,000	15,400
Closing accumulated surpluses	57,200	30,200

Extracts from Notes to the Financial Statements

4. During 20X2, the entity changed its accounting policy with respect to the treatment of borrowing costs relating to a hydro-electric power station which is in the course of construction for use. In order to conform with the benchmark treatment in IPSAS 5, the entity now expenses rather than capitalizes such costs. This change in accounting policy has been accounted for retrospectively. The comparative statements for 20X1 have been restated to conform to the changed policy. The effect of the change is an increase in interest expense of 3,000 (20X2) and 2,600 (20X1). Opening accumulated surpluses for 20X1 have been reduced by 5,200 which is the amount of the adjustment relating to periods prior to 20X1.

Public Sector Entity—Statement of Financial Performance under the Allowed Alternative Treatment *(Extract)*

			Pro forma	
	20X2	20X1	20X2 (restated)	20X1 (restated)
Surplus from operating activities before interest	30,000	18,000	30,000	18,000
Interest expense	(3,000)	–	(3,000)	(2,600)
Cumulative effect of change in accounting policy	(7,800)	–	–	–
Net surplus	19,200	18,000	27,000	15,400

Public Sector Entity—Statement of Changes in Net Assets/Equity under the Allowed Alternative Treatment

			Pro forma	
	20X2	20X1	20X2 (restated)	20X1 (restated)
Opening accumulated surpluses as previously reported	38,000	20,000	38,000	20,000
Change in accounting policy with respect to the capitalization of interest (Note 1)	–	–	(7,800)	(5,200)
Opening accumulated surpluses as restated	38,000	20,000	30,200	14,800
Net surplus	19,200	18,000	27,000	15,400
Closing accumulated surpluses	57,200	38,000	57,200	30,200

Extracts from Notes to the Financial Statements

64. An adjustment of 7,800 has been made in the statement of financial performance for 20X2 representing the effect of a change in accounting policy with respect to the treatment of borrowing costs relating to the construction of a hydro-electric power station which is in the course of construction for use. In order to conform with the benchmark treatment in IPSAS 5, the entity now expenses rather than capitalizes such costs. This change in accounting policy has been accounted for retrospectively. Restated pro forma information, which assumes that the new policy had always been in use, is presented. The opening accumulated surpluses in the pro forma information for 20X1 have been reduced by 5,200 which is the amount of the adjustment relating to periods prior to 20X1.

Comparison with IAS 8

International Public Sector Accounting Standard (IPSAS) 3, "Net Surplus or Deficit for the Period, Fundamental Errors and Changes in Accounting Policies," is drawn primarily from International Accounting Standard (IAS) 8, "Net Profit or Loss for the Period, Fundamental Errors and Changes in Accounting Policies." The main differences between IPSAS 3 and IAS 8 are as follows:

- Commentary additional to that in IAS 8 has been included in IPSAS 3 to clarify the applicability of the standards to accounting by public sector entities.
- IPSAS 3 uses different terminology, in certain instances, from IAS 8. The most significant examples are the use of the terms "entity," "revenue," "statement of financial performance," "statement of financial position" and "net assets/equity" in IPSAS 3. The equivalent terms in IAS 8 are "enterprise," "income," "income statement," "balance sheet" and "equity."
- IPSAS 3 contains a different set of definitions of technical terms from IAS 8 (paragraph 6).
- IPSAS 3 contains a different definition of extraordinary items from IAS 8. IPSAS 3 contains a specific requirement that extraordinary items must be outside the control or influence of the entity (paragraph 6).

IPSAS 4—THE EFFECTS OF CHANGES IN FOREIGN EXCHANGE RATES

Acknowledgment

This International Public Sector Accounting Standard is drawn primarily from International Accounting Standard (IAS) 21, "The Effects of Changes in Foreign Exchange Rates" 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 IASC. The International Accounting Standards (IASs) issued by IASC remain in force until they are amended or withdrawn by IASB. Extracts from IAS 21 are reproduced in this publication of the Public Sector Committee of the International Federation of Accountants with the permission of IASB.

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IPSAS 4—THE EFFECTS OF CHANGES IN FOREIGN EXCHANGE RATES

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The standards, which have been set in bold type, should be read in the context of the commentary paragraphs in this Standard, which are in plain type, and in the context of the "Preface to International Public Sector Accounting Standards." International Public Sector Accounting Standards are not intended to apply to immaterial items.

Objective

An entity may carry on foreign activities in two ways. It may have transactions in foreign currencies or it may have foreign operations. In order to include foreign currency transactions and foreign operations in the financial statements of an entity, transactions must be expressed in the entity's reporting currency and the financial statements of foreign operations must be translated into the entity's reporting currency.

The principal issues in accounting for foreign currency transactions and foreign operations are to decide which exchange rate to use and how to recognize in the financial statements the financial effect of changes in exchange rates.

Scope

1. **An entity which prepares and presents financial statements under the accrual basis of accounting should apply this Standard:**

   (a) **In accounting for transactions (including the subsequent reporting of monetary and non-monetary items) in foreign currencies; and**

   (b) **In translating the financial statements of foreign operations that are included in the financial statements of the entity by consolidation, proportionate consolidation or by the equity method.**

2. This Standard does not deal with hedge accounting for foreign currency items other than the classification of exchange differences arising on a foreign currency liability accounted for as a hedge of a net investment in a foreign entity. Accordingly, entities may apply relevant national accounting standards dealing with hedge accounting.

3. Guidance on other aspects of hedge accounting, including the criteria to use hedge accounting, can be found in International Accounting Standard (IAS) 39, "Financial Instruments: Recognition and Measurement."

4. **This Standard applies to all public sector entities other than Government Business Enterprises.**

5. Government Business Enterprises (GBEs) are required to comply with International Accounting Standards issued by the International Accounting

Standards Committee. The Public Sector Committee's Guideline No. 1, "Financial Reporting by Government Business Enterprises" notes that IASs are relevant to all business enterprises, regardless of whether they are in the private or public sector. Accordingly, Guideline No. 1 recommends that GBEs should present financial statements that conform, in all material respects, to IASs.

6. This Standard does not specify the currency in which an entity presents its financial statements. However, an entity normally uses the currency of the country in which it is domiciled. If it uses a different currency, this Standard requires disclosure of the reason for using that currency. This Standard also requires disclosure of the reason for any change in the reporting currency.

7. This Standard does not deal with the restatement of an entity's financial statements from its reporting currency into another currency for the convenience of users accustomed to that currency or for similar purposes.

8. This Standard deals with the presentation of revenue and expenses arising from transactions in a foreign currency and translating the financial statements of a foreign operation. It does not deal with the presentation in a cash flow statement of cash flows arising from transactions in a foreign currency and the translation of cash flows of a foreign operation (see International Public Sector Accounting Standard (IPSAS) 2, "Cash Flow Statements").

Definitions

9. **The following terms are used in this Standard with the meanings specified:**

   Accrual basis means 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.

   Assets are resources controlled by an entity as a result of past events and from which future economic benefits or service potential are expected to flow to the entity.

   Associate is an entity in which the investor has significant influence and which is neither a controlled entity nor a joint venture of the investor.

Cash comprises cash on hand and demand deposits.

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.

Cash flows are inflows and outflows of cash and cash equivalents.

Closing rate is the spot exchange rate at the reporting date.

Consolidated financial statements are the financial statements of an economic entity presented as those of a single entity.

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

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

(b) **Can be sold, exchanged, transferred or redeemed.**

Control is the power to govern the financial and operating policies of another entity so as to benefit from its activities.

Controlled entity is an entity that is under the control of another entity (known as the controlling entity).

Controlling entity is an entity that hs one or more controlled entities.

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

Economic entity means a group of entities comprising a controlling entity and one or more controlled entities.

Equity method is 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.

Exchange difference is the difference resulting from reporting the same number of units of a foreign currency in the reporting currency at different exchange rates.

Exchange rate is the ratio for exchange of two currencies.

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

Extraordinary items are 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.

Fair value is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.

Financing activities are activities that result in changes in the size and composition of the contributed capital and borrowings of the entity.

Foreign currency is a currency other than the reporting currency of an entity.

Foreign entity is a foreign operation, the activities of which are not an integral part of those of the reporting entity.

Foreign operation is 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.

Government Business Enterprise means an entity that has all the following characteristics:

(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.**

Investing activities are the acquisition and disposal of long-term assets and other investments not included in cash equivalents.

Joint venture is a binding arrangement whereby two or more parties are committed to undertake an activity which is subject to joint control.

Liabilities are present obligations of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits or service potential.

Minority interest is 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.

Monetary items are money held and assets and liabilities to be received or paid in fixed or determinable amounts of money.

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

Net investment in a foreign entity is the reporting entity's share in the net assets/equity of that entity.

Net surplus/deficit comprises the following components:

(a) **Surplus or deficit from ordinary activities; and**

(b) **Extraordinary items.**

Operating activities are the activities of the entity that are not investing or financing activities.

Ordinary activities are 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.

Proportionate consolidation is 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.

Reporting currency is the currency used in presenting the financial statements.

<u>Reporting date</u> means the date of the last day of the reporting period to which the financial statements relate.

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

<u>Surplus/deficit from ordinary activities</u> is the residual amount that remains after expenses arising from ordinary activities have been deducted from revenue arising from ordinary activities.

Economic Entity

10. The term "economic entity" is used in this Standard to define, for financial reporting purposes, a group of entities comprising the controlling entity and any controlled entities.

11. Other terms sometimes used to refer to an economic entity include "administrative entity," "financial reporting entity," "consolidated entity" and "group."

12. 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.

Future Economic Benefits or Service Potential

13. 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 Standard uses the term "future economic benefits or service potential" to describe the essential characteristic of assets.

Government Business Enterprises

14. 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. 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.

Net Assets/Equity

15. "Net assets/equity" is the term used in this Standard 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.

Foreign Currency Transactions

Initial Recognition

16. A foreign currency transaction is a transaction which is denominated in or requires settlement in a foreign currency, including transactions arising when an entity either:

    (a) Buys or sells goods or services whose price is denominated in a foreign currency;

    (b) Borrows or lends funds when the amounts payable or receivable are denominated in a foreign currency;

    (c) Becomes a party to an unperformed foreign exchange contract; or

    (d) Otherwise acquires or disposes of assets, or incurs or settles liabilities, denominated in a foreign currency.

17. **A foreign currency transaction should be recorded, on initial recognition in the reporting currency, by applying to the foreign currency amount the exchange rate between the reporting currency and the foreign currency at the date of the transaction.**

18. The exchange rate at the date of the transaction is often referred to as the spot rate. For practical reasons, a rate that approximates the actual rate at the date of the transaction is often used, for example, an average rate for a week or a month might be used for all transactions in each foreign currency occurring during that period. However, if exchange rates fluctuate significantly, the use of the average rate for a period is unreliable.

19. Exchange rate changes may have an impact on cash or cash equivalents held or due in a foreign currency. The presentation of such exchange differences is dealt with in IPSAS 2. Although these changes are not cash flows, the effect of exchange rate changes on cash or cash equivalents held or due in a foreign currency are reported in the cash flow statement in order to

reconcile cash and cash equivalents at the beginning and the end of the period. These amounts are presented separately from cash flows from operating, investing and financing activities and include the differences, if any, had those cash flows been reported at end-of-period exchange rates.

Reporting at Subsequent Reporting Dates

20. **At each reporting date:**

    (a) **Foreign currency monetary items should be reported using the closing rate;**

    (b) **Non-monetary items which are carried in terms of historical cost denominated in a foreign currency should be reported using the exchange rate at the date of the transaction; and**

    (c) **Non-monetary items which are carried at fair value denominated in a foreign currency should be reported using the exchange rates that existed when the values were determined.**

21. The carrying amount of an item is determined in accordance with the relevant International Public Sector Accounting Standards. For example, certain financial instruments and property, plant and equipment may be measured at fair value or at historical cost. Whether the carrying amount is determined based on historical cost or fair value, the amounts so determined for foreign currency items are then reported in the reporting currency in accordance with this Standard.

Recognition of Exchange Differences

22. Paragraphs 24 to 28 set out the accounting treatment required by this Standard in respect of exchange differences on foreign currency transactions. These paragraphs include the benchmark treatment for exchange differences that result from a severe devaluation or depreciation of a currency against which there is no practical means of hedging and that affects liabilities which cannot be settled and which arise directly on the recent acquisition of assets invoiced in a foreign currency. The allowed alternative treatment for such exchange differences is set out in paragraph 31.

23. This Standard does not deal with hedge accounting for foreign currency items other than the classification of exchange differences arising on a foreign currency liability accounted for as a hedge of a net investment in a foreign entity. Guidance in relation to other aspects of hedge accounting, including the criteria to use hedge accounting, can be found in IAS 39.

24. **Exchange differences arising on the settlement of monetary items or on reporting an entity's monetary items at rates different from those at**

which they were initially recorded during the period, or reported in previous financial statements, should be recognized as revenue or as expenses in the period in which they arise, with the exception of exchange differences dealt with in accordance with paragraphs 27 and 29.

25. An exchange difference results when there is a change in the exchange rate between the transaction date and the date of settlement of any monetary items arising from a foreign currency transaction. When the transaction is settled within the same accounting period as that in which it occurred, all the exchange difference is recognized in that period. However, when the transaction is settled in a subsequent accounting period, the exchange difference recognized in each intervening period up to the period of settlement is determined by the change in exchange rates during that period.

26. The treatment of foreign currency exchange rate changes in a cash flow statement is described in paragraph 19.

Net Investment in a Foreign Entity

27. **Exchange differences arising on a monetary item that, in substance, forms part of an entity's net investment in a foreign entity should be classified as net assets/equity in the entity's financial statements until the disposal of the net investment, at which time they should be recognized as revenue or as expenses in accordance with paragraph 55.**

28. An entity may have a monetary item that is receivable from, or payable to, a foreign entity. An item for which settlement is neither planned nor likely to occur in the foreseeable future is, in substance, an extension to, or deduction from, the entity's net investment in that foreign entity. Such monetary items may include long-term receivables or loans.

29. **Exchange differences arising on a foreign currency liability accounted for as a hedge of an entity's net investment in a foreign entity should be classified as net assets/equity in the entity's financial statements until the disposal of the net investment, at which time they should be recognized as revenue or as expenses in accordance with paragraph 55.**

Allowed Alternative Treatment

30. The benchmark treatment for exchange differences dealt with in paragraph 31 is set out in paragraph 24.

31. **Exchange differences may result from a severe devaluation or depreciation of a currency against which there is no practical means of hedging and that affects liabilities which cannot be settled and which arise directly on the recent acquisition of an asset invoiced in a foreign**

currency. Such exchange differences should be included in the carrying amount of the related asset.

32. Exchange differences are not included in the carrying amount of an asset when the entity is able to settle or hedge the foreign currency liability arising on the acquisition of the asset. However, exchange losses are part of the directly attributable costs of the asset when the liability cannot be settled and there is no practical means of hedging, for example when, as a result of exchange controls, there is a delay in obtaining foreign currency. Therefore, under the allowed alternative treatment, the cost of an asset invoiced in a foreign currency is regarded as the amount of reporting currency that the entity ultimately has to pay to settle its liabilities arising directly on the recent acquisition of the asset.

Financial Statements of Foreign Operations

Classification of Foreign Operations

33. The method used to translate the financial statements of a foreign operation depends on the way in which it is financed and operates in relation to the reporting entity. For this purpose, foreign operations are classified as either "foreign operations that are integral to the operations of the reporting entity" or "foreign entities."

34. A foreign operation that is integral to the operations of the reporting entity carries on its activities as if it were an extension of the reporting entity's operations. For example, a department of defense might have a number of overseas bases which conduct activities on behalf of a national government. The defense bases might conduct their activities substantially in the reporting currency of the reporting entity. For example, military personnel may be paid in the reporting currency and receive only a small allowance in local currency. Purchases of supplies and equipment might be largely obtained via the reporting entity with purchases in local currency being kept to a minimum. Another example would be an overseas campus of a public university which operates under the management and direction of the domestic campus. In such cases, a change in the exchange rate between the reporting currency and the currency in the country of foreign operation has an almost immediate effect on the reporting entity's cash flow from operations. Therefore, the change in the exchange rate affects the individual monetary items held by the foreign operation rather than the reporting entity's net investment in that operation.

35. In contrast, a foreign entity accumulates cash and other monetary items, incurs expenses, generates revenue and perhaps arranges borrowings, all substantially in its local currency. It may also enter into transactions in foreign currencies, including transactions in the reporting currency. Some

examples of government-owned foreign entities which may operate independently of other government agencies include tourist offices, petroleum exploration companies, trade boards and broadcasting operations. Such entities may be established as Government Business Enterprises. When there is a change in the exchange rate between the reporting currency and the local currency, there is little or no direct effect on the present and future cash flows from operations of either the foreign entity or the reporting entity. The change in the exchange rate affects the reporting entity's net investment in the foreign entity rather than the individual monetary and non-monetary items held by the foreign entity.

36. The following are indications that a foreign operation is a foreign entity rather than a foreign operation that is integral to the operations of the reporting entity:

(a) While the reporting entity may control the foreign operation, the activities of the foreign operation are carried out with a significant degree of autonomy from those of the reporting entity;

(b) Transactions with the reporting entity are not a high proportion of the foreign operation's activities;

(c) The activities of the foreign operation are financed mainly from its own operations or local borrowings rather than from the reporting entity;

(d) Costs of labor, material and other components of the foreign operation's products or services are primarily paid or settled in the foreign operation's local currency rather than in the reporting currency;

(e) The foreign operation's revenues are mainly in currencies other than the reporting currency; and

(f) Cash flows of the reporting entity are insulated from the day-to-day activities of the foreign operation rather than being directly affected by the activities of the foreign operation.

It is not necessary for all these indicators to be present in order to classify a foreign operation as a foreign entity. The appropriate classification for each operation can, in principle, be established from factual information related to the indicators listed above. In some cases, the classification of a foreign operation as either a foreign entity or an integral operation of the reporting entity may not be clear, and judgment is necessary to determine the appropriate classification.

Foreign Operations that are Integral to the Operations of the Reporting Entity

37. **The financial statements of a foreign operation that is integral to the operations of the reporting entity should be translated using the standards and procedures in paragraphs 16 to 32 as if the transactions of the foreign operation had been those of the reporting entity itself.**

38. The individual items in the financial statements of the foreign operation are translated as if all its transactions had been entered into by the reporting entity itself.

39. The cost and depreciation of property, plant and equipment is translated using the exchange rate at the date of purchase of the asset or, if the asset is carried at fair value, using the rate that existed on the date of the valuation. The cost of inventories is translated at the exchange rates that existed when those costs were incurred. The realizable value of an asset is translated using the exchange rate that existed when the net realizable value was determined. For example, when the net realizable value of an item of inventory is determined in a foreign currency, that value is translated using the exchange rate at the date as at which the net realizable value is determined. The rate used is therefore usually the closing rate. An adjustment may be required to reduce the carrying amount of an asset in the financial statements of the reporting entity to its net realizable value even when no such adjustment is necessary in the financial statements of the foreign operation. Alternatively, an adjustment in the financial statements of the foreign operation may need to be reversed in the financial statements of the reporting entity.

40. For practical reasons, a rate that approximates the actual rate at the date of the transaction is often used, for example, an average rate for a week or a month might be used for all transactions in each foreign currency occurring during that period. However, if exchange rates fluctuate significantly, the use of the average rate for a period is unreliable.

Foreign Entities

41. **In translating the financial statements of a foreign entity for incorporation in its financial statements, the reporting entity should use the following procedures:**

    (a) **The assets and liabilities, both monetary and non-monetary, of the foreign entity should be translated at the closing rate;**

    (b) **Revenue and expense items of the foreign entity should be translated at exchange rates at the dates of the transactions, except when the foreign entity reports in the currency of a**

hyperinflationary economy, in which case revenue and expense items should be translated at the closing rate; and

(c) **All resulting exchange differences should be classified as net assets/equity until the disposal of the net investment.**

42. Refer to paragraph 52 for a discussion of the restatement of financial statements of foreign entities that report in the currency of a hyperinflationary economy.

43. In translating the cash flows, that is the cash receipts and cash payments, of a foreign entity for incorporation in its cash flow statement, the reporting entity should comply with the procedures in IPSAS 2. IPSAS 2 requires that the cash flows of a foreign controlled entity should be translated at the exchange rates between the reporting currency and the foreign currency at the dates of the cash flows. IPSAS 2 also outlines the presentation of unrealized gains and losses arising from changes in foreign currency exchange rates on cash and cash equivalents held or due in a foreign currency.

44. For practical reasons, a rate that approximates the actual exchange rates, for example an average rate for the period, is often used to translate revenue and expense items of a foreign operation.

45. The translation of the financial statements of a foreign entity results in the recognition of exchange differences arising from:

(a) Translating revenue and expense items at the exchange rates at the dates of transactions and assets and liabilities at the closing rate;

(b) Translating the opening net investment in the foreign entity at an exchange rate different from that at which it was previously reported; and

(c) Other changes to net assets/equity in the foreign entity.

These exchange differences are not recognized as revenue or expenses for the period because the changes in the exchange rates have little or no direct effect on the present and future cash flows from operations of either the foreign entity or the reporting entity. When a foreign entity is consolidated but is not wholly owned, accumulated exchange differences arising from translation and attributable to minority interests are allocated to, and reported as part of, the minority interest in the consolidated statement of financial position.

46. Any goodwill arising on the acquisition of a foreign entity and any fair value adjustments to the carrying amounts of assets and liabilities arising on the acquisition of that foreign entity are treated as either:

(a) Assets and liabilities of the foreign entity and translated at the closing rate in accordance with paragraph 41; or

(b) Assets and liabilities of the reporting entity which either are already expressed in the reporting currency or are non-monetary foreign currency items which are reported using the exchange rate at the date of the transaction in accordance with paragraph 20(b).

47. The incorporation of the financial statements of a foreign entity in those of the reporting entity follows normal consolidation procedures, such as the elimination of balances and transactions within an economic entity. (See IPSAS 6 and IPSAS 8, “Financial Reporting of Interests in Joint Ventures.”)

48. However, an exchange difference arising on a monetary item within an economic entity, whether short term or long term, cannot be eliminated against a corresponding amount arising on other balances within an economic entity because the monetary item represents a commitment to convert one currency into another and exposes the reporting entity to a gain or loss through currency fluctuations. Accordingly, in the consolidated financial statements of a reporting entity, such an exchange difference continues to be recognized as revenue or an expense or, if it arises from the circumstances described in paragraphs 27 and 29, it is classified as net assets/equity until the disposal of the net investment.

49. When the financial statements of a foreign entity are drawn up to a different reporting date from that of the reporting entity, the foreign entity often prepares, for purposes of incorporation in the financial statements of the reporting entity, statements as at the same date as the reporting entity. When it is impracticable to do this, IPSAS 6 allows the use of financial statements drawn up to a different reporting date provided that the difference is no greater than three months.

50. When there is a difference between the reporting date of the reporting entity and the foreign entity, the assets and liabilities of the foreign entity are translated at the exchange rate at the reporting date of the foreign entity.

51. Adjustments are made when appropriate for significant movements in exchange rates up to the reporting date of the reporting entity in accordance with IPSAS 6 and IPSAS 7, “Accounting for Investments in Associates.”

52. **The financial statements of a foreign entity that reports in the currency of a hyperinflationary economy should be restated in accordance with the appropriate standards that address financial reporting in hyperinflationary economies, before they are translated into the**

reporting currency of the reporting entity. When the economy ceases to be hyperinflationary and the foreign entity discontinues the preparation and presentation of financial statements in accordance with the appropriate standards addressing financial reporting in hyperinflationary economies, it should use the amounts expressed in the measuring unit current at the date of discontinuation as the historical costs for translation into the reporting currency of the reporting entity.

53. A hyperinflationary economy is one in which the loss of purchasing power of money is at such a rate that comparison of amounts from transactions and other events that have occurred at different times, even within the same accounting period, is misleading.

54. Hyperinflation is indicated by characteristics of the economic environment of a country which include the following:

    (a) The general population prefers to keep its wealth in non-monetary assets or in a relatively stable foreign currency. Amounts of local currency held are immediately invested to maintain purchasing power;

    (b) The general population regards monetary amounts not in terms of the local currency but in terms of a relatively stable foreign currency. Prices may be quoted in that currency;

    (c) Sales and purchases on credit take place at prices that compensate for the expected loss of purchasing power during the credit period, even if the period is short;

    (d) Interest rates, wages and prices are linked to a price index; and

    (e) The cumulative inflation rate over three years is approaching, or exceeds, 100%.

Disposal of a Foreign Entity

55. **On the disposal of a foreign entity, the cumulative amount of the exchange differences which have been deferred and which relate to that foreign entity should be recognized as revenue or as expenses in the same period in which the gain or loss on disposal is recognized.**

56. An entity may dispose of its interest in a foreign entity through sale, liquidation, repayment of contributed capital, or abandonment of all, or part of, that entity. The payment of a dividend forms part of a disposal only when it constitutes a return of the investment. In the case of a partial disposal, only the proportionate share of the related accumulated exchange differences is included in the gain or loss. A write-down of the carrying

amount of a foreign entity does not constitute a partial disposal. Accordingly, no part of the deferred foreign exchange gain or loss is recognized at the time of a write-down.

Change in the Classification of a Foreign Operation

57. **When there is a change in the classification of a foreign operation, the translation procedures applicable to the revised classification should be applied from the date of the change in the classification.**

58. A change in the way in which a foreign operation is financed and operates in relation to the reporting entity may lead to a change in the classification of that foreign operation.

59. When a foreign operation that is integral to the operations of the reporting entity is reclassified as a foreign entity, exchange differences arising on the translation of non-monetary assets at the date of the reclassification are classified as net assets/equity. When a foreign entity is reclassified as a foreign operation that is integral to the operation of the reporting entity, the translated amounts for non-monetary items at the date of the change are treated as the historical cost for those items in the period of change and subsequent periods. Exchange differences which have been deferred are not recognized as revenue or expenses until the disposal of the operation.

All Changes in Foreign Exchange Rates

Tax Effects of Exchange Differences

60. For reporting entities subject to income taxes, guidance on the treatment of tax effects associated with the gains and losses on foreign currency transactions and exchange differences arising on the translation of the financial statements of foreign operations can be found in IAS 12, "Income Taxes."

Disclosure

61. **The entity should disclose:**

    (a) **The amount of exchange differences included in the net surplus or deficit for the period;**

    (b) **Net exchange differences classified as a separate component of net assets/equity, and a reconciliation of the amount of such exchange differences at the beginning and end of the period; and**

    (c) **The amount of exchange differences arising during the period which is included in the carrying amount of an asset in**

accordance with the allowed alternative treatment in paragraph 31.

62. **When the reporting currency is different from the currency of the country in which the entity is domiciled, the reason for using a different currency should be disclosed. The reason for any change in the reporting currency should also be disclosed.**

63. **When there is a change in the classification of a significant foreign operation, an entity should disclose:**

    (a) **The nature of the change in classification;**

    (b) **The reason for the change;**

    (c) **The impact of the change in classification on net assets/equity; and**

    (d) **The impact on net surplus or deficit for each prior period presented had the change in classification occurred at the beginning of the earliest period presented.**

64. **When goodwill and fair value adjustments arising on the acquisition of a foreign entity are recognized, an entity should disclose the method selected to translate those adjustments in accordance with paragraph 46.**

65. Disclosure is also encouraged of an entity's foreign currency risk management policy.

Transitional Provisions

66. **On the first occasion that an entity applies this Standard, the entity should, except when the amount is not reasonably determinable, classify separately and disclose the cumulative balance, at the beginning of the period, of exchange differences deferred and classified as net assets/equity in previous periods.**

Effective Date

67. **This International Public Sector Accounting Standard becomes effective for annual financial statements covering periods beginning on or after July 1, 2001. Earlier application is encouraged.**

68. When an entity adopts the accrual basis of accounting, as defined by International Public Sector Accounting Standards, for financial reporting purposes, subsequent to this effective date, this Standard applies to the entity's annual financial statements covering periods beginning on or after the date of adoption.

Comparison with IAS 21

International Public Sector Accounting Standard (IPSAS) 4, "The Effects of Changes in Foreign Exchange Rates," is drawn primarily from International Accounting Standard (IAS) 21, "The Effects of Changes in Foreign Exchange Rates." The main differences between IPSAS 4 and IAS 21 are as follows:

- Commentary additional to that in IAS 21 has been included in IPSAS 4 to clarify the applicability of the standards to accounting by public sector entities.
- IPSAS 4 uses different terminology, in certain instances, from IAS 21. The most significant examples are the use of the terms "entity," "revenue," "statement of financial performance," "statement of financial position" and "net assets/equity" in IPSAS 4. The equivalent terms in IAS 21 are "enterprise," "income," "income statement," "balance sheet" and "equity."
- IPSAS 4 contains a different set of definitions of technical terms from IAS 21 (paragraph 9).
- IPSAS 4 paragraph 31 requires exchange differences arising from a severe devaluation or depreciation of a currency under certain circumstances to be capitalized in the related asset. IAS 21 contains the additional requirement that such capitalization cannot exceed the lower of the replacement cost and recoverable amount of the asset. The Committee intends to address this issue in a future Standard on impairment.

IPSAS 5—BORROWING COSTS

Acknowledgment

This International Public Sector Accounting Standard is drawn primarily from International Accounting Standard (IAS) 23, "Borrowing Costs" 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 IASC. The International Accounting Standards (IASs) issued by IASC remain in force until they are amended or withdrawn by IASB. Extracts from IAS 23 are reproduced in this publication of the Public Sector Committee of the International Federation of Accountants with the permission of IASB.

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IPSAS 5—BORROWING COSTS

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The standards, which have been set in bold, should be read in the context of the commentary paragraphs in this Standard which are in plain type, and in the context of the "Preface to International Public Sector Accounting Standards." International Public Sector Accounting Standards are not intended to apply to immaterial items.

Objective

This Standard prescribes the accounting treatment for borrowing costs. This Standard generally requires the immediate expensing of borrowing costs. However, the Standard permits, as an allowed alternative treatment, the capitalization of borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset.

Scope

1. **This Standard should be applied in accounting for borrowing costs.**

2. **This Standard applies to all public sector entities other than Government Business Enterprises.**

3. Government Business Enterprises (GBEs) are required to comply with International Accounting Standards (IASs) issued by the International Accounting Standards Committee. The Public Sector Committee's Guideline No. 1, "Financial Reporting by Government Business Enterprises" notes that IASs are relevant to all business enterprises, regardless of whether they are in the private or public sector. Accordingly, Guideline No. 1 recommends that GBEs should present financial statements that conform, in all material respects, to IASs.

4. This Standard does not deal with the actual or imputed cost of net assets/equity. Where jurisdictions apply a capital charge to individual entities, judgment will need to be exercised to determine whether the charge meets the definition of borrowing costs or whether it should be treated as an actual or imputed cost of net assets/equity.

Definitions

5. **The following terms are used in this Standard with the meanings specified:**

   Accounting policies are the specific principles, bases, conventions, rules and practices adopted by an entity in preparing and presenting financial statements.

   Accrual basis means 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.

<u>Assets</u> are resources controlled by an entity as a result of past events and from which future economic benefits or service potential are expected to flow to the entity.

<u>Borrowing costs</u> are interest and other expenses incurred by an entity in connection with the borrowing of funds.

<u>Cash</u> comprises cash on hand and demand deposits.

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

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

(b) **Can be sold, exchanged, transferred or redeemed.**

<u>Control</u> is the power to govern the financial and operating policies of another entity so as to benefit from its activities.

<u>Controlled entity</u> is an entity that is under the control of another entity (known as the controlling entity).

<u>Controlling entity</u> is an entity that has one or more controlled entities.

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

<u>Economic entity</u> means a group of entities comprising a controlling entity and one or more controlled entities.

<u>Exchange difference</u> is the difference resulting from reporting the same number of units of a foreign currency in the reporting currency at different exchange rates.

Exchange rate is the ratio for exchange of two currencies.

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

Foreign currency is a currency other than the reporting currency of an entity.

Government Business Enterprise means an entity that has all the following characteristics:

(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.**

Liabilities are present obligations of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits or service potential.

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

Qualifying asset is an asset that necessarily takes a substantial period of time to get ready for its intended use or sale.

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

Borrowing Costs

6. Borrowing costs may include:

(a) Interest on bank overdrafts and short-term and long-term borrowings;

(b) Amortization of discounts or premiums relating to borrowings;

(c) Amortization of ancillary costs incurred in connection with the arrangement of borrowings;

(d) Finance charges in respect of finance leases; and

(e) Exchange differences arising from foreign currency borrowings to the extent that they are regarded as an adjustment to interest costs.

Economic Entity

7. The term “economic entity” is used in this Standard to define, for financial reporting purposes, a group of entities comprising the controlling entity and any controlled entities.

8. Other terms sometimes used to refer to an economic entity include “administrative entity,” “financial entity,” “consolidated entity” and “group.”

9. 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.

Future Economic Benefits or Service Potential

10. 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 Standard uses the term “future economic benefits or service potential” to describe the essential characteristic of assets.

Government Business Enterprises

11. 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. 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.

Net Assets/Equity

12. "Net assets/equity" is the term used in this Standard 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.

Qualifying Assets

13. Examples of qualifying assets are office buildings, hospitals, infrastructure assets such as roads, bridges and power generation facilities, and inventories that require a substantial period of time to bring them to a condition ready for use or sale. Other investments, and those assets that are routinely produced over a short period of time, are not qualifying assets. Assets that are ready for their intended use or sale when acquired also are not qualifying assets.

Borrowing Costs—Benchmark Treatment

Recognition

14. **Borrowing costs should be recognized as an expense in the period in which they are incurred.**

15. Under the benchmark treatment, borrowing costs are recognized as an expense in the period in which they are incurred, regardless of how the borrowings are applied.

Disclosure

16. **The financial statements should disclose the accounting policy adopted for borrowing costs.**

Borrowing Costs—Allowed Alternative Treatment

Recognition

17. **Borrowing costs should be recognized as an expense in the period in which they are incurred, except to the extent that they are capitalized in accordance with paragraph 18.**

18. **Borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset should be capitalized as part of the cost of that asset. The amount of borrowing costs eligible for capitalization should be determined in accordance with this Standard.**

19. Under the allowed alternative treatment, borrowing costs that are directly attributable to the acquisition, construction or production of an asset are included in the cost of that asset. Such borrowing costs are capitalized as part of the cost of the asset when it is probable that they will result in future

economic benefits or service potential to the entity and the costs can be measured reliably. Other borrowing costs are recognized as an expense in the period in which they are incurred.

20. **Where an entity adopts the allowed alternative treatment, that treatment should be applied consistently to all borrowing costs that are directly attributable to the acquisition, construction or production of all qualifying assets of the entity.**

Borrowing Costs Eligible for Capitalization

21. The borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset are those borrowing costs that would have been avoided if the outlays on the qualifying asset had not been made. When an entity borrows funds specifically for the purpose of obtaining a particular qualifying asset, the borrowing costs that directly relate to that qualifying asset can be readily identified.

22. It may be difficult to identify a direct relationship between particular borrowings and a qualifying asset and to determine the borrowings that could otherwise have been avoided. Such a difficulty occurs, for example, when the financing activity of an entity is co-ordinated centrally. Difficulties also arise when an economic entity uses a range of debt instruments to borrow funds at varying rates of interest, and transfers those funds on various bases to other entities in the economic entity. Funds which have been borrowed centrally may be transferred to other entities within the economic entity as a loan, a grant or a capital injection. Such transfers may be interest-free or require that only a portion of the actual interest cost be recovered. Other complications arise through the use of loans denominated in or linked to foreign currencies, when the economic entity operates in highly inflationary economies, and from fluctuations in exchange rates. As a result, the determination of the amount of borrowing costs that are directly attributable to the acquisition of a qualifying asset is difficult and the exercise of judgment is required.

23. **To the extent that funds are borrowed specifically for the purpose of obtaining a qualifying asset, the amount of borrowing costs eligible for capitalization on that asset should be determined as the actual borrowing costs incurred on that borrowing during the period less any investment income on the temporary investment of those borrowings.**

24. The financing arrangements for a qualifying asset may result in an entity obtaining borrowed funds and incurring associated borrowing costs before some or all of the funds are used for outlays on the qualifying asset. In such circumstances, the funds are often temporarily invested pending their outlay on the qualifying asset. In determining the amount of borrowing costs

eligible for capitalization during a period, any investment income earned on such funds is deducted from the borrowing costs incurred.

25. **To the extent that funds are borrowed generally and used for the purpose of obtaining a qualifying asset, the amount of borrowing costs eligible for capitalization should be determined by applying a capitalization rate to the outlays on that asset. The capitalization rate should be the weighted average of the borrowing costs applicable to the borrowings of the entity that are outstanding during the period, other than borrowings made specifically for the purpose of obtaining a qualifying asset. The amount of borrowing costs capitalized during a period should not exceed the amount of borrowing costs incurred during that period.**

26. Only those borrowing costs applicable to the borrowings of the entity may be capitalized. When a controlling entity borrows funds which are passed on to a controlled entity with no, or only partial, allocation of borrowing costs, the controlled entity may capitalize only those borrowing costs which it itself has incurred. Where a controlled entity receives an interest-free capital contribution or capital grant, it will not incur any borrowing costs and consequently will not capitalize any such costs.

27. When a controlling entity transfers funds at partial cost to a controlled entity, the controlled entity may capitalize that portion of borrowing costs which it itself has incurred. In the financial statements of the economic entity, the full amount of borrowing costs can be capitalized to the qualifying asset, provided that appropriate consolidation adjustments have been made to eliminate those costs capitalized by the controlled entity.

28. When a controlling entity has transferred funds at no cost to a controlled entity, neither the controlling entity nor the controlled entity would meet the criteria for capitalization of borrowing costs. However, if the economic entity met the criteria for capitalization of borrowing costs, it would be able to capitalize the borrowing costs to the qualifying asset in its financial statements.

29. In some circumstances, it is appropriate to include all borrowings of the controlling entity and its controlled entities when computing a weighted average of the borrowing costs; in other circumstances, it is appropriate for each controlled entity to use a weighted average of the borrowing costs applicable to its own borrowings.

Excess of the Carrying Amount of the Qualifying Asset over Recoverable Amount

30. When the carrying amount or the expected ultimate cost of the qualifying asset exceeds its recoverable amount or net realizable value, the carrying amount is written down or written off in accordance with the requirements of other international and/or national accounting standards. In certain circumstances, the amount of the write-down or write-off is written back in accordance with those other standards.

Commencement of Capitalization

31. **The capitalization of borrowing costs as part of the cost of a qualifying asset should commence when:**

    (a) **Outlays for the asset are being incurred;**

    (b) **Borrowing costs are being incurred; and**

    (c) **Activities that are necessary to prepare the asset for its intended use or sale are in progress.**

32. Outlays on a qualifying asset include only those outlays that have resulted in payments of cash, transfers of other assets or the assumption of interest-bearing liabilities. The average carrying amount of the asset during a period, including borrowing costs previously capitalized, is normally a reasonable approximation of the outlays to which the capitalization rate is applied in that period.

33. The activities necessary to prepare the asset for its intended use or sale encompass more than the physical construction of the asset. They include technical and administrative work prior to the commencement of physical construction, such as the activities associated with obtaining permits. However, such activities exclude the holding of an asset when no production or development that changes the asset's condition is taking place. For example, borrowing costs incurred while land is under development are capitalized during the period in which activities related to the development are being undertaken. However, borrowing costs incurred while land acquired for building purposes is held without any associated development activity do not qualify for capitalization.

Suspension of Capitalization

34. **Capitalization of borrowing costs should be suspended during extended periods in which active development is interrupted, and expensed.**

35. Borrowing costs may be incurred during an extended period in which the activities necessary to prepare an asset for its intended use or sale are interrupted. Such costs are costs of holding partially completed assets and

do not qualify for capitalization. However, capitalization of borrowing costs is not normally suspended during a period when substantial technical and administrative work is being carried out. Capitalization of borrowing costs is also not suspended when a temporary delay is a necessary part of the process of getting an asset ready for its intended use or sale. For example, capitalization continues during an extended period needed for inventories to mature or an extended period during which high water levels delay construction of a bridge, if such high water levels are common during the construction period in the geographic region involved.

Cessation of Capitalization

36. **Capitalization of borrowing costs should cease when substantially all the activities necessary to prepare the qualifying asset for its intended use or sale are complete.**

37. An asset is normally ready for its intended use or sale when the physical construction of the asset is complete even though routine administrative work might still continue. If minor modifications, such as the decoration of a property to the purchaser's or user's specification, are all that is outstanding, this indicates that substantially all the activities are complete.

38. **When the construction of a qualifying asset is completed in parts and each part is capable of being used while construction continues on other parts, capitalization of borrowing costs should cease when substantially all the activities necessary to prepare that part for its intended use or sale are completed.**

39. An office development comprising several buildings, each of which can be used individually, is an example of a qualifying asset for which each part is capable of being used while construction continues on other parts. Examples of qualifying assets that need to be complete before any part can be used include an operating theatre in a hospital when all construction must be complete before the theatre may be used; a sewage treatment plant where several processes are carried out in sequence at different parts of the plant; and a bridge forming part of a highway.

Disclosure

40. **The financial statements should disclose:**

    (a) **The accounting policy adopted for borrowing costs;**

    (b) **The amount of borrowing costs capitalized during the period; and**

    (c) **The capitalization rate used to determine the amount of borrowing costs eligible for capitalization (when it was**

necessary to apply a capitalization rate to funds borrowed generally).

Transitional Provisions

41. **When the adoption of this Standard constitutes a change in accounting policy, an entity is encouraged to adjust its financial statements in accordance with IPSAS 3, "Net Surplus or Deficit for the Period, Fundamental Errors and Changes in Accounting Policies." Alternatively, entities following the allowed alternative treatment should capitalize only those borrowing costs incurred after the effective date of this Standard which meet the criteria for capitalization.**

Effective Date

42. **This International Public Sector Accounting Standard becomes effective for annual financial statements covering periods beginning on or after July 1, 2001. Earlier application is encouraged.**

43. When an entity adopts the accrual basis of accounting, as defined by International Public Sector Accounting Standards, for financial reporting purposes, subsequent to this effective date, this Standard applies to the entity's annual financial statements covering periods beginning on or after the date of adoption.

Comparison with IAS 23

International Public Sector Accounting Standard (IPSAS) 5, "Borrowing Costs" is drawn primarily from International Accounting Standard (IAS) 23, "Borrowing Costs." The main differences between IPSAS 5 and IAS 23 are as follows:

- Commentary additional to that in IAS 23 has been included in IPSAS 5 to clarify the applicability of the standards to accounting by public sector entities.
- IPSAS 5 uses different terminology, in certain instances, from IAS 23. The most significant examples are the use of the terms "entity," "revenue," "statement of financial performance," "statement of financial position" and "net assets/equity" in IPSAS 5. The equivalent terms in IAS 23 are "enterprise," "income," "income statement," "balance sheet" and "equity."
- IPSAS 5 contains a different set of definitions of technical terms from IAS 23 (paragraph 5).

IPSAS 6—CONSOLIDATED FINANCIAL STATEMENTS AND ACCOUNTING FOR CONTROLLED ENTITIES

Acknowledgment

This International Public Sector Accounting Standard is drawn primarily from International Accounting Standard (IAS) 27 (reformatted 1994), "Consolidated Financial Statements and Accounting for Controlled Entities" 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 IASC. The International Accounting Standards (IASs) issued by IASC remain in force until they are amended or withdrawn by IASB. Extracts from IAS 27 are reproduced in this publication of the Public Sector Committee of the International Federation of Accountants with the permission of IASB.

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IPSAS 6—CONSOLIDATED FINANCIAL STATEMENTS AND ACCOUNTING FOR CONTROLLED ENTITIES

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The standards, which have been set in bold type, should be read in the context of the commentary paragraphs in this Standard, which are in plain type, and in the context of the "Preface to International Public Sector Accounting Standards." International Public Sector Accounting Standards are not intended to apply to immaterial items.

Scope

1. **An entity which prepares and presents financial statements under the accrual basis of accounting should apply this Standard in the preparation and presentation of consolidated financial statements for an economic entity.**

2. **This Standard should also be applied in accounting for controlled entities in a controlling entity's separate financial statements.**

3. Consolidated financial statements are encompassed by the term "financial statements" included in the Preface to International Public Sector Accounting Standards. Therefore, consolidated financial statements are prepared in accordance with International Public Sector Accounting Standards.

4. **This Standard applies to the preparation and presentation of consolidated financial statements, and accounting for controlled entities, by all public sector entities other than Government Business Enterprises.**

5. Government Business Enterprises (GBEs) are required to comply with International Accounting Standards (IASs) issued by the International Accounting Standards Committee. The Public Sector Committee's Guideline No. 1, "Financial Reporting by Government Business Enterprises" notes that IASs are relevant to all business enterprises, regardless of whether they are in the private or public sector. Accordingly, Guideline No.1 recommends that GBEs should present financial statements that conform, in all material respects, to IASs.

6. This Standard establishes requirements for the preparation and presentation of consolidated financial statements, and for accounting for controlled entities in the separate financial statements of the controlling entity. Although GBEs are not required to comply with this Standard in their own financial statements, the provisions of this Standard will apply where a public sector entity that is not a GBE has one or more controlled entities that are GBEs. In these circumstances, this Standard should be applied in consolidating GBEs into the financial statements of the economic entity, and in accounting for investments in GBEs in the controlling entity's separate financial statements.

7. This Standard does not deal with:

   (a) Methods of accounting for entity combinations and their effects on consolidation, including goodwill arising on a entity combination (guidance on accounting for entity combinations can be found in International Accounting Standard (IAS) 22, "Business Combinations");

   (b) Accounting for investments in associates (see International Public Sector Accounting Standard (IPSAS) 7, "Accounting for Investments in Associates"); and

   (c) Accounting for investments in joint ventures (see IPSAS 8, "Financial Reporting of Interests in Joint Ventures").

Definitions

8. **The following terms are used in this Standard with the meanings specified:**

   <u>Accounting policies</u> are the specific principles, bases, conventions, rules and practices adopted by an entity in preparing and presenting financial statements.

   <u>Accrual basis</u> means 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.

   <u>Assets</u> are resources controlled by an entity as a result of past events and from which future economic benefits or service potential are expected to flow to the entity.

   <u>Associate</u> is an entity in which the investor has significant influence and which is neither a controlled entity nor a joint venture of the investor.

   <u>Cash</u> comprises cash on hand and demand deposits.

   <u>Consolidated financial statements</u> are the financial statements of an economic entity presented as those of a single entity.

   <u>Contributions from owners</u> means future economic benefits or service potential that has been contributed to the entity by parties external to

the entity, other than those that result in liabilities of the entity, that establish a financial interest in the net assets/equity of the entity, which:

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

(b) **Can be sold, exchanged, transferred or redeemed.**

Control is the power to govern the financial and operating policies of another entity so as to benefit from its activities.

Controlled entity is an entity that is under the control of another entity (known as the controlling entity).

Controlling entity is an entity that has one or more controlled entities.

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

Economic entity means a group of entities comprising a controlling entity and one or more controlled entities.

Equity method is 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.

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

Government Business Enterprise means an entity that has all the following characteristics:

(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.**

Investor in a joint venture is a party to a joint venture and does not have joint control over that joint venture.

Joint control is the agreed sharing of control over an activity by a binding arrangement.

Joint venture is a binding arrangement whereby two or more parties are committed to undertake an activity which is subject to joint control.

Liabilities are present obligations of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits or service potential.

Minority interest is 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.

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

Net surplus/deficit comprises the following components:

(a) **Surplus or deficit from ordinary activities; and**

(b) **Extraordinary items.**

Reporting date means the date of the last day of the reporting period to which the financial statements relate.

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

Significant influence (for the purpose of this Standard) is the power to participate in the financial and operating policy decisions of the investee, but is not control over those policies.

Economic Entity

9. The term "economic entity" is used in this Standard to define, for financial reporting purposes, a group of entities comprising the controlling entity and any controlled entities.

10. Other terms sometimes used to refer to an economic entity include "administrative entity," "financial entity," "consolidated entity" and "group."

11. 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.

Future Economic Benefits or Service Potential

12. 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 Standard uses the term "future economic benefits or service potential" to describe the essential characteristic of assets.

Government Business Enterprises

13. 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. This Standard 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.

Net Assets/Equity

14. "Net assets/equity" is the term used in this Standard 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.

Presentation of Consolidated Financial Statements

15. **A controlling entity, other than a controlling entity mentioned in paragraph 16, should present consolidated financial statements.**

16. **A controlling entity that is a wholly owned controlled entity, or is virtually wholly owned, need not present consolidated financial statements provided users of such financial statements are unlikely to exist or their information needs are met by the controlling entity's consolidated financial statements; or, in the case of one that is virtually wholly owned, the controlling entity obtains the approval of the owners of the minority interest. Such a controlling entity should disclose the reasons why consolidated financial statements have not been presented together with the bases on which controlled entities are accounted for in its separate financial statements. The name and the principal address of its controlling entity that publishes consolidated financial statements should also be disclosed.**

17. Users of the financial statements of a controlling entity are usually concerned with, and need to be informed about, the financial affairs of the economic entity as a whole. This need may be served by consolidated financial statements, which present financial information about the economic entity as a single entity without regard for the legal boundaries of the separate legal entities.

18. A controlling entity that is itself wholly owned by another entity may not always present consolidated financial statements since such statements may not be required by its controlling entity and the needs of other users may be best served by the consolidated financial statements of its controlling entity. However, in the public sector many controlling entities that are either wholly owned or virtually wholly owned, represent key sectors or activities of a government and the purpose of this Standard is not to exempt such entities from preparing consolidated financial statements. In this situation the information needs of certain users may not be served by the consolidated financial statements at a whole-of-government level alone. In many jurisdictions governments have recognized this and have legislated the financial reporting requirements of such entities.

19. In some countries, a controlling entity is also exempted from presenting consolidated financial statements if it is virtually wholly owned by another entity and the controlling entity obtains the approval of the owners of the minority interest. Virtually wholly owned is often taken to mean that the controlling entity owns 90% or more of the voting power.

20. In some instances, an economic entity will include a number of intermediate controlling entities. For example, whilst a department of health may be the ultimate controlling entity, there may be intermediate controlling entities at the local or regional health authority level. Accountability and reporting requirements in each jurisdiction may specify which entities are required to (or exempted from the requirement to) prepare consolidated financial statements. Where there is no specific reporting requirement for an intermediate controlling entity to prepare consolidated financial statements for which users are likely to exist, intermediate controlling entities are to prepare and publish consolidated financial statements.

Scope of Consolidated Financial Statements

21. **A controlling entity which issues consolidated financial statements should consolidate all controlled entities, foreign and domestic, other than those referred to in paragraph 22.**

22. **A controlled entity should be excluded from consolidation when:**

    (a) **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**

    (b) **It operates under severe external long-term restrictions which prevent the controlling entity from benefiting from its activities.**

23. Such controlled entities should be accounted for as if they are investments. IAS 39, "Financial Instruments: Recognition and Measurement" provides guidance on accounting for investments.

24. An example of temporary control is where a controlled entity is acquired with a firm plan to dispose of it in the short term. This may occur where an economic entity is acquired and an entity within it is to be disposed of because its activities are dissimilar to those of the acquirer. Temporary control also occurs where the controlling entity intends to cede control over a controlled entity to another entity — for example a national government may transfer its interest in a controlled entity to a local government. For this exemption to apply, the controlling entity must be demonstrably committed to a formal plan to dispose of, or no longer control, the entity that is subject to temporary control. For the exemption to apply at more than one successive reporting date, the controlling entity must demonstrate an ongoing intent to dispose of, or no longer control, the entity that is subject to temporary control. An entity is demonstrably committed to dispose of, or no longer control, another entity when it has a formal plan to do so and there is no realistic possibility of withdrawal from that plan.

25. An entity may be subject to severe restrictions that prevent the other entity from benefiting from its activities. For example, a foreign government may sequester the operating assets of a foreign controlled entity. Under these circumstances, control is unlikely to exist and the consolidation procedures in this Standard would no longer apply.

Establishing Control of another Entity for Financial Reporting Purposes

26. Whether an entity controls another entity for financial reporting purposes is a matter of judgment based on the definition of control in this Standard and the particular circumstances of each case. That is, consideration needs to be given to the nature of the relationship between the two entities. In particular, the two elements of the definition of control in this Standard need to be considered. These are the power element (the power to govern the financial and operating policies of another entity) and the benefit element (which represents the ability of the controlling entity to benefit from the activities of the other entity).

27. For the purposes of establishing control, the controlling entity needs to benefit from the activities of the other entity. For example, an entity may benefit from the activities of another entity in terms of a distribution of its surpluses (such as a dividend) and is exposed to the risk of a potential loss. In other cases, an entity may not obtain any financial benefits from the other entity but may benefit from its ability to direct the other entity to work with it to achieve its objectives. It may also be possible for an entity to derive both financial and non-financial benefits from the activities of another entity. For example, a GBE may provide a controlling entity with a dividend and also enable it to achieve some of its social policy objectives.

Control for Financial Reporting Purposes

28. For the purposes of financial reporting, control stems from an entity's power to govern the financial and operating policies of another entity and does not necessarily require an entity to hold a majority shareholding or other equity interest in the other entity. The power to control must be presently exercisable. That is, the entity must already have had this power conferred upon it by legislation or some formal agreement. The power to control is not presently exercisable if it requires changing legislation or renegotiating agreements in order to be effective. This should be distinguished from the fact that the existence of the power to control another entity is not dependent upon the probability or likelihood of that power being exercised.

29. Similarly, the existence of control does not require an entity to have responsibility for the management of (or involvement in) the day-to-day

operations of the other entity. In many cases, an entity may only exercise its power to control another entity where there is a breach or revocation of an agreement between the controlled entity and its controlling entity.

30. For example, a government department may have an ownership interest in a rail authority, which operates as a GBE. The rail authority is allowed to operate autonomously and does not rely on the government for funding but has raised capital through significant borrowings that are guaranteed by the government. The rail authority has not returned a dividend to government for several years. The government has the power to appoint and remove a majority of the members of the governing body of the rail authority. The government has never exercised the power to remove members of the governing body and would be reluctant to do so because of sensitivity in the electorate regarding the previous government's involvement in the operation of the rail network. In this case, the power to control is presently exercisable but under the existing relationship between the controlled entity and controlling entity, an event has not occurred to warrant the controlling entity exercising its powers over the controlled entity. Accordingly, control exists because the power to control is sufficient even though the controlling entity may choose not to exercise that power.

31. The existence of separate legislative powers does not, of itself, preclude an entity from being controlled by another entity. For example, the Office of the Government Statistician usually has statutory powers to operate independently of the government. That is, the Office of the Government Statistician may have the power to obtain information and report on its findings without recourse to government or any other body. The existence of control does not require an entity to have responsibility over the day-to-day operations of another entity or the manner in which professional functions are performed by the entity.

32. The power of one entity to govern decision-making in relation to the financial and operating policies of another entity is insufficient, in itself, to ensure the existence of control as defined in this Standard. The controlling entity needs to be able to govern decision-making so as to be able to benefit from its activities, for example by enabling the other entity to operate with it as part of an economic entity in pursuing its objectives. This will have the effect of excluding from the definitions of a "controlling entity" and "controlled entity" relationships which do not extend beyond, for instance, that of a liquidator and the entity being liquidated, and would normally exclude a lender and borrower relationship. Similarly, a trustee whose relationship with a trust does not extend beyond the normal responsibilities of a trustee would not be considered to control the trust for the purposes of this Standard.

Regulatory and Purchase Power

33. Governments and their agencies have the power to regulate the behavior of many entities by use of their sovereign or legislative powers. Regulatory and purchase powers do not constitute control for the purposes of financial reporting. To ensure that the financial statements of public sector entities include only those resources that they control and can benefit from, the meaning of control for the purposes of this Standard does not extend to:

    (a) The power of the legislature to establish the regulatory framework within which entities operate and to impose conditions or sanctions on their operations. Such power does not constitute control by a public sector entity of the assets deployed by these entities. For example, a pollution control authority may have the power to close down the operations of entities that are not complying with environmental regulations. However, this power does not constitute control because the pollution control authority only has the power to regulate; or

    (b) Entities that are economically dependent on a public sector entity. That is, where an entity retains discretion as to whether it will take funding from, or do business with, a public sector entity, that entity has the ultimate power to govern its own financial or operating policies, and accordingly is not controlled by the public sector entity. For example, a government department may be able to influence the financial and operating policies of an entity which is dependent on it for funding (such as a charity) or a profit-orientated entity that is economically dependent on business from it. Accordingly, the government department has some power as a purchaser but not to govern the entity's financial and operating policies.

Determining whether Control Exists for Financial Reporting Purposes

34. Public sector entities may create other entities to achieve some of their objectives. In some cases it may be clear that an entity is controlled, and hence should be consolidated. In other cases it may not be clear. Paragraphs 35 and 36 provide guidance to help determine whether or not control exists for financial reporting purposes.

35. In examining the relationship between two entities, control is presumed to exist when at least one of the following power conditions and one of the following benefit conditions exists, unless there is clear evidence of control being held by another entity.

Power Conditions

(a) The entity has, directly or indirectly through controlled entities, ownership of a majority voting interest in the other entity.

(b) The entity has the power, either granted by or exercised within existing legislation, to appoint or remove a majority of the members of the governing body of the other entity.

(c) The entity has the power to cast, or regulate the casting of, a majority of the votes that are likely to be cast at a general meeting of the other entity.

(d) The entity has the power to cast the majority of votes at meetings of the board of directors or equivalent governing body.

Benefit Conditions

(a) The entity has the power to dissolve the other entity and obtain a significant level of the residual economic benefits or bear significant obligations. For example the benefit condition may be met if an entity had responsibility for the residual liabilities of another entity.

(b) The entity has the power to extract distributions of assets from the other entity, and/or may be liable for certain obligations of the other entity.

36. When one or more of the circumstances listed in paragraph 35 does not exist, the following factors are likely, either individually or collectively, to be indicative of the existence of control.

Power Indicators

(a) The entity has the ability to veto operating and capital budgets of the other entity.

(b) The entity has the ability to veto, overrule, or modify governing body decisions of the other entity.

(c) The entity has the ability to approve the hiring, reassignment and removal of key personnel of the other entity.

(d) The mandate of the other entity is established and limited by, legislation.The entity holds a "golden share"[1] (or equivalent) in the other entity that confers rights to govern the financial and operating policies of that other entity.

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1 "Golden share" refers to a class of share that entitles the holder to specified powers or rights generally exceeding those normally associated with the holder's ownership interest or representation on the governing body.

Benefit Indicators

(a) The entity holds direct or indirect title to the net assets/equity of the other entity with an ongoing right to access these.

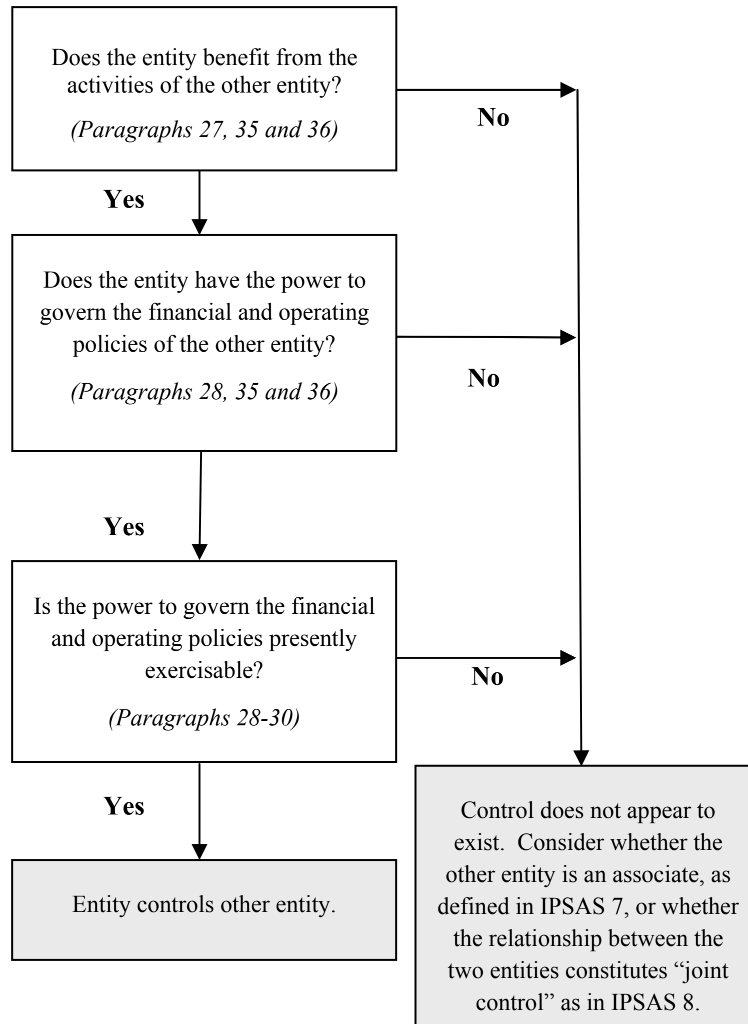
(b) The entity has a right to a significant level of the net assets/equity of the other entity in the event of a liquidation or in a distribution other than a liquidation.

(c) The entity is able to direct the other entity to co-operate with it in achieving its objectives.

(d) The entity is exposed to the residual liabilities of the other entity.

37. The following diagram indicates the basic steps involved in establishing control of another entity. It should be read in conjunction with paragraphs 26 to 36.

Establishing Control of Another Entity for Financial Reporting Purposes



38. Sometimes a controlled entity is excluded from consolidation when its activities are dissimilar to those of other entities within the economic entity, for example, the consolidation of GBEs with entities in the budget sector. Exclusion on these grounds is not justified because better information would be provided by consolidating such controlled entities and disclosing additional information in the consolidated financial statements about the different activities of controlled entities. For example, disaggregated disclosures can help to explain the significance of different activities within the economic entity.

Consolidation Procedures

39. 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. In order that the consolidated financial statements present financial information about the economic entity as that of a single entity, the following steps are then taken:

    (a) The carrying amount of the controlling entity's investment in each controlled entity and the controlling entity's portion of net assets/equity of each controlled entity are eliminated (IAS 22 provides guidance on the treatment of any resultant goodwill);

    (b) Minority interests in the net surplus or deficit of consolidated controlled entities for the reporting period are identified and adjusted against the net surplus or deficit of the economic entity in order to arrive at the net surplus or deficit attributable to the owners of the controlling entity; and

    (c) Minority interests in the net assets/equity of consolidated controlled entities are identified and presented in the consolidated statement of financial position separately from liabilities and the controlling entity's net assets/equity. Minority interests in the net assets/equity consist of:

        (i) The amount at the date of the original combination (IAS 22 provides guidance on calculating this amount); and

        (ii) The minority's share of movements in net assets/equity since the date of combination.

40. Guidance on accounting for taxes payable by either the controlling entity or its controlled entities on distribution to the controlling entity of the surpluses retained in controlled entities can be found in IAS 12, "Income Taxes."

41. **Balances and transactions between entities within the economic entity and resulting unrealized gains should be eliminated in full. Unrealized losses resulting from transactions within the economic entity should also be eliminated unless cost cannot be recovered.**

42. Balances and transactions between entities within the economic entity, including sales, transfers and revenues recognized consequent to an appropriation or other budgetary authority, expenses and dividends, are eliminated in full. Unrealized surpluses resulting from transactions within the economic entity that are included in the carrying amount of assets, such as inventory and fixed assets, are eliminated in full. Unrealized deficits resulting from transactions within the economic entity that are deducted in arriving at the carrying amount of assets are also eliminated unless cost cannot be recovered. Guidance on accounting for timing differences that arise from the elimination of unrealized surpluses and deficits resulting from transactions within the economic entity, can be found in IAS 12.

43. **When the financial statements used in the consolidation are drawn up to different reporting dates, adjustments should be made for the effects of significant transactions or other events that occur between those dates and the date of the controlling entity's financial statements. In any case the difference between reporting dates should be no more than three months.**

44. The financial statements of the controlling entity and its controlled entities used in the preparation of the consolidated financial statements are usually drawn up to the same date. When the reporting dates are different, the controlled entity often prepares, for consolidation purposes, statements as at the same date as the economic entity. When it is impracticable to do this, financial statements drawn up to different reporting dates may be used provided the difference is no greater than three months. The consistency principle dictates that the length of the reporting periods and any difference in the reporting dates should be the same from period to period.

45. **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.**

46. If a member of the economic entity uses accounting policies other than those adopted in the consolidated financial statements for like transactions and events in similar circumstances, appropriate adjustments are made to its

financial statements when they are used in preparing the consolidated financial statements.

47. The net surplus or deficit of a controlled entity is included in the consolidated financial statements as from the date on which control becomes effective. The surplus or deficit from operating activities of a controlled entity disposed of is included in the consolidated statement of financial performance until the date of disposal, which is the date on which the controlling entity ceases to have control of the controlled entity. The difference between the proceeds from the disposal of the controlled entity and the carrying amount of its assets less liabilities as of the date of disposal is recognized in the consolidated statement of financial performance as the net surplus or deficit on the disposal of the controlled entity. In order to ensure the comparability of the financial statements from one accounting period to the next, supplementary information is often provided about the effect of the acquisition and disposal of controlled entities on the financial position at the reporting date and the results for the reporting period and on the corresponding amounts for the preceding period.

48. From the date an entity ceases to fall within the definition of a controlled entity and does not become an associate as defined in IPSAS 7, or a jointly controlled entity as defined in IPSAS 8, it should be accounted for as an investment. IAS 39 provides guidance on accounting for investments.

49. The carrying amount of the investment at the date that it ceases to be a controlled entity is regarded as cost thereafter.

50. **Minority interests should be presented in the consolidated statement of financial position separately from liabilities and the controlling entity's net assets/equity. Minority interests in the net surplus or deficit of the economic entity should also be separately presented.**

51. The losses applicable to the minority in a consolidated controlled entity may exceed the minority interest in the net assets/equity of the controlled entity. The excess, and any further losses applicable to the minority, are charged against the majority interest except to the extent that the minority has a binding obligation to, and is able to, make good the losses. If the controlled entity subsequently reports surpluses, the majority interest is allocated all such surpluses until the minority's share of losses previously absorbed by the majority has been recovered.

52. If a controlled entity has outstanding cumulative preferred shares which are held outside the economic entity, the controlling entity computes its share of surpluses and losses after adjusting for the controlled entity's preferred dividends, whether or not dividends have been declared.

Accounting for Controlled Entities in a Controlling Entity's Separate Financial Statements

53. **In a controlling entity's separate financial statements, controlled entities that are included in the consolidated financial statements should be either:**

    (a) **Accounted for using the equity method as described in IPSAS 7; or**

    (b) **Accounted for as an investment .**

54. **Controlled entities that are excluded from consolidation should be accounted for as investments in the controlling entity's separate financial statements.**

55. Guidance on accounting for investments can be found in international and/or national accounting standards.

56. In many countries separate financial statements are presented by a controlling entity in order to meet legal or other requirements.

Disclosure

57. **In addition to those disclosures required by paragraph 16, the following disclosures should be made:**

    (a) **In consolidated financial statements, a list of significant controlled entities including the name, the jurisdiction in which it operates (when it is different from that of the controlling entity), proportion of ownership interest and, where that interest is in the form of shares, the proportion of voting power held (only where this is different from the proportionate ownership interest);**

    (b) **In consolidated financial statements, where applicable:**

        (i) **The reasons for not consolidating a controlled entity;**

        (ii) **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;**

        (iii) **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; and**

        (iv) **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 on the corresponding amounts for the preceding period; and

(c) **In the controlling entity's separate financial statements, a description of the method used to account for controlled entities.**

Transitional Provisions

58. **Entities are not required to comply with the requirement in paragraph 41 concerning the elimination of balances and transactions between entities within the economic entity for reporting periods beginning on a date within three years following the date of first adoption of this Standard.**

59. Controlling entities that adopt this Standard may have many controlled entities with significant number of transactions between these entities. Accordingly, it may be difficult to identify some transactions and balances that need to be eliminated for the purpose of preparing the consolidated financial statements of the economic entity. For this reason, paragraph 58 provides relief from the requirement to eliminate balances and transactions between entities within the economic entity in full.

60. **Where entities apply the transitional provision in paragraph 58, they should disclose the fact that not all balances and transactions occurring between entities within the economic entity have been eliminated.**

Effective Date

61. **This International Public Sector Accounting Standard becomes effective for annual financial statements covering periods beginning on or after July 1, 2001. Earlier application is encouraged.**

62. When an entity adopts the accrual basis of accounting, as defined by International Public Sector Accounting Standards, for financial reporting purposes, subsequent to this effective date, this Standard applies to the entity's annual financial statements covering periods beginning on or after the date of adoption.

Comparison with IAS 27

International Public Sector Accounting Standard (IPSAS) 6, "Consolidated Financial Statements and Accounting for Controlled Entities" is drawn primarily from International Accounting Standard (IAS) 27, "Consolidated Financial Statements and Accounting for Investments in Subsidiaries." The main differences between IPSAS 6 and IAS 27 are as follows:

- Commentary additional to that in IAS 27 has been included in IPSAS 6 to clarify the applicability of the standards to accounting by public sector entities.
- IPSAS 6 uses different terminology, in certain instances, from IAS 27. The most significant examples are the use of the terms "entity," "revenue," "statement of financial performance," "statement of financial position," "net assets/equity," "controlling entity" and "controlled entity" in IPSAS 6. The equivalent terms in IAS 27 are "enterprise," "income," "income statement," "balance sheet," "equity," "parent" and "subsidiary."
- IPSAS 6 contains a different set of definitions of technical terms from IAS 27 (paragraph 8).
- IPSAS 6 includes a transitional provision that permits entities to not eliminate all balances and transactions between entities within the economic entity for reporting periods beginning on a date within three years following the date of first adoption of this Standard.

IPSAS 7—ACCOUNTING FOR INVESTMENTS IN ASSOCIATES

Acknowledgment

This International Public Sector Accounting Standard is drawn primarily from International Accounting Standard (IAS) 28, "Accounting for Investments in Associates" 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 IASC. The International Accounting Standards (IASs) issued by IASC remain in force until they are amended or withdrawn by IASB. Extracts from IAS 28 are reproduced in this publication of the Public Sector Committee of the International Federation of Accountants with the permission of IASB.

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May 2000

IPSAS 7—ACCOUNTING FOR INVESTMENTS IN ASSOCIATES

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The standards, which have been set in bold type, should be read in the context of the commentary paragraphs in this Standard, which are in plain type, and in the context of the "Preface to International Public Sector Accounting Standards." International Public Sector Accounting Standards are not intended to apply to immaterial items.

Scope

1. **An entity which prepares and presents financial statements under the accrual basis of accounting should apply this Standard in accounting by an investor for investments in associates where the investment in the associate leads to the holding of an ownership interest in the form of a shareholding or other formal equity structure.**

2. This Standard provides the basis for accounting for ownership interests in associates. That is, the investment in the other entity confers on the investor the risks and rewards incidental to an ownership interest. The Standard applies only to investments in the formal equity structure (or its equivalent) of an investee. A formal equity structure means share capital or an equivalent form of unitized capital, such as units in a property trust, but may also include other equity structures in which the investor's interest can be measured reliably. Where the equity structure is poorly defined it may not be possible to obtain a reliable measure of the ownership interest.

3. Some contributions made by public sector entities may be referred to as an "investment" but may not give rise to an ownership interest. For example, a public sector entity may make a substantial investment in the development of a hospital that is owned and operated by a charity. Whilst such contributions are non-reciprocal in nature, they allow the public sector entity to participate in the operation of the hospital, and the charity is accountable to the public sector entity for its use of public monies. However, the contributions made by the public sector entity do not constitute an ownership interest, as the charity could seek alternative funding and thereby prevent the public sector entity from participating in the operation of the hospital. Accordingly, the public sector entity is not exposed to the risks nor does it enjoy the rewards which are incidental to an ownership interest.

4. **This Standard applies to all public sector entities other than Government Business Enterprises.**

5. Government Business Enterprises (GBEs) are required to comply with International Accounting Standards (IASs) issued by the International Accounting Standards Committee. The Public Sector Committee's Guideline No. 1, "Financial Reporting by Government Business Enterprises" notes that IASs are relevant to all business enterprises, regardless of whether they are in the private or public sector. Accordingly, Guideline No.1

recommends that GBEs should present financial statements that conform, in all material respects, to IASs.

Definitions

6. **The following terms are used in this Standard with the meanings specified:**

Accounting policies are the specific principles, bases, conventions, rules and practices adopted by an entity in preparing and presenting financial statements.

Accrual basis means 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.

Assets are resources controlled by an entity as a result of past events and from which future economic benefits or service potential are expected to flow to the entity.

Associate is an entity in which the investor has significant influence and which is neither a controlled entity nor a joint venture of the investor.

Consolidated financial statements are the financial statements of an economic entity presented as those of a single entity.

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

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

(b) **Can be sold, exchanged, transferred or redeemed.**

Control is the power to govern the financial and operating policies of another entity so as to benefit from its activities.

Controlled entity is an entity that is subject to the control of another entity (known as the controlling entity).

Controlling entity is an entity that has one or more controlled entities.

Cost method is 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.

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

Economic entity means a group of entities comprising a controlling entity and one or more controlled entities.

Equity method is 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.

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

Fair value is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.

Government Business Enterprise means an entity that has all the following characteristics:

(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.**

Investor in a joint venture is a party to a joint venture and does not have joint control over that joint venture.

Joint venture is a binding arrangement whereby two or more parties are committed to undertake an activity which is subject to joint control.

Liabilities are present obligations of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits or service potential.

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

Net surplus/deficit comprises the following components:

(a) **Surplus or deficit from ordinary activities; and**

(b) **Extraordinary items.**

Reporting date means the date of the last day of the reporting period to which the financial statements relate.

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

Significant influence (for the purpose of this Standard) is the power to participate in the financial and operating policy decisions of the investee, but is not control over those policies.

Cost Method

7. Under the cost method, an investor records its investment in the investee at cost. The investor recognizes revenue only to the extent that it is entitled to receive distributions from the accumulated net surpluses of the investee arising subsequent to the date of acquisition by the investor. Entitlements due or received in excess of such surpluses are considered a recovery of investment and are recognized as a reduction of the cost of the investment.

Economic Entity

8. The term “economic entity” is used in this Standard to define, for financial reporting purposes, a group of entities comprising the controlling entity and any controlled entities.

9. Other terms sometimes used to refer to an economic entity include "administrative entity," "financial entity," "consolidated entity" and "group."

10. 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.

Equity Method

11. Under the equity method, the investment is initially recorded at cost and the carrying amount is increased or decreased to recognize the investor's share of net surpluses or deficits of the investee after the date of acquisition. Distributions received from an investee reduce the carrying amount of the investment. Adjustments to the carrying amount may also be necessary for alterations in the investor's proportionate interest in the investee arising from changes in the investee's equity that have not been included in the statement of financial performance. Such changes include those arising from the revaluation of property, plant, equipment and investments, from foreign exchange translation differences and from the adjustment of differences arising from business combinations.

Future Economic Benefits or Service Potential

12. 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 Standard uses the term "future economic benefits or service potential" to describe the essential characteristic of assets.

Government Business Enterprises

13. 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.

Net Assets/Equity

14. "Net assets/equity" is the term used in this Standard 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.

Significant Influence

15. Whether an investor has significant influence over the investee is a matter of judgment based on the nature of the relationship between the investor and the investee, and on the definition of significant influence in this Standard. This Standard applies only to those associates in which an entity holds an ownership interest.

16. The existence of significant influence by an investor is usually evidenced in one or more of the following ways:

    (a) Representation on the board of directors or equivalent governing body of the investee;

    (b) Participation in policy-making processes;

    (c) Material transactions between the investor and the investee;

    (d) Interchange of managerial personnel; or

    (e) Provision of essential technical information.

17. If the investor's ownership interest is in the form of shares and it holds, directly or indirectly through controlled entities, 20% or more of the voting power of the investee, it is presumed that the investor does have significant influence, unless it can be clearly demonstrated that this is not the case. Conversely, if the investor holds, directly or indirectly through controlled entities, less than 20% of the voting power of the investee, it is presumed that the investor does not have significant influence, unless such influence can be clearly demonstrated. A substantial or majority ownership by another investor does not necessarily preclude an investor from having significant influence.

Consolidated Financial Statements

18. **An investment in an associate should be accounted for in consolidated financial statements under the equity method except when the investment is acquired and held exclusively with a view to its disposal in the near future, in which case it should be accounted for under the cost method.**

19. The recognition of revenue on the basis of distributions received may not be an adequate measure of the revenue earned by an investor on an investment in an associate because the distributions received may bear little relationship to the performance of the associate. In particular, where the associate has not-for-profit objectives, investment performance will be determined by factors such as the cost of outputs and overall service delivery. As the investor has significant influence over the associate, the investor has a measure of responsibility for the associate's performance and, as a result, the return on its investment. The investor accounts for this stewardship by extending the scope of its consolidated financial statements to include its share of net surpluses or deficits of such an associate and so provides an analysis of earnings and investment from which more useful ratios can be calculated. As a result, the application of the equity method provides more informative reporting of the net assets/equity and net surplus or deficit of the investor.

20. An investment in an associate is accounted for using the cost method when it operates under severe long-term restrictions that significantly impair its ability to transfer funds or provide other non-financial benefits to, or on behalf of, the investor. Investments in associates are also accounted for using the cost method when the investment is acquired and held exclusively with a view to its disposal in the near future.

21. **An investor should discontinue the use of the equity method from the date that:**

    (a) **It ceases to have significant influence in an associate but retains, either in whole or in part, its investment; or**

    (b) **The use of the equity method is no longer appropriate because the associate operates under severe long-term restrictions that significantly impair its ability to transfer funds or provide other non-financial benefits to, or on behalf of, the investor.**

    The carrying amount of the investment at that date should be regarded as cost thereafter.

22. An entity is required to discontinue the equity method where severe long-term restrictions have the effect of preventing, or substantially preventing, the investee from transferring funds or providing other non-financial benefits to the investor. Where the associate does not have a profit objective (such as a social welfare agency) the associate may not be able to transfer funds to the investor but may nonetheless be able to deliver services to beneficiaries, consistent with the objectives of the investor.

Separate Financial Statements of the Investor

23. **An investment in an associate that is included in the separate financial statements of an investor that issues consolidated financial statements should be either:**

    (a) **Accounted for using the equity method or the cost method, whichever is used for the associate in the investor's consolidated financial statements; or**

    (b) **Accounted for as an investment.**

24. Guidance on accounting for investments can be found in international and/or national accounting standards.

25. The preparation of consolidated financial statements does not, in itself, obviate the need for separate financial statements for an investor.

26. **An investment in an associate that is included in the financial statements of an investor that does not issue consolidated financial statements should be either:**

    (a) **Accounted for using the equity method or the cost method, whichever would be appropriate for the associate if the investor issued consolidated financial statements; or**

    (b) **Accounted for as an investment.**

27. Guidance on accounting for investments can be found in international and/or national accounting standards.

28. An investor that has investments in associates may not issue consolidated financial statements because it does not have controlled entities. It is appropriate that such an investor provides the same information about its investments in associates as those entities that issue consolidated financial statements.

Application of the Equity Method

29. Many of the procedures appropriate for the application of the equity method are similar to the consolidation procedures set out in IPSAS 6. Furthermore, the broad concepts underlying the consolidation procedures used in the acquisition of a controlled entity are adopted on the acquisition of an investment in an associate.

30. **Where an associate is accounted for using the equity method, unrealized surpluses and deficits resulting from all transactions between an investor (or its consolidated controlled entities) and**

associates should be eliminated to the extent of the investor's interest in the associate. Unrealized deficits should not be eliminated to the extent that the transaction provides evidence of an impairment of the asset transferred.

31. An investment in an associate is accounted for under the equity method from the date on which it falls within the definition of an associate. Guidance on accounting for any difference (whether positive or negative) between the cost of acquisition and the investor's share of the fair values of the net identifiable assets of the associate can be found in International Accounting Standard (IAS) 22, "Business Combinations." Appropriate adjustments to the investor's share of the surpluses or deficits after acquisition are made to account for:

    (a) Depreciation of the depreciable assets, based on their fair values; and

    (b) Amortization of the difference between the cost of the investment and the investor's share of the fair values of the net identifiable assets.

32. The most recent available financial statements of the associate are used by the investor in applying the equity method; they are usually drawn up to the same date as the financial statements of the investor. When the reporting dates of the investor and the associate are different, the associate often prepares, for the use of the investor, statements as at the same date as the financial statements of the investor. When it is impracticable to do this, financial statements drawn up to a different reporting date may be used. The consistency principle dictates that the length of the reporting periods, and any difference in the reporting dates, are consistent from period to period.

33. When financial statements with a different reporting date are used, adjustments are made for the effects of any significant events or transactions between the investor and the associate that occur between the date of the associate's financial statements and the date of the investor's financial statements.

34. The investor's financial statements are usually prepared using uniform accounting policies for like transactions and events in similar circumstances. In many cases, if an associate uses accounting policies other than those adopted by the investor for like transactions and events in similar circumstances, appropriate adjustments are made to the associate's financial statements when they are used by the investor in applying the equity method. If it is not practicable for such adjustments to be calculated, that fact is generally disclosed.

35. If an associate has outstanding cumulative preferred shares, held by outside interests, the investor computes its share of net surpluses or deficits after adjusting for the preferred dividends, whether or not the dividends have been declared.

36. If, under the equity method, an investor's share of deficits of an associate equals or exceeds the carrying amount of an investment, the investor ordinarily discontinues including its share of further losses. The investment is reported at nil value. Additional losses are provided for to the extent that the investor has incurred obligations or made payments on behalf of the associate to satisfy obligations of the associate that the investor has guaranteed or otherwise committed. If the associate subsequently reports surpluses, the investor resumes including its share of those surpluses only after its share of surpluses equals the share of net deficits not recognized.

Impairment Losses

37. If there is an indication that an investment in an associate may be impaired, an entity should consider the relevant international and/or national standards on accounting for such an impairment.

Income Taxes

38. Guidance on accounting for income taxes arising from investments in associates can be found in IAS 12, "Income Taxes."

Contingencies

39. In accordance with the appropriate standards that address provisions, contingent liabilities and contingent assets, the investor discloses:

    (a) Its share of the contingent liabilities of an associate for which it is also contingently liable;

    (b) Those contingent liabilities that arise because the investor is severally liable for all the liabilities of the associate; and

    (c) Its share of the contingent assets of an associate.

Disclosure

40. **The following disclosures should be made:**

    (a) **An appropriate listing and description of significant associates including the proportion of ownership interest and, if different, the proportion of voting power held; and**

    (b) **The methods used to account for such investments.**

41. **Investments in associates accounted for using the equity method should be classified as non-current assets and disclosed as a separate item in**

the statement of financial position. The investor's share of the net surpluses or deficits of such investments should be disclosed as a separate item in the statement of financial performance. The investor's share of any extraordinary or prior period items should also be separately disclosed.

42. IPSAS 1, "Presentation of Financial Statements" also requires the share of net surpluses or deficits of associates accounted for using the equity method of accounting to be presented on the face of the statement of financial performance.

Effective Date

43. **This International Public Sector Accounting Standard becomes effective for annual financial statements covering periods beginning on or after July 1, 2001. Earlier application is encouraged.**

44. When an entity adopts the accrual basis of accounting, as defined by International Public Sector Accounting Standards, for financial reporting purposes, subsequent to this effective date, this Standard applies to the entity's annual financial statements covering periods beginning on or after the date of adoption.

Comparison with IAS 28

International Public Sector Accounting Standard (IPSAS) 7, "Accounting for Investments in Associates" is drawn primarily from International Accounting Standard (IAS) 28, "Accounting for Investments in Associates." The main differences between IPSAS 7 and IAS 28 are as follows:

- Commentary additional to that in IAS 28 has been included in IPSAS 7 to clarify the applicability of the standards to accounting by public sector entities.
- IPSAS 7 applies to all investments in associates where the investor holds an ownership interest in the associate in the form of a shareholding or other formal equity structure. IAS 28 does not contain similar ownership interest requirements. However, it is unlikely that equity accounting could be applied unless the associate had a formal or other reliably measurable equity structure.
- IPSAS 7 uses different terminology, in certain instances, from IAS 28. The most significant examples are the use of the terms "entity," "revenue," "statement of financial performance," "statement of financial position" and "net assets/equity" in IPSAS 7. The equivalent terms in IAS 28 are "enterprise," "income," "income statement," "balance sheet" and "equity."
- IPSAS 7 contains a different set of definitions of technical terms from IAS 28 (paragraph 6).
- In common with IAS 28 this Standard allows an investment in an associate that is included in the separate financial statements of an investor that issues consolidated financial statements, to be carried at cost or accounted for using the equity method. International Accounting Standard IAS 28 also allows such investments in associates to be accounted for as an available-for-sale financial asset as described in International Accounting Standard IAS 39, "Financial Instruments: Recognition and Measurement." By contrast this Standard allows such investments to be accounted for in the same way as other investments shown in the financial statements of the investor.

IPSAS 8—FINANCIAL REPORTING OF INTERESTS IN JOINT VENTURES

Acknowledgment

This International Public Sector Accounting Standard is drawn primarily from International Accounting Standard (IAS) 31, "Financial Reporting of Interests In Joint Ventures" 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 IASC. The International Accounting Standards (IASs) issued by IASC remain in force until they are amended or withdrawn by IASB. Extracts from IAS 31 are reproduced in this publication of the Public Sector Committee of the International Federation of Accountants with the permission of IASB.

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May 2000

IPSAS 8—FINANCIAL REPORTING OF INTERESTS IN JOINT VENTURES

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Comparison with IAS 31

The standards, which have been set in bold type, should be read in the context of the commentary paragraphs in this Standard, which are in plain type, and in the context of the "Preface to International Public Sector Accounting Standards." International Public Sector Accounting Standards are not intended to apply to immaterial items.

Scope

1. **An entity which prepares and presents financial statements under the accrual basis of accounting should apply this Standard in accounting for interests in joint ventures and the reporting of joint venture assets, liabilities, revenue and expenses in the financial statements of venturers and investors, regardless of the structures or forms under which the joint venture activities take place.**

2. This Standard provides the basis for accounting for interests in joint ventures.

3. **This Standard applies to all public sector entities other than Government Business Enterprises.**

4. Government Business Enterprises (GBEs) are required to comply with International Accounting Standards (IASs) issued by the International Accounting Standards Committee. The Public Sector Committee's Guideline No. 1, "Financial Reporting by Government Business Enterprises" notes that IASs are relevant to all business enterprises, regardless of whether they are in the private or public sector. Accordingly, Guideline No. 1 recommends that GBEs should present financial statements that conform, in all material respects, to IASs.

Definitions

5. **The following terms are used in this Standard with the meanings specified:**

   <u>Accrual basis</u> means 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.

   <u>Assets</u> are resources controlled by an entity as a result of past events and from which future economic benefits or service potential are expected to flow to the entity.

Associate is an entity in which the investor has significant influence and which is neither a controlled entity nor a joint venture of the investor.

Cash comprises cash on hand and demand deposits.

Cash flows are inflows and outflows of cash and cash equivalents.

Consolidated financial statements are the financial statements of an economic entity presented as those of a single entity.

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

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

(b) **Can be sold, exchanged, transferred or redeemed.**

Control is the power to govern the financial and operating policies of another entity so as to benefit from its activities.

Controlled entity is an entity that is under the control of another entity (known as the controlling entity).

Controlling entity is an entity that has one or more controlled entities.

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

Economic entity means a group of entities comprising a controlling entity and one or more controlled entities.

Equity method (for the purpose of this Standard) is 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.

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

Government Business Enterprise means an entity that has all the following characteristics:

(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.**

Investor in a joint venture is a party to a joint venture and does not have joint control over that joint venture.

Joint control is the agreed sharing of control over an activity by a binding arrangement.

Joint venture is a binding arrangement whereby two or more parties are committed to undertake an activity which is subject to joint control.

Liabilities are present obligations of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits or service potential.

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

Proportionate consolidation is 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.

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

Significant influence (for the purpose of this Standard) is the power to participate in the financial and operating policy decisions of an activity but is not control or joint control over those policies.

Venturer is a party to a joint venture and has joint control over that joint venture.

Binding Arrangement

6. The existence of a binding arrangement distinguishes interests which involve joint control from investments in associates where the investor has significant influence (see International Public Sector Accounting Standard (IPSAS) 7, "Accounting for Investments in Associates"). For the purposes of this Standard, an arrangement includes all binding arrangements between venturers. That is, in substance, the arrangement confers similar rights and obligations on the parties to it as if it were in the form of a contract. For instance, two government departments may enter into a formal arrangement to undertake a joint venture but the arrangement may not constitute a legal contract because, in that jurisdiction, individual departments may not be separate legal entities with the power to contract. Activities which have no binding arrangement to establish joint control are not joint ventures for the purposes of this Standard.

7. The arrangement may be evidenced in a number of ways, for example by a contract between the venturers or minutes of discussions between the venturers. In some cases, the arrangement is incorporated in the enabling legislation, articles or other by-laws of the joint venture. Whatever its form, the arrangement is usually in writing and deals with such matters as:

   (a) The activity, duration and reporting obligations of the joint venture;

   (b) The appointment of the board of directors or equivalent governing body of the joint venture and the voting rights of the venturers;

   (c) Capital contributions by the venturers; and

   (d) The sharing by the venturers of the output, revenue, expenses, surpluses or deficits, or cash flows of the joint venture.

8. The arrangement establishes joint control over the joint venture. Such a requirement ensures that no single venturer is in a position to unilaterally control the activity. The arrangement identifies those decisions in areas essential to the goals of the joint venture which require the consent of all the venturers and those decisions which may require the consent of a specified majority of the venturers.

9. The arrangement may identify one venturer as the operator or manager of the joint venture. The operator does not control the joint venture but acts

within the financial and operating policies which have been agreed by the venturers in accordance with the arrangement and delegated to the operator. If the operator has the power to govern the financial and operating policies of the activity, it controls the venture and the venture is a controlled entity of the operator and not a joint venture.

Economic Entity

10. The term "economic entity" is used in this Standard to define, for financial reporting purposes, a group of entities comprising the controlling entity and any controlled entities.

11. Other terms sometimes used to refer to an economic entity include "administrative entity," "financial entity," "consolidated entity" and "group."

12. 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.

Forms of Joint Venture

13. Many public sector entities establish joint ventures to undertake a variety of activities. The nature of these activities ranges from commercial undertakings to provision of community services at no charge. The terms of a joint venture are set out in a contract or other binding arrangement and usually specify the initial contribution from each joint venturer and the share of revenues or other benefits (if any), and expenses of each of the joint venturers.

14. Joint ventures take many different forms and structures. This Standard identifies three broad types—jointly controlled operations, jointly controlled assets and jointly controlled entities—which are commonly described as, and meet the definition of, joint ventures. The following characteristics are common to all joint ventures:

    (a) Two or more venturers are bound by an arrangement; and

    (b) The arrangement establishes joint control.

Future Economic Benefits or Service Potential

15. 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 Standard uses the term "future economic benefits or service potential" to describe the essential characteristic of assets.

Government Business Enterprises

16. 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. 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.

Net Assets/Equity

17. "Net assets/equity" is the term used in this Standard 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.

Jointly Controlled Operations

18. The operation of some joint ventures involves the use of the assets and other resources of the venturers rather than the establishment of a corporation, partnership or other entity, or a financial structure that is separate from the venturers themselves. Each venturer uses its own property, plant and equipment and carries its own inventories. It also incurs its own expenses and liabilities and raises its own finance, which represent its own obligations. The joint venture activities may be carried out by the venturer's employees alongside the venturer's similar activities. The joint venture agreement usually provides a means by which the revenue from the sale or provision of the joint product or service and any expenses incurred in common are shared among the venturers.

19. An example of a jointly controlled operation is when two or more venturers combine their operations, resources and expertise in order to manufacture, market and distribute jointly a particular product, such as aircraft. Different parts of the manufacturing process are carried out by each of the venturers. Each venturer bears its own costs and takes a share of the revenue from the sale of the aircraft, such share being determined in accordance with the arrangement. A further example is when two entities combine their

operations, resources and expertise in order to jointly deliver a service, such as aged care where, in accordance with an agreement, a local government offers domestic services and a local hospital offers medical care. Each venturer bears its own costs and takes a share of revenue, such as user charges and government grants; such share being determined in accordance with the agreement.

20. **In respect of its interests in jointly controlled operations, a venturer should recognize in its separate financial statements and consequently in its consolidated financial statements:**

    (a) **The assets that it controls and the liabilities that it incurs; and**

    (b) **The expenses that it incurs and its share of the revenue that it earns from the sale or provision of goods or services by the joint venture.**

21. Because the assets, liabilities, revenue (if any) and expenses are already recognized in the separate financial statements of the venturer, and consequently in its consolidated financial statements, no adjustments or other consolidation procedures are required in respect of these items when the venturer presents consolidated financial statements.

22. Separate accounting records may not be required for the joint venture itself and financial statements may not be prepared for the joint venture. However, the venturers may prepare management accounts so that they may assess the performance of the joint venture.

Jointly Controlled Assets

23. Some joint ventures involve the joint control, and often the joint ownership by the venturers, of one or more assets contributed to, or acquired for the purpose of, the joint venture and dedicated to the purposes of the joint venture. The assets are used to obtain benefits for the venturers. Each venturer may take a share of the output from the assets and each bears an agreed share of the expenses incurred.

24. These joint ventures do not involve the establishment of a corporation, partnership or other entity, or a financial structure that is separate from the venturers themselves. Each venturer has control over its share of future economic benefits or service potential through its share in the jointly controlled asset.

25. Some activities in the public sector involve jointly controlled assets. For example, a local government may enter into an arrangement with a private sector corporation to construct a toll road. The road provides the citizens

with improved access between the local government's industrial estate and its port facilities. The road also provides the private sector corporation with direct access between its manufacturing plant and the port. The agreement between the local authority and the private sector corporation specifies each party's share of revenues and expenses associated with the toll road. Accordingly, each venturer derives economic benefits or service potential from the jointly controlled asset and bears an agreed proportion of the costs of operating the road. Similarly, many activities in the oil, gas and mineral extraction industries involve jointly controlled assets; for example, a number of oil production companies may jointly control and operate an oil pipeline. Each venturer uses the pipeline to transport its own product in return for which it bears an agreed proportion of the expenses of operating the pipeline. Another example of a jointly controlled asset is when two entities jointly control a property, each taking a share of rents received and bearing a share of the expenses.

26. **In respect of its interest in jointly controlled assets, a venturer should recognize in its separate financial statements and consequently in its consolidated financial statements:**

    (a) **Its share of the jointly controlled assets, classified according to the nature of the assets;**

    (b) **Any liabilities which it has incurred;**

    (c) **Its share of any liabilities incurred jointly with the other venturers in relation to the joint venture;**

    (d) **Any revenue from the sale or use of its share of the output of the joint venture, together with its share of any expenses incurred by the joint venture; and**

    (e) **Any expenses which it has incurred in respect of its interest in the joint venture.**

27. In respect of its interest in jointly controlled assets, each venturer includes in its accounting records and recognizes in its separate financial statements and consequently in its consolidated financial statements:

    (a) Its share of the jointly controlled assets, classified according to the nature of the assets rather than as an investment. For example, a share of a jointly controlled road is classified as property, plant and equipment;

    (b) Any liabilities which it has incurred, for example those incurred in financing its share of the assets;

    (c) Its share of any liabilities incurred jointly with other venturers in relation to the joint venture;

(d) Any revenue from the sale or use of its share of the output of the joint venture, together with its share of any expenses incurred by the joint venture; and

(e) Any expenses which it has incurred in respect of its interest in the joint venture, for example those related to financing the venturer's interest in the assets and selling its share of the output.

28. Because the assets, liabilities, revenue and expenses are already recognized in the separate financial statements of the venturer, and consequently in its consolidated financial statements, no adjustments or other consolidation procedures are required in respect of these items when the venturer presents consolidated financial statements.

29. The treatment of jointly controlled assets reflects the substance and economic reality and, usually, the legal form of the joint venture. Separate accounting records for the joint venture itself may be limited to those expenses incurred in common by the venturers and ultimately borne by the venturers according to their agreed shares. Financial statements may not be prepared for the joint venture, although the venturers may prepare management accounts so that they may assess the performance of the joint venture.

Jointly Controlled Entities

30. A jointly controlled entity is a joint venture which involves the establishment of a corporation, partnership or other entity in which each venturer has an interest. The entity operates in the same way as other entities, except that an arrangement between the venturers establishes joint control over the activity of the entity.

31. A jointly controlled entity controls the assets of the joint venture, incurs liabilities and expenses and earns revenue. It may enter into contracts in its own name and raise finance for the purposes of the joint venture activity. Each venturer is entitled to a share of the results of the jointly controlled entity, although some jointly controlled entities also involve a sharing of the output of the joint venture.

32. A common example of a jointly controlled entity is when two entities combine their activities in a particular line of service delivery by transferring the relevant assets and liabilities into a jointly controlled entity. Another example arises when an entity commences a business in a foreign country in conjunction with a government or other agency in that country, by establishing a separate entity which is jointly controlled by the entity and the government or agency in the foreign country.

33. Many jointly controlled entities are similar in substance to those joint ventures referred to as jointly controlled operations or jointly controlled assets. For example, the venturers may transfer a jointly controlled asset, such as a road, into a jointly controlled entity, for tax or other reasons. Similarly, the venturers may contribute into a jointly controlled entity, assets which will be operated jointly. Some jointly controlled operations also involve the establishment of a jointly controlled entity to deal with particular aspects of the activity, for example, the design, marketing, distribution or after-sales service of the product.

34. A jointly controlled entity maintains its own accounting records and prepares and presents financial statements in the same way as other entities in conformity with the appropriate accounting standards.

35. Each venturer usually contributes cash or other resources to the jointly controlled entity. These contributions are included in the accounting records of the venturer and recognized in its separate financial statements as an investment in the jointly controlled entity.

Consolidated Financial Statements of a Venturer

Benchmark Treatment—Proportionate Consolidation

36. **In its consolidated financial statements, a venturer should report its interest in a jointly controlled entity using one of the two reporting formats for proportionate consolidation.**

37. When reporting an interest in a jointly controlled entity in consolidated financial statements, it is essential that a venturer reflects the substance and economic reality of the arrangement, rather than the joint venture's particular structure or form. In a jointly controlled entity, a venturer has control over its share of future economic benefits or service potential through its share of the assets and liabilities of the venture. This substance and economic reality is reflected in the consolidated financial statements of the venturer when the venturer reports its interests in the assets, liabilities, revenue and expenses of the jointly controlled entity by using one of the two reporting formats for proportionate consolidation described in paragraph 39.

38. The application of proportionate consolidation means that the consolidated statement of financial position of the venturer includes its share of the assets that it controls jointly and its share of the liabilities for which it is jointly responsible. The consolidated statement of financial performance of the venturer includes its share of the revenue and expenses of the jointly controlled entity. Many of the procedures appropriate for the application of proportionate consolidation are similar to the procedures for the

consolidation of investments in controlled entities, which are set out in IPSAS 6.

39. Different reporting formats may be used to give effect to proportionate consolidation. The venturer may combine its share of each of the assets, liabilities, revenue and expenses of the jointly controlled entity with the similar items in its consolidated financial statements on a line-by-line basis. For example, it may combine its share of the jointly controlled entity's inventory with the inventory of the economic entity and its share of the jointly controlled entity's property, plant and equipment with the same items of the economic entity. Alternatively, the venturer may include separate line items for its share of the assets, liabilities, revenue and expenses of the jointly controlled entity in its consolidated financial statements. For example, it may show its share of the current assets of the jointly controlled entity separately as part of the current assets of the economic entity; it may show its share of the property, plant and equipment of the jointly controlled entity separately as part of the property, plant and equipment of the economic entity. Both these reporting formats result in the reporting of identical amounts of net revenue and expenses; both formats are acceptable for the purposes of this Standard.

40. Whatever format is used to give effect to proportionate consolidation, it is inappropriate to offset any assets or liabilities by the deduction of other liabilities or assets or any revenue or expenses by the deduction of other expenses or revenue, unless a legal right of set-off exists and the offsetting represents the expectation as to the realization of the asset or the settlement of the liability.

41. **A venturer should discontinue the use of proportionate consolidation from the date on which it ceases to have joint control over a jointly controlled entity.**

42. A venturer discontinues the use of proportionate consolidation from the date on which it ceases to share in the control of a jointly controlled entity. This may happen, for example, when the venturer disposes of its interest or when external restrictions are placed on the jointly controlled entity so that it can no longer achieve its goals.

Allowed Alternative Treatment—Equity Method

43. **In its consolidated financial statements, a venturer should report its interest in a jointly controlled entity using the equity method.**

44. Some venturers report their interests in jointly controlled entities using the equity method, as described in IPSAS 7. The use of the equity method is supported by those who argue that it is inappropriate to combine controlled

items with jointly controlled items and by those who believe that venturers have significant influence, rather than joint control, in a jointly controlled entity. This Standard does not recommend the use of the equity method because proportionate consolidation better reflects the substance and economic reality of a venturer's interest in a jointly controlled entity — that is control over the venturer's share of the future economic benefits or service potential. Nevertheless, this Standard permits the use of the equity method, as an allowed alternative treatment, when reporting interests in jointly controlled entities.

45. **A venturer should discontinue the use of the equity method from the date on which it ceases to have joint control over, or have significant influence in, a jointly controlled entity.**

Exceptions to Benchmark and Allowed Alternative Treatments

46. **The following interests should be accounted for as investments:**

    (a) **An interest in a jointly controlled entity which is acquired and held exclusively with a view to its subsequent disposal in the near future; and**

    (b) **An interest in a jointly controlled entity which operates under severe long-term restrictions that significantly impair its ability to transfer funds or provide other non-financial benefits to the venturer.**

47. Guidance on accounting for investments can be found in international and/or national accounting standards.

48. The use of either proportionate consolidation or the equity method is inappropriate when the interest in a jointly controlled entity is acquired and held exclusively with a view to its subsequent disposal in the near future. It is also inappropriate when the jointly controlled entity operates under severe long-term restrictions which significantly impair its ability to transfer funds or provide other non-financial benefits to the venturer.

49. **From the date on which a jointly controlled entity becomes a controlled entity of a venturer, the venturer accounts for its interest in accordance with IPSAS 6.**

Separate Financial Statements of a Venturer

50. In some jurisdictions, separate financial statements may be presented by a venturer in order to meet legal or other requirements. Such separate financial statements are prepared in order to meet a variety of needs with the result that different reporting practices are in use in different

jurisdictions. Accordingly, this Standard does not indicate a preference for any particular treatment.

Transactions Between a Venturer and a Joint Venture

51. **When a venturer contributes or sells assets to a joint venture, recognition of any portion of a gain or loss from the transaction should reflect the substance of the transaction. While the assets are retained by the joint venture, and provided the venturer has transferred the significant risks and rewards of ownership, the venturer should recognize only that portion of the gain or loss which is attributable to the interests of the other venturers. The venturer should recognize the full amount of any loss when the contribution or sale provides evidence of a reduction in the net realizable value of current assets or an impairment loss.**

52. **When a venturer purchases assets from a joint venture, the venturer should not recognize its share of the gains of the joint venture from the transaction until it resells the assets to an independent party. A venturer should recognize its share of the losses resulting from these transactions in the same way as gains except that losses should be recognized immediately when they represent a reduction in the net realizable value of current assets or an impairment loss.**

53. To assess whether a transaction between a venturer and a joint venture provides evidence of impairment of an asset, the venturer determines the recoverable amount of the assets in accordance with the relevant guidance on impairment of assets. In determining value in use, future cash flows from the asset are estimated based on continuing use of the asset and its ultimate disposal by the joint venture.

Reporting Interests in Joint Ventures in the Financial Statements of an Investor

54. **An investor in a joint venture, which does not have joint control, but does have significant influence should report its interest in a joint venture in accordance with IPSAS 7.**

55. International Accounting Standard (IAS) 39, "Financial Instruments: Recognition and Measurement" provides guidance on accounting for interests in joint ventures where an investor does not have joint control or significant influence.

Operators of Joint Ventures

56. **Operators or managers of a joint venture should account for any fees in accordance with the appropriate standards that address accounting for revenue from exchange transactions.**

57. One or more venturers may act as the operator or manager of a joint venture. Operators are usually paid a management fee for such duties. The fees are accounted for by the joint venture as an expense.

Disclosure

58. **In accordance with the appropriate standards that address provisions, contingent liabilities and contingent assets, a venturer should disclose:**

    (a) **The aggregate amount of the following contingent liabilities, unless the possibility of any outflow in settlement is remote, separately from the amount of other contingent liabilities:**

        (i) **Any contingent liabilities that the venturer has incurred in relation to its interests in joint ventures and its share in each of the contingent liabilities which have been incurred jointly with other venturers;**

        (ii) **Its share of the contingent liabilities of the joint ventures themselves for which it is contingently liable; and**

        (iii) **Those contingent liabilities that arise because the venturer is contingently liable for the liabilities of the other venturers of a joint venture; and**

    (b) **A brief description of the following contingent assets and, where practicable, an estimate of their financial effect, where an inflow of economic benefits or service potential is probable:**

        (i) **Any contingent assets of the venturer arising in relation to its interests in joint ventures and its share in each of the contingent assets which have arisen jointly with other venturers; and**

        (ii) **Its share of the contingent assets of the joint ventures themselves.**

59. **A venturer should disclose the aggregate amount of the following commitments, in respect of its interests in joint ventures, separately from other commitments:**

    (a) **Any capital commitments of the venturer in relation to its interests in joint ventures and its share in the capital**

commitments that have been incurred jointly with other venturers; and

(b) **Its share of the capital commitments of the joint ventures themselves.**

60. **A venturer should disclose a listing and description of interests in significant joint ventures and the proportion of ownership interest held in jointly controlled entities. A venturer which reports its interests in jointly controlled entities using the line-by-line reporting format for proportionate consolidation or the equity method should disclose the aggregate amounts of each of current assets, non-current assets, current liabilities, non-current liabilities, revenue and expenses related to its interest in joint ventures.**

61. **A venturer which does not issue consolidated financial statements because it does not have controlled entities, should disclose the information required in paragraphs 58, 59, and 60 (where applicable).**

62. It is appropriate that a venturer which does not prepare consolidated financial statements because it does not have controlled entities provides the same information about its interests in joint ventures as those venturers that issue consolidated financial statements.

Transitional Provisions

63. **Where the benchmark treatment set out in this Standard is adopted, entities are not required to eliminate balances and transactions between themselves, their controlled entities and entities that they jointly control for reporting periods beginning on a date within three years following the date of first adoption of this Standard.**

64. Entities that adopt this Standard may have many controlled and jointly controlled entities with a significant number of transactions between these entities. Accordingly, it may initially be difficult to identify all the transactions and balances that need to be eliminated for the purpose of preparing the financial statements. For this reason, paragraph 63 provides temporary relief from eliminating in full balances and transactions between entities and their jointly controlled entities.

65. **Where entities apply the transitional provision in paragraph 63, an entity should disclose the fact that not all inter-entity balances and transactions have been eliminated.**

Effective Date

66. **This International Public Sector Accounting Standard becomes effective for annual financial statements covering periods beginning on or after July 1, 2001. Earlier application is encouraged.**

67. When an entity adopts the accrual basis of accounting, as defined by International Public Sector Accounting Standards, for financial reporting purposes, subsequent to this effective date, this Standard applies to the entity's annual financial statements covering periods beginning on or after the date of adoption.

Comparison with IAS 31

International Public Sector Accounting Standard (IPSAS) 8, "Financial Reporting of Interests in Joint Ventures" is drawn primarily from International Accounting Standard (IAS) 31, "Financial Reporting of Interests in Joint Ventures." The main differences between IPSAS 8 and IAS 31 are as follows:

- Commentary additional to that in IAS 31 has been included in IPSAS 8 to clarify the applicability of the standards to accounting by public sector entities.
- IPSAS 8 uses different terminology, in certain instances, from IAS 31. The most significant examples are the use of the terms "entity," "revenue," "statement of financial performance," "statement of financial position" and "net assets/equity" in IPSAS 8. The equivalent terms in IAS 31 are "enterprise," "income," "income statement," "balance sheet" and "equity."
- IPSAS 8 contains a different set of definitions of technical terms from IAS 31 (paragraph 5).
- IPSAS 8 uses a different definition of joint venture from IAS 31. The term "contractual arrangement" has been replaced by "binding arrangement."
- IPSAS 8 includes a transitional provision that permits entities which adopt the benchmark treatment to not eliminate all balances and transactions between entities within the economic entity for reporting periods beginning on a date within three years following the date of first application of this Standard.

IPSAS 9—REVENUE FROM EXCHANGE TRANSACTIONS

Acknowledgment

This International Public Sector Accounting Standard is drawn primarily from International Accounting Standard (IAS) 18 (revised 1993), "Revenue" 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 IASC. The International Accounting Standards (IASs) issued by IASC remain in force until they are amended or withdrawn by the IASB. Extracts from IAS 18 are reproduced in this publication of the Public Sector Committee of the International Federation of Accountants with the permission of IASB.

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IPSAS 9—REVENUE FROM EXCHANGE TRANSACTIONS

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Appendix

Comparison with IAS 18

The standards, which have been set in bold type, should be read in the context of the commentary paragraphs in this Standard, which are in plain type, and in the context of the "Preface to International Public Sector Accounting Standards." International Public Sector Accounting Standards are not intended to apply to immaterial items.

Objective

The International Accounting Standards Committee (IASC) "Framework for the Preparation and Presentation of Financial Statements" defines income as "increases in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases of liabilities that result in increases in equity, other than those relating to contributions from equity participants." The IASC definition of income encompasses both revenue and gains. This Standard uses the term "revenue," which encompasses both revenues and gains, in place of the term "income." Certain specific items to be recognized as revenues are addressed in other Standards and are excluded from the scope of this Standard. For example, gains arising on the sale of property, plant and equipment are specifically addressed in Standards on property, plant and equipment and are not covered in this Standard.

The objective of this Standard is to prescribe the accounting treatment of revenue arising from exchange transactions and events.

The primary issue in accounting for revenue is determining when to recognize revenue. Revenue is recognized when it is probable that future economic benefits or service potential will flow to the entity and these benefits can be measured reliably. This Standard identifies the circumstances in which these criteria will be met and, therefore, revenue will be recognized. It also provides practical guidance on the application of these criteria.

Scope

1. **An entity which prepares and presents financial statements under the accrual basis of accounting should apply this Standard in accounting for revenue arising from the following exchange transactions and events:**

   (a) **The rendering of services;**

   (b) **The sale of goods; and**

   (c) **The use by others of entity assets yielding interest, royalties and dividends.**

2. **This Standard applies to all public sector entities other than Government Business Enterprises.**

3. Government Business Enterprises (GBEs) are required to comply with International Accounting Standards (IASs) issued by the International Accounting Standards Committee. The Public Sector Committee's Guideline No. 1, "Financial Reporting by Government Business Enterprises" notes that IASs are relevant to all business enterprises, regardless of whether they are in the private or public sector. Accordingly, Guideline No. 1 recommends that GBEs should present financial statements that conform, in all material respects, to IASs.

4. This Standard does not deal with revenue arising from non-exchange transactions.

5. Public sector entities may derive revenues from exchange or non-exchange transactions. 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.

6. In distinguishing between exchange and non-exchange revenues, substance rather than the form of the transaction should be considered. Examples of non-exchange transactions include revenue from the use of sovereign powers (for example, direct and indirect taxes, duties, and fines), grants and donations.

7. The rendering of services typically involves the performance by the entity of an agreed task over an agreed period of time. The services may be rendered within a single period or over more than one period. Examples of services rendered by public sector entities for which revenue is typically received in exchange may include the provision of housing, management of water facilities, management of toll roads, and management of transfer payments. Some agreements for the rendering of services are directly related to construction contracts, for example, those for the services of project managers and architects. Revenue arising from these agreements is not dealt with in this Standard but is dealt with in accordance with the requirements for construction contracts as specified in International Public Sector Accounting Standard (IPSAS) 11, "Construction Contracts."

8. Goods includes goods produced by the entity for the purpose of sale, such as publications, and goods purchased for resale, such as merchandise or land and other property held for resale.

9. The use by others of entity assets gives rise to revenue in the form of:

   (a) Interest — charges for the use of cash or cash equivalents or amounts due to the entity;

   (b) Royalties — charges for the use of long-term assets of the entity, for example, patents, trademarks, copyrights and computer software; and

   (c) Dividends or equivalents — distributions of surpluses to holders of equity investments in proportion to their holdings of a particular class of capital.

10. This Standard does not deal with revenues:

   (a) Addressed in other International Public Sector Accounting Standards, including:

      (i) Lease agreements (see IPSAS 13, "Leases");

      (ii) Dividends arising from investments which are accounted for under the equity method (see IPSAS 7, "Accounting for Investments in Associates"); and

      (iii) Gains from the sale of property, plant and equipment (which are dealt with in IPSAS 17, "Property, Plant and Equipment"),

   Arising from insurance contracts of insurance entities;

   (c) Arising from changes in the fair value of financial assets and financial liabilities or their disposal (guidance on accounting for financial instruments can be found in International Accounting Standard (IAS) 39, "Financial Instruments: Recognition and Measurement");

   (d) Arising from changes in the value of other current assets;

   (e) Arising from natural increases in herds, and agricultural and forest products; and

   (f) Arising from the extraction of mineral ores.

Definitions

11. **The following terms are used in this Standard with the meanings specified:**

   Fair value is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.

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

Terms defined in other International Public Sector Accounting Standards are used in this Standard with the same meaning as in those other Standards, and are reproduced in the Glossary of Defined Terms published separately.

Revenue

12. Revenue includes only the gross inflows of economic benefits or service potential received and receivable by the entity on its own account. Amounts collected as agent of the government or another government organization or on behalf of other third parties, for example the collection of telephone and electricity payments by the post office on behalf of entities providing such services, are not economic benefits or service potential which flow to the entity and do not result in increases in assets or decreases in liabilities. Therefore, they are excluded from revenue. Similarly, in a custodial or agency relationship, the gross inflows of economic benefits or service potential include amounts collected on behalf of the principal and which do not result in increases in net assets/equity for the entity. The amounts collected on behalf of the principal are not revenue. Instead, revenue is the amount of any commission received or receivable for the collection or handling of the gross flows.

13. Financing inflows, notably borrowings, do not meet the definition of revenue because they result in an equal change in both assets and liabilities and have no impact upon net assets/equity. Financing inflows are taken directly to the statement of financial position and added to the balances of assets and liabilities.

Measurement of Revenue

14. **Revenue should be measured at the fair value of the consideration received or receivable.**

15. The amount of revenue arising on a transaction is usually determined by agreement between the entity and the purchaser or user of the asset or service. It is measured at the fair value of the consideration received or receivable taking into account the amount of any trade discounts and volume rebates allowed by the entity.

16. In most cases, the consideration is in the form of cash or cash equivalents and the amount of revenue is the amount of cash or cash equivalents received or receivable. However, when the inflow of cash or cash

equivalents is deferred, the fair value of the consideration may be less than the nominal amount of cash received or receivable. For example, an entity may provide interest free credit to the purchaser or accept a note receivable bearing a below-market interest rate from the purchaser as consideration for the sale of goods. When the arrangement effectively constitutes a financing transaction, the fair value of the consideration is determined by discounting all future receipts using an imputed rate of interest. The imputed rate of interest is the more clearly determinable of either:

(a) The prevailing rate for a similar instrument of an issuer with a similar credit rating; or

(b) A rate of interest that discounts the nominal amount of the instrument to the current cash sales price of the goods or services.

The difference between the fair value and the nominal amount of the consideration is recognized as interest revenue in accordance with paragraphs 33 and 34.

17. When goods or services are exchanged or swapped for goods or services which are of a similar nature and value, the exchange is not regarded as a transaction which generates revenue. This is often the case with commodities like oil or milk where suppliers exchange or swap inventories in various locations to fulfill demand on a timely basis in a particular location. When goods are sold or services are rendered in exchange for dissimilar goods or services, the exchange is regarded as a transaction which generates revenue. The revenue is measured at the fair value of the goods or services received, adjusted by the amount of any cash or cash equivalents transferred. When the fair value of the goods or services received cannot be measured reliably, the revenue is measured at the fair value of the goods or services given up, adjusted by the amount of any cash or cash equivalents transferred.

Identification of the Transaction

18. The recognition criteria in this Standard are usually applied separately to each transaction. However, in certain circumstances, it is necessary to apply the recognition criteria to the separately identifiable components of a single transaction in order to reflect the substance of the transaction. For example, when the price of a product includes an identifiable amount for subsequent servicing, that amount is deferred and recognized as revenue over the period during which the service is performed. Conversely, the recognition criteria are applied to two or more transactions together when they are linked in such a way that the effect cannot be understood without reference to the series of transactions as a whole. For example, an entity may sell goods and, at the same time, enter into a separate agreement to repurchase the goods at

a later date, thus negating the substantive effect of the transaction; in such a case, the two transactions are dealt with together.

Rendering of Services

19. **When the outcome of a transaction involving the rendering of services can be estimated reliably, revenue associated with the transaction should be recognized by reference to the stage of completion of the transaction at the reporting date. The outcome of a transaction can be estimated reliably when all the following conditions are satisfied:**

    (a) **The amount of revenue can be measured reliably;**

    (b) **It is probable that the economic benefits or service potential associated with the transaction will flow to the entity;**

    (c) **The stage of completion of the transaction at the reporting date can be measured reliably; and**

    (d) **The costs incurred for the transaction and the costs to complete the transaction can be measured reliably.**

20. The recognition of revenue by reference to the stage of completion of a transaction is often referred to as the percentage of completion method. Under this method, revenue is recognized in the reporting periods in which the services are rendered. For example, an entity providing property valuation services would recognize revenue as the individual valuations are completed. The recognition of revenue on this basis provides useful information on the extent of service activity and performance during a period. IPSAS 11, also requires the recognition of revenue on this basis. The requirements of that Standard are generally applicable to the recognition of revenue and the associated expenses for a transaction involving the rendering of services.

21. Revenue is recognized only when it is probable that the economic benefits or service potential associated with the transaction will flow to the entity. However, when an uncertainty arises about the collectability of an amount already included in revenue, the uncollectable amount, or the amount in respect of which recovery has ceased to be probable, is recognized as an expense, rather than as an adjustment of the amount of revenue originally recognized.

22. An entity is generally able to make reliable estimates after it has agreed to the following with the other parties to the transaction:

    (a) Each party's enforceable rights regarding the service to be provided and received by the parties;

    (b) The consideration to be exchanged; and

(c) The manner and terms of settlement.

It is also usually necessary for the entity to have an effective internal financial budgeting and reporting system. The entity reviews and, when necessary, revises the estimates of revenue as the service is performed. The need for such revisions does not necessarily indicate that the outcome of the transaction cannot be estimated reliably.

23. The stage of completion of a transaction may be determined by a variety of methods. An entity uses the method that measures reliably the services performed. Depending on the nature of the transaction, the methods may include:

(a) Surveys of work performed;

(b) Services performed to date as a percentage of total services to be performed; or

(c) The proportion that costs incurred to date bear to the estimated total costs of the transaction. Only costs that reflect services performed to date are included in costs incurred to date. Only costs that reflect services performed or to be performed are included in the estimated total costs of the transaction.

Progress payments and advances received from customers often do not reflect the services performed.

24. For practical purposes, when services are performed by an indeterminate number of acts over a specified time frame, revenue is recognized on a straight line basis over the specified time frame unless there is evidence that some other method better represents the stage of completion. When a specific act is much more significant than any other acts, the recognition of revenue is postponed until the significant act is executed.

25. **When the outcome of the transaction involving the rendering of services cannot be estimated reliably, revenue should be recognized only to the extent of the expenses recognized that are recoverable.**

26. During the early stages of a transaction, it is often the case that the outcome of the transaction cannot be estimated reliably. Nevertheless, it may be probable that the entity will recover the transaction costs incurred. Therefore, revenue is recognized only to the extent of costs incurred that are expected to be recoverable. As the outcome of the transaction cannot be estimated reliably, no surplus is recognized.

27. When the outcome of a transaction cannot be estimated reliably and it is not probable that the costs incurred will be recovered, revenue is not recognized

and the costs incurred are recognized as an expense. When the uncertainties that prevented the outcome of the contract being estimated reliably no longer exist, revenue is recognized in accordance with paragraph 19 rather than in accordance with paragraph 25.

Sale of Goods

28. **Revenue from the sale of goods should be recognized when all the following conditions have been satisfied:**

    (a) **The entity has transferred to the purchaser the significant risks and rewards of ownership of the goods;**

    (b) **The entity retains neither continuing managerial involvement to the degree usually associated with ownership nor effective control over the goods sold;**

    (c) **The amount of revenue can be measured reliably;**

    (d) **It is probable that the economic benefits or service potential associated with the transaction will flow to the entity; and**

    (e) **The costs incurred or to be incurred in respect of the transaction can be measured reliably.**

29. The assessment of when an entity has transferred the significant risks and rewards of ownership to the purchaser requires an examination of the circumstances of the transaction. In most cases, the transfer of the risks and rewards of ownership coincides with the transfer of the legal title or the passing of possession to the purchaser. This is the case for most sales. However, in certain other cases, the transfer of risks and rewards of ownership occurs at a different time from the transfer of legal title or the passing of possession.

30. If the entity retains significant risks of ownership, the transaction is not a sale and revenue is not recognized. An entity may retain a significant risk of ownership in a number of ways. Examples of situations in which the entity may retain the significant risks and rewards of ownership are:

    (a) When the entity retains an obligation for unsatisfactory performance not covered by normal warranty provisions;

    (b) When the receipt of the revenue from a particular sale is contingent on the derivation of revenue by the purchaser from its sale of the goods (for example, where a government publishing operation distributes educational material to schools on a sale or return basis);

(c) When the goods are shipped subject to installation and the installation is a significant part of the contract which has not yet been completed by the entity; and

(d) When the purchaser has the right to rescind the purchase for a reason specified in the sales contract and the entity is uncertain about the probability of return.

31. If an entity retains only an insignificant risk of ownership, the transaction is a sale and revenue is recognized. For example, a seller may retain the legal title to the goods solely to protect the collectability of the amount due. In such a case, if the entity has transferred the significant risks and rewards of ownership, the transaction is a sale and revenue is recognized. Another example of an entity retaining only an insignificant risk of ownership may be a sale when a refund is offered if the purchaser is not satisfied. Revenue in such cases is recognized at the time of sale provided the seller can reliably estimate future returns and recognizes a liability for returns based on previous experience and other relevant factors.

32. Revenue is recognized only when it is probable that the economic benefits or service potential associated with the transaction will flow to the entity. In some cases, this may not be probable until the consideration is received or until an uncertainty is removed. For example, the revenue may be dependent upon the ability of another entity to supply goods as part of the contract and if there is any doubt that this will occur, recognition may be delayed until it has occurred. When the goods are supplied, the uncertainty is removed and revenue is recognized. However, when an uncertainty arises about the collectability of an amount already included in revenue, the uncollectable amount, or the amount in respect of which recovery has ceased to be probable, is recognized as an expense, rather than as an adjustment of the amount of revenue originally recognized.

Interest, Royalties and Dividends

33. **Revenue arising from the use by others of entity assets yielding interest, royalties and dividends should be recognized using the accounting treatments set out in paragraph 34 when:**

(a) **It is probable that the economic benefits or service potential associated with the transaction will flow to the entity; and**

(b) **The amount of the revenue can be measured reliably.**

34. **Revenue should be recognized using the following accounting treatments:**

(a) **Interest should be recognized on a time proportion basis that takes into account the effective yield on the asset;**

(b) **Royalties should be recognized as they are earned in accordance with the substance of the relevant agreement; and**

(c) **Dividends or their equivalents should be recognized when the shareholder's or the entity's right to receive payment is established.**

35. The effective yield on an asset is the rate of interest required to discount the stream of future cash receipts expected over the life of the asset to equate to the initial carrying amount of the asset. Interest revenue includes the amount of amortization of any discount, premium or other difference between the initial carrying amount of a debt security and its amount at maturity.

36. When unpaid interest has accrued before the acquisition of an interest-bearing investment, the subsequent receipt of interest is allocated between pre-acquisition and post-acquisition periods; only the post-acquisition portion is recognized as revenue. When dividends on equity securities are declared from pre-acquisition net surplus, those dividends are deducted from the cost of the securities. If it is difficult to make such an allocation except on an arbitrary basis, dividends are recognized as revenue unless they clearly represent a recovery of part of the cost of the equity securities.

37. Royalties, such as petroleum royalties, accrue in accordance with the terms of the relevant agreement and are usually recognized on that basis unless, having regard to the substance of the agreement, it is more appropriate to recognize revenue on some other systematic and rational basis.

38. Revenue is recognized only when it is probable that the economic benefits or service potential associated with the transaction will flow to the entity. However, when an uncertainty arises about the collectability of an amount already included in revenue, the uncollectable amount, or the amount in respect of which recovery has ceased to be probable, is recognized as an expense, rather than as an adjustment of the amount of revenue originally recognized.

Disclosure

39. **An entity should disclose:**

(a) **The accounting policies adopted for the recognition of revenue including the methods adopted to determine the stage of completion of transactions involving the rendering of services;**

(b) **The amount of each significant category of revenue recognized during the period including revenue arising from:**

   (i) **The rendering of services;**

   (ii) **The sale of goods;**

   (iii) **Interest;**

   (iv) **Royalties; and**

   (v) **Dividends or their equivalents; and**

(c) **The amount of revenue arising from exchanges of goods or services included in each significant category of revenue.**

40. Guidance on disclosure of any contingent assets and contingent liabilities can be found in IAS 37, "Provisions, Contingent Liabilities and Contingent Assets." Contingent assets and contingent liabilities may arise from items such as warranty costs, claims, penalties or possible losses.

Effective Date

41. **This International Public Sector Accounting Standard becomes effective for annual financial statements covering periods beginning on or after July 1, 2002. Earlier application is encouraged.**

42. When an entity adopts the accrual basis of accounting, as defined by International Public Sector Accounting Standards, for financial reporting purposes, subsequent to this effective date, this Standard applies to the entity's annual financial statements covering periods beginning on or after the date of adoption.

Appendix

The appendix is illustrative only and does not form part of the standards. The purpose of the appendix is to illustrate the application of the standards to assist in clarifying their meaning in a number of situations. The examples focus on particular aspects of a transaction and are not a comprehensive discussion of all the relevant factors which might influence the recognition of revenue. The examples generally assume that the amount of revenue can be measured reliably, it is probable that the economic benefits or service potential will flow to the entity and the costs incurred or to be incurred can be measured reliably. The examples do not modify or override the standards.

Public sector entities derive revenues from exchange or non-exchange transactions. This Standard deals only with revenue arising from exchange transactions. Revenue from exchange transactions is derived from:

(a) Sale of goods or provision of services to third parties;

(b) Sale of goods or provision of services to other government agencies; and

(c) The use by others of entity assets yielding interest, royalties and dividends.

The application of the recognition criteria to particular transactions may be affected by:

(a) The law in different countries, which may determine the point in time at which the entity transfers the significant risks and rewards of ownership. Therefore, the examples in this section of the appendix need to be read in the context of the laws in the country in which the transaction takes place; and

(b) The nature of the relationship (contractual or otherwise) between the entity that pays and the entity that receives the revenue (that is, the entities may agree on specific points in time at which the receiving entity can recognize revenue).

Rendering of Services

1. *Housing*

   Rental income from the provision of housing is recognized as the income is earned in accordance with the terms of the tenancy agreement.

2. *School transport*

   Revenue from fares charged to passengers for the provision of school transport is recognized as the transport is provided.

3. *Management of toll roads*

   Revenue from the management of toll roads is recognized as it is earned, based on the usage of the roads.

4. *Processing of court cases*

   Revenue from the processing of court cases can be recognized either by reference to the stage of completion of the processing, or based on the periods during which the courts are in session.

5. *Management of facilities, assets or services*

   Revenue from the management of facilities, assets or services is recognized over the term of the contract as the management services are provided.

6. *Science and technology research*

   Revenue received from clients from contracts for undertaking science and technology research is recognized by reference to the stage of completion on individual projects.

7. *Installation fees*

   Installation fees are recognized as revenue by reference to the stage of completion of the installation, unless they are incidental to the sale of a product in which case they are recognized when the goods are sold.

8. *Servicing fees included in the price of the product*

   When the selling price of a product includes an identifiable amount for subsequent servicing (for example, after sales support and product enhancement on the sale of software), that amount is deferred and recognized as revenue over the period during which the service is performed. The amount deferred is that which will cover the expected costs of the services under the agreement, together with a reasonable return on those services.

9. *Insurance agency commissions*

   Insurance agency commissions received or receivable which do not require the agent to render further service are recognized as revenue by the agent on the effective commencement or renewal dates of the related policies. However, when it is probable that the agent will be required to render further services during the life of the policy, the commission, or part thereof, is deferred and recognized as revenue over the period during which the policy is in force.

10. *Financial service fees*

The recognition of revenue for financial service fees depends on the purposes for which the fees are assessed and the basis of accounting for any associated financial instrument. The description of fees for financial services may not be indicative of the nature and substance of the services provided. Therefore, it is necessary to distinguish between fees which are an integral part of the effective yield of a financial instrument, fees which are earned as services are provided, and fees which are earned on the execution of a significant act.

(a) *Fees which are an integral part of the effective yield of a financial instrument*

Such fees are generally treated as an adjustment to the effective yield. However, when the financial instrument is to be measured at fair value subsequent to its initial recognition the fees are recognized as revenue when the instrument is initially recognized.

(b) *Fees earned as services are provided*

(i) *Fees charged for servicing a loan*

Fees charged by an entity for servicing a loan are recognized as revenue as the services are provided. If the entity sells a loan but retains the servicing of that loan at a fee which is lower than a normal fee for such services, part of the sales price of the loan is deferred and recognized as revenue as the servicing is provided.

(ii) *Commitment fees to originate or purchase a loan*

If it is unlikely that a specific lending arrangement will be entered into, the commitment fee is recognized as revenue on a time proportion basis over the commitment period.

(c) *Fees earned on the execution of a significant act, which is much more significant than any other act.*

The fees are recognized as revenue when the significant act has been completed.

11. *Admission fees*

Revenue from artistic performances, banquets and other special events is recognized when the event takes place. When a subscription to a number of events is sold, the fee is allocated to each event on a basis which reflects the extent to which services are performed at each event.

12. *Tuition fees*

    Revenue is recognized over the period of instruction.

13. *Initiation, entrance and membership fees*

    Revenue recognition depends on the nature of the services provided. If the fee permits only membership, and all other services or products are paid for separately, or if there is a separate annual subscription, the fee is recognized as revenue when no significant uncertainty as to its collectability exists. If the fee entitles the member to services or publications to be provided during the membership period, or to purchase goods or services at prices lower than those charged to non-members, it is recognized on a basis that reflects the timing, nature and value of the benefits provided.

14. *Franchise or concession fees*

    Franchise or concession fees may cover the supply of initial and subsequent services, equipment and other tangible assets, and know-how. Accordingly, franchise or concession fees are recognized as revenue on a basis that reflects the purpose for which the fees were charged. The following methods of franchise or concession fee recognition are appropriate:

    (a) Supplies of equipment and other tangible assets

        The amount, based on the fair value of the assets sold, is recognized as revenue when the items are delivered or title passes.

    (b) Supplies of initial and subsequent services

        Fees for the provision of continuing services, whether part of the initial fee or a separate fee, are recognized as revenue as the services are rendered. When the separate fee does not cover the cost of continuing services together with a reasonable return, part of the initial fee, sufficient to cover the costs of continuing services and to provide a reasonable return on those services, is deferred and recognized as revenue as the services are rendered.

    (c) *Continuing franchise or concession fees*

        Fees charged for the use of continuing rights granted by the agreement, or for other services provided during the period of the agreement, are recognized as revenue as the services are provided or the rights used.

    (d) *Agency transactions*

        Transactions may take place between the franchisor and the franchisee which, in substance, involve the franchisor acting as agent for the franchisee. For example, the franchisor may order supplies

and arrange for their delivery to the franchisee at no return. Such transactions do not give rise to revenue.

15. *Fees from the development of customized software*

    Fees from the development of customized software are recognized as revenue by reference to the stage of completion of the development, including completion of services provided for post delivery service support.

Sale of Goods

16. "Bill and hold" sales, in which delivery is delayed at the purchaser's request but the purchaser takes title and accepts billing

    Revenue is recognized when the purchaser takes title, provided:

    (a) It is probable that delivery will be made;

    (b) The item is on hand, identified and ready for delivery to the purchaser at the time the sale is recognized;

    (c) The purchaser specifically acknowledges the deferred delivery instructions; and

    (d) The usual payment terms apply.

    Revenue is not recognized when there is simply an intention to acquire or manufacture the goods in time for delivery.

17. *Goods shipped subject to conditions*

    (a) Installation and inspection

    Revenue is normally recognized when the purchaser accepts delivery, and installation and inspection are complete. However, revenue is recognized immediately upon the purchaser's acceptance of delivery when:

    (i) The installation process is simple in nature; or

    (ii) The inspection is performed only for purposes of final determination of contract prices.

    (b) *On approval when the purchaser has negotiated a limited right of return*

    If there is uncertainty about the possibility of return, revenue is recognized when the shipment has been formally accepted by the purchaser or the goods have been delivered and the time period for rejection has elapsed.

    (c) *Consignment sales under which the recipient (purchaser) undertakes to sell the goods on behalf of the shipper (seller)*

Revenue is recognized by the shipper when the goods are sold by the recipient to a third party.

(d) *Cash on delivery sales*

Revenue is recognized when delivery is made and cash is received by the seller or its agent.

18. *Lay away sales under which the goods are delivered only when the purchaser makes the final payment in a series of installments*

Revenue from such sales is recognized when the goods are delivered. However, when experience indicates that most such sales are consummated, revenue may be recognized when a significant deposit is received provided the goods are on hand, identified and ready for delivery to the purchaser.

19. *Orders when payment (or partial payment) is received in advance of delivery for goods not presently held in inventory, for example, the goods are still to be manufactured or will be delivered directly to the customer from a third party*

Revenue is recognized when the goods are delivered to the purchaser.

20. *Sale and repurchase agreements (other than swap transactions) under which the seller concurrently agrees to repurchase the same goods at a later date, or when the seller has a call option to repurchase, or the purchaser has a put option to require the repurchase, by the seller, of the goods*

The terms of the agreement need to be analyzed to ascertain whether, in substance, the seller has transferred the risks and rewards of ownership to the purchaser and hence revenue is recognized. When the seller has retained the risks and rewards of ownership, even though legal title has been transferred, the transaction is a financing arrangement and does not give rise to revenue.

21. *Sales to intermediate parties, such as distributors, dealers or others for resale*

Revenue from such sales is generally recognized when the risks and rewards of ownership have passed. However, when the purchaser is acting, in substance, as an agent, the sale is treated as a consignment sale.

22. *Subscriptions to publications and similar items*

When the items involved are of similar value in each time period, revenue is recognized on a straight line basis over the period in which the items are dispatched. When the items vary in value from period to period, revenue is recognized on the basis of the sales value of the item dispatched in relation to the total estimated sales value of all items covered by the subscription.

23. *Installment sales, under which the consideration is receivable in installments*

    Revenue attributable to the sales price, exclusive of interest, is recognized at the date of sale. The sale price is the present value of the consideration, determined by discounting the installments receivable at the imputed rate of interest. The interest element is recognized as revenue as it is earned, on a time proportion basis that takes into account the imputed rate of interest.

24. *Real estate sales*

    Revenue is normally recognized when legal title passes to the purchaser. However, in some jurisdictions the equitable interest in a property may vest in the purchaser before legal title passes and therefore the risks and rewards of ownership have been transferred at that stage. In such cases, provided that the seller has no further substantial acts to complete under the contract, it may be appropriate to recognize revenue. In either case, if the seller is obliged to perform any significant acts after the transfer of the equitable and/or legal title, revenue is recognized as the acts are performed. An example is a building or other facility on which construction has not been completed.

    In some cases, real estate may be sold with a degree of continuing involvement by the seller such that the risks and rewards of ownership have not been transferred. Examples are sale and repurchase agreements which include put and call options, and agreements whereby the seller guarantees occupancy of the property for a specified period, or guarantees a return on the purchaser's investment for a specified period. In such cases, the nature and extent of the seller's continuing involvement determines how the transaction is accounted for. It may be accounted for as a sale, or as a financing, leasing or some other profit sharing arrangement. If it is accounted for as a sale, the continuing involvement of the seller may delay the recognition of revenue.

    A seller must also consider the means of payment and evidence of the purchaser's commitment to complete payment. For example, when the aggregate of the payments received, including the purchaser's initial down payment, or continuing payments by the purchaser, provide insufficient evidence of the purchaser's commitment to complete payment, revenue is recognized only to the extent cash is received.

Interest, Royalties and Dividends

25. *License fees and royalties*

    Fees and royalties paid for the use of an entity's assets (such as trademarks, patents, software, music copyright, record masters and motion picture films) are normally recognized in accordance with the substance of the agreement. As a practical matter, this may be on a straight line basis over the life of the

agreement, for example, when a licensee has the right to use certain technology for a specified period of time.

An assignment of rights for a fixed fee or non refundable guarantee under a non cancelable contract which permits the licensee to exploit those rights freely and the licensor has no remaining obligations to perform is, in substance, a sale. An example is a licensing agreement for the use of software when the licensor has no obligations subsequent to delivery. Another example is the granting of rights to exhibit a motion picture film in markets where the licensor has no control over the distributor and expects to receive no further revenues from the box office receipts. In such cases, revenue is recognized at the time of sale.

In some cases, whether or not a license fee or royalty will be received is contingent on the occurrence of a future event. In such cases, revenue is recognized only when it is probable that the fee or royalty will be received, which is normally when the event has occurred.

Comparison with IAS 18

International Public Sector Accounting Standard (IPSAS) 9, "Revenue From Exchange Transactions" is drawn primarily from International Accounting Standard (IAS) 18, "Revenue." The main differences between IPSAS 9 and IAS 18 are as follows:

- The title of IPSAS 9 differs from that of IAS 18 and this difference clarifies that IPSAS 9 does not deal with revenue from non-exchange transactions.
- The definition of revenue adopted in IPSAS 9 is similar to the definition adopted in IAS 18. The main difference is that the definition in IAS 18 refers to "ordinary activities."
- At the time of issuing this Standard, the Public Sector Committee has not considered the applicability of International Accounting Standards (IAS) 41, "Agriculture" to public sector entities, therefore IPSAS 9 does not reflect amendments made to IAS 18 consequent upon the issuing of IAS 41.
- Commentary additional to that in IAS 18 has also been included in IPSAS 9 to clarify the applicability of the standards to accounting by public sector entities.
- IPSAS 9 uses different terminology, in certain instances, from IAS 18. The most significant examples are the use of the terms "entity," "statement of financial position" and "net assets/equity" in IPSAS 9. The equivalent terms in IAS 18 are "enterprise," "balance sheet" and "equity."

IPSAS 10—FINANCIAL REPORTING IN HYPERINFLATIONARY ECONOMIES

Acknowledgment

This International Public Sector Accounting Standard is drawn primarily from International Accounting Standard (IAS) 29 (reformatted 1994), "Financial Reporting in Hyperinflationary Economies" 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 IASC. The International Accounting Standards (IASs) issued by IASC remain in force until they are amended or withdrawn by IASB. Extracts from IAS 29 are reproduced in this publication of the Public Sector Committee of the International Federation of Accountants with the permission of IASB.

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IPSAS 10—FINANCIAL REPORTING IN HYPERINFLATIONARY ECONOMIES

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Appendix — Restatement of Financial Statements

Comparison with IAS 29

The standards, which have been set in bold type, should be read in the context of the commentary paragraphs in this Standard, which are in plain type, and in the context of the "Preface to International Public Sector Accounting Standards." International Public Sector Accounting Standards are not intended to apply to immaterial items.

Scope

1. **An entity which prepares and presents financial statements under the accrual basis of accounting should apply this Standard to the primary financial statements, including the consolidated financial statements, of any entity that reports in the currency of a hyperinflationary economy.**

2. **This Standard applies to all public sector entities other than Government Business Enterprises.**

3. In a hyperinflationary economy, reporting of operating results and financial position in the local currency without restatement is not useful. Money loses purchasing power at such a rate that comparison of amounts from transactions and other events that have occurred at different times, even within the same reporting period, is misleading.

4. This Standard does not establish an absolute rate at which hyperinflation is deemed to arise. It is a matter of judgment when restatement of financial statements in accordance with this Standard becomes necessary. Hyperinflation is indicated by characteristics of the economic environment of a country which include, but are not limited to, the following:

   (a) The general population prefers to keep its wealth in non-monetary assets or in a relatively stable foreign currency. Amounts of local currency held are immediately invested to maintain purchasing power;

   (b) The general population regards monetary amounts not in terms of the local currency but in terms of a relatively stable foreign currency. Prices may be quoted in that currency;

   (c) Sales and purchases on credit take place at prices that compensate for the expected loss of purchasing power during the credit period, even if the period is short;

   (d) Interest rates, wages and prices are linked to a price index; and

   (e) The cumulative inflation rate over three years is approaching, or exceeds, 100%.

5. It is preferable that all entities that report in the currency of the same hyperinflationary economy apply this Standard from the same date. Nevertheless, this Standard applies to the financial statements of any entity

from the beginning of the reporting period in which it identifies the existence of hyperinflation in the country in whose currency it reports.

6. Government Business Enterprises (GBEs) are required to comply with International Accounting Standards (IASs) issued by the International Accounting Standards Committee. The Public Sector Committee's Guideline No. 1, "Financial Reporting by Government Business Enterprises" notes that IASs are relevant to all business enterprises, regardless of whether they are in the private or public sector. Accordingly, Guideline No. 1 recommends that GBEs should present financial statements that conform, in all material respects, to IASs.

Definitions

7. **The following terms are used in this Standard with the meanings specified:**

Carrying amount of an asset is the amount at which an asset is recognized in the statement of financial position after deducting any accumulated depreciation and accumulated impairment losses thereon.

Carrying amount of a liability is the amount at which a liability is recognized in the statement of financial position.

Cash comprises cash on hand and demand deposits.

Monetary items are money held and assets and liabilities to be received or paid in fixed or determinable amounts of money.

Non-monetary items are items that are not monetary items.

Terms defined in other International Public Sector Accounting Standards are used in this Standard with the same meaning as in those other Standards, and are reproduced in the Glossary of Defined Terms published separately.

The Restatement of Financial Statements

8. Prices change over time as the result of various specific or general political, economic and social forces. Specific forces such as changes in supply and demand and technological changes may cause individual prices to increase or decrease significantly and independently of each other. In addition, general forces may result in changes in the general level of prices and therefore in the general purchasing power of money.

9. In a hyperinflationary economy, financial statements are useful only if they are expressed in terms of the measuring unit current at the reporting date. As a result, this Standard applies to the primary financial statements of entities reporting in the currency of a hyperinflationary economy. Presentation of the information required by this Standard as a supplement to unrestated financial statements is not permitted. Furthermore, separate presentation of the financial statements before restatement is discouraged.

10. Many entities in the public sector include in their financial statements the related budgetary information, to facilitate comparisons with the budget. Where this occurs, the budgetary information should also be restated in accordance with this Standard.

11. **The financial statements of an entity that reports in the currency of a hyperinflationary economy should be stated in terms of the measuring unit current at the reporting date. The corresponding figures for the previous period required by International Public Sector Accounting Standard (IPSAS) 1, "Presentation of Financial Statements," and any information in respect of earlier periods, should also be stated in terms of the measuring unit current at the reporting date.**

12. **The surplus or deficit on the net monetary position should be separately disclosed in the statement of financial performance.**

13. The restatement of financial statements in accordance with this Standard requires the application of certain procedures as well as judgment. The consistent application of these procedures and judgments from period to period is more important than the precise accuracy of the resulting amounts included in the restated financial statements.

Statement of Financial Position

14. Statement of financial position amounts not already expressed in terms of the measuring unit current at the reporting date are restated by applying a general price index.

15. Monetary items are not restated because they are already expressed in terms of the monetary unit current at the reporting date. Monetary items are money held and assets and liabilities to be received or paid in fixed or determinable amounts of money.

16. Assets and liabilities linked by agreement to changes in prices, such as index linked bonds and loans, are adjusted in accordance with the agreement in order to ascertain the amount outstanding at the reporting date. These items are carried at this adjusted amount in the restated statement of financial position.

17. All other assets and liabilities are non-monetary. Some non-monetary items are carried at amounts current at the reporting date, such as net realizable value and market value, so they are not restated. All other non-monetary assets and liabilities are restated.

18. Most non-monetary items are carried at cost or cost less depreciation; hence they are expressed at amounts current at their date of acquisition. The restated cost, or cost less depreciation, of each item is determined by applying to its historical cost and accumulated depreciation the change in a general price index from the date of acquisition to the reporting date. Hence, property, plant and equipment, investments carried at cost, inventories of raw materials and merchandise, goodwill, patents, trademarks and similar assets are restated from the dates of their purchase. Inventories of partly-finished and finished goods are restated from the dates on which the costs of purchase and of conversion were incurred.

19. Detailed records of the acquisition dates of items of property, plant and equipment may not be available or able to be estimated. In these circumstances, it may be necessary, in the first period of application of this Standard, to use an independent professional assessment of the value of the items as the basis for their restatement.

20. A general price index may not be available for the periods for which the restatement of property, plant and equipment is required by this Standard. In these rare circumstances, it may be necessary to use an estimate based, for example, on the movements in the exchange rate between the reporting currency and a relatively stable foreign currency.

21. Some non-monetary items are carried at amounts current at dates other than that of acquisition or that of the statement of financial position, for example, property, plant and equipment that has been revalued at some earlier date. In these cases, the carrying amounts are restated from the date of the revaluation.

22. To determine whether the restated amount of a non-monetary item has become impaired and should be reduced an entity applies relevant impairment tests in international and/or national accounting standards. Hence, in such cases, restated amounts of property, plant and equipment, goodwill, patents and trademarks are reduced to recoverable amount, restated amounts of inventories are reduced to net realizable value and restated amounts of current investments are reduced to market value.

23. An investee that is accounted for under the equity method may report in the currency of a hyperinflationary economy. The statement of financial position and statement of financial performance of such an investee are

restated in accordance with this Standard in order to calculate the investor's share of its net assets/equity and results of operations. Where the restated financial statements of the investee are expressed in a foreign currency they are translated at closing rates.

24. The impact of inflation is usually recognized in borrowing costs. It is not appropriate both to restate the capital expenditure financed by borrowing and to capitalize that part of the borrowing costs that compensates for the inflation during the same period. This part of the borrowing costs is recognized as an expense in the period in which the costs are incurred.

25. An entity may acquire assets under an arrangement that permits it to defer payment without incurring an explicit interest charge. Where it is impracticable to impute the amount of interest, such assets are restated from the payment date and not the date of purchase.

26. IPSAS 4, "The Effects of Changes in Foreign Exchange Rates" permits an entity to include foreign exchange differences on borrowings in the carrying amount of assets following a severe and recent devaluation. Such a practice is not appropriate for an entity reporting in the currency of a hyperinflationary economy when the carrying amount of the asset is restated from the date of its acquisition.

27. At the beginning of the first period of application of this Standard, the components of net assets/equity, except accumulated surpluses/deficits and any revaluation reserve, are restated by applying a general price index from the dates the components were contributed or otherwise arose. Any revaluation reserve that arose in previous periods is eliminated. Restated accumulated surpluses/deficits are derived from all the other amounts in the restated statement of financial position.

28. At the end of the first period and in subsequent periods, all components of net assets/equity are restated by applying a general price index from the beginning of the period or the date of contribution, if later. The movements for the period in net assets/equity are disclosed in accordance with IPSAS 1.

Statement of Financial Performance

29. This Standard requires that all items in the statement of financial performance are expressed in terms of the measuring unit current at the reporting date. Therefore all amounts need to be restated by applying the change in the general price index from the dates when the items of revenue and expenses were initially recorded.

Surplus or Deficit on Net Monetary Position

30. In a period of inflation, an entity holding an excess of monetary assets over monetary liabilities loses purchasing power and an entity with an excess of monetary liabilities over monetary assets gains purchasing power to the extent the assets and liabilities are not linked to a price level. This surplus or deficit on the net monetary position may be derived as the difference resulting from the restatement of non-monetary assets, accumulated surpluses/deficits and items in the statement of financial performance and the adjustment of index linked assets and liabilities. The surplus or deficit may be estimated by applying the change in a general price index to the weighted average for the period of the difference between monetary assets and monetary liabilities.

31. The surplus or deficit on the net monetary position is included in the statement of financial performance. The adjustment to those assets and liabilities linked by agreement to changes in prices made in accordance with paragraph 16 is offset against the surplus or deficit on net monetary position. Other items in the statement of financial performance, such as interest revenue and expense, and foreign exchange differences related to invested or borrowed funds, are also associated with the net monetary position. Although such items are separately disclosed, it may be helpful if they are presented together with the surplus or deficit on net monetary position in the statement of financial performance.

Cash Flow Statement

32. This Standard requires that all items in the cash flow statement are expressed in terms of the measuring unit current at the reporting date.

Corresponding Figures

33. Corresponding figures for the previous reporting period, whether they were based on a historical cost approach or a current cost approach, are restated by applying a general price index so that the comparative financial statements are presented in terms of the measuring unit current at the end of the reporting period. Information that is disclosed in respect of earlier periods is also expressed in terms of the measuring unit current at the end of the reporting period.

Consolidated Financial Statements

34. A controlling entity that reports in the currency of a hyperinflationary economy may have controlled entities that also report in the currencies of hyperinflationary economies. The financial statements of any such controlled entity need to be restated by applying a general price index of the country in whose currency it reports before they are included in the consolidated financial statements issued by its controlling entity. Where

such a controlled entity is a foreign controlled entity, its restated financial statements are translated at closing rates. The financial statements of controlled entities that do not report in the currencies of hyperinflationary economies are dealt with in accordance with IPSAS 4.

35. If financial statements with different reporting dates are consolidated, all items, whether non-monetary or monetary, need to be restated into the measuring unit current at the date of the consolidated financial statements.

Selection and Use of the General Price Index

36. The restatement of financial statements in accordance with this Standard requires the use of a general price index that reflects changes in general purchasing power. It is preferable that all entities that report in the currency of the same economy use the same index.

Economies Ceasing to be Hyperinflationary

37. **When an economy ceases to be hyperinflationary and an entity discontinues the preparation and presentation of financial statements prepared in accordance with this Standard, it should treat the amounts expressed in the measuring unit current at the end of the previous reporting period as the basis for the carrying amounts in its subsequent financial statements.**

Disclosures

38. **The following disclosures should be made:**

    (a) **The fact that the financial statements and the corresponding figures for previous periods have been restated for the changes in the general purchasing power of the reporting currency and, as a result, are stated in terms of the measuring unit current at the reporting date; and**

    (b) **The identity and level of the price index at the reporting date and the movement in the index during the current and the previous reporting periods.**

39. The disclosures required by this Standard are needed to make clear the basis of dealing with the effects of hyperinflation in the financial statements. They are also intended to provide other information necessary to understand that basis and the resulting amounts.

Effective Date

40. **This International Public Sector Accounting Standard becomes effective for annual financial statements covering periods beginning on or after July 1, 2002. Earlier application is encouraged.**

41. When an entity adopts the accrual basis of accounting, as defined by International Public Sector Accounting Standards, for financial reporting purposes, subsequent to this effective date, this Standard applies to the entity's annual financial statements covering periods beginning on or after the date of adoption.

Appendix

Restatement of Financial Statements

This appendix is illustrative only and does not form part of the standards. The purpose of the appendix is to illustrate the application of the standards and to assist in clarifying their meaning.

The Standard sets out the requirements for the restatement of financial statements, including the consolidated financial statements, of entities reporting in the currency of a hyperinflationary economy.

The following example illustrates the process for restatement of financial statements. In preparing this illustration:

- The surplus on net monetary position for the period was indirectly derived as the difference resulting from the restatement of non-monetary assets and liabilities, accumulated surpluses/deficits and items in the statement of financial performance (see paragraph 30).
- Inventory on hand at the end of the reporting period was assumed to have been acquired later in the reporting period when the general inflation index was 170.
- The general price index was 120 at the beginning of the period, 180 at the end of the period and it averaged 150 during the period.
- Revenue and expenses, other than depreciation, are assumed to accrue evenly throughout the reporting period.
- Assets whose historical cost was 7,500 were completely depreciated and scrapped; their salvage value was zero.

Financial Reporting Under Hyperinflation

Example

Statement of Financial Position	**1.1.X0 (Per IPSAS 12)**	**31.12.X0 (Unadjusted)**	**Indexation Factor**	**31.12.X0 (Per IPSAS 12)**		**Surplus/Deficit on Net Monetary Position**
Cash and investments	5,000	10,000	–	10,000		–
Inventories	–	2,000	180/170	2,118	*Restated*	118
Physical assets:						
Historical cost	47,500	40,000	180/120	60,000		20,000
Accum. depreciation	(22,500)	(20,000)	180/120	(30,000)		(10,000)
Net book value	25,000	20,000	180/120	30,000	*Restated*	10,000
Total Assets	**30,000**	**32,000**		**42,118**		
Borrowings	**26,000**	**26,000**	–	**26,000**		
Net Assets						
Brought forward	**4,000**	**4,000**	180/120	6,000	*Restated*	(2,000)
Net surplus for period (see below)		2,000	See below	10,118		1,100
	4,000	**6,000**		**16,118**		**9,218**
Statement of Financial Performance						
Revenues		50,000	180/150	60,000	*Restated*	10,000
Depreciation		(5,000)	180/120	(7,500)	*Restated*	(2,500)
Other expenses		(43,000)	180/150	(51,600)	*Restated*	(8,600)
Surplus on net monetary position				9,218		
Surplus for the year		**2,000**		**10,118**		**(1,100)**

NB: The Standard (paragraph 29) requires that statement of financial performance items be restated using the movement in the index from the dates that the transactions were recorded. In this example, items of revenue and expense, other than depreciation, accrue evenly over the reporting period and an average inflation rate has been applied. The surplus on net monetary position has been derived indirectly (see final column) by applying the general price index to the non-monetary items in the statement of financial position and the statement of financial performance (paragraph 30).

Comparison with IAS 29

International Public Sector Accounting Standard (IPSAS) 10, "Financial Reporting in Hyperinflationary Economies" is drawn primarily from International Accounting Standard (IAS) 29, "Financial Reporting in Hyperinflationary Economies." The main differences between IPSAS 10 and IAS 29 are as follows:

- Commentary additional to that in IAS 29 has been included in IPSAS 10 to clarify the applicability of the standards to accounting by public sector entities.
- IPSAS 10 uses different terminology, in certain instances, from IAS 29. The most significant examples are the use of the terms "entity," "revenue," "statement of financial performance," "statement of financial position" and "net assets/equity" in IPSAS 10. The equivalent terms in IAS 29 are "enterprise," "income," "income statement," "balance sheet" and "equity."
- IAS 29 contains guidance on the restatement of current cost financial statements. IPSAS 10 does not include this guidance.
- IPSAS 10 contains an appendix which illustrates the process of the restating of financial statements, using an indirect method, of an entity reporting in the currency of a hyperinflationary economy.

IPSAS 11—CONSTRUCTION CONTRACTS

Acknowledgment

This International Public Sector Accounting Standard is drawn primarily from International Accounting Standard (IAS) 11 (revised 1993), "Construction Contracts" 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 IASC. The International Accounting Standards (IASs) issued by IASC remain in force until they are amended or withdrawn by IASB. Extracts from IAS 11 are reproduced in this publication of the Public Sector Committee of the International Federation of Accountants with the permission of IASB.

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IPSAS 11—CONSTRUCTION CONTRACTS

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The standards, which have been set in bold type, should be read in the context of the commentary paragraphs in this Standard, which are in plain type, and in the context of the "Preface to International Public Sector Accounting Standards." International Public Sector Accounting Standards are not intended to apply to immaterial items.

Objective

The objective of this Standard is to prescribe the accounting treatment of costs and revenue associated with construction contracts. The Standard:

- Identifies the arrangements that are to be classified as construction contracts;
- Provides guidance on the types of construction contracts that can arise in the public sector; and
- Specifies the basis for recognition and disclosure of contract expenses and, if relevant, contract revenues.

Because of the nature of the activity undertaken in construction contracts, the date at which the contract activity is entered into and the date when the activity is completed usually fall into different reporting periods.

In many jurisdictions, construction contracts entered into by public sector entities will not specify an amount of contract revenue. Rather, funding to support the construction activity will be provided by an appropriation or similar allocation of general government revenue, or by aid or grant funds. In these cases, the primary issue in accounting for construction contracts is the allocation of construction costs to the reporting period in which the construction work is performed and the recognition of related expenses.

In some jurisdictions, construction contracts entered into by public sector entities may be established on a commercial basis or a non-commercial full or partial cost recovery basis. In these cases, the primary issue in accounting for construction contracts is the allocation of both contract revenue and contract costs to the reporting periods in which construction work is performed.

Scope

1. **A contractor which prepares and presents financial statements under the accrual basis of accounting should apply this Standard in accounting for construction contracts.**

2. **This Standard applies to all public sector entities other than Government Business Enterprises.**

3. Government Business Enterprises (GBEs) are required to comply with International Accounting Standards (IASs) issued by the International Accounting Standards Committee. The Public Sector Committee's Guideline No. 1, "Financial Reporting by Government Business Enterprises" notes that IASs are relevant to all business enterprises, regardless of whether they are in the private or public sector. Accordingly, Guideline No. 1 recommends that GBEs should present financial statements that conform, in all material respects, to IASs.

Definitions

4. **The following terms are used in this Standard with the meanings specified:**

   Construction contract is 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.

   Contractor is an entity that performs construction work pursuant to a construction contract.

   Cost plus or cost based contract is 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.

   Fixed price contract is 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.

   Terms defined in other International Public Sector Accounting Standards are used in this Standard with the same meaning as in those other Standards, and are reproduced in the Glossary of Defined Terms published separately.

Construction Contracts

5. A construction contract (the terms "construction contract" and "contract" are used interchangeably in the remainder of this Standard) may be negotiated for the construction of a single asset such as a bridge, building, dam, pipeline, road, ship or tunnel. A construction contract may also deal with the construction of a number of assets which are closely interrelated or interdependent in terms of their design, technology and function or their ultimate purpose or use — examples of such contracts include those for the

construction of reticulated water supply systems, refineries and other complex infrastructure assets.

6. For the purposes of this Standard, construction contracts include:

   (a) Contracts for the rendering of services which are directly related to the construction of the asset, for example, those for the services of project managers and architects; and

   (b) Contracts for the destruction or restoration of assets, and the restoration of the environment following the demolition of assets.

7. For the purposes of this Standard, construction contracts also include all arrangements that are binding on the parties to the arrangement, but which may not take the form of a documented contract. For example, two government departments may enter into a formal arrangement for the construction of an asset but the arrangement may not constitute a legal contract because in that jurisdiction individual departments may not be separate legal entities with the power to contract. However, provided that the arrangement confers similar rights and obligations on the parties to it as if it were in the form of a contract, it is a construction contract for the purposes of this Standard. Such binding arrangements could include (but are not limited to) a ministerial direction, a cabinet decision, a legislative direction (such as an Act of Parliament), or a memorandum of understanding.

8. Construction contracts are formulated in a number of ways which, for the purposes of this Standard, are classified as fixed price contracts and cost plus or cost based contracts. Some commercial construction contracts may contain characteristics of both a fixed price contract and a cost plus or cost based contract, for example in the case of a cost plus or cost based contract with an agreed maximum price. In such circumstances, a contractor needs to consider all the conditions in paragraphs 31 and 32 in order to determine when to recognize contract revenue and expenses.

9. Cost plus and cost based contracts encompass both commercial and non-commercial contracts. A commercial contract will specify that revenue to cover the constructor's construction costs as agreed and generate a profit margin will be provided by the other parties to the contract. However, a public sector entity may also enter into a non-commercial contract to construct an asset for another entity in return for full or partial reimbursement of costs from that entity or other parties. In some cases, the cost recovery may encompass payments by the recipient entity and specific purpose construction grants or funding from other parties.

10. In many jurisdictions, where one public sector entity constructs assets for another public sector entity the cost of construction activity is not recovered directly from the recipient. Rather, the construction activity is funded indirectly by way of a general appropriation or other allocation of general government funds to the contractor, or from general purpose grants from third party funding agencies or other governments. These are classified as fixed price contracts for the purpose of this Standard.

Contractor

11. A contractor is an entity that enters into a contract to build structures, construct facilities, produce goods, or render services to the specifications of another entity. The term "contractor" includes a general or prime contractor, a subcontractor to a general contractor, or a construction manager.

Combining and Segmenting Construction Contracts

12. The requirements of this Standard are usually applied separately to each construction contract. However, in certain circumstances, it is necessary to apply the Standard to the separately identifiable components of a single contract or to a group of contracts together in order to reflect the substance of a contract or a group of contracts.

13. **When a contract covers a number of assets, the construction of each asset should be treated as a separate construction contract when:**

    (a) **Separate proposals have been submitted for each asset;**

    (b) **Each asset has been subject to separate negotiation and the contractor and customer have been able to accept or reject that part of the contract relating to each asset; and**

    (c) **The costs and revenues of each asset can be identified.**

14. **A group of contracts, whether with a single customer or with several customers, should be treated as a single construction contract when:**

    (a) **The group of contracts is negotiated as a single package;**

    (b) **The contracts are so closely interrelated that they are, in effect, part of a single project with an overall margin, if any; and**

    (c) **The contracts are performed concurrently or in a continuous sequence.**

15. **A contract may provide for the construction of an additional asset at the option of the customer or may be amended to include the**

construction of an additional asset. The construction of the additional asset should be treated as a separate construction contract when:

(a) **The asset differs significantly in design, technology or function from the asset or assets covered by the original contract; or**

(b) **The price of the asset is negotiated without regard to the original contract price.**

Contract Revenue

16. **Contract revenue should comprise:**

(a) **The initial amount of revenue agreed in the contract; and**

(b) **Variations in contract work, claims and incentive payments to the extent that:**

(i) **It is probable that they will result in revenue; and**

(ii) **They are capable of being reliably measured.**

17. Contract revenue is measured at the fair value of the consideration received or receivable. Both the initial and ongoing measurement of contract revenue are affected by a variety of uncertainties that depend on the outcome of future events. The estimates often need to be revised as events occur and uncertainties are resolved. Where a contract is a cost plus or cost based contract, the initial amount of revenue may not be stated in the contract. Instead, it may need to be estimated on a basis consistent with the terms and provisions of the contract, such as by reference to expected costs over the life of the contract.

18. In addition, the amount of contract revenue may increase or decrease from one period to the next. For example:

(a) A contractor and a customer may agree to variations or claims that increase or decrease contract revenue in a period subsequent to that in which the contract was initially agreed;

(b) The amount of revenue agreed in a fixed price, cost plus or cost based contract may increase as a result of cost escalation or other clauses;

(c) The amount of contract revenue may decrease as a result of penalties arising from delays caused by the contractor in the completion of the contract; or

(d) When a fixed price contract involves a fixed price per unit of output, contract revenue increases or decreases as the number of units is increased or decreased.

19. A variation is an instruction by the customer for a change in the scope of the work to be performed under the contract. A variation may lead to an increase or a decrease in contract revenue. Examples of variations are changes in the specifications or design of the asset and changes in the duration of the contract. A variation is included in contract revenue when:

    (a) It is probable that the customer will approve the variation and the amount of revenue arising from the variation; and

    (b) The amount of revenue can be reliably measured.

20. A claim is an amount that the contractor seeks to collect from the customer or another party as reimbursement for costs not included in the contract price. A claim may arise from, for example, customer caused delays, errors in specifications or design, and disputed variations in contract work. The measurement of the amounts of revenue arising from claims is subject to a high level of uncertainty and often depends on the outcome of negotiations. Therefore, claims are only included in contract revenue when:

    (a) Negotiations have reached an advanced stage such that it is probable that the customer will accept the claim; and

    (b) The amount that it is probable will be accepted by the customer can be measured reliably.

21. Incentive payments are additional amounts paid to the contractor if specified performance standards are met or exceeded. For example, a contract may allow for an incentive payment to the contractor for early completion of the contract. Incentive payments are included in contract revenue when:

    (a) The contract is sufficiently advanced that it is probable that the specified performance standards will be met or exceeded; and

    (b) The amount of the incentive payment can be measured reliably.

22. Contractors should review all amounts relating to the construction contract which are paid directly to subcontractors by third party funding agencies to determine whether they meet the definition of, and recognition criteria for, revenue of the contractor under the terms of the contract. Amounts meeting the definition and recognition criteria for revenue should be accounted for by the contractor in the same way as other contract revenue. Such amounts should also be recognized as contract costs (refer to paragraph 25). Funding agencies may include national and international aid agencies and multilateral and bilateral development banks.

Contract Costs

23. **Contract costs should comprise:**

    (a) **Costs that relate directly to the specific contract;**

    (b) **Costs that are attributable to contract activity in general and can be allocated to the contract on a systematic and rational basis; and**

    (c) **Such other costs as are specifically chargeable to the customer under the terms of the contract.**

24. Costs that relate directly to a specific contract include:

    (a) Site labor costs, including site supervision;

    (b) Costs of materials used in construction;

    (c) Depreciation of plant and equipment used on the contract;

    (d) Costs of moving plant, equipment and materials to and from the contract site;

    (e) Costs of hiring plant and equipment;

    (f) Costs of design and technical assistance that are directly related to the contract;

    (g) The estimated costs of rectification and guarantee work, including expected warranty costs; and

    (h) Claims from third parties.

    These costs may be reduced by any incidental revenue that is not included in contract revenue, for example revenue from the sale of surplus materials at the end of the contract.

25. Contractors should review all amounts relating to the construction contract paid directly by subcontractors and which are reimbursed by third party funding agencies, to determine whether they qualify as contract costs. Amounts meeting the definition of, and recognition criteria for, contract expenses should be accounted for by the contractor in the same way as other contract expenses. Amounts reimbursed by third party funding agencies which meet the definition of, and recognition criteria for, revenue should be accounted for by the contractor in the same way as other contract revenue (refer to paragraph 22).

26. Costs that may be attributable to contract activity in general and can be allocated to specific contracts include:

    (a) Insurance;

(b) Costs of design that are not directly related to a specific contract; and

(c) Construction overheads.

Such costs are allocated using methods that are systematic and rational and are applied consistently to all costs having similar characteristics. The allocation is based on the normal level of construction activity. Construction overheads include costs such as the preparation and processing of construction personnel payroll. Costs that may be attributable to contract activity in general and can be allocated to specific contracts also include borrowing costs when the contractor adopts the allowed alternative treatment in IPSAS 5, "Borrowing Costs."

27. Costs that are specifically chargeable to the customer under the terms of the contract may include some general administration costs and development costs for which reimbursement is specified in the terms of the contract.

28. Costs that cannot be attributed to contract activity or cannot be allocated to a contract are excluded from the costs of a construction contract. Such costs include:

(a) General administration costs for which reimbursement is not specified in the contract;

(b) Selling costs;

(c) Research and development costs for which reimbursement is not specified in the contract; and

(d) Depreciation of idle plant and equipment that is not used on a particular contract.

29. Contract costs include the costs attributable to a contract for the period from the date of securing the contract to the final completion of the contract. However, costs that relate directly to a contract and which are incurred in securing the contract are also included as part of the contract costs if they can be separately identified and measured reliably and it is probable that the contract will be obtained. When costs incurred in securing a contract are recognized as an expense in the period in which they are incurred, they are not included in contract costs when the contract is obtained in a subsequent period.

Recognition of Contract Revenue and Expenses

30. **When the outcome of a construction contract can be estimated reliably, contract revenue and contract costs associated with the construction contract should be recognized as revenue and expenses respectively by**

reference to the stage of completion of the contract activity at the reporting date. An expected deficit on a construction contract to which paragraph 44 applies should be recognized as an expense immediately in accordance with paragraph 44.

31. **In the case of a fixed price contract, the outcome of a construction contract can be estimated reliably when all the following conditions are satisfied:**

    (a) **Total contract revenue, if any, can be measured reliably;**

    (b) **It is probable that the economic benefits or service potential associated with the contract will flow to the entity;**

    (c) **Both the contract costs to complete the contract and the stage of contract completion at the reporting date can be measured reliably; and**

    (d) **The contract costs attributable to the contract can be clearly identified and measured reliably so that actual contract costs incurred can be compared with prior estimates.**

32. **In the case of a cost plus or cost based contract, the outcome of a construction contract can be estimated reliably when all the following conditions are satisfied:**

    (a) **It is probable that the economic benefits or service potential associated with the contract will flow to the entity; and**

    (b) **The contract costs attributable to the contract, whether or not specifically reimbursable, can be clearly identified and measured reliably.**

33. The recognition of revenue and expenses by reference to the stage of completion of a contract is often referred to as the percentage of completion method. Under this method, contract revenue is matched with the contract costs incurred in reaching the stage of completion, resulting in the reporting of revenue, expenses and surplus/deficit which can be attributed to the proportion of work completed. This method provides useful information on the extent of contract activity and performance during a period.

34. Under the percentage of completion method, contract revenue is recognized as revenue in the statement of financial performance in the reporting periods in which the work is performed. Contract costs are usually recognized as an expense in the statement of financial performance in the reporting periods in which the work to which they relate is performed. However, where it is intended at inception of the contract that contract costs are to be fully recovered from the parties to the construction contract, any

expected excess of total contract costs over total contract revenue for the contract is recognized as an expense immediately in accordance with paragraph 44.

35. A contractor may have incurred contract costs that relate to future activity on the contract. Such contract costs are recognized as an asset provided it is probable that they will be recovered. Such costs represent an amount due from the customer and are often classified as contract work in progress.

36. The outcome of a construction contract can only be estimated reliably when it is probable that the economic benefits or service potential associated with the contract will flow to the entity. However, when an uncertainty arises about the collectability of an amount already included in contract revenue, and already recognized in the statement of financial performance, the uncollectable amount or the amount in respect of which recovery has ceased to be probable is recognized as an expense rather than as an adjustment of the amount of contract revenue.

37. An entity is generally able to make reliable estimates after it has agreed to a contract which establishes:

    (a) Each party's enforceable rights regarding the asset to be constructed;

    (b) The consideration, if any, to be exchanged; and

    (c) The manner and terms of settlement.

    It is also usually necessary for the entity to have an effective internal financial budgeting and reporting system. The entity reviews and, when necessary, revises the estimates of contract revenue and contract costs as the contract progresses. The need for such revisions does not necessarily indicate that the outcome of the contract cannot be estimated reliably.

38. The stage of completion of a contract may be determined in a variety of ways. The entity uses the method that measures reliably the work performed. Depending on the nature of the contract, the methods may include:

    (a) The proportion that contract costs incurred for work performed to date bear to the estimated total contract costs;

    (b) Surveys of work performed; or

    (c) Completion of a physical proportion of the contract work.

    Progress payments and advances received from customers often do not reflect the work performed.

39. When the stage of completion is determined by reference to the contract costs incurred to date, only those contract costs that reflect work performed are included in costs incurred to date. Examples of contract costs which are excluded are:

    (a) Contract costs that relate to future activity on the contract, such as costs of materials that have been delivered to a contract site or set aside for use in a contract but not yet installed, used or applied during contract performance, unless the materials have been made specially for the contract; and

    (b) Payments made to subcontractors in advance of work to be performed under the subcontract.

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

    (a) **Revenue should be recognized only to the extent of contract costs incurred that it is probable will be recoverable; and**

    (b) **Contract costs should be recognized as an expense in the period in which they are incurred.**

    An expected deficit on a construction contract to which paragraph 44 applies should be recognized as an expense immediately in accordance with paragraph 44.

41. During the early stages of a contract it is often the case that the outcome of the contract cannot be estimated reliably. Nevertheless, it may be probable that the entity will recover the contract costs incurred. Therefore, contract revenue is recognized only to the extent of costs incurred that are expected to be recoverable. As the outcome of the contract cannot be estimated reliably, no surplus or deficit is recognized. However, even though the outcome of the contract cannot be estimated reliably, it may be probable that total contract costs will exceed total contract revenues. In such cases, any expected excess of total contract costs over total contract revenues for the contract is recognized as an expense immediately in accordance with paragraph 44.

42. Where contract costs which are to be reimbursed by parties to the contract are not probable of being recovered, they are recognized as an expense immediately. Examples of circumstances in which the recoverability of contract costs incurred may not be probable and in which contract costs may need to be recognized as an expense immediately include contracts:

    (a) Which are not fully enforceable, that is, their validity is seriously in question;

(b) The completion of which is subject to the outcome of pending litigation or legislation;

(c) Relating to properties that are likely to be condemned or expropriated;

(d) Where the customer is unable to meet its obligations; or

(e) Where the contractor is unable to complete the contract or otherwise meet its obligations under the contract.

43. **When the uncertainties that prevented the outcome of the contract being estimated reliably no longer exist, revenue and expenses associated with the construction contract should be recognized in accordance with paragraph 30 rather than in accordance with paragraph 40.**

Recognition of Expected Deficits

44. **In respect of construction contracts in which it is intended at inception of the contract that contract costs are to be fully recovered from the parties to the construction contract, when it is probable that total contract costs will exceed total contract revenue, the expected deficit should be recognized as an expense immediately.**

45. Public sector entities may enter into construction contracts which specify that the revenue intended to cover the construction costs will be provided by the other parties to the contract. This may occur where, for example:

(a) Government departments and agencies which are largely dependant on appropriations or similar allocations of government revenue to fund their operations are also empowered to contract with GBE's or private sector entities for the construction of assets on a commercial or full cost recovery basis; or

(b) Government departments and agencies transact with each other on an arm's length or commercial basis as may occur under a "purchaser-provider" or similar model of government.

In these cases, an expected deficit on a construction contract is recognised immediately in accordance with paragraph 44.

46. As noted in paragraph 9, in some cases a public sector entity may enter into a construction contract for less than full cost recovery from the other parties to the contract. In these cases, funding in excess of that specified in the construction contract will be provided from an appropriation or other allocation of government funds to the contractor, or from general purpose

grants from third party funding agencies or other governments. The requirements of paragraph 44 do not apply to these construction contracts.

47. In determining the amount of any deficit under paragraph 44, total contract revenue and total contract costs may include payments made directly to subcontractors by third party funding agencies in accordance with paragraphs 22 and 25.

48. The amount of such a deficit is determined irrespective of:

(a) Whether or not work has commenced on the contract;

(b) The stage of completion of contract activity; or

(c) The amount of surpluses expected to arise on other commercial construction contracts which are not treated as a single construction contract in accordance with paragraph 14.

Changes in Estimates

49. The percentage of completion method is applied on a cumulative basis in each reporting period to the current estimates of contract revenue and contract costs. Therefore, the effect of a change in the estimate of contract revenue or contract costs, or the effect of a change in the estimate of the outcome of a contract, is accounted for as a change in accounting estimate (see IPSAS 3, "Net Surplus or Deficit for the Period, Fundamental Errors and Changes in Accounting Policies"). The changed estimates are used in the determination of the amount of revenue and expenses recognized in the statement of financial performance in the period in which the change is made and in subsequent periods.

Disclosure

50. **An entity should disclose:**

(a) **The amount of contract revenue recognized as revenue in the period;**

(b) **The methods used to determine the contract revenue recognized in the period; and**

(c) **The methods used to determine the stage of completion of contracts in progress.**

51. **An entity should disclose each of the following for contracts in progress at the reporting date:**

(a) **The aggregate amount of costs incurred and recognized surpluses (less recognized deficits) to date;**

(b) **The amount of advances received; and**

(c) **The amount of retentions.**

52. Retentions are amounts of progress billings which are not paid until the satisfaction of conditions specified in the contract for the payment of such amounts or until defects have been rectified. Progress billings are amounts of contract revenue billed for work performed on a contract whether or not they have been paid by the customer. Advances are amounts of contract revenue received by the contractor before the related work is performed.

53. **An entity should present:**

    (a) **The gross amount due from customers for contract work as an asset; and**

    (b) **The gross amount due to customers for contract work as a liability.**

54. The gross amount due from customers for contract work is the net amount of:

    (a) Costs incurred plus recognized surpluses; less

    (b) The sum of recognized deficits and progress billings for all contracts in progress for which costs incurred plus recognized surpluses to be recovered by way of contract revenue (less recognized deficits) exceeds progress billings.

55. The gross amount due to customers for contract work is the net amount of:

    (a) Costs incurred plus recognized surpluses; less

    (b) The sum of recognised deficits and progress billingsfor all contracts in progress for which progress billings exceed costs incurred plus recognized surpluses to be recovered by way of contract revenue (less recognized deficits).

56. Guidance on the disclosure of contingent liabilities and contingent assets can be found IAS 37, "Provisions, Contingent Liabilities and Contingent Assets." Contingent liabilities and contingent assets may arise from such items as warranty costs, claims, penalties or possible losses.

Effective Date

57. **This International Public Sector Accounting Standard becomes effective for annual financial statements covering periods beginning on or after July 1, 2002. Earlier application is encouraged.**

58. When an entity adopts the accrual basis of accounting, as defined by International Public Sector Accounting Standards, for financial reporting purposes, subsequent to this effective date, this Standard applies to the entity's annual financial statements covering periods beginning on or after the date of adoption.

Appendix

The appendix is illustrative only and does not form part of the standards. The purpose of the appendix is to illustrate the application of the standards to assist in clarifying their meaning.

Disclosure of Accounting Policies

The following are examples of accounting policy disclosures for a department which enters non-commercial construction contracts with other government agencies for full, partial or no cost recovery from the other parties to the contract. The Department is also empowered to enter into commercial construction contracts with private sector entities and Government Business Enterprises (GBEs) and to enter full cost recovery construction contracts with certain state hospitals and state universities.

Non-Commercial Contracts

Contract costs are recognized as an expense on the percentage of completion method, measured by reference to the percentage of labor hours incurred to date to estimated total labor hours for each contract. In some cases, certain construction activity and technical supervision have been subcontracted to private sector contractors for a fixed "completion of contract" fee. Where this has occurred, the subcontracted costs are recognized as an expense on the percentage of completion method for each subcontract.

Contract revenue from full cost recovery contracts and partial cost recovery contracts entered into by the Department is recognized by reference to the recoverable costs incurred during the period, measured by the proportion that recoverable costs incurred to date bear to the estimated total recoverable costs of the contract.

Commercial Contracts

Revenue from fixed price construction contracts is recognized on the percentage of completion method, measured by reference to the percentage of labor hours incurred to date to estimated total labor hours for each contract.

Revenue from cost plus or cost based contracts is recognized by reference to the recoverable costs incurred during the period plus the fee earned, measured by the proportion that costs incurred to date bear to the estimated total costs of the contract.

The Determination of Contract Revenue and Expenses

The following examples deal with a non-commercial and a commercial construction contract. The examples illustrate one method of determining the stage of completion of a contract and the timing of the recognition of contract revenue and expenses (see paragraphs 30 to 43 of the Standard).

Non-Commercial Contracts

The Department of Works and Services (the construction contractor) has a contract to build a bridge for the Department of Roads and Highways. The Department of Works and Services is funded by appropriation. The construction contract identifies construction requirements including anticipated costs, technical specifications and timing of completion but does not provide for any recovery of construction costs directly from the Department of Roads and Highways. The construction contract is a key management planning and accountability document attesting to the design and construction qualities of the bridge. It is used as input in assessing the performance of the contracting parties in delivering services of agreed technical specification within projected cost parameters. It is also used as input to future cost projections.

The initial estimate of contract costs is 8,000. It will take three years to build the bridge. An aid agency has agreed to provide funding of 4,000 being half of the construction costs — this is specified in the construction contract.

By the end of Year 1, the estimate of contract costs has increased to 8,050. The aid agency agrees to fund half of this increase in estimated costs.

In Year 2, the Government on the advice of the Department of Roads and Highways approves a variation resulting in estimated additional contract costs of 150. The aid agency agrees to fund 50% of this variation. At the end of Year 2, costs incurred include 100 for standard materials stored at the site to be used in Year 3 to complete the project.

The Department of Works and Services determines the stage of completion of the contract by calculating the proportion that contract costs incurred for work performed to date bear to the latest estimated total contract costs.

A summary of the financial data during the construction period is as follows:

	Year 1	**Year 2**	**Year 3**
Initial amount of revenue agreed in contract	4,000	4,000	4,000
Variation in contract revenue	–	100	100
Total Contract Revenue	4,000	4,100	4,100
Contract costs incurred to date	2,093	6,168	8,200
Contract costs to complete	5,957	2,032	–
Total estimated contract costs	8,050	8,200	8,200
Stage of completion	26%	74%	100%

The stage of completion for Year 2 (74%) is determined by excluding from contract costs incurred for work performed to date the 100 for standard materials stored at the site for use in Year 3.

The amounts of contract revenue and expenses recognized in the statement of financial performance in the three years are as follows:

	To Date	**Recognized in prior years**	**Recognized in current year**
Year 1			
Revenue (4,000 × .26)	1,040		1,040
Expenses (8,050 × .26)	2,093		2,093
Year 2			
Revenue (4,100 × .74)	3,034	1,040	1,994
Expenses (8,200 × .74)	6,068	2,093	3,975
Year 3			
Revenue (4,100 × 1.00)	4,100	3,034	1,066
Expenses (8,200 × 1.00)	8,200	6,068	2,132

Commercial Contracts

The Department of Works and Services (the contractor) while predominantly funded by appropriation is empowered to undertake limited construction work on a commercial basis for private sector entities. With the authority of the Minister, the Department has entered a fixed price commercial contract for 9,000 to build a bridge.

The initial amount of revenue agreed in the contract is 9,000. The contractor's initial estimate of contract costs is 8,000. It will take three years to build the bridge.

By the end of Year 1, the Department's estimate of contract costs has increased to 8,050.

In Year 2, the customer approves a variation resulting in an increase in contract revenue of 200 and estimated additional contract costs of 150. At the end of Year 2, costs incurred include 100 for standard materials stored at the site to be used in Year 3 to complete the project.

The Department determines the stage of completion of the contract by calculating the proportion that contract costs incurred for work performed to date bear to the latest estimated total contract costs. A summary of the financial data during the construction period is as follows:

	Year 1	**Year 2**	**Year 3**
Initial amount of revenue agreed in contract	9,000	9,000	9,000
Variation	–	200	200
Total Contract Revenue	9,000	9,200	9,200
Contract costs incurred to date	2,093	6,168	8,200
Contract costs to complete	5,957	2,032	–
Total estimated contract costs	8,050	8,200	8,200
Estimated surplus	950	1,000	1,000
Stage of completion	26%	74%	100%

The stage of completion for Year 2 (74%) is determined by excluding from contract costs incurred for work performed to date the 100 for standard materials stored at the site for use in Year 3.

The amounts of revenue, expenses and surplus recognized in the statement of financial performance in the three years are as follows:

	To Date	Recognized in prior years	Recognized in current year
Year 1			
Revenue (9,000 × .26)	2,340		2,340
Expeses (8,050 × .26)	2,093		2,093
Surplus	247		247
Year 2			
Revenue (9,200 × .74)	6,808	2,340	4,468
Expenses (8,200 × .74)	6,068	2,093	3,975
Surplus	740	247	493
Year 3			
Revenue (9,200 × 1.00)	9,200	6,808	2,392
Expenses (8,200 × 1.00)	8,200	6,068	2,132
Surplus	1,000	740	260

Contract Disclosures

Appropriation/Aid Funded Contracts and Full Cost Recovery Contracts

The Department of Works and Services was recently created as the entity to manage the construction of major buildings and roadworks for other government entities. It is funded predominantly by appropriation but with the approval of the Minister is empowered to undertake construction projects financed by national or international aid agencies. It has its own construction capabilities and can also subcontract. With the approval of the Minister, the Department may also undertake construction work on a commercial basis for private sector entities and Government Business Enterprises (GBEs) and on a full cost recovery basis for state hospitals and state run universities.

The Department of Works and Services has reached the end of its first year of operations. All its contract costs incurred have been paid for in cash and all its progress billings (to aid agencies that have commissioned construction work) have been received in cash. No advances to the Department for construction work were made during the period. Contract costs incurred for contracts B and C include the cost of materials that have been purchased for the contract but which have not been used in contract performance to date. No commercial contracts have been undertaken this year. (See below for examples of commercial contracts.)

- Contract A is funded out of general appropriation revenue. (The contract includes no "contract revenue" as defined.)
- Contract B is with the Department of Education and the XX Aid Agency which is funding 50% of the construction costs. (50% of the contract cost is to be reimbursed by parties to the contract and therefore is "contract revenue" as defined.)
- Contract C is totally funded by the National University. (The terms of the arrangement specify that all of the contract costs are to be reimbursed by the National University from the University's major construction fund. Therefore, "contract revenue" as defined equals contract costs.)

The status of the three contracts in progress at the end of Year 1 is as follows:

	Contract			
	A	**B**	**C**	**Total**
Contract Revenue recognized in accordance with paragraph 30	–	225	350	575
Contract Expenses recognized in accordance with paragraph 30	110	450	350	910
Contract Costs funded by Appropriation	110	225	–	335
Contract Costs incurred in the period	110	510	450	1,070
– recognized as expenses (para 30)	110	450	350	910
– recognized as an asset (para 35)	–	60	100	160
Contract Revenue (see above)	–	225	350	575
Progress Billings (para 52)	–	225	330	555
Unbilled Contract Revenue	–	–	20	20
Advances (para 52)	–	–	–	–

The amounts to be disclosed in accordance with the standard are as follows:

Contract revenue recognized as revenue in the period (para 50(a))	575
Contract costs incurred to date (para 51(a)) (there are no recognized surpluses/less recognized deficits)	1,070

Gross amount due from contract customers for contract work (determined in accordance with paragraph 54 and presented as an asset in accordance with paragraph 53(a))	150

The amounts to be disclosed in accordance with the standard are as follows:

Contract revenue recognized as revenue in the period (para 50(a))	575
Contract costs incurred to date (para 51(a)) (there are no recognized surpluses/less recognized deficits)	1,070
Gross amount due from contract customers for contract work (determined in accordance with paragraph 54 and presented as an asset in accordance with paragraph 53(a))	150

Amounts to be disclosed in accordance with paragraphs 51(a) and 53(a) are as follows (*Note: contract revenue for B is 50% of contract costs*):

	A	**B**	**C**	**Total**
Contract costs incurred	110	510	450	1,070
Progress billings	0	225	330	555
Due from aid agencies and customers	–	30	120	150

The amount disclosed in accordance with paragraph 51(a) is the same as the amount for the current period because the disclosures relate to the first year of operation.

Commercial Contracts

The Division of National Construction Works has been established within the Department of Works and Services to undertake construction work on a commercial basis for GBEs and private sector entities at the direction, and with the approval, of the Minister. The Division has reached the end of its first year of operations. All its contract costs incurred have been paid for in cash and all its progress billings and advances have been received in cash. Contract costs incurred for contracts B, C and E include the cost of materials that have been purchased for the contract but which have not been used in contract performance to date. For contracts B, C and E, the customers have made advances to the contractor for work not yet performed.

The status of its five contracts in progress at the end of Year 1 is as follows:

	Contract					
	A	B	C	D	E	Total
Contract revenue recognized in accordance with paragraph 30	145	520	380	200	55	1,300
Contract expenses recognized in accordance with paragraph 30	110	450	350	250	55	1,215
Expected deficits recognized in accordance with paragraph 44	–	–	–	40	30	70
Recognized surpluses less recognized deficits	35	70	30	(90)	(30)	15
Contract costs incurred in the period	110	510	450	250	100	1,420
Contract costs incurred recognized as contract expenses in the period in accordance with paragraph 30	110	450	350	250	55	1,215
Contract costs that relate to future activity recognized as an asset in accordance with paragraph 35	–	60	100	–	45	205
Contract revenue (see above)	145	520	380	200	55	1,300
Progress billings (para 52)	100	520	380	180	55	1,235
Unbilled contract Revenue	45	–	–	20	–	65
Advances (para 52)	–	80	20	–	25	125

The amounts to be disclosed in accordance with the Standard are as follows:

Contract revenue recognized as revenue in the period (para 50(a))	1,300
Contract costs incurred and recognized surpluses (less recognized deficits) to date (para 51(a))	1,435
Advances received (para 51(b))	125
Gross amount due from customers for contract work — presented as an asset in accordance with paragraph 53(a)	220
Gross amount due to customers for contract work — presented as an asset in accordance with paragraph 53(b)	(20)

The amounts to be disclosed in accordance with paragraphs 51(a), 53(a) and 53(b) are calculated as follows:

	A	B	C	D	E	Total
Contract costs incurred	110	510	450	250	100	1,420
Recognized surpluses less recognized deficits	35	70	30	(90)	(30)	15
	145	580	480	160	70	1,435
Progress billings	100	520	380	180	55	1,235
Due from customers	45	60	100	–	15	220
Due to customers	–	–	–	(20)	–	(20)

The amount disclosed in accordance with paragraph 51(a) is the same as the amount for the current period because the disclosures relate to the first year of operation.

Comparison with IAS 11

International Public Sector Accounting Standard (IPSAS) 11, “Construction Contracts” is drawn primarily from International Accounting Standard (IAS) 11, “Construction Contracts.” The main differences between IPSAS 11 and IAS 11 are as follows:

- Commentary additional to that in IAS 11 has been included in IPSAS 11 to clarify the applicability of the standards to accounting by public sector entities.
- IPSAS 11 uses different terminology, in certain instances, from IAS 11. The most significant examples are the use of the terms “entity,” “revenue” and “statement of financial performance” in IPSAS 11. The equivalent terms in IAS 11 are “enterprise,” “income” and “income statement.”
- IPSAS 11 includes binding arrangements that do not take the form of a legal contract within the scope of the Standard.
- IPSAS 11 includes cost based and non-commercial contracts within the scope of the Standard.
- IPSAS 11 makes it clear that the requirement to recognize an expected deficit on a contract immediately it becomes probable that contract costs will exceed total contract revenues applies only to contracts in which it is intended at inception of the contract that contract costs are to be fully recovered from the parties to that contract.
- IPSAS 11 includes additional examples to illustrate the application of the Standard to non-commercial construction contracts.

IPSAS 12—INVENTORIES

Acknowledgment

This International Public Sector Accounting Standard is drawn primarily from International Accounting Standard (IAS) 2 (revised 1993), "Inventories" 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 International Accounting Standards (IASs) issued by IASC remain in force until they are amended or withdrawn by IASB. Extracts from IAS 2 are reproduced in this publication of the Public Sector Committee of the International Federation of Accountants with the permission of IASB.

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IPSAS 12—INVENTORIES

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Comparison with IAS 2

The standards, which have been set in bold type, should be read in the context of the commentary paragraphs in this Standard, which are in plain type, and in the context of the "Preface to International Public Sector Accounting Standards." International Public Sector Accounting Standards are not intended to apply to immaterial items.

Objective

The objective of this Standard is to prescribe the accounting treatment for inventories under the historical cost system. A primary issue in accounting for inventories is the amount of cost to be recognized as an asset and carried forward until the related revenues are recognized. This Standard provides practical guidance on the determination of cost and its subsequent recognition as an expense, including any write-down to net realizable value. It also provides guidance on the cost formulas that are used to assign costs to inventories.

Scope

1. **An entity which prepares and presents financial statements under the accrual basis of accounting should apply this Standard in the context of the historical cost system in accounting for inventories other than:**

   (a) **Work in progress arising under construction contracts, including directly related service contracts (see International Public Sector Accounting Standard (IPSAS) 11, "Construction Contracts");**

   (b) **Financial instruments;**

   (c) **Producers' inventories of livestock, agricultural and forest products, and mineral ores to the extent that they are measured at net realizable value in accordance with well established practices in certain industries; and**

   (d) **Work in progress of services to be provided for no or nominal consideration directly in return from the recipients.**

2. **This Standard applies to all public sector entities other than Government Business Enterprises.**

3. Government Business Enterprises (GBEs) are required to comply with International Accounting Standards (IASs) issued by the International Accounting Standards Committee. The Public Sector Committee's Guideline No. 1, "Financial Reporting by Government Business Enterprises" notes that IASs are relevant to all business enterprises, regardless of whether they are in the private or public sector. Accordingly, Guideline No. 1, recommends that GBEs should present financial statements that conform, in all material respects, to IASs.

4. The inventories referred to in paragraph 1(c) may be measured at net realizable value at certain stages of production. This occurs, for example, when agricultural crops have been harvested or mineral ores have been extracted and sale is assured under a forward contract or a government guarantee, or when a homogenous market exists and there is a negligible risk of failure to sell. These inventories are excluded from the scope of this Standard.

5. The inventories referred to in paragraph 1(d) are not encompassed by IAS 2, "Inventories" and are excluded from the scope of this Standard because they involve specific public sector issues that require further consideration.

Definitions

6. **The following terms are used in this Standard with the meanings specified:**

Current replacement cost is the cost the entity would incur to acquire the asset on the reporting date.

Inventories are 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.**

Net realizable value is 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.

Terms defined in other International Public Sector Accounting Standards are used in this Standard with the same meaning as in those other Standards, and are reproduced in the Glossary of Defined Terms published separately.

Inventories

7. Inventories encompass goods purchased and held for resale including, for example, merchandise purchased by an entity and held for resale, or land and other property held for sale. Inventories also encompass finished goods produced, or work in progress being produced, by the entity. Inventories

also include materials and supplies awaiting use in the production process and goods purchased or produced by an entity, which are for distribution to other parties for no charge or for a nominal charge; for example, educational books produced by a health authority for donation to schools. In many public sector entities inventories will relate to the provision of services rather than goods purchased and held for resale or goods manufactured for sale. In the case of a service provider, inventories include the costs of the service, as described in paragraph 23, for which the entity has not yet recognized the related revenue (guidance on recognition of revenue can be found in IPSAS 9, "Revenue from Exchange Transactions").

8. Inventories in the public sector may include:

    (a) Ammunition;

    (b) Consumable stores;

    (c) Maintenance materials;

    (d) Spare parts for plant and equipment other than those dealt with in Standards on Property, Plant And Equipment;

    (e) Strategic stockpiles (for example, energy reserves);

    (f) Stocks of unissued currency;

    (g) Postal service supplies held for sale (for example, stamps);

    (h) Work in progress, including:

        (i) Educational/training course materials; and

        (ii) Client services (for example, auditing services) where those services are sold at arm's length prices; and

    (i) Land/property held for sale.

9. Where the government controls the rights to create and issue various assets, including postal stamps and currency, these items of inventory are recognized as inventories for the purposes of this Standard. They are not reported at face value, but measured in accordance with paragraph 11, that is at their printing or minting cost.

10. When a government maintains strategic stockpiles of various reserves, such as energy reserves (for example, oil), for use in emergency or other situations (for example, natural disasters or other civil defense emergencies), these stockpiles are recognized as inventories for the purposes of this Standard and treated accordingly.

Measurement of Inventories

11. **Inventories should be measured at the lower of cost and net realizable value, except where paragraph 12 applies.**

12. **Inventories should be measured at the lower of cost and current replacement cost where they are held for:**

    (a) **Distribution at no charge or for a nominal charge; or**

    (b) **Consumption in the production process of goods to be distributed at no charge or for a nominal charge.**

Cost of Inventories

13. **The cost of inventories should comprise all costs of purchase, costs of conversion and other costs incurred in bringing the inventories to their present location and condition.**

Costs of Purchase

14. The costs of purchase of inventories comprise the purchase price, import duties and other taxes (other than those subsequently recoverable by the entity from the taxing authorities), and transport, handling and other costs directly attributable to the acquisition of finished goods, materials and supplies. Trade discounts, rebates and other similar items are deducted in determining the costs of purchase.

15. The costs of purchase may include foreign exchange differences which arise directly on the recent acquisition of inventories invoiced in a foreign currency in the circumstances permitted in the allowed alternative treatment in IPSAS 4, "The Effects of Changes in Foreign Exchange Rates." These exchange differences are limited to those resulting from a severe devaluation or depreciation of a currency against which there is no practical means of hedging and that affects liabilities which cannot be settled and which arise on the recent acquisition of the inventories.

Costs of Conversion

16. The costs of converting work-in-progress inventories into finished goods inventories are incurred primarily in a manufacturing environment. The costs of conversion of inventories include costs directly related to the units of production, such as direct labor. They also include a systematic allocation of fixed and variable production overheads that are incurred in converting materials into finished goods. Fixed production overheads are those indirect costs of production that remain relatively constant regardless of the volume of production, such as depreciation and maintenance of factory buildings and equipment, and the cost of factory management and administration. Variable production overheads are those indirect costs of

production that vary directly, or nearly directly, with the volume of production, such as indirect materials and indirect labor.

17. The allocation of fixed production overheads to the costs of conversion is based on the normal capacity of the production facilities. Normal capacity is the production expected to be achieved on average over a number of periods or seasons under normal circumstances, taking into account the loss of capacity resulting from planned maintenance. The actual level of production may be used if it approximates normal capacity. The amount of fixed overhead allocated to each unit of production is not increased as a consequence of low production or idle plant. Unallocated overheads are recognized as an expense in the period in which they are incurred. In periods of abnormally high production, the amount of fixed overhead allocated to each unit of production is decreased so that inventories are not measured above cost. Variable production overheads are allocated to each unit of production on the basis of the actual use of the production facilities.

18. For example, the allocation of costs, both fixed and variable, incurred in the development of undeveloped land held for sale into residential or commercial landholdings, could include costs relating to landscaping, drainage, pipe laying for utility connection, etc.

19. A production process may result in more than one product being produced simultaneously. This is the case, for example, when joint products are produced or when there is a main product and a by-product. When the costs of conversion of each product are not separately identifiable, they are allocated between the products on a rational and consistent basis. The allocation may be based, for example, on the relative sales value of each product either at the stage in the production process when the products become separately identifiable, or at the completion of production. Most by-products, by their nature, are immaterial. When this is the case, they are often measured at net realizable value and this value is deducted from the cost of the main product. As a result, the carrying amount of the main product is not materially different from its cost.

Other Costs

20. Other costs are included in the cost of inventories only to the extent that they are incurred in bringing the inventories to their present location and condition. For example, it may be appropriate to include non-production overheads or the costs of designing products for specific customers in the cost of inventories.

21. Examples of costs excluded from the cost of inventories and recognized as expenses in the period in which they are incurred are:

(a) Abnormal amounts of wasted materials, labor, or other production costs;

(b) Storage costs, unless those costs are necessary in the production process prior to a further production stage;

(c) Administrative overheads that do not contribute to bringing inventories to their present location and condition; and

(d) Selling costs.

22. In limited circumstances, borrowing costs are included in the cost of inventories. These circumstances are identified in the allowed alternative treatment in IPSAS 5, "Borrowing Costs."

Cost of Inventories of a Service Provider

23. The cost of inventories of a service provider consists primarily of the labor and other costs of personnel directly engaged in providing the service, including supervisory personnel, and attributable overheads. The costs of labor not engaged in providing the service are not included. Labor and other costs relating to sales and general administrative personnel are not included but are recognized as expenses in the period in which they are incurred.

Techniques for the Measurement of Cost

24. Techniques for the measurement of the cost of inventories, such as the standard cost method or the retail method, may be used for convenience if the results approximate cost. Standard costs take into account normal levels of materials and supplies, labor, efficiency and capacity utilization. They are regularly reviewed and, if necessary, revised in the light of current conditions.

Cost Formulas

25. **The cost of inventories of items that are not ordinarily interchangeable and goods or services produced and segregated for specific projects should be assigned by using specific identification of their individual costs.**

26. Specific identification of costs means that specific costs are attributed to identified items of inventory. This is an appropriate treatment for items that are segregated for a specific project. However, specific identification of costs is inappropriate when there are large numbers of items of inventory which are ordinarily interchangeable. In such circumstances, the method of selecting those items that remain in inventories could be used to obtain predetermined effects on the net surplus or deficit for the period.

27. **When applying paragraph 28 an entity should use the same cost formula for all inventories having similar nature and use to the entity. For inventories with different nature or use (for example, certain commodities used in one segment and the same type of commodities used in another segment), different cost formulas may be justified. A difference in geographical location of inventories (and in the respective tax rules), by itself, is not sufficient to justify the use of different cost formulas.**

28. **The cost of inventories, other than those dealt with in paragraph 25, should be assigned by using the first-in, first-out (FIFO) or weighted average cost formulas.**

29. The FIFO formula assumes that the items of inventory which were purchased first are sold first, and consequently the items remaining in inventory at the end of the period are those most recently purchased or produced. Under the weighted average cost formula, the cost of each item is determined from the weighted average of the cost of similar items at the beginning of a period and the cost of similar items purchased or produced during the period. The average may be calculated on a periodic basis, or as each additional shipment is received, depending upon the circumstances of the entity.

Net Realizable Value

30. The cost of inventories may not be recoverable if those inventories are damaged, if they have become wholly or partially obsolete, or if their selling prices have declined. The cost of inventories may also not be recoverable if the estimated costs of completion or the estimated costs to be incurred to make the sale, exchange or distribution have increased. The practice of writing inventories down below cost to net realizable value is consistent with the view that assets should not be carried in excess of the future economic benefits or service potential expected to be realized from their sale, exchange, distribution or use.

31. Inventories are usually written down to net realizable value on an item by item basis. In some circumstances, however, it may be appropriate to group similar or related items. This may be the case with items of inventory that have similar purposes or end uses and cannot practicably be evaluated separately from other items in that product line. It is not appropriate to write-down inventories based on a classification of inventory, for example, finished goods, or all the inventories in a particular operation or geographical segment. Service providers generally accumulate costs in respect of each service for which a separate selling price may be charged. Therefore, each such service is treated as a separate item.

32. Estimates of net realizable value are based on the most reliable evidence available at the time the estimates are made as to the amount the inventories are expected to realize. These estimates take into consideration fluctuations of price or cost directly relating to events occurring after the end of the period to the extent that such events confirm conditions existing at the end of the period.

33. Estimates of net realizable value also take into consideration the purpose for which the inventory is held. For example, the net realizable value of the quantity of inventory held to satisfy firm sales or service contracts is based on the contract price. If the sales contracts are for less than the inventory quantities held, the net realizable value of the excess is based on general selling prices. Guidance on the treatment of provisions or contingent liabilities, such as those arising from firm sales contracts in excess of inventory quantities held, and on firm purchase contracts can be found in IAS 37, "Provisions, Contingent Liabilities and Contingent Assets."

34. Materials and other supplies held for use in the production of inventories are not written down below cost if the finished products in which they will be incorporated are expected to be sold, exchanged or distributed at or above cost. However, when a decline in the price of materials indicates that the cost of the finished products will exceed net realizable value, the materials are written down to net realizable value. In such circumstances, the replacement cost of the materials may be the best available measure of their net realizable value.

35. A new assessment is made of net realizable value in each subsequent period. When the circumstances which previously caused inventories to be written down below cost no longer exist, the amount of the write-down is reversed so that the new carrying amount is the lower of the cost and the revised net realizable value. This occurs, for example, when an item of inventory, which is carried at net realizable value because its selling price has declined, is still on hand in a subsequent period and its selling price has increased.

Distributing Goods at No Charge or for a Nominal Charge

36. A public sector entity may hold inventories whose future economic benefits or service potential are not directly related to their ability to generate net cash inflows. These types of inventories may arise when a government has determined to distribute certain goods at no charge or for a nominal amount. In these cases, the future economic benefits or service potential of the inventory for financial reporting purposes is reflected by the amount the entity would need to pay to acquire the economic benefits or service potential if this was necessary to achieve the objectives of the entity. Where

the economic benefits or service potential cannot be acquired in the market, an estimate of replacement cost will need to be made. If the purpose for which the inventory is held changes, then the inventory is valued using the provisions of paragraph 11.

Recognition as an Expense

37. **When inventories are sold, exchanged or distributed the carrying amount of those inventories should be recognized as an expense in the period in which the related revenue is recognized. If there is no related revenue, the expense is recognized when the goods are distributed or related service is rendered. The amount of any write-down of inventories and all losses of inventories should 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 should be recognized as a reduction in the amount of inventories recognized as an expense in the period in which the reversal occurs.**

38. The process of recognizing as an expense the carrying amount of inventories sold, exchanged or distributed results in the matching of costs and revenues. For a service provider, the point when inventories are recognized as expenses normally occurs when services are rendered, or upon billing for chargeable services.

39. Some inventories may be allocated to other asset accounts, for example, inventory used as a component of self-constructed property, plant or equipment. Inventories allocated to another asset in this way are recognized as an expense during the useful life of that asset.

Disclosure

40. **The financial statements should disclose:**

    (a) **The accounting policies adopted in measuring inventories, including the cost formula used;**

    (b) **The total carrying amount of inventories and the carrying amount in classifications appropriate to the entity;**

    (c) **The amount of any reversal of any write-down that is recognized in the statement of financial performance in the period in accordance with paragraph 37;**

    (d) **The circumstances or events that led to the reversal of a write-down of inventories in accordance with paragraph 37; and**

    (e) **The carrying amount of inventories pledged as security for liabilities.**

41. Information about the carrying amounts held in different classifications of inventories and the extent of the changes in these assets is useful to financial statement users. Common classifications of inventories are merchandise, production supplies, materials, work in progress and finished goods. The inventories of a service provider may simply be described as work in progress.

42. **The financial statements should disclose either:**

    (a) **The cost of inventories recognized as an expense during the period; or**

    (b) **The operating costs applicable to revenues, recognized as an expense during the period, classified by their nature.**

43. The cost of inventories recognized as an expense during the period consists of those costs previously included in the measurement of the items of inventory sold, exchanged or distributed, and unallocated production overheads and abnormal amounts of production costs of inventories. The circumstances of the entity may also warrant the inclusion of other costs, such as distribution costs.

44. Some entities adopt a different format for the statement of financial performance, which results in different amounts being disclosed instead of the cost of inventories recognized as an expense during the period. Under this different format, an entity discloses the amounts of operating costs applicable to revenues for the period, classified by their nature. In this case, the entity discloses the costs recognized as an expense for raw materials and consumables, labor costs and other operating costs together with the amount of the net change in inventories for the period.

45. A write-down to net realizable value may be of such size, incidence or nature to require disclosure under IPSAS 3, "Net Surplus or Deficit for the Period, Fundamental Errors and Changes in Accounting Policies."

Effective Date

46. **This International Public Sector Accounting Standard becomes effective for annual financial statements covering periods beginning on or after July 1, 2002. Earlier application is encouraged.**

47. When an entity adopts the accrual basis of accounting, as defined by International Public Sector Accounting Standards, for financial reporting purposes, subsequent to this effective date, this Standard applies to the entity's annual financial statements covering periods beginning on or after the date of adoption.

Comparison with IAS 2

International Public Sector Accounting Standard (IPSAS) 12, "Inventories" is drawn primarily from International Accounting Standard (IAS) 2 (revised 1993), "Inventories." The main differences between IPSAS 12 and IAS 2 are as follows:

- At the time of issuing this Standard, the Public Sector Committee has not considered the applicability of IAS 41, "Agriculture," to public sector entities, therefore IPSAS 12 does not reflect amendments made to IAS 2 consequent upon the issuing of IAS 41.
- IPSAS 12 uses a different definition from IAS 2, the difference recognizes that in the public sector some inventories are distributed at no charge or for a nominal charge.
- IPSAS 12 clarifies that work-in-progress of services which are to be distributed for no or nominal consideration directly in return from the recipients are excluded from the scope of the Standard.
- A definition of "current replacement cost," which is additional to the definitions in IAS 2, has been included in IPSAS 12.
- IPSAS 12 requires that where inventories are provided at no charge or for a nominal charge, they are to be valued at the lower of cost and current replacement cost.
- IPSAS 12 does not allow the cost of inventories to be assigned using the last-in, first-out (LIFO) formula.
- Commentary additional to that in IAS 2 has been included in IPSAS 12 to clarify the applicability of the standards to accounting by public sector entities.
- IPSAS 12 uses different terminology, in certain instances, from IAS 2. The most significant examples are the use of the terms "entity," "revenue" and "statement of financial performance" in IPSAS 12. The equivalent terms in IAS 2 are "enterprise," "income" and "income statement."

IPSAS 13—LEASES

Acknowledgment

This International Public Sector Accounting Standard is drawn primarily from International Accounting Standard (IAS) 17 (revised 1997), "Leases" published by the International Accounting Standards Committee (IASC). The International Accounting Standards Board (IASB) and International Accounting Standards Committee Foundation (IASCF) were established in 2001 to replace IASC. The International Accounting Standards (IASs) issued by IASC remain in force until they are amended or withdrawn by IASB. Extracts from IAS 17 are reproduced in this publication of the Public Sector Committee of the International Federation of Accountants with the permission of IASB.

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IPSAS 13—LEASES

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The standards, which have been set in bold type, should be read in the context of the commentary paragraphs in this Standard, which are in plain type, and in the context of the "Preface to International Public Sector Accounting Standards." International Public Sector Accounting Standards are not intended to apply to immaterial items.

Objective

The objective of this Standard is to prescribe, for lessees and lessors, the appropriate accounting policies and disclosures to apply in relation to finance and operating leases.

Scope

1. **An entity which prepares and presents financial statements under the accrual basis of accounting should apply this Standard in accounting for all leases other than:**

   (a) **Lease agreements to explore for or use natural resources, such as oil, gas, timber, metals and other mineral rights; and**

   (b) **Licensing agreements for such items as motion picture films, video recordings, plays, manuscripts, patents and copyrights.**

   However, this Standard should not be applied to the measurement by:

   (a) **Lessees of investment property held under finance leases; or**

   (b) **Lessors of investment property leased out under operating leases (see International Public Sector Accounting Standard (IPSAS) 16, "Investment Property").**

2. **This Standard applies to all public sector entities other than Government Business Enterprises.**

3. This Standard applies to agreements that transfer the right to use assets even though substantial services by the lessor may be called for in connection with the operation or maintenance of such assets. On the other hand, this Standard does not apply to agreements that are contracts for services that do not transfer the right to use assets from one contracting party to the other. Public sector entities may enter into complex arrangements for the delivery of services, which may or may not include leases of assets. These arrangements are discussed in paragraphs 17 to 19.

4. This Standard does not apply to lease agreements to explore for or use natural resources such as oil, gas, timber, metals and other mineral rights, and licensing agreements for such items as motion picture films, video recordings, plays, manuscripts, patents and copyrights. This is because these types of agreements have the potential to raise complex accounting issues which need to be addressed separately.

5. This Standard does not apply to investment property. Investment properties are measured by lessors and lessees in accordance with the provisions of IPSAS 16.

6. Government Business Enterprises (GBEs) are required to comply with International Accounting Standards (IASs) issued by the International Accounting Standards Committee. The Public Sector Committee's Guideline No. 1, "Financial Reporting by Government Business Enterprises" notes that IASs are relevant to all business enterprises, regardless of whether they are in the private or public sector. Accordingly, Guideline No. 1 recommends that GBEs should present financial statements that conform, in all material respects, to IASs.

Definitions

7. **The following terms are used in this Standard with the meanings specified:**

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 (for example, percentage of sales, amount of usage, price indices, market rates of interest).

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.**

A finance lease is a lease that transfers substantially all the risks and rewards incident to ownership of an asset. Title may or may not eventually be transferred.

Gross investment in the lease is 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.

Guaranteed residual value is:

(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.**

The <u>inception of the lease</u> is the earlier of the date of the lease agreement or of a commitment by the parties to the principal provisions of the lease.

The <u>interest rate implicit in the lease</u> is 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.**

A <u>lease</u> is 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.

The <u>lease term</u> is 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.

The <u>lessee's incremental borrowing rate of interest</u> is 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.

<u>Minimum lease payments</u> are 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:

(a) **In the case of the lessee, any amounts guaranteed by the lessee or by a party related to the lessee; or**

(b) **In the case of the lessor, any residual value guaranteed to the lessor by either:**

  (i) **The lessee;**

  (ii) **A party related to the lessee; or**

(iii) **An independent third party financially capable of meeting this guarantee.**

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.

Net investment in the lease is the gross investment in the lease less unearned finance revenue.

A non-cancelable lease is 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.**

An operating lease is a lease other than a finance lease.

Unearned finance revenue is 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.**

Unguaranteed residual value is 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.

Useful life is 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.

Terms defined in other International Public Sector Accounting Standards are used in this Standard with the same meaning as in those

other Standards, and are reproduced in the Glossary of Defined Terms published separately.

Hire Purchase Contracts

8. The definition of a lease includes contracts for the hire of an asset which contain a provision giving the hirer an option to acquire title to the asset upon the fulfillment of agreed conditions. These contracts are sometimes known as hire purchase contracts.

Incremental Borrowing Rate of Interest

9. Where an entity has borrowings which are guaranteed by the government, the determination of the lessee's incremental borrowing rate of interest should reflect the existence of any government guarantee and any related fees. This will normally lead to the use of a lower incremental borrowing rate of interest.

Classification of Leases

10. The classification of leases adopted in this Standard is based on the extent to which risks and rewards incident to ownership of a leased asset lie with the lessor or the lessee. Risks include the possibilities of losses from idle capacity, technological obsolescence or changes in value due to changing economic conditions. Rewards may be represented by the expectation of service potential or profitable operation over the asset's economic life and of gain from appreciation in value or realization of a residual value.

11. A lease is classified as a finance lease if it transfers substantially all the risks and rewards incident to ownership. A lease is classified as an operating lease if it does not transfer substantially all the risks and rewards incident to ownership.

12. Since the transaction between a lessor and a lessee is based on a lease agreement common to both parties, it is appropriate to use consistent definitions. The application of these definitions to the differing circumstances of the two parties may sometimes result in the same lease being classified differently by lessor and lessee.

13. Whether a lease is a finance lease or an operating lease depends on the substance of the transaction rather than the form of the contract. Although the following are examples of situations which would normally lead to a lease being classified as a finance lease, a lease does not need to meet all these criteria in order to be classified as a finance lease:

    (a) The lease transfers ownership of the asset to the lessee by the end of the lease term;

(b) The lessee has the 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 it is reasonably certain that the option will be exercised;

(c) The lease term is for the major part of the economic life of the asset even if title is not transferred;

(d) At the inception of the lease the present value of the minimum lease payments amounts to at least substantially all of the fair value of the leased asset;

(e) The leased assets are of a specialized nature such that only the lessee can use them without major modifications being made; and

(f) The leased assets cannot easily be replaced by another asset.

14. Other indicators which individually or in combination could also lead to a lease being classified as a finance lease are:

(a) If the lessee can cancel the lease, the lessor's losses associated with the cancellation are borne by the lessee;

(b) Gains or losses from the fluctuation in the fair value of the residual fall to the lessee (for example in the form of a rent rebate equaling most of the sales proceeds at the end of the lease); and

(c) The lessee has the ability to continue the lease for a secondary period at a rent which is substantially lower than market rent.

15. Lease classification is made at the inception of the lease. If at any time the lessee and the lessor agree to change the provisions of the lease, other than by renewing the lease, in a manner that would have resulted in a different classification of the lease under the criteria in paragraphs 10 to 14 had the changed terms been in effect at the inception of the lease, the revised agreement is considered as a new agreement over its term. Changes in estimates (for example, changes in estimates of the economic life or the residual value of the leased property) or changes in circumstances (for example, default by the lessee), however, do not give rise to a new classification of a lease for accounting purposes.

16. Leases of land and buildings are classified as operating or finance leases in the same way as leases of other assets. However, a characteristic of land is that it normally has an indefinite economic life and, if title is not expected to pass to the lessee by the end of the lease term, the lessee does not receive substantially all of the risks and rewards incident to ownership. A premium paid for such a leasehold represents pre-paid lease payments which are

amortized over the lease term in accordance with the pattern of benefits provided.

Leases and Other Contracts

17. A contract may consist solely of an agreement to lease an asset. However, a lease may also be one element in a broader set of agreements with private sector entities to construct, own, operate and/or transfer assets. Public sector entities often enter into such agreements, particularly in relation to long-lived physical assets and infrastructure assets. For example, a public sector entity may construct a tollway. It may then lease the tollway to a private sector entity as part of an arrangement whereby the private sector entity agrees to:

    (a) Lease the tollway for an extended period of time (with or without an option to purchase the facility);

    (b) Operate the tollway; and

    (c) Fulfill extensive maintenance requirements, including regular upgrading of both the road surface and the traffic control technology.

    Other agreements may involve a public sector entity leasing infrastructure from the private sector.

18. Where an arrangement contains an identifiable operating lease or finance lease as defined in this Standard, the provisions of this Standard should be applied in accounting for the lease component of the arrangement.

19. Public sector entities may also enter a variety of agreements for the provision of goods and/or services, which necessarily involve the use of dedicated assets. In some of these agreements, it may not be clear whether or not a lease, as defined by this Standard, has arisen. In these cases, professional judgment is exercised, and if a lease has arisen this standard is applied; and if a lease has not arisen entities account for those agreements by applying the provisions of other relevant International Public Sector Accounting Standards, or in the absence thereof, other relevant international and/or national accounting standards.

Leases in the Financial Statements of Lessees

Finance Leases

20. **Lessees should recognize assets acquired under finance leases as assets and the associated lease obligations as liabilities. The assets and liabilities should be 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. In calculating the present value of the minimum lease payments the discount factor is the interest rate implicit in the lease, if this is practicable to determine; if not, the lessee's incremental borrowing rate should be used.

21. Transactions and other events are accounted for and presented in accordance with their substance and financial reality and not merely with legal form. While the legal form of a lease agreement is that the lessee may acquire no legal title to the leased asset, in the case of finance leases the substance and financial reality are that the lessee acquires the economic benefits or service potential of the use of the leased asset for the major part of its economic life in return for entering into an obligation to pay for that right an amount approximating to the fair value of the asset and the related finance charge.

22. If such lease transactions are not reflected in the lessee's financial statements, the assets and liabilities of an entity are understated, thereby distorting financial ratios. It is therefore appropriate that a finance lease be recognized in the lessee's financial statements both as an asset and as an obligation to pay future lease payments. At the inception of the lease, the asset and the liability for the future lease payments are recognized in the financial statements at the same amounts.

23. It is not appropriate for the liabilities for leased assets to be presented in the financial statements as a deduction from the leased assets.

24. If for the presentation of liabilities on the face of the statement of financial position a distinction is made between current and non-current liabilities, the same distinction is made for lease liabilities.

25. Initial direct costs are often incurred in connection with specific leasing activities, as in negotiating and securing leasing arrangements. The costs identified as directly attributable to activities performed by the lessee for a finance lease are included as part of the amount recognized as an asset under the lease.

26. **Lease payments should be apportioned between the finance charge and the reduction of the outstanding liability. The finance charge should be allocated to periods during the lease term so as to produce a constant periodic rate of interest on the remaining balance of the liability for each period.**

27. In practice, in allocating the finance charge to periods during the lease term, some form of approximation may be used to simplify the calculation.

28. **A finance lease gives rise to a depreciation expense for depreciable assets as well as a finance expense for each accounting period. The depreciation policy for depreciable leased assets should be consistent with that for depreciable assets which are owned, and the depreciation recognized should be calculated on the basis set out in International Public Sector Accounting Standard (IPSAS) 17, "Property, Plant and Equipment" and any international and/or national accounting standard on intangible assets which has been adopted by the entity. If there is no reasonable certainty that the lessee will obtain ownership by the end of the lease term, the asset should be fully depreciated over the shorter of the lease term or its useful life.**

29. The depreciable amount of a leased asset is allocated to each accounting period during the period of expected use on a systematic basis consistent with the depreciation policy the lessee adopts for depreciable assets that are owned. If there is reasonable certainty that the lessee will obtain ownership by the end of the lease term, the period of expected use is the useful life of the asset; otherwise the asset is depreciated over the shorter of the lease term or its useful life.

30. The sum of the depreciation expense for the asset and the finance expense for the period is rarely the same as the lease payments payable for the period, and it is therefore inappropriate simply to recognize the lease payments payable as an expense in the statement of financial performance. Accordingly, the asset and the related liability are unlikely to be equal in amount after the inception of the lease.

31. To determine whether a leased asset has become impaired an entity applies relevant impairment tests in international and/or national accounting standards.

32. **Lessees should make the following disclosures for finance leases:**

    (a) **For each class of asset, the net carrying amount at the reporting date;**

    (b) **A reconciliation between the total of minimum lease payments at the reporting date, and their present value.**

    (c) **In addition, an entity should disclose the total of minimum lease payments at the reporting date, and their present value, for each of the following periods:**

        (i) **Not later than one year;**

        (ii) **Later than one year and not later than five years; and**

        (iii) **Later than five years;**

(d) **Contingent rents recognized in the statement of financial performance for the period;**

(e) **The total of future minimum sublease payments expected to be received under non-cancelable subleases at the reporting date; and**

(f) **A general description of the lessee's significant leasing arrangements including, but not limited to, the following:**

(i) **The basis on which contingent rent payments are determined;**

(ii) **The existence and terms of renewal or purchase options and escalation clauses; and**

(iii) **Restrictions imposed by lease arrangements, such as those concerning return of net surplus, return of capital contributions, dividends, additional debt and further leasing.**

33. In addition, the disclosure requirements of IPSAS 16, IPSAS 17 and any international and/or national accounting standard on intangible assets and on impairment of assets which have been adopted by the entity should be applied to the amounts of leased assets under finance leases that are accounted for by the lessee as acquisitions of assets.

Operating Leases

34. **Lease payments under an operating lease should be recognized as an expense in the statement of financial performance on a straight line basis over the lease term unless another systematic basis is representative of the time pattern of the user's benefit.**

35. For operating leases, lease payments (excluding costs for services such as insurance and maintenance) are recognized as an expense in the statement of financial performance on a straight-line basis unless another systematic basis is representative of the time pattern of the user's benefit, even if the payments are not on that basis.

36. **Lessees should make the following disclosures for operating leases:**

(a) **The total of future minimum lease payments under non-cancelable operating leases for each of the following periods:**

(i) **Not later than one year;**

(ii) **Later than one year and not later than five years; and**

(iii) **Later than five years;**

(b) **The total of future minimum sublease payments expected to be received under non-cancelable subleases at the reporting date;**

(c) **Lease and sublease payments recognized in the statement of financial performance for the period, with separate amounts for minimum lease payments, contingent rents, and sublease payments; and**

(d) **A general description of the lessee's significant leasing arrangements including, but not limited to, the following:**

(i) **The basis on which contingent rent payments are determined;**

(ii) **The existence and terms of renewal or purchase options and escalation clauses; and**

(iii) **Restrictions imposed by lease arrangements, such as those concerning return of net surplus, return of capital contributions, dividends, additional debt, and further leasing.**

Leases in the Financial Statements of Lessors

Finance Leases

37. This Standard describes the treatment of finance revenue earned under finance leases. The term "manufacturer or trader lessor" is used in this Standard to refer to all public sector entities that manufacture or trade assets and also act as lessors of those assets, regardless of the scale of their leasing, trading and manufacturing activities. With respect to an entity that is a manufacturer or trader lessor, the Standard also describes the treatment of gains or losses arising from the transfer of assets.

38. Public sector entities may enter into finance leases as a lessor under a variety of circumstances. Some public sector entities may trade assets on a regular basis. For example, governments may create special purpose entities that are responsible for the central procurement of assets and supplies for all other entities. Centralization of the purchasing function may provide greater opportunity to obtain trade discounts or other favorable conditions. In some jurisdictions, a central purchasing entity may purchase items on behalf of other entities, with all transactions being conducted in the name of the other entities. In other jurisdictions, a central purchasing entity may purchase items in its own name and its functions may include:

(a) Procuring assets and supplies;

(b) Transferring assets by way of sale or finance lease; and/or

(c) Managing a portfolio of assets, such as a motor vehicle fleet, for use by other entities and making those assets available for short or long-term lease, or purchase.

39. Other public sector entities may enter into lease transactions on a more limited scale and at less frequent intervals. In particular, in some jurisdictions public sector entities which have traditionally owned and operated infrastructure assets such as roads, dams, and water treatment plants are no longer automatically assuming complete ownership and operational responsibility for these assets. Public sector entities may transfer existing infrastructure assets to private sector entities by way of sale or by way of finance lease. In addition, public sector entities may construct new long-lived physical and infrastructure assets in partnership with private sector entities with the intention that the private sector entity will assume responsibility for the assets by way of outright purchase or by way of finance lease once they are completed. In some cases, the arrangement provides for a period of control by the private sector before reversion of title and control of the asset to the public sector — for example, a local government may build a hospital and lease the facility to a private sector company for a period of twenty years, after which time the facility reverts to public control.

40. **Lessors should recognize lease payments receivable under a finance lease as assets in their statements of financial position. They should present such assets as a receivable at an amount equal to the net investment in the lease.**

41. Under a finance lease, substantially all the risks and rewards incident to legal ownership are transferred by the lessor, and thus the lease payment receivable is treated by the lessor as repayment of principal and finance revenue to reimburse and reward the lessor for its investment and services.

42. **The recognition of finance revenue should 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.**

43. A lessor aims to allocate finance revenue over the lease term on a systematic and rational basis. This revenue allocation is based on a pattern reflecting a constant periodic return on the lessor's net investment outstanding in respect of the finance lease. Lease payments relating to the accounting period, excluding costs for services, are applied against the gross investment in the lease to reduce both the principal and the unearned finance revenue.

44. Estimated unguaranteed residual values used in computing the lessor's gross investment in a lease are reviewed regularly. If there has been a reduction in the estimated unguaranteed residual value, the revenue allocation over the lease term is revised and any reduction in respect of amounts already accrued is recognized immediately.

45. Initial direct costs, such as commissions and legal fees, are often incurred by lessors in negotiating and arranging a lease. For finance leases, these initial direct costs are incurred to produce finance revenue and are either recognized immediately as an expense or allocated against revenue over the lease term.

46. **Manufacturer or trader lessors should recognize gains or losses on sale of assets in the statement of financial performance for the period, in accordance with the policy followed by the entity for outright sales.**

47. **If artificially low rates of interest are quoted, any gains or losses on sale of assets should be restricted to those which would apply if a commercial rate of interest were charged. Initial direct costs should be recognized as an expense in the statement of financial performance at the inception of the lease.**

48. Public sector entities which manufacture or trade assets may offer to potential purchasers the choice of either buying or leasing an asset. A finance lease of an asset by a manufacturer or trader lessor gives rise to two types of revenue:

    (a) The gain or loss equivalent to the gain or loss resulting from an outright sale of the asset being leased, at normal selling prices, reflecting any applicable volume or trade discounts; and

    (b) The finance revenue over the lease term.

49. The sales revenue recorded at the commencement of a finance lease term by a manufacturer or trader lessor is the fair value of the asset, or, if lower, the present value of the minimum lease payments accruing to the lessor, computed at a commercial rate of interest. The cost of sale of an asset recognized at the commencement of the lease term is the cost, or carrying amount if different, of the leased property less the present value of the unguaranteed residual value. The difference between the sales revenue and the cost of sale is the gain or loss on sale which is recognized in accordance with the policy followed by the entity for sales of assets.

50. Manufacturer or trader lessors may sometimes offer customers lower rates of interest than their normal lending rates. The use of such a rate would result in an excessive portion of the total revenue from the transaction being

recognized at the time of sale. If artificially low rates of interest are quoted, revenue recognized as gain or loss on sale would be restricted to that which would apply if the entity's normal lending rate for that type of transaction were charged.

51. Initial direct costs are recognized as an expense at the commencement of the lease term because they are mainly related to earning the manufacturer's or trader's gain or loss on sale.

52. **Lessors should make the following disclosures for finance leases:**

    (a) **A reconciliation between the total gross investment in the lease at the reporting date, and the present value of minimum lease payments receivable at the reporting date. In addition, an entity should disclose the total gross investment in the lease and the present value of minimum lease payments receivable at the reporting date, for each of the following periods:**

        (i) **Not later than one year;**

        (ii) **Later than one year and not later than five years; and**

        (iii) **Later than five years;**

    (b) **Unearned finance revenue;**

    (c) **The unguaranteed residual values accruing to the benefit of the lessor;**

    (d) **The accumulated allowance for uncollectible minimum lease payments receivable;**

    (e) **Contingent rents recognized in the statement of financial performance; and**

    (f) **A general description of the lessor's significant leasing arrangements.**

53. As an indicator of growth in leasing activities it is often useful to also disclose the gross investment less unearned revenue in new business added during the accounting period, after deducting the relevant amounts for canceled leases.

Operating Leases

54. **Lessors should present assets subject to operating leases in their statements of financial position according to the nature of the asset.**

55. **Lease revenue from operating leases should be recognized as revenue on a straight-line basis over the lease term, unless another systematic**

basis is more representative of the time pattern in which benefits derived from the leased asset is diminished.

56. Costs, including depreciation, incurred in earning the lease revenue are recognized as an expense. Lease revenue (excluding receipts for services provided such as insurance and maintenance) is recognized as revenue on a straight line basis over the lease term even if the receipts are not on such a basis, unless another systematic basis is more representative of the time pattern in which use benefit derived from the leased asset is diminished.

57. Initial direct costs incurred specifically to earn revenues from an operating lease are either deferred and recognized as an expense over the lease term in proportion to the recognition of rent revenue, or recognized as an expense in the statement of financial performance in the period in which they are incurred.

58. **The depreciation of depreciable leased assets should be on a basis consistent with the lessor's normal depreciation policy for similar assets, and the depreciation charge should be calculated on the basis set out in IPSAS 17, and any international and/or national accounting standard on intangible assets which has been adopted by the entity.**

59. To determine whether a leased asset has become impaired, an entity applies relevant impairment tests in international and/or national accounting standards.

60. A manufacturer or trader lessor does not recognize any gain on sale on entering into an operating lease because it is not the equivalent of a sale.

61. **Lessors should make the following disclosures for operating leases:**

    (a) **The future minimum lease payments under non-cancelable operating leases in the aggregate and for each of the following periods:**

        (i) **Not later than one year;**

        (ii) **Later than one year and not later than five years; and**

        (iii) **Later than five years;**

    (b) **Total contingent rents recognized in the statement of financial performance; and**

    (c) **A general description of the lessor's significant leasing arrangements.**

Sale and Leaseback Transactions

62. A sale and leaseback transaction involves the sale of an asset by the vendor and the leasing of the same asset back to the vendor. The lease payment and the sale price are usually interdependent as they are negotiated as a package. The accounting treatment of a sale and leaseback transaction depends upon the type of lease involved.

63. **If a sale and leaseback transaction results in a finance lease, any excess of sales proceeds over the carrying amount should not be immediately recognized as revenue in the financial statements of a seller-lessee. Instead, it should be deferred and amortized over the lease term.**

64. If the leaseback is a finance lease, the transaction is a means whereby the lessor provides finance to the lessee, with the asset as security. For this reason it is not appropriate to regard an excess of sales proceeds over the carrying amount as revenue. Such excess is deferred and amortized over the lease term.

65. **If a sale and leaseback transaction results in an operating lease, and it is clear that the transaction is established at fair value, any gain or loss should be recognized immediately. If the sale price is below fair value, any gain or loss should be recognized immediately except that, if the loss is compensated by future lease payments at below market price, it should be deferred and amortized in proportion to the lease payments over the period for which the asset is expected to be used. If the sale price is above fair value, the excess over fair value should be deferred and amortized over the period for which the asset is expected to be used.**

66. If the leaseback is an operating lease, and the lease payments and the sale price are established at fair value, there has in effect been a normal sale transaction and any gain or loss is recognized immediately.

67. **For operating leases, if the fair value at the time of a sale and leaseback transaction is less than the carrying amount of the asset, a loss equal to the amount of the difference between the carrying amount and fair value should be recognized immediately.**

68. For finance leases, no such adjustment is necessary unless there has been an impairment in value and that impairment is required to be recognized by any international and/or national accounting standard on impairment which has been adopted by the entity.

69. Disclosure requirements for lessees and lessors apply equally to sale and leaseback transactions. The required description of the significant leasing arrangements leads to disclosure of unique or unusual provisions of the agreement or terms of the sale and leaseback transactions.

70. Sale and leaseback transactions may be required to be separately disclosed in accordance with IPSAS 3, "Net Surplus or Deficit for the Period, Fundamental Errors and Changes in Accounting Policies."

Transitional Provisions

71. **All provisions of this Standard should be applied from the date of first adoption, except in relation to leased assets which have not been recognized as a result of transitional provisions under another International Public Sector Accounting Standard. The provisions of this Standard would not be required to apply to such assets until the transitional provision in the other International Public Sector Accounting Standard expires. In no case should the existence of transitional provisions in other Standards preclude the full application of this Standard for a period exceeding five years after the date of first adoption of this Standard.**

72. Notwithstanding the existence of transitional provisions under another International Public Sector Accounting Standard, entities that are in the process of adopting the accrual basis of accounting are encouraged to comply in full with the provisions of that other Standard as soon as possible.

73. **Retrospective application of this Standard by entities that have already adopted the accrual basis of accounting and which intend to comply with International Public Sector Accounting Standards as they are issued is encouraged but not required. If the Standard is not applied retrospectively, the balance of any pre-existing finance lease is deemed to have been properly determined by the lessor and should be accounted for thereafter in accordance with the provisions of this Standard.**

74. Entities that have already adopted the accrual basis of accounting and which intend to comply with International Public Sector Accounting Standards as they are issued, may have pre-existing finance leases which have been recognized as assets and liabilities in the statement of financial position. Retrospective application of this Standard to existing finance leases is encouraged. Retrospective application could lead to the restatement of such assets and liabilities. Such assets and liabilities are required to be restated only if the Standard is applied retrospectively.

Effective Date

75. **This International Public Sector Accounting Standard becomes effective for annual financial statements covering periods beginning on or after January 1, 2003. Earlier application is encouraged.**

76. When an entity adopts the accrual basis of accounting, as defined by International Public Sector Accounting Standards, for financial reporting purposes, subsequent to this effective date, this Standard applies to the entity's annual financial statements covering periods beginning on or after the date of adoption.

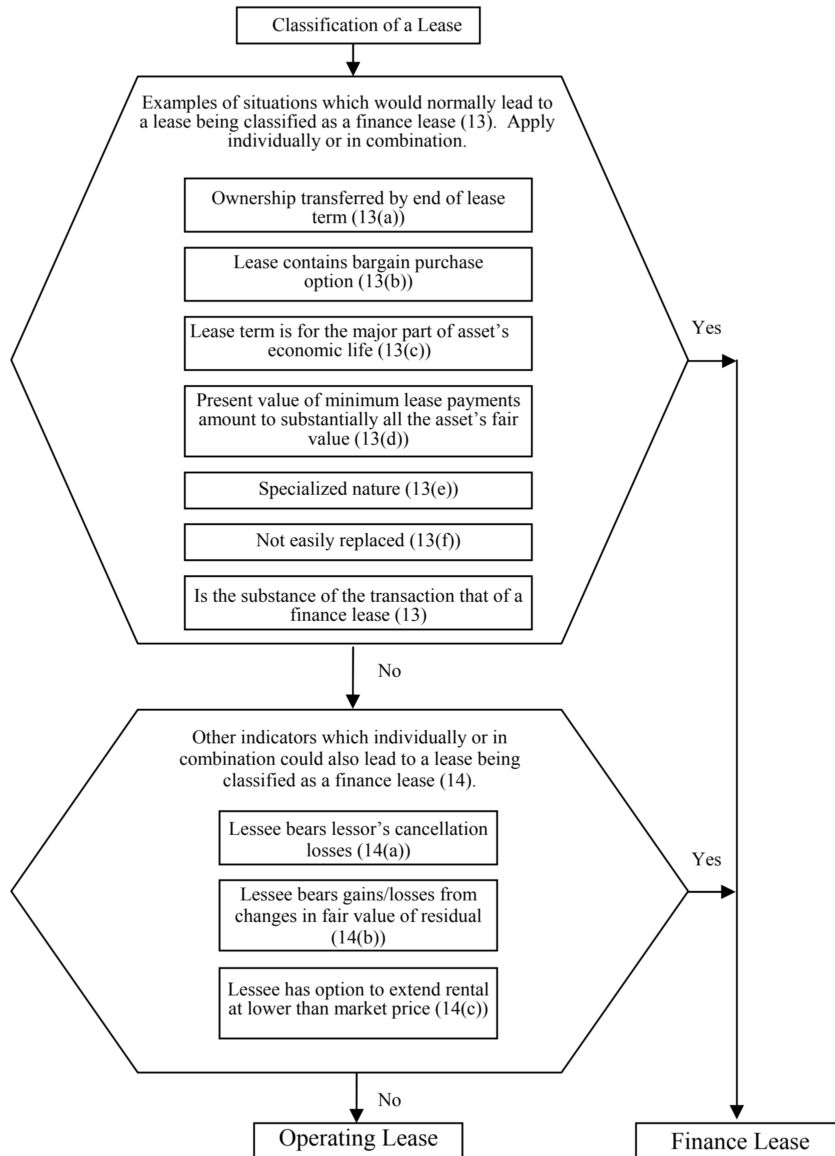
Appendix 1—Classification of a Lease

The appendix is illustrative only and does not form part of the standards, it should however be interpreted in the context of the standards. The purpose of the appendix is to illustrate the application of the standards to assist in clarifying their meaning.

The objective of the chart on the next page is to assist in classifying a lease as either a finance lease or an operating lease. A finance lease is a lease that transfers substantially all the risks and rewards incident to ownership of an asset. An operating lease is a lease other than a finance lease.

The examples contained in this chart do not necessarily reflect all possible situations in which a lease may be classified as a finance lease, nor should a lease necessarily be classified as a finance lease by virtue of the route followed in this chart. Whether a lease is a finance lease or an operating lease depends on the substance of the transaction rather than the form of the contract (paragraph 13).

In the flowchart, the numbers in parentheses refer to paragraph numbers in the Standard.

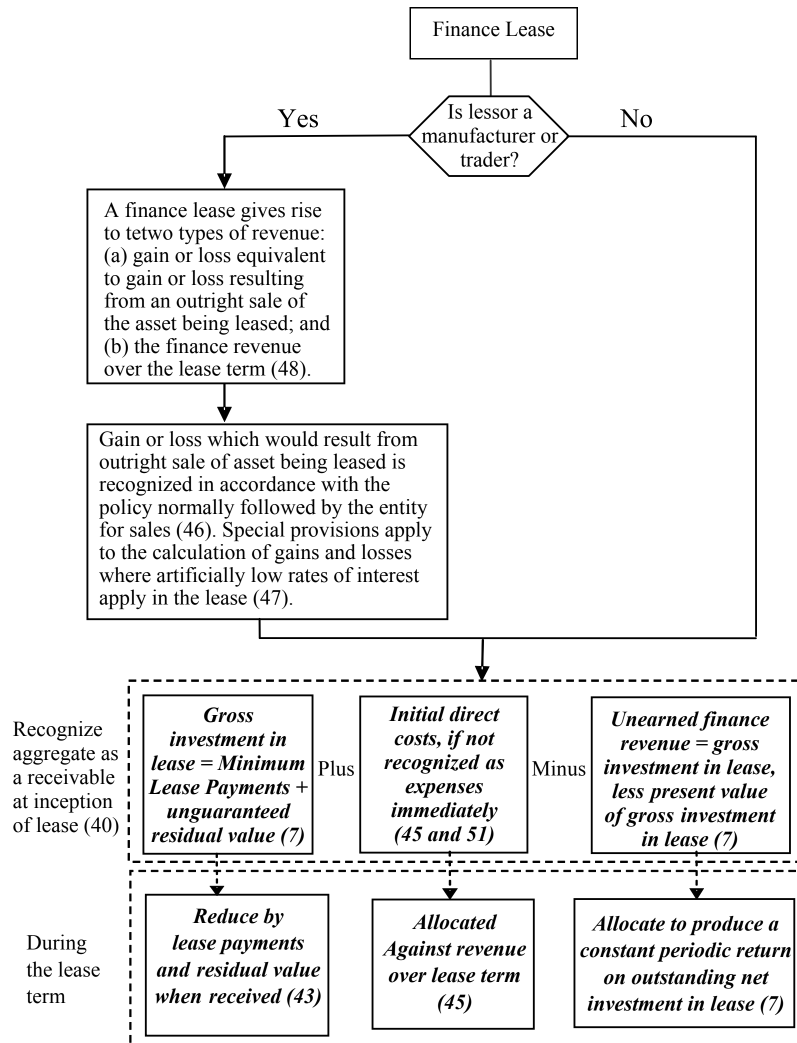

Classification of a Lease
Examples of situations which would normally lead to a lease being classified as a finance lease (13). Apply individually or in combination.
Ownership transferred by end of lease term (13(a))
Lease contains bargain purchase option (13(b))
Lease term is for the major part of asset's economic life (13(c))
Present value of minimum lease payments amount to substantially all the asset's fair value (13(d))
Specialized nature (13(e))
Not easily replaced (13(f))
Is the substance of the transaction that of a finance lease (13)
Yes
No
Other indicators which individually or in combination could also lead to a lease being classified as a finance lease (14).
Lessee bears lessor's cancellation losses (14(a))
Lessee bears gains/losses from changes in fair value of residual (14(b))
Lessee has option to extend rental at lower than market price (14(c))
Yes
No
Operating Lease
Finance Lease

PUBLIC SECTOR

Appendix 2—Accounting for a Finance Lease by a Lessor

The appendix is illustrative only and does not form part of the standards, it should however be interpreted in the context of the standards. The purpose of the appendix is to illustrate the application of the standards to assist in clarifying their meaning.

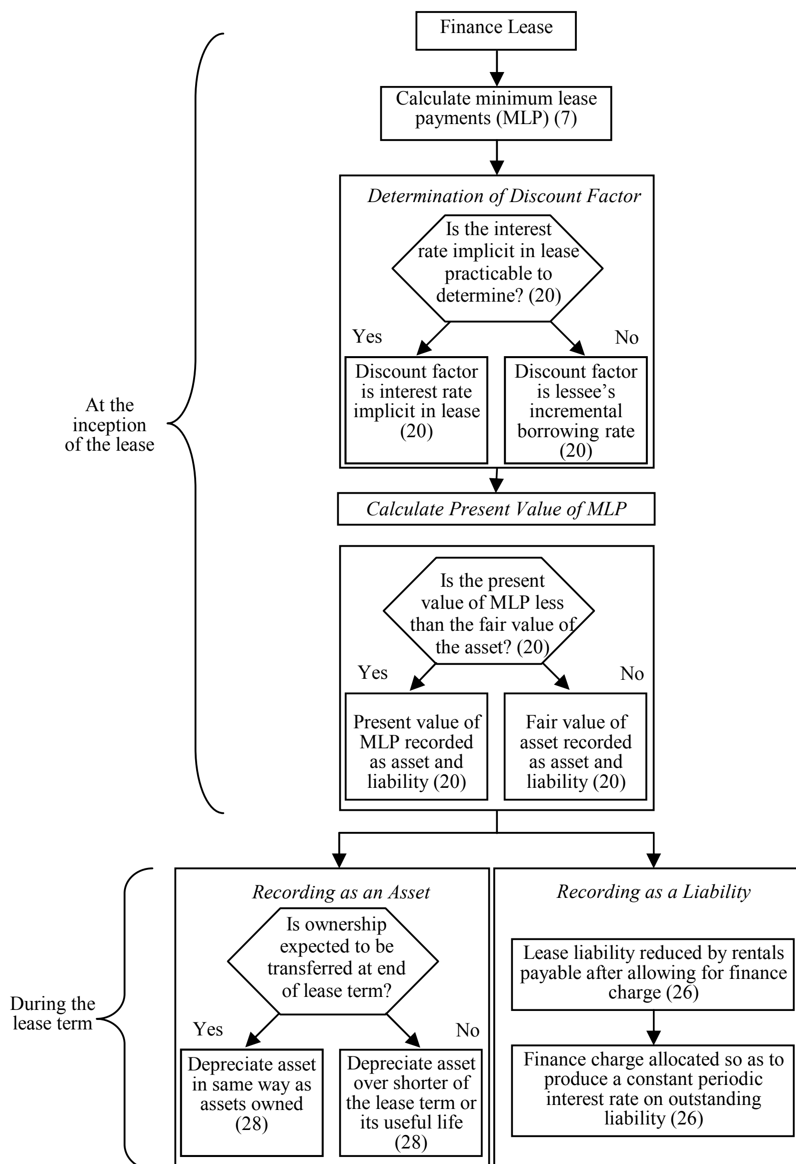
In the flowchart, the numbers in parentheses refer to paragraph numbers in the Standard.



Appendix 3—Accounting for a Finance Lease by a Lessee

The appendix is illustrative only and does not form part of the standards, it should however be interpreted in the context of the standards. The purpose of the appendix is to illustrate the application of the standards to assist in clarifying their meaning.

In the flowchart, the numbers in parentheses refer to paragraph numbers in the Standard.



Appendix 4—Sale and Leaseback Transactions that Result in Operating Leases

The appendix is illustrative only and does not form part of the standards. The purpose of the appendix is to illustrate the application of the standards to assist in clarifying their meaning.

A sale and leaseback transaction that results in an operating lease may give rise to a gain or a loss, the determination and treatment of which depends upon the leased asset's carrying amount, fair value and selling price. The table on the following page shows the requirements of the Standard in various circumstances.

Sale price established at fair value (paragraph 65)	**Carrying amount equal to fair value**	**Carrying amount less than fair value**	**Carrying amount above fair value**
Gain	no gain	recognize gain immediately	no gain
Loss	no loss	no loss	recognize loss immediately
Sale price below fair value (paragraph 65)	**Carrying amount equal to fair value**	**Carrying amount less than fair value**	**Carrying amount above fair value**
Gain	no gain	recognize gain immediately	no gain (note 1)
Loss <u>not</u> compensated by future lease payments at below market price	recognize loss immediately	recognize loss immediately	(note 1)
Loss compensated by future lease payments at below market price	defer and amortize loss	defer and amortize loss	(note 1)
Sale price above fair value (paragraph 65)	**Carrying amount equal to fair value**	**Carrying amount less than fair value**	**Carrying amount above fair value**
Gain	defer and amortize gain	defer and amortize gain (note 2)	defer and amortize gain (note 3)
Loss	no loss	no loss	(note 1)

Note 1 These parts of the table represent circumstances that would have been dealt with under paragraph 67 of the Standard. Paragraph 67 requires the carrying amount of an asset to be written down to fair value where it is subject to a sale and leaseback.

Note 2 If the sale price is above fair value, the excess over fair value should be deferred and amortized over the period for which the asset is expected to be used (paragraph 65).

Note 3 The gain would be the difference between fair value and sale price as the carrying amount would have been written down to fair value in accordance with paragraph 67.

Appendix 5—Calculating the Interest Rate Implicit in a Finance Lease

The appendix is illustrative only and does not form part of the standards. The purpose of the appendix is to illustrate the application of the standards to assist in clarifying their meaning.

The Standard (paragraph 20) requires the lessees of assets acquired under finance leases to calculate the interest rate implicit in a lease, where practical. Paragraph 26 requires the lessees to apportion lease payments between the finance charge and the reduction of the outstanding liability using the interest rate implicit in the lease. Many lease agreements explicitly identify the interest rate implicit in the lease, but some do not. If a lease agreement does not identify the interest rate implicit in the lease the lessee needs to calculate the rate, using the present value formula. Financial calculators and spreadsheets will automatically calculate the interest rate implicit in a lease. Where these are not available, entities can use the present value formula to manually calculate the rate. This appendix illustrates the following two common methods for calculating the interest rate: trial and error, and interpolation. Both methods use the present value formula to derive the interest rate.

Derivations of present value formulas are widely available in accounting and finance textbooks. The present value (PV) of minimum lease payments (MLP) is calculated by means of the following formula:

$$PV(MLP) = \frac{S}{(1+r)^n} + \frac{A}{r}\left[1 - \frac{1}{(1+r)^n}\right]$$

Where:

“S” is the guaranteed residual value

“A” is the regular periodical payment

“r” is the periodic interest rate implicit in the lease expressed as a decimal

“n” is the number of periods in the term of the lease

Example

Department X enters into an agreement to acquire a motor vehicle on a finance lease. The fair value of the motor vehicle at the inception of the lease is 25,000 currency units, the annual lease payments are 5,429 currency units payable in arrears, the lease term is four years, and the guaranteed residual value is 10,000 currency units. The lease agreement does not provide any services additional to the supply of the motor vehicle. Department X is responsible for all the running costs of the vehicle including insurance, fuel and maintenance. The lease agreement does not specify the interest rate implicit in the lease. The Department’s incremental borrowing rate is 7%

per annum. Several financial institutions are advertising loans secured by motor vehicles at rates varying between 7.5% and 10%.

Trial and Error Method

The calculation is an iterative process — that is, the lessee must make a "best guess" of the interest rate and calculate the present value of the minimum lease payments and compare the result to the fair value of the leased asset at the inception of the lease. If the result is less than the fair value, the interest rate selected was too high, if the result is greater than the fair value, the interest rate selected was too low. The interest rate implicit in a lease is the rate used when the present value of the minimum lease payments is equal to the fair value of the leased asset at the inception of the lease.

The Department X would begin calculations using a best estimate — for example its incremental borrowing rate of 7% per annum, which is too low. It would then use the maximum feasible rate — for example the 10% per annum rate offered for loans secured by a motor vehicle, which would prove too high. After several calculations it would arrive at the correct rate of 8.5% per annum.

To calculate the interest rate the Department uses the PV(MLP) formula above, where:

S = 10,000   n = 4   r = Annual interest rate expressed as a decimal

A = 5,429   Target PV(MLP) = 25,000

At Department X's incremental borrowing rate of 7% (0.07) per annum (figures are rounded):

$$\text{PV(MLP)} = \frac{10{,}000}{(1+0.07)^4} + \frac{5{,}429}{0.07}\left[1 - \frac{1}{(1+0.07)^4}\right]$$

$$= 7{,}629 + 18{,}390$$

$$= 26{,}019$$

The PV(MLP) using the incremental borrowing rate is greater than the fair value of the leased asset, therefore a higher rate is implicit in the lease. The Department must make calculations at other rates to determine the actual rate (figures are rounded):

PV(MLP) at 7.5%	= 25,673	Interest rate too low
PV(MLP) at 10%	= 24,040	Interest rate too high
PV(MLP) at 9%	= 24,674	Interest rate too high
PV(MLP) at 8%	= 25,333	Interest rate too low
PV(MLP) at 8.5%	= 25,000	Correct interest rate

The Department will now use the interest rate of 8.5% to apportion the lease payments between the finance charge and the reduction of the lease liability, as shown in the table below.

Interpolation Method

Calculating the interest rate implicit in a lease requires lessees to initially calculate the present value for an interest rate that is too high, and one that is too low. The differences (in absolute terms) between the results obtained and the actual net present value are used to interpolate the correct interest rate. Using the data provided above, and the results for 7% and 10%, the actual rate can be interpolated as follows (figures are rounded):

PV at 7% = 26,019, difference = 1,019 (i.e., 26,019 – 25,000)

PV at 10% = 24,040, difference = 960 (i.e., 24,040 – 25,000)

$$r = 7\% + (10\% - 7\%)\frac{1{,}019}{(1{,}019 + 960)}$$

$= 7\% + (3\% \times 0.5)$

$= 7\% + 1.5\%$

$= 8.5\%$

The Department X will now use the interest rate of 8.5% to record the lease in its books and apportion the lease payments between the finance charge and the reduction of the lease liability, as shown in the table below.

Apportionment of Lease Payment (figures are rounded)

	Year 0	Year 1	Year 2	Year 3	Year 4
Opening PV of Lease Liability	25,000	25,000	21,696	18,110	14,221
Interest Expense	-	2,125	1,844	1,539	1,209
Reduction of Liability	-	3,304	3,585	3,890	14,221*
Closing Lease Liability	25,000	21,696	18,110	14,221	-

* Includes payment of guaranteed residual value.

Comparison with IAS 17

International Public Sector Accounting Standard (IPSAS) 13, "Leases" is drawn primarily from International Accounting Standard (IAS) 17, (revised 1997), "Leases." The main differences between IPSAS 13 and IAS 17 are as follows:

- At the time of issuing this Standard, the PSC has not considered the applicability of International Accounting Standard (IAS) 41, "Agriculture," to public sector entities, therefore IPSAS 13 does not reflect amendments made to IAS 17 consequent upon the issuing of IAS 41.
- Commentary additional to that in IAS 17 has been included in IPSAS 13 to clarify the applicability of the standards to accounting by public sector entities.
- IPSAS 13 uses different terminology, in certain instances, from IAS 17. The most significant examples are the use of the terms "entity," "revenue," "statement of financial performance" and "statement of financial position" in IPSAS 13. The equivalent terms in IAS 17 are "enterprise," "income," "income statement" and "balance sheet."
- IAS 17 includes a definition of "fair value" in its set of definitions of technical terms, IPSAS 13 does not include this definition, as it is included in the "Glossary of Defined Terms" published separately (paragraph 7).
- IPSAS 13 has additional appendices which illustrate the classification of a lease, the treatment of a finance lease by a lessee, the treatment of a finance lease by a lessor, and the calculation of the interest rate implicit in a finance lease.

IPSAS 14—EVENTS AFTER THE REPORTING DATE

Acknowledgment

This International Public Sector Accounting Standard is drawn primarily from International Accounting Standard (IAS) 10 (revised 1999), "Events After the Balance Sheet Date" 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 IASC. The International Accounting Standards (IASs) issued by IASC remain in force until they are amended or withdrawn by IASB. Extracts from IAS 10 are reproduced in this publication of the Public Sector Committee of the International Federation of Accountants with the permission of IASB.

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December 2001

IPSAS 14—EVENTS AFTER THE REPORTING DATE

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The standards, which have been set in bold type, should be read in the context of the commentary paragraphs in this Standard, which are in plain type, and in the context of the "Preface to International Public Sector Accounting Standards." International Public Sector Accounting Standards are not intended to apply to immaterial items.

Objective

The objective of this Standard is to prescribe:

(a) When an entity should adjust its financial statements for events after the reporting date; and

(b) The disclosures that an entity should give about the date when the financial statements were authorized for issue and about events after the reporting date.

The Standard also requires that an entity should not prepare its financial statements on a going concern basis if events after the reporting date indicate that the going concern assumption is not appropriate.

Scope

1. **An entity which prepares and presents financial statements under the accrual basis of accounting should apply this Standard in the accounting for, and disclosure of, events after the reporting date.**

2. **This Standard applies to all public sector entities other than Government Business Enterprises.**

3. Government Business Enterprises (GBEs) are required to comply with International Accounting Standards (IASs) issued by the International Accounting Standards Committee. The Public Sector Committee's Guideline No. 1, "Financial Reporting by Government Business Enterprises" notes that IASs are relevant to all business enterprises, regardless of whether they are in the private or public sector. Accordingly, Guideline No. 1 recommends that GBEs should present financial statements that conform, in all material respects, to IASs.

Definitions

4. **The following terms are used in this Standard with the meanings specified:**

   Events after the reporting date are 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 (adjusting events after the reporting date); and**

(b) **Those that are indicative of conditions that arose after the reporting date (non-adjusting events after the reporting date).**

Reporting date means the date of the last day of the reporting period to which the financial statements relate.

Terms defined in other International Public Sector Accounting Standards are used in this Standard with the same meaning as in those other Standards, and are reproduced in the Glossary of Defined Terms published separately.

Authorizing the Financial Statements for Issue

5. In order to determine which events satisfy the definition of events after the reporting date, it is necessary to identify both the reporting date and the date on which the financial statements are authorized for issue. The reporting date is the last day of the reporting period to which the financial statements relate. The date of authorization for issue is the date on which the financial statements have received approval from the individual or body with the authority to finalize those statements for issue. The audit opinion is provided on those finalized financial statements. Events after the reporting date are all events, both favorable and unfavorable, that occur between the reporting date and the date when the financial statements are authorized for issue, even if those events occur after the publication of an announcement of the net surplus/deficit, the authorization of the financial statements of a controlled entity, or publication of other selected information relating to the financial statements.

6. The process involved in preparing and authorizing the financial statements for issue may vary for different types of entities within and across jurisdictions. It can depend upon the nature of the entity, the governing body structure, the statutory requirements relating to that entity and the procedures followed in preparing and finalizing the financial statements. Responsibility for authorization of financial statements of individual government agencies may rest with the head of the central finance agency (or the senior finance official/accounting officer such as the controller or accountant-general). Responsibility for authorization of consolidated financial statements of the government as a whole may rest jointly with the head of the central finance agency (or the senior finance official such as the controller or accountant-general) and the finance minister (or equivalent).

7. In some cases, as the final step in the authorization process, an entity is required to submit its financial statements to another body (for example, a

legislative body such as Parliament or a local council). This body may have the power to require changes to the audited financial statements. In other cases, the submission of statements to the other body may be merely a matter of protocol or process and that other body may not have the power to require changes to the statements. The date of authorization for issue of the financial statements will be determined in the context of the particular jurisdiction.

Recognition and Measurement

8. In the period between the reporting date and the date of authorization for issue, elected government officials may announce a government's intentions in relation to certain matters. Whether or not these announced government intentions would require recognition as adjusting events would depend upon whether they provide more information about the conditions existing at reporting date and whether there is sufficient evidence that they can and will be fulfilled. In most cases, the announcement of government intentions will not lead to the recognition of adjusting events. Instead, they would generally qualify for disclosure as non-adjusting events.

Adjusting Events After the Reporting Date

9. **An entity should adjust the amounts recognized in its financial statements to reflect adjusting events after the reporting date.**

10. The following are examples of adjusting events after the reporting date that require an entity to adjust the amounts recognized in its financial statements, or to recognize items that were not previously recognized:

    (a) The resolution after the reporting date of a court case which, because it confirms that an entity already had a present obligation at the reporting date, requires the entity to adjust a provision already recognized, or to recognize a provision instead of merely disclosing a contingent liability. Guidance on accounting for provisions and contingent liabilities is found in IPSAS 19, "Provisions, Contingent Liabilities and Contingent Assets;"[1]

[1] The Committee has published IPSAS 19, "Provisions, Contingent Liabilities and Contingent Assets" which deals with the application of IAS 37, "Provisions, Continget Liabilities and Contingent Assets" to the public sector. International Public Sector Accounting Standard (IPSAS) 1, "Presentation of Financial Statements" also includes requirements for the presentation of items in the financial statements and notes to the financial statements, including provisions, contingent liabilities and contingent assets.

(b) The receipt of information after the reporting date indicating that an asset was impaired[2] at the reporting date, or that the amount of a previously recognized impairment loss for that asset needs to be adjusted. For example:

(i) The bankruptcy of a debtor which occurs after the reporting date usually confirms that a loss already existed at the reporting date on a receivable account and that the entity needs to adjust the carrying amount of the receivable account; and

(ii) The sale of inventories after the reporting date may give evidence about their net realizable value at the reporting date;

(c) The determination after the reporting date of the cost of assets purchased, or the proceeds from assets sold, before the reporting date;

(d) The determination after the reporting date of the amount of revenue collected during the reporting period to be shared with another government under a revenue sharing agreement in place during the reporting period;

(e) The determination after the reporting date of performance bonus payments to be made to staff if the entity had a present legal or constructive obligation at the reporting date to make such payments as a result of events before that date; and

(f) The discovery of fraud or errors that show that the financial statements were incorrect.

Non-adjusting Events After the Reporting Date

11. **An entity should not adjust the amounts recognized in its financial statements to reflect non-adjusting events after the reporting date.**

12. The following are examples of non-adjusting events after the reporting date:

(a) Where an entity has adopted a policy of regularly revaluing property to fair value, a decline in the fair value of property between the reporting date and the date when the financial statements are authorized for issue. The fall in fair value does not normally relate to the condition of the property at the reporting date, but reflects circumstances that have arisen in the following period. Therefore, despite its policy of regularly revaluing, an entity would not adjust

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[2] The Public Sector Committee is currently developing proposals for the identification and measurement of impairment within the public sector. Refer to "Exposure Draft 23—Impairment of Assets" (Issued September 2003).

the amounts recognized in its financial statements for the properties. Similarly, the entity does not update the amounts disclosed for the property as at the reporting date, although it may need to give additional disclosure under paragraph 29; and

(b) Where an entity charged with operating particular community service programs decides after the reporting date, but before the financial statements are authorized, to provide/distribute additional benefits directly or indirectly to participants in those programs. The entity would not adjust the expenses recognized in its financial statements in the current reporting period, although the additional benefits may meet the conditions for disclosure as non-adjusting events under paragraph 29.

Dividends/Distributions

13. **If dividends or similar distributions are proposed or declared after the reporting date, an entity should not recognize those distributions as a liability at the reporting date.**

14. Dividends may arise in the public sector when, for example, a public sector entity controls and consolidates the financial statements of a GBE that has outside ownership interests to whom it pays dividends. In addition, some public sector entities adopt a financial management framework, for example "purchaser provider" models, that require them to pay income distributions to their controlling entity, such as the central government.

15. International Public Sector Accounting Standard (IPSAS) 1, "Presentation of Financial Statements" requires an entity to disclose the amount of dividends or distributions to owners that were proposed or declared after the reporting date but before the financial statements were authorized for issue. Dividends and similar distributions do not include a return of capital. IPSAS 1 permits an entity to make this disclosure either:

(a) On the face of the statement of financial position as a separate component of net assets/equity; or

(b) In the notes to the financial statements.

Going Concern

16. The determination of whether the going concern assumption is appropriate needs to be considered by each entity. However, the assessment of going concern is likely to be of more relevance for individual entities than for a government as a whole. For example, an individual government agency may not be a going concern because the government of which it forms part has decided to transfer all its activities to another government agency.

However, this restructuring has no impact upon the assessment of going concern for the government itself.

17. **An entity should not prepare its financial statements on a going concern basis if those responsible for the preparation of the financial statements or the governing body determine after the reporting date either that there is an intention to liquidate the entity or to cease operating, or that there is no realistic alternative but to do so.**

18. In assessing whether the going concern assumption is appropriate for an individual entity, those responsible for the preparation of the financial statements, and/or the governing body, need to consider a wide range of factors. Those factors will include the current and expected performance of the entity, any announced and potential restructuring of organizational units, the likelihood of continued government funding and, if necessary, potential sources of replacement funding.

19. In the case of entities whose operations are substantially budget-funded, going concern issues generally only arise if the government announces its intention to cease funding the entity.

20. Some agencies, although not GBEs, may be required to be fully or substantially self-funding, and to recover the cost of goods and services from users. For any such entity, deterioration in operating results and financial position after the reporting date may indicate a need to consider whether the going concern assumption is still appropriate.

21. If the going concern assumption is no longer appropriate, this Standard requires an entity to reflect this in its financial statements. The impact of such a change will depend upon the particular circumstances of the entity, for example, whether operations are to be transferred to another government entity, sold or liquidated. Judgment is required in determining whether a change in the carrying value of assets and liabilities is required.

22. When the going concern assumption is no longer appropriate, it is also necessary to consider whether the change in circumstances leads to the creation of additional liabilities or triggers clauses in debt contracts leading to the reclassification of certain debts as current liabilities.

23. IPSAS 1 requires certain disclosures if:

    (a) The financial statements are not prepared on a going concern basis. Ipsas 1 requires that when the financial statements are not prepared on a going concern basis, this must be disclosed, together with the

basis on which the financial statements are prepared and the reason why the entity is not considered to be a going concern; or

(b) Those responsible for the preparation of the financial statements are aware of material uncertainties related to events or conditions that may cast significant doubt upon the entity's ability to continue as a going concern. The events or conditions requiring disclosure may arise after the reporting date. IPSAS 1 requires such uncertainties to be disclosed.

Restructuring

24. Where a restructuring announced after the reporting date meets the definition of a non-adjustable event, the appropriate disclosures should be made in accordance with this Standard. Guidance on the recognition of provisions associated with restructuring is found in Accounting Standards on "Provisions, Contingent Liabilities and Contingent Assets." Simply because a restructuring involves the disposal of a component of an entity this does not in itself bring into question the entity's ability to continue as a going concern. However, where a restructuring announced after the reporting date means that an entity is no longer a going concern, the nature and amount of assets and liabilities recognized may change.

Disclosure

Disclosure of Date of Authorization for Issue

25. **An entity should disclose the date when the financial statements were authorized for issue and who gave that authorization. If another body has the power to amend the financial statements after issuance, the entity should disclose that fact.**

26. It is important for users to know when the financial statements were authorized for issue, as the financial statements do not reflect events after this date. It is also important for users to know of the rare circumstances in which any persons or organizations have the authority to amend the financial statements after issuance. Examples of individuals or bodies that may have the power to amend the financial statements after issuance are Ministers, the government of which the entity forms part, Parliament or an elected body of representatives. If changes are made, the amended financial statements are a new set of financial statements.

Updating Disclosure about Conditions at the Reporting Date

27. **If an entity receives information after the reporting date, but before the financial statements are authorized for issue, about conditions that existed at the reporting date, the entity should update disclosures that relate to these conditions, in the light of the new information.**

28. In some cases, an entity needs to update the disclosures in its financial statements to reflect information received after the reporting date but before the financial statements are authorized for issue, even when the information does not affect the amounts that the entity recognizes in its financial statements. One example of the need to update disclosures is when evidence becomes available after the reporting date about a contingent liability that existed at the reporting date. In addition to considering whether it should now recognize a provision an entity updates its disclosures about the contingent liability in the light of that evidence.

Disclosure of Non-adjusting Events After the Reporting Date

29. **Where non-adjusting events after the reporting date are of such importance that non-disclosure would affect the ability of the users of the financial statements to make proper evaluations and decisions, an entity should disclose the following information for each significant category of non-adjusting event after the reporting date:**

    (a) **The nature of the event; and**

    (b) **An estimate of its financial effect, or a statement that such an estimate cannot be made.**

30. The following are examples of non-adjusting events after the reporting date that may be of such importance that non-disclosure would affect the ability of the users of the financial statements to make proper evaluations and decisions:

    (a) An unusually large decline in the value of property carried at fair value, where that decline is unrelated to the condition of the property at reporting date, but is due to circumstances that have arisen since reporting date;

    (b) The entity decides after reporting date, to provide/distribute substantial additional benefits in the future directly or indirectly to participants in community service programs that it operates, and those additional benefits have a major impact on the entity;

    (c) An acquisition or disposal of a major controlled entity or the outsourcing of all or substantially all of the activities currently undertaken by an entity after the reporting date;

    (d) Announcing a plan to discontinue an operation or major program, disposing of assets or settling liabilities attributable to a discontinuing operation[3] or major program, or entering into binding

[3] The Public Sector Committee has not yet addressed the issue of discontinuing operations, which was previously included within IAS 8 (revised 1993), "Net Profit/Loss for the Period, Fundamental

agreements to sell such assets or settle such liabilities. International Accounting Standard (IAS) 35, "Discontinuing Operations" provides guidance on the treatment and disclosure of discontinuing operations;

(e) Major purchases and disposals of assets;

(f) The destruction of a major building by a fire after the reporting date;

(g) Announcing, or commencing the implementation of, a major restructuring (guidance on accounting for provisions associated with restructuring is found in accounting standards on provisions, contingent liabilities and contingent assets);

(h) The introduction of legislation to forgive loans made to entities or individuals as part of a program;

(i) Abnormally large changes after the reporting date in asset prices or foreign exchange rates;

(j) In the case of entities that are liable for income tax or income tax equivalents, changes in tax rates or tax laws enacted or announced after the reporting date that have a significant effect on current and deferred tax assets and liabilities IAS 12, "Income Taxes" contains guidance on accounting for income taxes);

(k) Entering into significant commitments or contingent liabilities, for example, by issuing significant guarantees after the reporting date; and

(l) Commencing major litigation arising solely out of events that occurred after the reporting date.

Errors and Changes in Accounting Policies" and which is now the subject of a separate Standard, IAS 35 (1998), "Discontinuing Operations." Consistent with the definition in IAS 35, the term discontinuing operation as used in this Standard refers to a component of an entity:

(a) That the entity, pursuant to a single plan, is:
   (i) Disposing of substantially in its entirety, such as by selling the component in a single transaction, by demerger or spin-off of ownership of the component to the entity's owners;
   (ii) Disposing of piecemeal, such as by selling off the component's assets and settling its liabilities individually; or
   (iii) Terminating through abandonment;

(b) That represents a separate major activity/line of business or geographical area of operations; and

(c) That can be distinguished operationally and for financial reporting purposes.

Effective Date

31. **This International Public Sector Accounting Standard becomes effective for annual financial statements covering periods beginning on or after January 1, 2003. Earlier application is encouraged.**

32. When an entity adopts the accrual basis of accounting, as defined by International Public Sector Accounting Standards, for financial reporting purposes, subsequent to this effective date, this Standard applies to the entity's annual financial statements covering periods beginning on or after the date of adoption.

Comparison with IAS 10

International Public Sector Accounting Standard (IPSAS) 14, "Events After the Reporting Date" is drawn primarily from International Accounting Standard (IAS) 10 (revised 1999), "Events After the Balance Sheet Date." The main differences between IPSAS 14 and IAS 10 are as follows:

- IPSAS 14 notes that where the going concern assumption is no longer appropriate, judgment is required in determining the impact of this change on the carrying value of assets and liabilities recognized in the financial statements (paragraph 21).
- IPSAS 14 contains additional commentary on determining the date of authorization for issue (paragraphs 5, 6 and 7).
- Commentary additional to that in IAS 10 has been included in IPSAS 14 to clarify the applicability of the standards to accounting by public sector entities.
- IPSAS 14 uses different terminology, in certain instances, from IAS 10. The most significant examples are the use of the terms "entity," "revenue," "statement of financial position," "net assets/equity" and "reporting date" in IPSAS 14. The equivalent terms in IAS 10 are "enterprise," "income," "balance sheet," "equity" and "balance sheet date."
- IPSAS 14 contains a definition of "reporting date," IAS 10 does not contain a definition of "balance sheet date."

IPSAS 15—FINANCIAL INSTRUMENTS: DISCLOSURE AND PRESENTATION

Acknowledgment

This International Public Sector Accounting Standard is drawn primarily from International Accounting Standard (IAS) 32 (revised 1998), "Financial Instruments: Disclosure and Presentation" 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 IASC. The International Accounting Standards (IASs) issued by IASC remain in force until they are amended or withdrawn by IASB. Extracts from IAS 32 are reproduced in this publication of the Public Sector Committee of the International Federation of Accountants with the permission of IASB.

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IPSAS 15—FINANCIAL INSTRUMENTS: DISCLOSURE AND PRESENTATION

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The standards, which have been set in bold type, should be read in the context of the commentary paragraphs in this Standard, which are in plain type, and in the context of the "Preface to International Public Sector Accounting Standards." International Public Sector Accounting Standards are not intended to apply to immaterial items.

Some public sector entities such as national governments and public sector financial institutions may hold a wide range of financial instruments. However, some individual government agencies may not issue or hold a wide range of instruments. In such cases, the Standard will have limited application and preparers of financial statements will need to identify those aspects of the Standard that apply to them. The purpose of the implementation guide located in Appendix 1 is to assist preparers in this task.

Objective

The dynamic nature of international financial markets has resulted in the widespread use of a variety of financial instruments ranging from traditional primary instruments, such as bonds, to various forms of derivative instruments, such as interest rate swaps. Public sector entities use a wide range of financial instruments from simple instruments such as payables and receivables to more complex instruments (such as cross-currency swaps to hedge commitments in foreign currencies) in their operations. To a lesser extent, public sector entities may issue equity instruments or compound liability/equity instruments. This may occur where an economic entity includes a partly-privatized Government Business Enterprise (GBE) that issues equity instruments into the financial markets or where a public sector entity issues debt instruments that convert to an ownership interest under certain conditions.

The objective of this Standard is to enhance financial statement users' understanding of the significance of on-balance-sheet and off-balance-sheet financial instruments to a government's or other public sector entity's financial position, performance and cash flows. In this Standard, references to "balance sheet" in the context of "on-balance-sheet" and "off-balance-sheet" have the same meaning as "statement of financial position."

The Standard prescribes certain requirements for 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. The presentation standards deal with the classification of financial instruments between liabilities and net assets/equity, the classification of related interest, dividends, revenues and expenses, and the circumstances in which financial assets and financial liabilities should be offset. The disclosure standards deal with information about factors that affect the amount, timing and certainty of an entity's future cash flows relating to financial instruments and the accounting policies applied to the instruments. In addition, the Standard encourages disclosure of

information about the nature and extent of an entity's use of financial instruments, the financial purposes that they serve, the risks associated with them and management's policies for controlling those risks.

Scope

1. **An entity which prepares and presents financial statements under the accrual basis of accounting should apply this Standard for the presentation and disclosure of financial instruments.**

2. **This Standard applies to all public sector entities other than Government Business Enterprises.**

3. Government Business Enterprises (GBEs) are required to comply with International Accounting Standards (IASs) issued by the International Accounting Standards Committee. The Public Sector Committee's Guideline No. 1, "Financial Reporting by Government Business Enterprises" notes that IASs are relevant to all business enterprises, regardless of whether they are in the private or public sector. Accordingly, Guideline No. 1 recommends that GBEs should present financial statements that conform, in all material respects, to IASs.

4. **This Standard should be applied in presenting and disclosing information about all types of financial instruments, both recognized and unrecognized, other than:**

   (a) **Interests in controlled entities, as defined in International Public Sector Accounting Standard (IPSAS) 6, "Consolidated Financial Statements and Accounting for Controlled Entities;"**

   (b) **Interests in associates, as defined in IPSAS 7, "Accounting for Investments in Associates;"**

   (c) **Interests in joint ventures, as defined in IPSAS 8, "Financial Reporting of Interests in Joint Ventures;"**

   (d) **Obligations arising under insurance contracts;**

   (e) **Employers' and plans' obligations for post-employment benefits of all types, including employee benefit plans; and**

   (f) **Obligations for payments arising under social benefits provided by an entity for which it receives no consideration, or consideration that is not approximately equal to the fair value of the benefits, directly in return from the recipients of those benefits.**

5. This Standard does not apply to an entity's net assets/equity interests in controlled entities. However, it does apply to all financial instruments included in the consolidated financial statements of a controlling entity, regardless of whether those instruments are held or issued by the controlling entity or by a controlled entity. Similarly, the Standard applies to financial instruments held or issued by a joint venture and included in the financial statements of a venturer either directly or through proportionate consolidation.

6. Some economic entities in the public sector may include entities that issue insurance contracts. Those entities are within the scope of this Standard. However, this Standard excludes the insurance contracts themselves from its scope. For the purposes of this Standard, an insurance contract is 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. However, the provisions of this Standard apply when a financial instrument takes the form of an insurance contract but principally involves the transfer of financial risks (see paragraph 49), for example, some types of financial reinsurance and guaranteed investment contracts issued by public sector insurance and other entities. Entities that have obligations under insurance contracts are encouraged to consider the appropriateness of applying the provisions of this Standard in presenting and disclosing information about such obligations.

7. This Standard does not apply to financial instruments that arise from obligations from employee benefit schemes or obligations of a government to provide social benefits to its citizens for which it receives no consideration, or consideration that is not approximately equal to the fair value of the benefits, directly in return from the recipients of those benefits (such as old age pensions, unemployment benefits, disability benefits and other forms of financial assistance provided by governments).

8. Additional guidance on the presentation and disclosure of specific types of financial instruments can be found in international and/or national accounting standards. For example, IPSAS 13, "Leases" contains specific disclosure requirements relating to finance leases.

Definitions

9. **The following terms are used in this Standard with the meanings specified:**

An equity instrument is any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities.

Fair value is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.

Financial asset is 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.**

A financial instrument is 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.

Financial liability is 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.

An insurance contract (for the purposes of this Standard) is 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.

Market value is the amount obtainable from the sale, or payable on the acquisition, of a financial instrument in an active market.

Monetary financial assets and financial liabilities (also referred to as monetary financial instruments) are financial assets and financial liabilities to be received or paid in fixed or determinable amounts of money.

Terms defined in other International Public Sector Accounting Standards are used in this Standard with the same meaning as in those other Standards, and are reproduced in the Glossary of Defined Terms published separately.

10. In this Standard, the terms "contract" and "contractual" refer to an agreement between two or more parties that has clear economic consequences that the parties have little, if any, discretion to avoid, usually because the agreement is enforceable at law. Contracts, and thus financial instruments, may take a variety of forms and need not be in writing.

11. For purposes of the definitions in paragraph 9, the term "entity" includes public sector bodies, individuals, partnerships and incorporated bodies.

12. Parts of the definitions of a financial asset and a financial liability include the terms financial asset and financial instrument, but the definitions are not circular. When there is a contractual right or obligation to exchange financial instruments, the instruments to be exchanged give rise to financial assets, financial liabilities, or equity instruments. A chain of contractual rights or obligations may be established but it ultimately leads to the receipt or payment of cash or to the acquisition or issuance of an equity instrument.

13. Financial instruments include both primary instruments, such as receivables, payables and equity securities, and derivative instruments, such as financial options, futures and forwards, interest rate swaps and currency swaps. Derivative financial instruments, whether recognized or unrecognized, meet the definition of a financial instrument and, accordingly, are subject to this Standard.

14. Derivative financial instruments create rights and obligations that have the effect of transferring between the parties to the instrument one or more of the financial risks inherent in an underlying primary financial instrument. Derivative instruments do not result in a transfer of the underlying primary financial instrument on inception of the contract and such a transfer does not necessarily take place on maturity of the contract.

15. Physical assets such as inventories, property, plant and equipment, leased assets and intangible assets such as radio spectrum, patents and trademarks are not financial assets. Control of such physical and intangible assets creates an opportunity to generate an inflow of cash or other assets but it does not give rise to a present right to receive cash or other financial assets.

16. Assets, such as prepaid expenses, for which the future economic benefit is the receipt of goods or services rather than the right to receive cash or another financial asset are not financial assets. Similarly, items such as deferred revenue and most warranty obligations are not financial liabilities because the probable outflow of economic benefits associated with them is the delivery of goods and services rather than cash or another financial asset.

17. Liabilities or assets that are not contractual in nature, such as income taxes or tax equivalents that are created as a result of statutory requirements imposed on public sector entities by governments, are not financial liabilities or financial assets. International Accounting Standard (IAS) 12, “Income Taxes” provides guidance on accounting for income taxes.

18. Contractual rights and obligations that do not involve the transfer of a financial asset do not fall within the scope of the definition of a financial instrument. For example, some contractual rights (obligations), such as those that arise under a commodity futures contract, can be settled only by the receipt (delivery) of non-financial assets. Similarly, contractual rights (obligations) such as those that arise under an operating lease or build-own-operate arrangement for use of a physical asset, such as a hospital, can be settled only by the receipt (delivery) of services. In both cases, the contractual right of one party to receive a non-financial asset or service and the corresponding obligation of the other party do not establish a present right or obligation of either party to receive, deliver or exchange a financial asset. (Refer to Appendix 2, paragraphs A13–A17.)

19. The ability to exercise a contractual right or the requirement to satisfy a contractual obligation may be absolute, or it may be contingent on the occurrence of a future event. For example, a financial guarantee is a contractual right of the lender to receive cash from the guarantor, and a corresponding contractual obligation of the guarantor to pay the lender, if

the borrower defaults. The contractual right and obligation exist because of a past transaction or event (assumption of the guarantee), even though the lender's ability to exercise its right and the requirement for the guarantor to perform under its obligation are both contingent on a future act of default by the borrower. A contingent right and obligation meet the definition of a financial asset and a financial liability, even though many such assets and liabilities do not qualify for recognition in financial statements. For example, a national government may provide a private sector operator of an infrastructure facility protection against demand risk by guaranteeing a minimum level of revenue. The guarantee is a contingent obligation of the government until it becomes probable that the operator's revenue will fall below the guaranteed minimum.

20. An obligation of an entity to issue or deliver its own equity instruments, such as a share option or warrant, is itself an equity instrument, not a financial liability, since the entity is not obliged to deliver cash or another financial asset. Similarly, the cost incurred by an entity to purchase a right to re-acquire its own equity instruments from another party is a deduction from its net assets/equity, not a financial asset.

21. The minority interest that may arise on an entity's statement of financial position from consolidating a controlled entity is not a financial liability or an equity instrument of the entity. In consolidated financial statements, an entity presents the interests of other parties in the net assets/equity and the net surplus or deficit of its controlled entities in accordance with IPSAS 6. Accordingly, a financial instrument classified as an equity instrument by a controlled entity is eliminated on consolidation when held by the controlling entity, or presented by the controlling entity in the consolidated statement of financial position as a minority interest separate from the net assets/equity of its own shareholders. A financial instrument classified as a financial liability by a controlled entity remains a liability in the controlling entity's consolidated statement of financial position unless eliminated on consolidation as an intra-economic entity balance. The accounting treatment by the controlling entity on consolidation does not affect the basis of presentation by the controlled entity in its financial statements.

Presentation

Liabilities and Net assets/Equity

22. **The issuer of a financial instrument should classify the instrument, or its component parts, as a liability or as net assets/equity in accordance with the substance of the contractual arrangement on initial recognition and the definitions of a financial liability and an equity instrument.**

23. The substance of a financial instrument, rather than its legal form, governs its classification on the issuer's statement of financial position. While substance and legal form are commonly consistent, this is not always the case. For example, some financial instruments take the legal form of equity but are liabilities in substance and others may combine features associated with equity instruments and features associated with financial liabilities. The classification of an instrument is made on the basis of an assessment of its substance when it is first recognized. That classification continues at each subsequent reporting date until the financial instrument is removed from the entity's statement of financial position. The classification of financial instruments as either liabilities or net assets/equity are not likely to be a significant issue for many reporting entities in the public sector.

24. Classification of financial instruments between liabilities and net assets/equity is required because of the different risks associated with each. Entities with instruments classified as financial liabilities are required to disclose information on interest rate risk exposure in accordance with paragraph 63, and to recognize interest, dividends, losses or gains as revenue or expense in accordance with paragraph 36. Paragraph 36 also specifies that distributions to holders of financial instruments classified as equity instruments should be debited by the issuer directly to net assets/equity.

25. While public sector entities will often hold an equity instrument as an investment (financial assets) it is not common for a public sector entity to issue equity instruments to parties outside the economic entity except where a controlled entity is partly-privatized. Nevertheless, the use of financial instruments in the public sector continues to evolve and classification by the issuer needs to be guided by their substance and not necessarily their form.

26. The critical feature in differentiating a financial liability from an equity instrument is the existence of a contractual obligation on one party to the financial instrument (the issuer) either to deliver cash or another financial asset to the other party (the holder) or to exchange another financial instrument with the holder under conditions that are potentially unfavorable to the issuer. When such a contractual obligation exists, that instrument meets the definition of a financial liability regardless of the manner in which the contractual obligation will be settled. A restriction on the ability of the issuer to satisfy an obligation, such as lack of access to foreign currency or the need to obtain approval for payment from a regulatory authority, does not negate the issuer's obligation or the holder's right under the instrument.

27. When a financial instrument does not give rise to a contractual obligation on the part of the issuer to deliver cash or another financial asset or to

exchange another financial instrument under conditions that are potentially unfavorable, it is an equity instrument. Although the holder of an equity instrument may be entitled to receive a pro rata share of any dividends or other distributions out of net assets/equity, the issuer does not have a contractual obligation to make such distributions.

28. A public sector entity may issue instruments with particular rights, such as preferred shares. When a preferred share provides for mandatory redemption by the issuer for a fixed or determinable amount at a fixed or determinable future date or gives the holder the right to require the issuer to redeem the share at or after a particular date for a fixed or determinable amount, the instrument meets the definition of a financial liability and is classified as such. A preferred share that does not establish such a contractual obligation explicitly may establish it indirectly through its terms and conditions. For example, a preferred share that does not provide for mandatory redemption or redemption at the option of the holder may have a contractually provided accelerating dividend such that, within the foreseeable future, the dividend yield is scheduled to be so high that the issuer will be economically compelled to redeem the instrument. In these circumstances, classification as a financial liability is appropriate because the issuer has little, if any, discretion to avoid redeeming the instrument. Similarly, if a financial instrument labeled as a share gives the holder an option to require redemption upon the occurrence of a future event that is highly likely to occur, classification as a financial liability on initial recognition reflects the substance of the instrument. (Refer to Appendix 2, paragraphs A7–A8 and A18–A21.)

Classification of Compound Instruments by the Issuer

29. **The issuer of a financial instrument that contains both a liability and a net assets/equity element should classify the instrument's component parts separately in accordance with paragraph 22.**

30. Public sector entities do not commonly issue compound financial instruments. The exceptions include partly-privatized GBEs within an economic entity that issues compound instruments into the financial markets. Where a public sector entity issues a compound instrument, this Standard requires the separate presentation on an issuer's statement of financial position of liability and net assets/equity elements created by a single financial instrument. It is more a matter of form than substance that both liabilities and net assets/equity interests are created by a single financial instrument rather than two or more separate instruments. An issuer's financial position is more faithfully represented by separate presentation of liability and net assets/equity components contained in a single instrument according to their nature. (Refer to Appendix 2, paragraphs A22–A23.)

31. For purposes of statement of financial position presentation, an issuer recognizes separately the component parts of a financial instrument that creates a primary financial liability of the issuer and grants an option to the holder of the instrument to convert it into an equity instrument of the issuer. A bond or similar instrument convertible by the holder into common shares of the issuer is an example of such an instrument. From the perspective of the issuer, such an instrument comprises two components: a financial liability (a contractual arrangement to deliver cash or other financial assets) and an equity instrument (a call option granting the holder the right, for a specified period of time, to convert into common shares of the issuer). The economic effect of issuing such an instrument is substantially the same as issuing simultaneously a debt instrument with an early settlement provision and warrants to purchase common shares, or issuing a debt instrument with detachable share purchase warrants. Accordingly, in all cases, the issuer presents the liability and net assets/equity elements separately on its statement of financial position.

32. Classification of the liability and net assets/equity components of a convertible instrument is not revised as a result of a change in the likelihood that a conversion option will be exercised, even when exercise of the option may appear to have become economically advantageous to some holders. Holders may not always act in the manner that might be expected because, for example, the tax consequences resulting from conversion may differ among holders. Furthermore, the likelihood of conversion will change from time to time. The issuer's obligation to make future payments remains outstanding until it is extinguished through conversion, the maturity of the instrument or some other transaction.

33. A financial instrument may contain components that are neither financial liabilities nor equity instruments of the issuer. For example, an instrument may give the holder the right to receive a non-financial asset such as a right to operate a government owned monopoly or a commodity in settlement and an option to exchange that right for shares of the issuer. The issuer recognizes and presents the equity instrument (the exchange option) separately from the liability components of the compound instrument, whether the liabilities are financial or non-financial.

34. This Standard does not deal with measurement of financial assets, financial liabilities and equity instruments and does not therefore prescribe any particular method for assigning a carrying amount to liability and net assets/equity elements contained in a single instrument. Approaches that might be followed include:

    (a) Assigning to the less easily measurable component (often an equity instrument), the residual amount after deducting from the instrument

as a whole the amount separately determined for the component that is more easily measurable; and

(b) Measuring the liability and net assets/equity components separately and, to the extent necessary, adjusting these amounts on a pro rata basis so that the sum of the components equals the amount of the instrument as a whole.

The sum of the carrying amounts assigned to the liability and net assets/equity components on initial recognition is always equal to the carrying amount that would be ascribed to the instrument as a whole. No gain or loss arises from recognizing and presenting the components of the instrument separately.

35. Under the first approach described in paragraph 34, where, for example, a public sector entity issues a bond convertible into an equity interest it first determines the carrying amount of the financial liability by discounting the stream of future payments of interest and principal at the prevailing market rate for a similar liability that does not have an associated net assets/equity component. The carrying amount of the equity instrument represented by the option to convert the instrument into common shares may then be determined by deducting the carrying amount of the financial liability from the amount of the compound instrument as a whole. Under the second approach, the issuer determines the value of the option directly either by reference to the fair value of a similar option, if one exists, or by using an option pricing model. The value determined for each component is then adjusted on a pro-rata basis to the extent necessary to ensure that the sum of the carrying amounts assigned to the components equals the amount of the consideration received for the convertible bond. (Refer to Appendix 2, paragraph A24.)

Interest, Dividends, Losses and Gains

36. **Interest, dividends, losses and gains relating to a financial instrument, or a component part, classified as a financial liability should be reported in the statement of financial performance as expense or revenue. Distributions to holders of a financial instrument classified as an equity instrument should be debited by the issuer directly to net assets/equity.**

37. The classification of a financial instrument in the statement of financial position determines whether interest, dividends, losses and gains relating to that instrument are classified as expenses or revenue and reported in the statement of financial performance. Thus, dividend payments on shares classified as liabilities are classified as expenses in the same way as interest on a bond and reported in the statement of financial performance. Similarly, gains and losses associated with redemptions or refinancings of instruments

classified as liabilities are reported in the statement of financial performance, while redemptions or refinancings of instruments classified as net assets/equity of the issuer are reported as movements in net assets/equity.

38. Dividends classified as an expense may be presented in the statement of financial performance either with interest on other liabilities or as a separate item. Disclosure of interest and dividends is subject to the requirements of IPSAS 1, "Presentation of Financial Statements." In some circumstances, because of significant differences between interest and dividends with respect to matters such as tax deductibility, it is desirable to disclose them separately within the statement of financial performance. For entities subject to income taxes, guidance on the disclosure of the amounts of tax effects can be found in IAS 12.

Offsetting of a Financial Asset and a Financial Liability

39. **A financial asset and a financial liability should be offset and the net amount reported in the statement of financial position when an entity:**

    (a) **Has a legally enforceable right to set off the recognized amounts; and**

    (b) **Intends either to settle on a net basis, or to realize the asset and settle the liability simultaneously.**

40. This Standard requires the presentation of financial assets and financial liabilities on a net basis when this reflects an entity's expected future cash flows from settling two or more separate financial instruments. When an entity has the right to receive or pay a single net amount and intends to do so, it has, in effect, only a single financial asset or financial liability. For example, a state government settles a financial liability to a national government on a net basis (that is, after deducting a financial asset it was owed by the national government). In other circumstances, financial assets and financial liabilities are presented separately from each other consistent with their characteristics as assets or liabilities of the entity. (Refer to Appendix 2, paragraph A25.)

41. Offsetting a recognized financial asset and a recognized financial liability and presenting the net amount differs from ceasing to recognize a financial asset or a financial liability. While offsetting does not give rise to recognition of a gain or a loss, ceasing to recognize a financial instrument not only results in the removal of the previously recognized item from the statement of financial position but may also result in recognition of a gain or a loss.

42. A right of set-off is a debtor's legal right, by contract or otherwise, to settle or otherwise eliminate all or a portion of an amount due to a creditor by applying against that amount an amount due from the creditor. In unusual circumstances, a debtor may have a legal right to apply an amount due from a third party against the amount due to a creditor provided that there is an agreement among the three parties that clearly establishes the debtor's right of set-off. Since the right of set-off is a legal right, the conditions supporting the right may vary from one legal jurisdiction to another and care must be taken to establish which laws apply to the relationships between the parties.

43. The existence of an enforceable right to set off a financial asset and a financial liability affects the rights and obligations associated with a financial asset and a financial liability and may affect significantly an entity's exposure to credit and liquidity risk. However, the existence of the right, by itself, is not a sufficient basis for offsetting. In the absence of an intention to exercise the right or to settle simultaneously, the amount and timing of an entity's future cash flows are not affected. When an entity does intend to exercise the right or to settle simultaneously, presentation of the asset and liability on a net basis reflects more appropriately the amounts and timing of the expected future cash flows, as well as the risks to which those cash flows are exposed. An intention by one or both parties to settle on a net basis without the legal right to do so is not sufficient to justify offsetting since the rights and obligations associated with the individual financial asset and financial liability remain unaltered.

44. An entity's intentions with respect to settlement of particular assets and liabilities may be influenced by its normal operating practices, the requirements of the financial markets and other circumstances that may limit the ability to settle net or to settle simultaneously. When an entity has a right of set-off but does not intend to settle net or to realize the asset and settle the liability simultaneously, the effect of the right on the entity's credit risk exposure is disclosed in accordance with the standard in paragraph 73.

45. Simultaneous settlement of two financial instruments may occur through, for example, the operation of a clearing house in an organized financial market or a face-to-face exchange. In these circumstances the cash flows are, in effect, equivalent to a single net amount and there is no exposure to credit or liquidity risk. In other circumstances, an entity may settle two instruments by receiving and paying separate amounts, becoming exposed to credit risk for the full amount of the asset or liquidity risk for the full amount of the liability. Such risk exposures may be significant even though relatively brief. Accordingly, realization of a financial asset and settlement of a financial liability are considered simultaneous only when the transactions occur at the same moment.

46. The conditions set out in paragraph 39 are generally not satisfied and offsetting is usually inappropriate when:

    (a) Several different financial instruments are used to emulate the features of a single financial instrument (that is, a "synthetic instrument");

    (b) Financial assets and financial liabilities arise from financial instruments having the same primary risk exposure (for example, assets and liabilities within a portfolio of forward contracts or other derivative instruments) but involve different counterparties;

    (c) Financial or other assets are pledged as collateral for non-recourse financial liabilities;

    (d) Financial assets are set aside in trust by a debtor for the purpose of discharging an obligation without those assets having been accepted by the creditor in settlement of the obligation (for example, a sinking fund arrangement); or

    (e) Obligations incurred as a result of events giving rise to losses are expected to be recovered from a third party by virtue of a claim made under an insurance policy.

47. An entity that undertakes a number of financial instrument transactions with a single counterparty may enter into a "master netting arrangement" with that counterparty. Such an agreement provides for a single net settlement of all financial instruments covered by the agreement in the event of default on, or termination of, any one contract. These arrangements are commonly used by financial institutions to provide protection against loss in the event of bankruptcy or other events that result in a counterparty being unable to meet its obligations. A master netting arrangement commonly creates a right of set-off that becomes enforceable and affects the realization or settlement of individual financial assets and financial liabilities only following a specified event of default or in other circumstances not expected to arise in the normal course of operations. A master netting arrangement does not provide a basis for offsetting unless both of the criteria in paragraph 39 are satisfied. When financial assets and financial liabilities subject to a master netting arrangement are not offset, the effect of the arrangement on an entity's exposure to credit risk is disclosed in accordance with paragraph 73.

Disclosure

48. The purpose of the disclosures required by this Standard is to provide information that will enhance understanding of the significance of on-balance-sheet and off-balance-sheet financial instruments to an entity's financial position, performance and cash flows and assist in assessing the

amounts, timing and certainty of future cash flows associated with those instruments. In addition to providing specific information about particular financial instrument balances and transactions, entities are encouraged to provide a discussion of the extent to which financial instruments are used, the associated risks and the financial purposes served. A discussion of management's policies for controlling the risks associated with financial instruments, including policies on matters such as hedging of risk exposures, avoidance of undue concentrations of risk and requirements for collateral to mitigate credit risks, provides a valuable additional perspective that is independent of the specific instruments outstanding at a particular time. Some entities provide such information in a commentary that accompanies their financial statements rather than as part of the financial statements.

49. Transactions in financial instruments may result in an entity assuming or transferring to another party one or more of the financial risks described below. The required disclosures provide information that assists users of financial statements in assessing the extent of risk related to both recognized and unrecognized financial instruments.

(a) Price risk—There are three types of price risk: currency risk, interest rate risk and market risk.

(i) Currency risk is the risk that the value of a financial instrument will fluctuate due to changes in foreign exchange rates.

(ii) Interest rate risk is the risk that the value of a financial instrument will fluctuate due to changes in market interest rates.

(iii) Market risk is the risk that the value of a financial instrument will fluctuate as a result of changes in market prices whether those changes are caused by factors specific to the individual security or its issuer or factors affecting all securities traded in the market.

The term "price risk" embodies not only the potential for loss but also the potential for gain.

(b) Credit risk—Credit risk is the risk that one party to a financial instrument will fail to discharge an obligation and cause the other party to incur a financial loss.

(c) Liquidity risk—Liquidity risk, also referred to as funding risk, is the risk that an entity will encounter difficulty in raising funds to meet commitments associated with financial instruments. Liquidity risk may result from an inability to sell a financial asset quickly at close

to its fair value. For some public sector entities, such as a national government, liquidity risks may be mitigated by raising taxes or other charges levied by the entity.

(d) Cash flow risk—Cash flow risk is the risk that future cash flows associated with a monetary financial instrument will fluctuate in amount. In the case of a floating rate debt instrument, for example, such fluctuations result in a change in the effective interest rate of the financial instrument, usually without a corresponding change in its fair value.

Disclosure of Risk Management Policies

50. **An entity should describe its financial risk management objectives and policies, including its policy for hedging each major type of forecasted transaction for which hedge accounting is used.**

51. The standards do not prescribe either the format of the information required to be disclosed or its location within the financial statements. With regard to recognized financial instruments, to the extent that the required information is presented on the face of the statement of financial position, it is not necessary for it to be repeated in the notes to the financial statements. With regard to unrecognized financial instruments, however, information in notes or supplementary schedules is the primary means of disclosure. Disclosures may include a combination of narrative descriptions and specific quantified data, as appropriate to the nature of the instruments and their relative significance to the entity.

52. Determination of the level of detail to be disclosed about particular financial instruments is a matter for the exercise of judgment taking into account the relative significance of those instruments. It is necessary to strike a balance between overburdening financial statements with excessive detail that may not assist users of financial statements and obscuring significant information as a result of too much aggregation. For example, when an entity is party to large numbers of financial instruments with similar characteristics and no one contract is individually significant, summarized information by reference to particular classes of instruments is appropriate. On the other hand, specific information about an individual instrument may be important when that instrument represents, for example, a significant element in an entity’s capital structure.

53. Management of an entity groups financial instruments into classes that are appropriate to the nature of the information to be disclosed, taking into account matters such as the characteristics of the instruments, whether they are recognized or unrecognized and, if they are recognized, the measurement basis that has been applied. In general, classes are determined

on a basis that distinguishes items carried on a cost basis from items carried at fair value. When amounts disclosed in notes or supplementary schedules relate to recognized assets and liabilities, sufficient information is provided to permit a reconciliation to relevant line items on the statement of financial position. When an entity is a party to financial instruments not dealt with by this Standard, such as obligations under retirement benefit plans or insurance contracts, these instruments constitute a class or classes of financial assets or financial liabilities disclosed separately from those dealt with by this Standard.

Terms, Conditions and Accounting Policies

54. **For each class of financial asset, financial liability and equity instrument, both recognized and unrecognized, an entity should disclose:**

    (a) **Information about the extent and nature of the financial instruments, including significant terms and conditions that may affect the amount, timing and certainty of future cash flows; and**

    (b) **The accounting policies and methods adopted, including the criteria for recognition and the basis of measurement applied.**

55. The contractual terms and conditions of a financial instrument are an important factor affecting the amount, timing and certainty of future cash receipts and payments by the parties to the instrument. When recognized and unrecognized instruments are important, either individually or as a class, in relation to the current financial position of an entity or its future operating results, their terms and conditions are disclosed. If no single instrument is individually significant to the future cash flows of a particular entity, the essential characteristics of the instruments are described by reference to appropriate groupings of like instruments.

56. When financial instruments held or issued by an entity, either individually or as a class, create a potentially significant exposure to the risks described in paragraph 49, terms and conditions that may warrant disclosure include:

    (a) The principal, stated, face or other similar amount which, for some derivative instruments, such as interest rate swaps, may be the amount (referred to as the notional amount) on which future payments are based;

    (b) The date of maturity, expiry or execution;

    (c) Early settlement options held by either party to the instrument, including the period in which, or date at which, the options may be exercised and the exercise price or range of prices;

(d) Options held by either party to the instrument to convert the instrument into, or exchange it for, another financial instrument or some other asset or liability, including the period in which, or date at which, the options may be exercised and the conversion or exchange ratio(s);

(e) The amount and timing of scheduled future cash receipts or payments of the principal amount of the instrument, including instalment repayments and any sinking fund or similar requirements;

(f) Stated rate or amount of interest, dividend or other periodic return on principal and the timing of payments;

(g) Collateral held, in the case of a financial asset, or pledged, in the case of a financial liability;

(h) In the case of an instrument for which cash flows are denominated in a currency other than the entity's reporting currency, the currency in which receipts or payments are required;

(i) In the case of an instrument that provides for an exchange, information described in items (a) to (h) for the instrument to be acquired in the exchange; and

(j) Any condition of the instrument or an associated covenant that, if contravened, would significantly alter any of the other terms (for example, a maximum debt-to-net assets/equity ratio in a bond covenant that, if contravened, would make the full principal amount of the bond due and payable immediately).

57. When the statement of financial position presentation of a financial instrument differs from the instrument's legal form, it is desirable for an entity to explain in the notes to the financial statements the nature of the instrument.

58. The usefulness of information about the extent and nature of financial instruments is enhanced when it highlights any relationships between individual instruments that may affect the amount, timing or certainty of the future cash flows of an entity. For example, it is important to disclose hedging relationships such as might exist when a central borrowing authority holds an investment in shares for which it has purchased a put option. Similarly, it is important to disclose relationships between the components of "synthetic instruments" such as fixed rate debt created by borrowing at a floating rate and entering into a floating to fixed interest rate swap. In each case, an entity presents the individual financial assets and financial liabilities in its statement of financial position according to their nature, either separately or in the class of financial asset or financial liability to which they belong. The extent to which a risk exposure is altered by the

relationships among the assets and liabilities may be apparent to financial statement users from information of the type described in paragraph 56 but in some circumstances further disclosure is necessary.

59. In accordance with IPSAS 1, an entity provides clear and concise disclosure of all significant accounting policies, including both the general principles adopted and the method of applying those principles to significant transactions and circumstances arising in the entity's operations. In the case of financial instruments, such disclosure includes:

    (a) The criteria applied in determining when to recognize a financial asset or financial liability on the statement of financial position and when to cease to recognize it;

    (b) The basis of measurement applied to financial assets and financial liabilities both on initial recognition and subsequently; and

    (c) The basis on which revenue and expense arising from financial assets and financial liabilities is recognized and measured.

60. Types of transactions for which it may be necessary to disclose the relevant accounting policies include:

    (a) Transfers of financial assets when there is a continuing interest in, or involvement with, the assets by the transferor, such as securitizations of financial assets, repurchase agreements and reverse repurchase agreements;

    (b) Transfers of financial assets to a trust for the purpose of satisfying liabilities when they mature without the obligation of the transferor being discharged at the time of the transfer, such as an in-substance defeasance trust;

    (c) Acquisition or issuance of separate financial instruments as part of a series of transactions designed to synthesize the effect of acquiring or issuing a single instrument;

    (d) Acquisition or issuance of financial instruments as hedges of risk exposures, such as an interest rate swap to hedge a finance lease obligation; and

    (e) Acquisition or issuance of monetary financial instruments bearing a stated interest rate that differs from the prevailing market rate at the date of issue, such as the issue of bonds by a central borrowing authority at a discount. (Refer to Appendix 2, paragraph A26)

61. To provide adequate information for users of financial statements to understand the basis on which financial assets and financial liabilities have been measured, disclosures of accounting policies indicate not only whether

cost, fair value or some other basis of measurement has been applied to a specific class of asset or liability but also the method of applying that basis. For example, for financial instruments carried on the cost basis, an entity may be required to disclose how it accounts for:

(a) Costs of acquisition or issuance;

(b) Premiums and discounts on monetary financial assets and financial liabilities;

(c) Changes in the estimated amount of determinable future cash flows associated with a monetary financial instrument such as a bond indexed to a commodity price;

(d) Changes in circumstances that result in significant uncertainty about the timely collection of all contractual amounts due from monetary financial assets;

(e) Declines in the fair value of financial assets below their carrying amount; and

(f) Restructured financial liabilities.

For financial assets and financial liabilities carried at fair value, an entity indicates whether carrying amounts are determined from quoted market prices, independent appraisals, discounted cash flow analysis or another appropriate method, and discloses any significant assumptions made in applying those methods. (Refer to Appendix 2, paragraph A27.)

62. An entity discloses the basis for reporting in the statement of financial performance realized and unrealized gains and losses, interest and other items of revenue and expense associated with financial assets and financial liabilities. This disclosure includes information about the basis on which revenue and expense arising from financial instruments held for hedging purposes are recognized. When an entity presents revenue and expense items on a net basis even though the corresponding financial assets and financial liabilities on the statement of financial position have not been offset, the reason for that presentation is disclosed if the effect is significant.

Interest Rate Risk

63. **For each class of financial asset and financial liability, both recognized and unrecognized, an entity should disclose information about its exposure to interest rate risk, including:**

(a) **Contractual repricing or maturity dates, whichever dates are earlier; and**

(b) **Effective interest rates, when applicable.**

64. An entity provides information concerning its exposure to the effects of future changes in the prevailing level of interest rates. Changes in market interest rates have a direct effect on the contractually determined cash flows associated with some financial assets and financial liabilities (cash flow risk) and on the fair value of others (price risk).

65. Information about maturity dates, or repricing dates when they are earlier, indicates the length of time for which interest rates are fixed and information about effective interest rates indicates the levels at which they are fixed. Disclosure of this information provides financial statement users with a basis for evaluating the interest rate price risk to which an entity is exposed and thus the potential for gain or loss. For instruments that reprice to a market rate of interest before maturity, disclosure of the period until the next repricing is more important than disclosure of the period to maturity.

66. To supplement the information about contractual repricing and maturity dates, an entity may elect to disclose information about expected repricing or maturity dates when those dates differ significantly from the contractual dates. Such information may be particularly relevant when, for example, an entity is able to predict, with reasonable reliability, the amount of fixed rate mortgage loans that will be repaid prior to maturity and it uses this data as the basis for managing its interest rate risk exposure. The additional information includes disclosure of the fact that it is based on management's expectations of future events and explains the assumptions made about repricing or maturity dates and how those assumptions differ from the contractual dates.

67. An entity indicates which of its financial assets and financial liabilities are:

    (a) Exposed to interest rate price risk, such as monetary financial assets and financial liabilities with a fixed interest rate;

    (b) Exposed to interest rate cash flow risk, such as monetary financial assets and financial liabilities with a floating interest rate that is reset as market rates change; and

    (c) Not exposed to interest rate risk, such as some investments in equity securities.

68. The effective interest rate (effective yield) of a monetary financial instrument is the rate that, when used in a present value calculation, results in the carrying amount of the instrument. The present value calculation applies the interest rate to the stream of future cash receipts or payments from the reporting date to the next repricing (maturity) date and to the expected carrying amount (principal amount) at that date. The rate is a historical rate for a fixed rate instrument carried at amortized cost and a

current market rate for a floating rate instrument or an instrument carried at fair value. The effective interest rate is sometimes termed the level yield to maturity or to the next repricing date, and is the internal rate of return of the instrument for that period.

69. The requirement in paragraph 63(b) applies to bonds, notes and similar monetary financial instruments involving future payments that create a return to the holder and a cost to the issuer reflecting the time value of money. The requirement does not apply to financial instruments such as non-monetary and derivative instruments that do not bear a determinable effective interest rate. For example, while instruments such as interest rate derivatives, including swaps, forward rate agreements and options, are exposed to price or cash flow risk from changes in market interest rates, disclosure of an effective interest rate is not relevant. However, when providing effective interest rate information, an entity discloses the effect on its interest rate risk exposure of hedging or "conversion" transactions such as interest rate swaps.

70. An entity may retain an exposure to the interest rate risks associated with financial assets removed from its statement of financial position as a result of a transaction such as a securitization. Similarly, it may become exposed to interest rate risks as a result of a transaction in which no financial asset or financial liability is recognized on its statement of financial position, such as a commitment to lend funds at a fixed interest rate, or loans to be provided to primary producers during times of drought or other disaster relief. In such circumstances, the entity discloses information that will permit financial statement users to understand the nature and extent of its exposure. In the case of a securitization or similar transfer of financial assets, this information normally includes the nature of the assets transferred, their stated principal, interest rate and term to maturity, and the terms of the transaction giving rise to the retained exposure to interest rate risk. In the case of a commitment to lend funds, the disclosure normally includes the stated principal, interest rate and term to maturity of the amount to be lent and the significant terms of the transaction giving rise to the exposure to risk.

71. The nature of an entity's operations and the extent of its activity in financial instruments will determine whether information about interest rate risk is presented in narrative form, in tables, or by using a combination of the two. When an entity has a significant number of financial instruments exposed to interest rate price or cash flow risks, it may adopt one or more of the following approaches to presenting information.

(a) The carrying amounts of financial instruments exposed to interest rate price risk may be presented in tabular form, grouped by those that are contracted to mature or be repriced:

  (i) Within one year of the reporting date;

  (ii) More than one year and less than five years from the reporting date; and

  (iii) Five years or more from the reporting date.

(b) When the performance of an entity is significantly affected by the level of its exposure to interest rate price risk or changes in that exposure, more detailed information is desirable. An entity such as a central borrowing authority may disclose, for example, separate groupings of the carrying amounts of financial instruments contracted to mature or be repriced:

  (i) Within one month of the reporting date;

  (ii) More than one and less than three months from the reporting date; and

  (iii) More than three and less than twelve months from the reporting date.

(c) Similarly, an entity may indicate its exposure to interest rate cash flow risk through a table indicating the aggregate carrying amount of groups of floating rate financial assets and financial liabilities maturing within various future time periods.

(d) Interest rate information may be disclosed for individual financial instruments or weighted average rates or a range of rates may be presented for each class of financial instrument. An entity groups instruments denominated in different currencies or having substantially different credit risks into separate classes when these factors result in instruments having substantially different effective interest rates.

72. In some circumstances, an entity may be able to provide useful information about its exposure to interest rate risks by indicating the effect of a hypothetical change in the prevailing level of market interest rates on the fair value of its financial instruments and future earnings and cash flows. Such interest rate sensitivity information may be based on an assumed 1% change in market interest rates occurring at the reporting date. The effects of a change in interest rates includes changes in interest revenue and expense relating to floating rate financial instruments and gains or losses resulting from changes in the fair value of fixed rate instruments. The reported interest rate sensitivity may be restricted to the direct effects of an

interest rate change on interest-bearing financial instruments on hand at the reporting date since the indirect effects of a rate change on financial markets and individual entities cannot normally be predicted reliably. When disclosing interest rate sensitivity information, an entity indicates the basis on which it has prepared the information, including any significant assumptions.

Credit Risk

73. **For each class of financial asset, both recognized and unrecognized, an entity should disclose information about its exposure to credit risk, including:**

    (a) **The amount that best represents its maximum credit risk exposure at the reporting date, without taking account of the fair value of any collateral, in the event other parties fail to perform their obligations under financial instruments; and**

    (b) **Significant concentrations of credit risk.**

74. An entity provides information relating to credit risk to permit users of its financial statements to assess the extent to which failures by counterparties to discharge their obligations could reduce the amount of future cash inflows from financial assets on hand at the reporting date. Such failures give rise to a financial loss recognized in an entity's statement of financial performance. Paragraph 73 does not require an entity to disclose an assessment of the probability of losses arising in the future.

75. The purposes of disclosing amounts exposed to credit risk without regard to potential recoveries from realization of collateral ("an entity's maximum credit risk exposure") are:

    (a) To provide users of financial statements with a consistent measure of the amount exposed to credit risk for both recognized and unrecognized financial assets; and

    (b) To take into account the possibility that the maximum exposure to loss may differ from the carrying amount of a recognized financial asset or the fair value of an unrecognized financial asset that is otherwise disclosed in the financial statements.

76. In the case of recognized financial assets exposed to credit risk, the carrying amount of the assets in the statement of financial position, net of any applicable provisions for loss, usually represents the amount exposed to credit risk. For example, in the case of an interest rate swap carried at fair value, the maximum exposure to loss at the reporting date is normally the carrying amount since it represents the cost, at current market rates, of replacing the swap in the event of default. In these circumstances, no

additional disclosure beyond that provided on the statement of financial position is necessary. On the other hand, as illustrated by the examples in paragraphs 77 and 78, an entity's maximum potential loss from some recognized financial assets may differ significantly from their carrying amount and from other disclosed amounts such as their fair value or principal amount. In such circumstances, additional disclosure is necessary to meet the requirements of paragraph 73(a).

77. A financial asset subject to a legally enforceable right of set-off against a financial liability is not presented on the statement of financial position net of the liability unless settlement is intended to take place on a net basis or simultaneously. Nevertheless, an entity discloses the existence of the legal right of set-off when providing information in accordance with paragraph 73. For example, when an entity is due to receive the proceeds from realization of a financial asset before settlement of a financial liability of equal or greater amount against which the entity has a legal right of set-off, the entity has the ability to exercise that right of set-off to avoid incurring a loss in the event of a default by the counterparty. However, if the entity responds, or is likely to respond, to the default by extending the term of the financial asset, an exposure to credit risk would exist if the revised terms are such that collection of the proceeds is expected to be deferred beyond the date on which the liability is required to be settled. To inform financial statement users of the extent to which exposure to credit risk at a particular point in time has been reduced, the entity discloses the existence and effect of the right of set-off when the financial asset is expected to be collected in accordance with its terms. When the financial liability against which a right of set-off exists is due to be settled before the financial asset, the entity is exposed to credit risk on the full carrying amount of the asset if the counterparty defaults after the liability has been settled.

78. An entity may have entered into one or more master netting arrangements that serve to mitigate its exposure to credit loss but do not meet the criteria for offsetting. When a master netting arrangement significantly reduces the credit risk associated with financial assets not offset against financial liabilities with the same counterparty, an entity provides additional information concerning the effect of the arrangement. Such disclosure indicates that:

(a) The credit risk associated with financial assets subject to a master netting arrangement is eliminated only to the extent that financial liabilities due to the same counterparty will be settled after the assets are realized; and

(b) The extent to which an entity's overall exposure to credit risk is reduced through a master netting arrangement may change substantially within a short period following the reporting date

because the exposure is affected by each transaction subject to the arrangement.

It is also desirable for an entity to disclose the terms of its master netting arrangements that determine the extent of the reduction in its credit risk.

79. When there is no credit risk associated with an unrecognized financial asset or the maximum exposure is equal to the principal, stated, face or other similar contractual amount of the instrument disclosed in accordance with paragraph 54 or the fair value disclosed in accordance with paragraph 84, no additional disclosure is required to comply with paragraph 73(a). However, with some unrecognized financial assets, the maximum loss that would be recognized upon default by the other party to the underlying instrument may differ substantially from the amounts disclosed in accordance with paragraphs 54 and 84. For example, an entity may have a right to mitigate the loss it would otherwise bear by setting off an unrecognized financial asset against an unrecognized financial liability. In such circumstances, paragraph 73(a) requires disclosure in addition to that provided in accordance with paragraphs 54 and 84.

80. Guaranteeing an obligation of another party exposes the guarantor to credit risk that would be taken into account in making the disclosures required by paragraph 73. This situation may arise as a result of, for example, a securitization transaction in which an entity remains exposed to credit risk associated with financial assets that have been removed from its statement of financial position. If the entity is obligated under recourse provisions of the transaction to indemnify the purchaser of the assets for credit losses, it discloses the nature of the assets removed from its statement of financial position, the amount and timing of the future cash flows contractually due from the assets, the terms of the recourse obligation and the maximum loss that could arise under that obligation. Similarly, where a local government guarantees the obligations of a private sector provider of public infrastructure, the maximum loss that could arise under that obligation in the event of default of the provider should be disclosed.

81. Concentrations of credit risk are disclosed when they are not apparent from other disclosures about the nature and financial position of the entity and they result in a significant exposure to loss in the event of default by other parties. Identification of significant concentrations is a matter for the exercise of judgment by management taking into account the circumstances of the entity and its debtors.

82. Concentrations of credit risk may arise from exposures to a single debtor or to groups of debtors having a similar characteristic such that their ability to meet their obligations is expected to be affected similarly by changes in

economic or other conditions. Characteristics that may give rise to a concentration of risk include the nature of the activities undertaken by debtors, such as the industry in which they operate, the geographic area in which activities are undertaken and the level of creditworthiness of groups of borrowers. For example, a state-owned coal mine will normally have trade accounts receivable from sale of its products for which the risk of non-payment is affected by economic changes in the electricity generation industry. A bank that normally lends on an international scale may have a significant amount of loans outstanding to less developed nations and the bank's ability to recover those loans may be adversely affected by local economic conditions.

83. Disclosure of concentrations of credit risk includes a description of the shared characteristic that identifies each concentration and the amount of the maximum credit risk exposure associated with all recognized and unrecognized financial assets sharing that characteristic.

Fair Value

84. **For each class of financial asset and financial liability, both recognized and unrecognized, an entity should disclose information about fair value. When it is not practicable within constraints of timeliness or cost to determine the fair value of a financial asset or financial liability with sufficient reliability, that fact should be disclosed together with information about the principal characteristics of the underlying financial instrument that are pertinent to its fair value.**

85. Fair value information is widely used for financial purposes in determining an entity's overall financial position and in making decisions about individual financial instruments. It is also relevant to many decisions made by users of financial statements since, in many circumstances, it reflects the judgment of the financial markets as to the present value of expected future cash flows relating to an instrument. Fair value information permits comparisons of financial instruments having substantially the same economic characteristics, regardless of their purpose and when and by whom they were issued or acquired. Fair values provide a neutral basis for assessing management's stewardship by indicating the effects of its decisions to buy, sell or hold financial assets and to incur, maintain or discharge financial liabilities. When an entity does not carry a financial asset or financial liability in its statement of financial position at fair value, it provides fair value information through supplementary disclosures.

86. The fair value of a financial asset or financial liability may be determined by one of several generally accepted methods. Disclosure of fair value information includes disclosure of the method adopted and any significant assumptions made in its application.

87. Underlying the definition of fair value is a presumption that an entity is a going concern without any intention or need to liquidate, curtail materially the scale of its operations or undertake a transaction on adverse terms. Fair value is not, therefore, the amount that an entity would receive or pay in a forced transaction, involuntary liquidation or distress sale. However, an entity takes its current circumstances into account in determining the fair values of its financial assets and financial liabilities. For example, the fair value of a financial asset that an entity has decided to sell for cash in the immediate future is determined by the amount that it expects to receive from such a sale. The amount of cash to be realized from an immediate sale will be affected by factors such as the current liquidity and depth of the market for the asset.

88. When a financial instrument is traded in an active and liquid market, its quoted market price provides the best evidence of fair value. The appropriate quoted market price for an asset held or liability to be issued is usually the current bid price and, for an asset to be acquired or liability held, the current offer or asking price. When current bid and offer prices are unavailable, the price of the most recent transaction may provide evidence of the current fair value provided that there has not been a significant change in economic circumstances between the transaction date and the reporting date. When an entity has matching asset and liability positions, it may appropriately use mid-market prices as a basis for establishing fair values.

89. When there is infrequent activity in a market, the market is not well established (for example, some “over the counter” markets) or small volumes are traded relative to the number of trading units of a financial instrument to be valued, quoted market prices may not be indicative of the fair value of the instrument. In these circumstances, as well as when a quoted market price is not available, estimation techniques may be used to determine fair value with sufficient reliability to satisfy the requirements of this Standard. Techniques that are well established in financial markets include reference to the current market value of another instrument that is substantially the same, discounted cash flow analysis and option pricing models. In applying discounted cash flow analysis, an entity uses a discount rate equal to the prevailing market rate of interest for financial instruments having substantially the same terms and characteristics, including the creditworthiness of the debtor, the remaining term over which the contractual interest rate is fixed, the remaining term to repayment of the principal and the currency in which payments are to be made.

90. The fair value to an entity of a financial asset or financial liability, whether determined from market value or otherwise, is determined without deduction for the costs that would be incurred to exchange or settle the

underlying financial instrument. The costs may be relatively insignificant for instruments traded in organized, liquid markets but may be substantial for other instruments. Transaction costs may include taxes and duties, fees and commissions paid to agents, advisers, brokers or dealers and levies by regulatory agencies or securities exchanges.

91. When an instrument is not traded in an organized financial market, it may not be appropriate for an entity to determine and disclose a single amount that represents an estimate of fair value. Instead, it may be more useful to disclose a range of amounts within which the fair value of a financial instrument is reasonably believed to lie.

92. When disclosure of fair value information is omitted because it is not practicable to determine fair value with sufficient reliability, information is provided to assist users of the financial statements in making their own judgments about the extent of possible differences between the carrying amount of financial assets and financial liabilities and their fair value. In addition to an explanation of the reason for the omission and the principal characteristics of the financial instruments that are pertinent to their value, information is provided about the market for the instruments. In some cases, the terms and conditions of the instruments disclosed in accordance with paragraph 54 may provide sufficient information about the characteristics of the instrument. When it has a reasonable basis for doing so, management may indicate its opinion as to the relationship between fair value and the carrying amount of financial assets and financial liabilities for which it is unable to determine fair value.

93. The historical cost carrying amount of receivables and payables subject to normal trade credit terms usually approximates fair value. Similarly, the fair value of a deposit liability without a specified maturity is the amount payable on demand at the reporting date.

94. Fair value information relating to classes of financial assets or financial liabilities that are carried on the statement of financial position at other than fair value is provided in a way that permits comparison between the carrying amount and the fair value. Accordingly, the fair values of recognized financial assets and financial liabilities are grouped into classes and offset only to the extent that their related carrying amounts are offset. Fair values of unrecognized financial assets and financial liabilities are presented in a class or classes separate from recognized items and are offset only to the extent that they meet the offsetting criteria for recognized financial assets and financial liabilities.

Financial Assets Carried at an Amount in Excess of Fair Value

95. **When an entity carries one or more financial assets at an amount in excess of their fair value, the entity should disclose:**

    (a) **The carrying amount and the fair value of either the individual assets or appropriate groupings of those individual assets; and**

    (b) **The reasons for not reducing the carrying amount, including the nature of the evidence that provides the basis for management's belief that the carrying amount will be recovered.**

96. Management exercises judgment in determining the amount it expects to recover from a financial asset and whether to write down the carrying amount of the asset when it is in excess of fair value. The information required by paragraph 95 provides users of financial statements with a basis for understanding management's exercise of judgment and assessing the possibility that circumstances may change and lead to a reduction in the asset's carrying amount in the future. When appropriate, the information required by paragraph 95(a) is grouped in a manner that reflects management's reasons for not reducing the carrying amount.

97. An entity's accounting policies with respect to recognition of declines in value of financial assets, disclosed in accordance with paragraph 54, assist in explaining why a particular financial asset is carried at an amount in excess of fair value. In addition, the entity provides the reasons and evidence specific to the asset that provide management with the basis for concluding that the asset's carrying amount will be recovered. For example, the fair value of a fixed rate loan intended to be held to maturity may have declined below its carrying amount as a result of an increase in interest rates. In such circumstances, the lender may not have reduced the carrying amount because there is no evidence to suggest that the borrower is likely to default.

Hedges of Anticipated Future Transactions

98. **When an entity has accounted for a financial instrument as a hedge of risks associated with anticipated future transactions, it should disclose:**

    (a) **A description of the anticipated transactions, including the period of time until they are expected to occur;**

    (b) **A description of the hedging instruments; and**

    (c) **The amount of any deferred or unrecognized gain or loss and the expected timing of recognition as revenue or expense.**

99. An entity's accounting policies indicate the circumstances in which a financial instrument is accounted for as a hedge and the nature of the special

recognition and measurement treatment applied to the instrument. The information required by paragraph 98 permits the users of an entity's financial statements to understand the nature and effect of a hedge of an anticipated future transaction. The information may be provided on an aggregate basis when a hedged position comprises several anticipated transactions or has been hedged by several financial instruments.

100. The amount disclosed in accordance with paragraph 98(c) includes all accrued gains and losses on financial instruments designated as hedges of anticipated future transactions, without regard to whether those gains and losses have been recognized in the financial statements. The accrued gain or loss may be unrealized but recorded in the entity's statement of financial position as a result of carrying the hedging instrument at fair value, it may be unrecognized if the hedging instrument is carried on the cost basis, or it may have been realized if the hedging instrument has been sold or settled. In each case, however, the accrued gain or loss on the hedging instrument has not been recognized in the entity's statement of financial performance pending completion of the hedged transaction.

Other Disclosures

101. Additional disclosures are encouraged when they are likely to enhance financial statement users' understanding of financial instruments. It may be desirable to disclose such information as:

(a) The total amount of the change in the fair value of financial assets and financial liabilities that has been recognized as revenue or expense for the period;

(b) The total amount of deferred or unrecognized gain or loss on hedging instruments other than those relating to hedges of anticipated future transactions; and

(c) The average aggregate carrying amount during the year of recognized financial assets and financial liabilities, the average aggregate principal, stated, notional or other similar amount during the year of unrecognized financial assets and financial liabilities and the average aggregate fair value during the year of all financial assets and financial liabilities, particularly when the amounts on hand at the reporting date are unrepresentative of amounts on hand during the year.

Transitional Provision

102. **When comparative information for prior periods is not available when this International Public Sector Accounting Standard is first adopted, such information need not be presented.**

Effective Date

103. **This International Public Sector Accounting Standard becomes effective for annual financial statements covering periods beginning on or after January 1, 2003. Earlier application is encouraged.**

104. When an entity adopts the accrual basis of accounting, as defined by International Public Sector Accounting Standards, for financial reporting purposes, subsequent to this effective date, this Standard applies to the entity's annual financial statements covering periods beginning on or after the date of adoption.

Appendix 1

Implementation Guide

This appendix is illustrative only and does not form part of the standards. The purpose of this appendix is to assist preparers of financial statements in identifying those aspects of the Standard that apply to them.

This implementation guide should be read jointly with the Standard. Readers are cautioned that the flowcharts and text included in this Guide provide only a broad overview of the requirements of the Standard.

Requirements of IPSAS 15 — Overview

All entities will need to review scope paragraphs 1–8 and consult the definition of a financial instrument and related commentary (paragraphs 9v21) to determine when the Standard is applicable and whether they hold financial instruments.

The relevant paragraphs in the Standard for entities with *only* financial assets are paragraphs 48–101 (Disclosure).

The relevant paragraphs in the Standard for entities with *only* financial liabilities are paragraphs 22–28 and 36–38 (Presentation), and paragraphs 48–72, 84–94 and 98–101 (Disclosure).

The relevant paragraphs in the Standard for entities with *only* equity instruments are paragraphs 22–28 and 36–38 (Presentation), and paragraphs 50–62 and 98–101 (Disclosure).

Where entities hold both financial assets and financial liabilities, additional relevant paragraphs are 39–47 (Presentation).

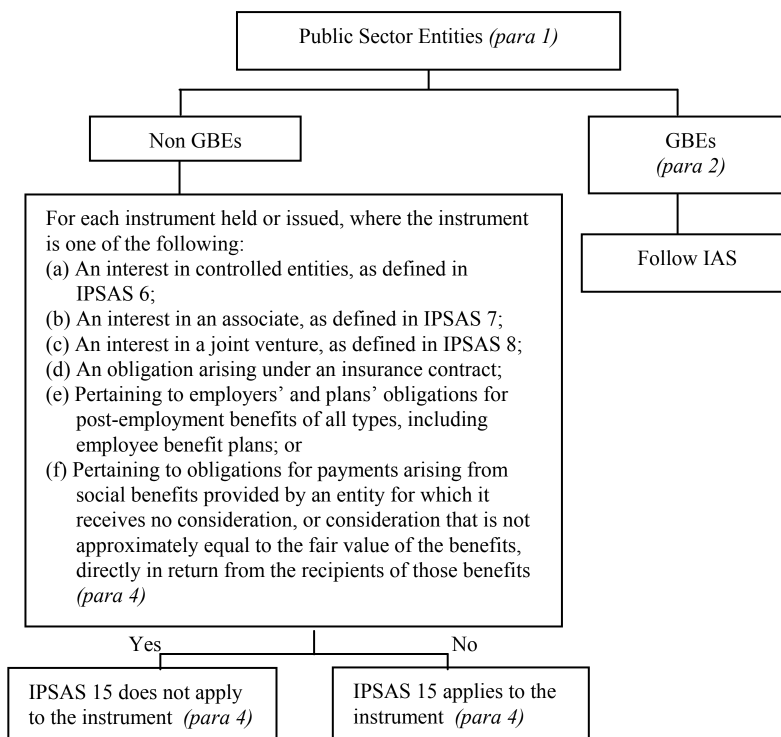
Where entities hold both financial liabilities and net assets/equity, additional relevant paragraphs are 29–35 (Presentation).

Comparative information is required for all instruments (see IPSAS 1, "Presentation of Financial Statements," paragraphs 60–63) except, if not available, during the year of first adoption (paragraph 102).

Summary of Standard Applicability, Presentation and Disclosure Requirements

This section provides an overview of the requirements in respect of financial assets, financial liabilities and equity instruments. The following flowcharts identify key black letter paragraphs of the Standard.

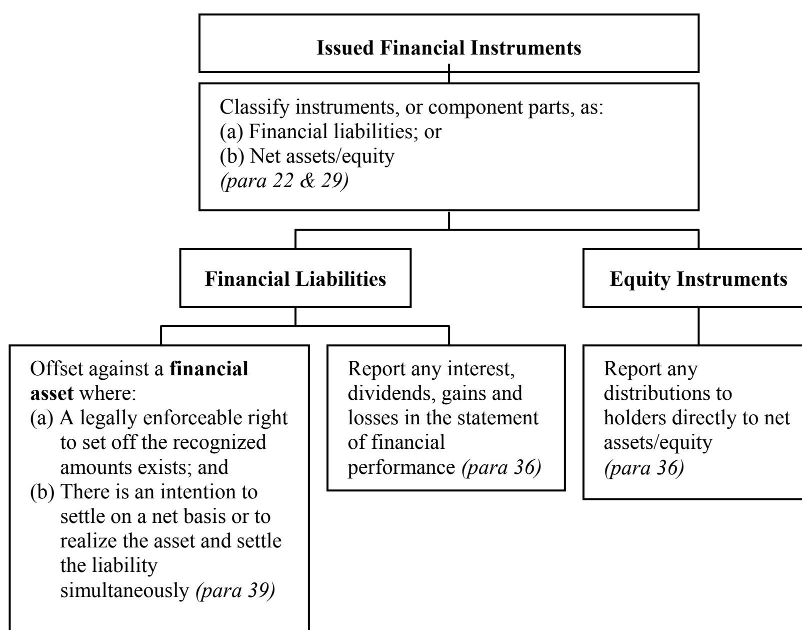
Scope of the Standard



Scope

This Standard applies to public sector entities reporting under the accrual basis of accounting. Government Business Enterprises (GBEs) are excluded from the scope of these IPSASs (paragraph 2), however, PSC Guideline No.1, "Financial Reporting by Government Business Enterprises" recommends that GBEs comply with IASs. This IPSAS also exempts financial instruments of the types identified in paragraph 4 of the Standard from having to comply with the disclosure and presentation rules set out within the Standard. Commentary on these excluded financial instruments can be found in paragraphs 5–8.

Presentation — Issued Financial Instruments



This Standard sets out the requirements for the presentation of financial instruments. Financial instruments can be classified as being financial assets, financial liabilities or equity instruments. These terms are defined in paragraph 9 of the Standard. Additional discussion clarifying these defined terms and what constitutes a financial instrument is located in commentary paragraphs 10–21. Examples of financial instruments covered by the Standard are included in Appendix 2, paragraphs A3–A16.

Classification

The Standard requires that the issuer of a financial instrument classify the instrument, or its component parts, as a financial liability or as net assets/equity (paragraph 22). Commentary in paragraphs 23–28 provides users with guidance in distinguishing the nature of the instrument to facilitate consistency in classification across users. Appendix 2, paragraphs A18–A21, provides examples of instruments which should be classified as liabilities or as net assets/equity.

It is likely that few public sector entities will issue compound financial instruments (paragraph 30). The Standard requires that where such instruments are issued, the financial liability and net assets/equity components should be separately classified and disclosed (paragraph 29). Commentary paragraphs 31–33 and Appendix 2,

paragraphs A22 and A23, discuss various instances where separate classification is necessary. Paragraphs 34 and 35 set out two methods by which preparers could assign a carrying amount to the various components, and Appendix 2, paragraph A24 illustrates an example of how to assign values to the elements.

Interest, Dividends, Losses and Gains

The Standard sets out when such items should be classified as revenue or expense, or as a direct debit to net assets/equity (paragraph 36). Further guidance and clarifying comments made regarding these classifications is located within paragraphs 37 and 38.

Offsetting

The Standard prescribes when an entity should offset a financial asset and a financial liability in the statement of financial position (paragraph 39). Subsequent commentary includes an explanation of the difference between offsetting instruments and ceasing to recognize an instrument (paragraph 41), a discussion of the conditions necessary before an offset is allowable (paragraphs 42–45), and provides examples of situations where offsetting would not be allowable (paragraphs 46 and 47). Paragraph 40 provides an example of where instruments should be offset, noting that in other circumstances, separate presentation consistent with the instrument's characteristics as an asset or liability is appropriate. Appendix 2, paragraph A25, notes that "synthetic instruments" with financial asset and financial liability components should not be offset unless they meet the criteria for offsetting detailed in paragraph 39.

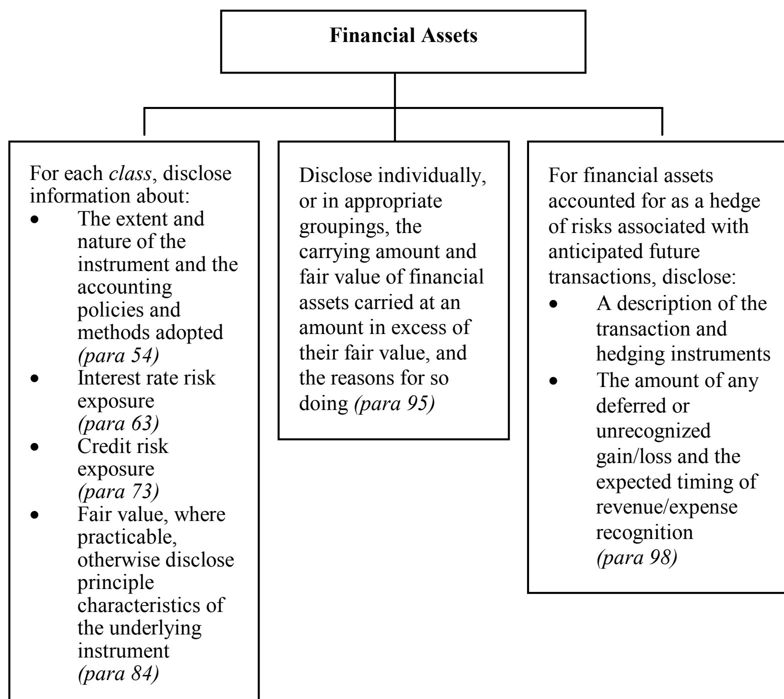
Further discussion pertaining to offsetting and disclosures warranted in those instances is located within paragraphs 77, 78 and 94 of the Standard.

Disclosure

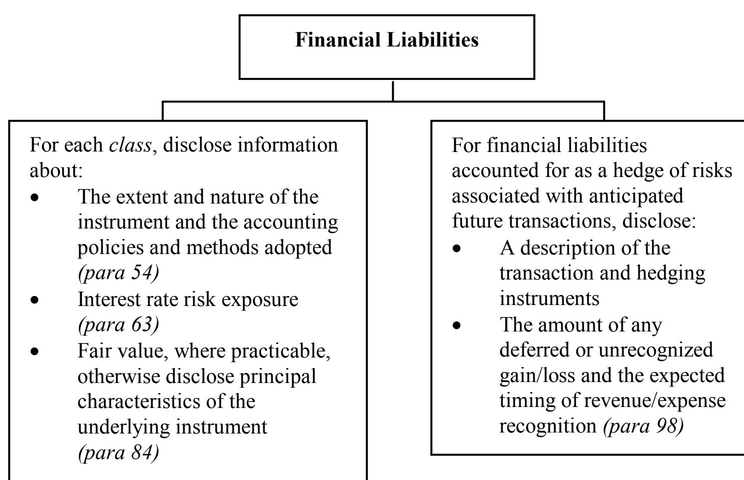
Risk Management Policies

The entity should describe its financial risk management objectives and policies (para 50).

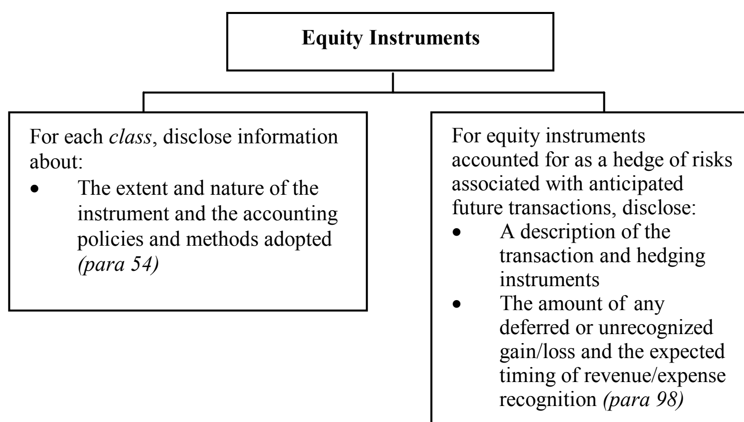
Financial Asset Disclosures



Financial Liability Disclosures



Equity Instrument Disclosures



A comprehensive example of the disclosures required of financial instruments under this Standard appears in Appendix 3.

Risk

A discussion on various forms of risk associated with financial instruments is located in paragraph 49 of the Standard. While the Standard requires disclosure of risk management objectives and policies (paragraph 50), the associated commentary paragraphs 51–53 indicate that aside from the specific inclusion required under paragraph 50, the format, location and level of detail is subject to management's judgement.

Terms, Conditions and Accounting Policies

The Standard requires disclosure of the extent and nature of financial instruments, and the accounting policies and methods employed (paragraph 54). Commentary paragraphs 55–62, and Appendix 2, paragraphs A26 and A27, provide guidance on the types of information that may be appropriate and instances where disclosure of information is warranted.

Interest Rate Risk

The reasons for the disclosures about interest rate risk exposure required by paragraph 63 and guidance on the types of information that should be disclosed is located in commentary paragraphs 64–70. Guidance on the presentation of this information is presented in paragraphs 71 and 72.

Credit Risk

The reasons for the disclosures about credit risk information for the financial assets of the entity is located at paragraph 74 and 75 of the Standard. Commentary paragraphs 76–83 provide readers with examples and discussion of instances where additional credit risk information is desirable or warranted.

Fair Value

Paragraph 85 explains why the Standard requires the disclosure of fair value information. Discussion regarding the determination of a fair value amount is located at paragraphs 86–91, and at paragraph 93 of the Standard.

Paragraph 84 of the Standard provides preparers with relief from having to disclose fair value information for each class of financial asset and financial liability where it is not practicable with regard to time or cost. Discussion regarding this relief, and the information to be disclosed is found in commentary paragraph 92.

Where classes of financial assets or financial liabilities are carried at other than at their fair value, paragraph 94 notes that information should be provided in a manner that permits comparison between the carrying value and the fair value.

Financial Assets Carried at an Amount in Excess of Fair Value

In some instances, management decides not to write down the carrying amount of financial assets to their fair value. Paragraph 95 requires certain disclosures to be made when this occurs. Paragraph 96 and 97 provide discussion of the issue.

Hedges of Anticipated Future Transactions

Paragraph 98 requires certain disclosures to be made in respect of financial instruments used for hedging risks related to an anticipated future transaction. Paragraph 99 explains why these disclosures are important. It also explains when such information may be provided on an aggregate basis. Paragraph 100 clarifies the types of items that would be included within paragraph 98(c) pertaining to the disclosure of any deferred or unrecognized gain or loss.

Other Disclosure

The Standard encourages preparers to disclose information that would be expected to enhance users' understanding of financial instruments. Examples of such disclosures are included in paragraph 101.

Appendix 2

Examples of the Application of the Standard

This appendix is illustrative only and does not form part of the standards. The purpose of the appendix is to illustrate the application of the standards to assist in clarifying their meaning.

A1. This appendix explains and illustrates the application of certain aspects of the Standard to various common financial instruments. The detailed examples are illustrative only and do not necessarily represent the only basis for applying the Standard in the specific circumstances discussed. Changing one or two of the facts assumed in the examples can lead to substantially different conclusions concerning the appropriate presentation or disclosure of a particular financial instrument. This appendix does not discuss the application of all requirements of the Standard in the examples provided. In all cases, the provisions of the Standard prevail.

A2. The Standard does not deal with the recognition or measurement of financial instruments. Certain recognition and measurement practices may be assumed for purposes of illustration but they are not required.

Definitions

Common Types of Financial Instruments, Financial Assets and Financial Liabilities

A3. Currency (cash) is a financial asset because it represents the medium of exchange and is therefore the basis on which all transactions are measured and reported in financial statements. A deposit of cash with a bank or similar financial institution is a financial asset because it represents the contractual right of the depositor to obtain cash from the institution or to draw a check or similar instrument against the balance in favour of a creditor in payment of a financial liability.

A4. Common examples of financial assets representing a contractual right to receive cash in the future and corresponding financial liabilities representing a contractual obligation to deliver cash in the future are:

(a) Trade accounts receivable and payable;

(b) Notes receivable and payable;

(c) Loans receivable and payable; and

(d) Bonds receivable and payable.

In each case, one party's contractual right to receive (or obligation to pay) cash is matched by the other party's corresponding obligation to pay (or right to receive).

A5. Another type of financial instrument is one for which the economic benefit to be received or given up is a financial asset other than cash. For example, a note payable in highly rated bonds gives the holder the contractual right to receive and the issuer the contractual obligation to deliver bonds, not cash. The bonds are financial assets because they represent obligations of the issuer to pay cash. The note is, therefore, a financial asset of the note holder and a financial liability of the note issuer.

A6. Under IPSAS 13, a finance lease is accounted for as a sale with delayed payment terms. The lease contract is considered to be primarily an entitlement of the lessor to receive, and an obligation of the lessee to pay, a stream of payments that are substantially the same as blended payments of principal and interest under a loan agreement. The lessor accounts for its investment in the amount receivable under the lease contract rather than the leased asset itself. An operating lease, on the other hand, is considered to be primarily an uncompleted contract committing the lessor to provide the use of an asset in future periods in exchange for consideration similar to a fee for a service. The lessor continues to account for the leased asset itself rather than any amount receivable in the future under the contract. Accordingly, a finance lease is considered to be a financial instrument and an operating lease is considered not to be a financial instrument (except as regards individual payments currently due and payable).

Equity Instruments

A7. Equity instruments are not commonly issued by public sector entities except for partly-privatized GBEs. Examples of equity instruments include common shares, certain types of preferred shares, and warrants or options to subscribe for or purchase common shares in the issuing entity. An entity's obligation to issue its own equity instruments in exchange for financial assets of another party is not potentially unfavorable since it results in an increase in net assets/equity and cannot result in a loss to the entity. The possibility that existing holders of a net assets/equity interest in the entity may find the fair value of their interest reduced as a result of the obligation does not make the obligation unfavorable to the entity itself.

A8. An option or other similar instrument acquired by an entity that gives it the right to reacquire its own equity instruments is not a financial asset of the entity. The entity will not receive cash or any other financial asset through exercise of the option. Exercise of the option is not potentially favorable to the entity since it results in a reduction in net assets/equity and an outflow

of assets. Any change in net assets/equity recorded by the entity from reacquiring and canceling its own equity instruments represents a transfer between those holders of equity instruments who have given up their net assets/equity interest and those who continue to hold a net assets/equity interest, rather than a gain or loss by the entity.

Derivative Financial Instruments

A9. On inception, derivative financial instruments give one party a contractual right to exchange financial assets with another party under conditions that are potentially favorable, or a contractual obligation to exchange financial assets with another party under conditions that are potentially unfavorable. Some instruments embody both a right and an obligation to make an exchange. Since the terms of the exchange are determined on inception of the derivative instrument, as prices in financial markets change, those terms may become either favorable or unfavorable.

A10. A put or call option to exchange financial instruments gives the holder a right to obtain potential future economic benefits associated with changes in the fair value of the financial instrument underlying the contract. Conversely, the writer of an option assumes an obligation to forego potential future economic benefits or bear potential losses of economic benefits associated with changes in the fair value of the underlying financial instrument. The contractual right of the holder and obligation of the writer meet the definition of a financial asset and a financial liability respectively. The financial instrument underlying an option contract may be any financial asset, including shares and interest-bearing instruments. An option may require the writer to issue a debt instrument, rather than transfer a financial asset, but the instrument underlying the option would still constitute a financial asset of the holder if the option were exercised. The option-holder’s right to exchange the assets under potentially favorable conditions and the writer’s obligation to exchange the assets under potentially unfavorable conditions are distinct from the underlying assets to be exchanged upon exercise of the option. The nature of the holder’s right and the writer’s obligation is not affected by the likelihood that the option will be exercised. An option to buy or sell an asset other than a financial asset (such as a commodity) does not give rise to a financial asset or financial liability because it does not fit the requirements of the definitions for the receipt or delivery of financial assets or exchange of financial instruments.

A11. Another example of a derivative financial instrument is a forward contract to be settled in six months’ time in which one party (the purchaser) promises to deliver 1,000,000 cash in exchange for 1,000,000 face amount of fixed rate government bonds, and the other party (the seller) promises to

deliver 1,000,000 face amount of fixed rate government bonds in exchange for 1,000,000 cash. During the six months, both parties have a contractual right and a contractual obligation to exchange financial instruments. If the market price of the government bonds rises above 1,000,000, the conditions will be favorable to the purchaser and unfavorable to the seller; if the market price falls below 1,000,000, the effect will be the opposite. The purchaser has both a contractual right (a financial asset) similar to the right under a call option held and a contractual obligation (a financial liability) similar to the obligation under a put option written; the seller has a contractual right (a financial asset) similar to the right under a put option held and a contractual obligation (a financial liability) similar to the obligation under a call option written. As with options, these contractual rights and obligations constitute financial assets and financial liabilities separate and distinct from the underlying financial instruments (the bonds and cash to be exchanged). The significant difference between a forward contract and an option contract is that both parties to a forward contract have an obligation to perform at the agreed time, whereas performance under an option contract occurs only if and when the holder of the option chooses to exercise it.

A12. Many other types of derivative instruments embody a right or obligation to make a future exchange, including interest rate and currency swaps, interest rate caps, collars and floors, loan commitments, note issuance facilities and letters of credit. An interest rate swap contract may be viewed as a variation of a forward contract in which the parties agree to make a series of future exchanges of cash amounts, one amount calculated with reference to a floating interest rate and the other with reference to a fixed interest rate. Futures contracts are another variation of forward contracts, differing primarily in that the contracts are standardized and traded on an exchange.

Commodity Contracts and Commodity-linked Financial Instruments

A13. As indicated by paragraph 18 of the Standard, contracts that provide for settlement by receipt or delivery of a physical asset only (for example, an option, futures or forward contract on silver) are not financial instruments. Many commodity contracts are of this type. Some are standardized in form and traded on organized markets in much the same fashion as some derivative financial instruments. For example, a commodity futures contract may be readily bought and sold for cash because it is listed for trading on an exchange and may change hands many times. However, the parties buying and selling the contract are, in effect, trading the underlying commodity. The ability to buy or sell a commodity contract for cash, the ease with which it may be bought or sold and the possibility of negotiating a cash settlement of the obligation to receive or deliver the commodity do

not alter the fundamental character of the contract in a way that creates a financial instrument.

A14. A contract that involves receipt or delivery of physical assets does not give rise to a financial asset of one party and a financial liability of the other party unless any corresponding payment is deferred past the date on which the physical assets are transferred. Such is the case with the purchase or sale of goods on trade credit.

A15. Some contracts are commodity-linked but do not involve settlement through physical receipt or delivery of a commodity. They specify settlement through cash payments that are determined according to a formula in the contract, rather than through payment of fixed amounts. For example, the principal amount of a bond may be calculated by applying the market price of oil prevailing at the maturity of the bond to a fixed quantity of oil. The principal is indexed by reference to a commodity price but is settled only in cash. Such a contract constitutes a financial instrument.

A16. The definition of a financial instrument encompasses also a contract that gives rise to a non-financial asset or liability in addition to a financial asset or liability. Such financial instruments often give one party an option to exchange a financial asset for a non-financial asset. For example, an oil-linked bond may give the holder the right to receive a stream of fixed periodic interest payments and a fixed amount of cash on maturity, with the option to exchange the principal amount for a fixed quantity of oil. The desirability of exercising this option will vary from time to time based on the fair value of oil relative to the exchange ratio of cash for oil (the exchange price) inherent in the bond. The intentions of the bondholder concerning the exercise of the option do not affect the substance of the component assets. The financial asset of the holder and the financial liability of the issuer make the bond a financial instrument, regardless of the other types of assets and liabilities also created.

A17. Although the Standard was not developed to apply to commodity or other contracts that do not satisfy the definition of a financial instrument, entities may consider whether it is appropriate to apply the relevant portions of the disclosure standards to such contracts.

Liabilities and Net Assets/Equity

A18. Although it is not common for public sector entities to issue equity instruments, in the event that such instruments are issued, it is relatively easy for issuers to classify certain types of financial instruments as liabilities or net assets/equity. Examples of equity instruments include common (ordinary) shares and options that, if exercised, would require the writer of the option to issue common shares. Common shares do not oblige

the issuer to transfer assets to shareholders, except when the issuer formally acts to make a distribution and becomes legally obligated to the shareholders to do so. This may be the case following declaration of a dividend or when the entity is being wound up and any assets remaining after the satisfaction of liabilities become distributable to shareholders.

"Perpetual" Debt Instruments

A19. "Perpetual" debt instruments, such as "perpetual" bonds, debentures and capital notes, normally provide the holder with the contractual right to receive payments on account of interest at fixed dates extending into the indefinite future, either with no right to receive a return of principal or a right to a return of principal under terms that make it very unlikely or very far in the future. For example, an entity may issue a financial instrument requiring it to make annual payments in perpetuity equal to a stated interest rate of 8% applied to a stated par or principal amount of 1,000. Assuming 8% to be the market rate of interest for the instrument when issued, the issuer assumes a contractual obligation to make a stream of future interest payments having a fair value (present value) of 1,000. The holder and issuer of the instrument have a financial asset and financial liability, respectively, of 1,000 and corresponding interest revenue and expense of 80 each year in perpetuity.

Preferred Shares

A20. Preferred (or preference) shares may be issued with various rights. In classifying a preferred share as a liability or net assets/equity, an entity assesses the particular rights attaching to the share to determine whether it exhibits the fundamental characteristic of a financial liability. For example, a preferred share that provides for redemption on a specific date or at the option of the holder meets the definition of a financial liability if the issuer has an obligation to transfer financial assets to the holder of the share. The inability of an issuer to satisfy an obligation to redeem a preferred share when contractually required to do so, whether due to a lack of funds or a statutory restriction, does not negate the obligation. An option of the issuer to redeem the shares does not satisfy the definition of a financial liability because the issuer does not have a present obligation to transfer financial assets to the shareholders. Redemption of the shares is solely at the discretion of the issuer. An obligation may arise, however, when the issuer of the shares exercises its option, usually by formally notifying the shareholders of an intention to redeem the shares.

A21. When preferred shares are non-redeemable, the appropriate classification is determined by the other rights that may attach to them. When distributions to holders of the preferred shares whether, cumulative or non-cumulative, are at the discretion of the issuer, the shares are equity instruments.

Compound Financial Instruments

A22. Paragraph 29 of the Standard applies only to a limited group of compound instruments for the purpose of having the issuers present liability and equity instrument components separately on their statements of financial position. Paragraph 29 does not deal with compound instruments from the perspective of holders.

A23. A common form of compound financial instrument is a debt security with an embedded conversion option, such as a bond convertible into common shares of the issuer. Paragraph 29 of the Standard requires the issuer of such a financial instrument to present the liability component and the equity instrument component separately on the statement of financial position from their initial recognition.

(a) The issuer's obligation to make scheduled payments of interest and principal constitutes a financial liability which exists as long as the instrument is not converted. On inception, the fair value of the liability component is the present value of the contractually determined stream of future cash flows discounted at the rate of interest applied by the market at that time to instruments of comparable credit status and providing substantially the same cash flows, on the same terms, but without the conversion option.

(b) The equity instrument is an embedded option to convert the liability into net assets/equity of the issuer. The fair value of the option comprises its time value and its intrinsic value, if any. The intrinsic value of an option or other derivative financial instrument is the excess, if any, of the fair value of the underlying financial instrument over the contractual price at which the underlying instrument is to be acquired, issued, sold or exchanged. The time value of a derivative instrument is its fair value less its intrinsic value. The time value is associated with the length of the remaining term to maturity or expiry of the derivative instrument. It reflects the revenue foregone by the holder of the derivative instrument from not holding the underlying instrument, the cost avoided by the holder of the derivative instrument from not having to finance the underlying instrument and the value placed on the probability that the intrinsic value of the derivative instrument will increase prior to its maturity or expiry due to future volatility in the fair value of the underlying instrument. It is uncommon for the embedded option in a convertible bond or similar instrument to have any intrinsic value on issuance.

A24. Paragraph 34 of the Standard describes how the components of a compound financial instrument may be valued on initial recognition. The following example illustrates in greater detail how such valuations may be made.

An entity issues 2,000 convertible bonds at the start of Year 1. The bonds have a three-year term, and are issued at par with a face value of 1,000 per bond, giving total proceeds of 2,000,000. Interest is payable annually in arrears at a nominal annual interest rate of 6%. Each bond is convertible at any time up to maturity into 250 common shares.

When the bonds are issued, the prevailing market interest rate for similar debt without conversion options is 9%. At the issue date, the market price of one common share is 3. The dividends expected over the three-year term of the bonds amount to 0.14 per share at the end of each year. The risk-free annual interest rate for a three-year term is 5%.

Residual Valuation of Equity Instrument Component:

Under this approach, the liability component is valued first, and the difference between the proceeds of the bond issue and the fair value of the liability is assigned to the net assets/equity component. The present value of the liability component is calculated using a discount rate of 9%, the market interest rate for similar bonds having no conversion rights, as shown.

Present value of the principal — 2,000,000 payable at the end of three years	1,544,367
Present value of the interest — 120,000 payable annually in arrears for three years	303,755
Total liability component	1,848,122
Equity instrument component (by deduction)	151,878
Proceeds of the bond issue	2,000,000

Option Pricing Model Valuation of Net Assets/Equity Component:

Option pricing models may be used to determine the fair value of conversion options directly rather than by deduction as illustrated above. Option pricing models are often used by financial institutions for pricing day-to-day transactions. There are a number of models available, of which the Black-Scholes model is one of the most well-known, and each has a number of variants. The following example illustrates the application of a version of the Black-Scholes model that utilises tables available in finance

textbooks and other sources. The steps in applying this version of the model are set out below.

This model first requires the calculation of two amounts that are used in the option valuation tables:

(a) Standard deviation of proportionate changes in the fair value of the asset underlying the option multiplied by the square root of the time to expiry of the option.

This amount relates to the potential for favorable (and unfavorable) changes in the price of the asset underlying the option, in this case the common shares of the entity issuing the convertible bonds. The volatility of the returns on the underlying asset are estimated by the standard deviation of the returns. The higher the standard deviation, the greater the fair value of the option. In this example, the standard deviation of the annual returns on the shares is assumed to be 30%. The time to expiry of the conversion rights is three years. The standard deviation of proportionate changes in fair value of the shares multiplied by the square root of the time to expiry of the option is thus determined as:

$0.3 \times \sqrt{3} = \underline{\underline{0.5196}}$

(b) Ratio of the fair value of the asset underlying the option to the present value of the option exercise price.

This amount relates the present value of the asset underlying the option to the cost that the option holder must pay to obtain that asset, and is associated with the intrinsic value of the option. The higher this amount, the greater the fair value of a call option. In this example, the market value of each share on issuance of the bonds is 3. The present value of the expected dividends over the term of the option is deducted from the market price, since the payment of dividends reduces the fair value of the shares and thus the fair value of the option. The present value of a dividend of 0.14 per share at the end of each year, discounted at the risk-free rate of 5%, is 0.3813. The present value of the asset underlying the option is therefore:

3 - 0.3813 = 2.6187 per share

The present value of the exercise price is 4 per share discounted at the risk-free rate of 5% over three years, assuming that the bonds are converted at maturity, or 3.4554. The ratio is thus determined as:

$2.6187 \div 3.4554 = \underline{\underline{0.7579}}$

The bond conversion option is a form of call option. The call option valuation table indicates that, for the two amounts calculated above (i.e,

0.5196 and 0.7579), the fair value of the option is approximately 11.05% of the fair value of the underlying asset.

The valuation of the conversion options can therefore be calculated as:

0.1105 × 2.6187 per share × 250 shares per bond × 2,000 bonds = 144,683

The fair value of the debt component of the compound instrument calculated above by the present value method plus the fair value of the option calculated by the Black–Scholes option pricing model does not equal the 2,000,000 proceeds from issuance of the convertible bonds (i.e., 1,848,122 + 144,683 = 1,992,805). The small difference can be prorated over the fair values of the two components to produce a fair value for the liability of 1,854,794 and a fair value for the option of 145,206.

Offsetting of a Financial Asset and a Financial Liability

A25. The Standard does not provide special treatment for so-called "synthetic instruments," which are groupings of separate financial instruments acquired and held to emulate the characteristics of another instrument. For example, a floating rate long-term debt combined with an interest rate swap that involves receiving floating payments and making fixed payments synthesizes a fixed rate long-term debt. Each of the separate components of a "synthetic instrument" represents a contractual right or obligation with its own terms and conditions and each may be transferred or settled separately. Each component is exposed to risks that may differ from the risks to which other components are exposed. Accordingly, when one component of a "synthetic instrument" is an asset and another is a liability, they are not offset and presented on an entity's statement of financial position on a net basis unless they meet the criteria for offsetting in paragraph 39 of the Standard. Such is often not the case. Disclosures are provided about the significant terms and conditions of each financial instrument constituting a component of a "synthetic instrument" without regard to the existence of the "synthetic instrument," although an entity may indicate in addition the nature of the relationship between the components (see paragraph 58 of the Standard).

Disclosure

A26. Paragraph 60 of the Standard lists examples of broad categories of matters that, when significant, an entity addresses in its disclosure of accounting policies. In each case, an entity has a choice from among two or more different accounting treatments. The following discussion elaborates on the examples in paragraph 60 and provides further examples of circumstances in which an entity discloses its accounting policies.

(a) An entity may acquire or issue a financial instrument under which the obligations of each party are partially or completely unperformed (sometimes referred to as an unexecuted or executory contract). Such a financial instrument may involve a future exchange and performance may be conditional on a future event. For example, neither the right nor the obligation to make an exchange under a forward contract results in any transaction in the underlying financial instrument until the maturity of the contract but the right and obligation constitute a financial asset and a financial liability, respectively. Similarly, a financial guarantee does not require the guarantor to assume any obligation to the holder of the guaranteed debt until an event of default has occurred. The guarantee is, however, a financial liability of the guarantor because it is a contractual obligation to exchange one financial instrument (usually cash) for another (a receivable from the defaulted debtor) under conditions that are potentially unfavorable.

(b) An entity may undertake a transaction that, in form, constitutes a direct acquisition or disposition of a financial instrument but does not involve the transfer of the economic interest in it. Such is the case with some types of repurchase and reverse repurchase agreements. Conversely, an entity may acquire or transfer to another party an economic interest in a financial instrument through a transaction that, in form, does not involve an acquisition or disposition of legal title. For example, in a non-recourse borrowing, an entity may pledge accounts receivable as collateral and agree to use receipts from the pledged accounts solely to service the loan.

(c) An entity may undertake a partial or incomplete transfer of a financial asset. For example, in a securitization, an entity acquires or transfers to another party some, but not all, of the future economic benefits associated with a financial instrument.

(d) An entity may be required, or intend, to link two or more individual financial instruments to provide specific assets to satisfy specific obligations. Such arrangements include, for example, “in substance” defeasance trusts in which financial assets are set aside for the purpose of discharging an obligation without those assets having been accepted by the creditor in settlement of the obligation, non-recourse secured financing and sinking fund arrangements.

(e) An entity may use various risk management techniques to minimize exposures to financial risks. Such techniques include, for example, hedging, interest rate conversion from floating rate to fixed rate or fixed rate to floating rate, risk diversification, risk pooling, guarantees and various types of insurance (including sureties and “hold harmless” agreements). These techniques generally reduce the

exposure to loss from only one of several different financial risks associated with a financial instrument and involve the assumption of additional but only partially offsetting risk exposures.

(f) An entity may link two or more separate financial instruments together notionally in a "synthetic instrument" or for some purposes other than those described in items (d) and (e) above.

(g) An entity may acquire or issue a financial instrument in a transaction in which the amount of the consideration exchanged for the instrument is uncertain. Such transactions may involve non-cash consideration or an exchange of several items.

(h) An entity may acquire or issue a bond, promissory note or other monetary instrument with a stated amount or rate of interest that differs from the prevailing market interest rate applicable to the instrument. Such financial instruments include zero coupon bonds and loans made on apparently favorable terms but involving non-cash consideration, for example, low interest rate loans to employees.

A27. Paragraph 61 of the Standard lists several issues that an entity addresses in its disclosure of accounting policies when the issues are significant to the application of the cost basis of measurement. In the case of uncertainty about the collectibility of amounts realizable from a monetary financial asset or a decline in the fair value of a financial asset below its carrying amount due to other causes, an entity indicates its policies for determining:

(a) When to reduce the carrying amount of the asset;

(b) The amount to which it reduces the carrying amount;

(c) How to recognize any revenue from the asset; and

(d) Whether the reduction in carrying amount may be reversed in the future if circumstances change.

Appendix 3

Examples of Disclosure Requirements

This appendix is illustrative only and does not form part of the standards. The purpose of the appendix is to illustrate the application of the standards and to assist in clarifying their meaning. The appendix illustrates an economic entity which includes a number of partly- privatized GBEs that have issued convertible notes and preference shares.

Note X1. Summary of Accounting Policies (Extract)

Trade Receivables

Trade receivables are carried at original invoice amount less an estimate made for doubtful receivables based on a review of all outstanding amounts at the year end. Bad debts are written off when identified.

Investments

Interests in listed and unlisted securities, other than controlled entities and associates in the consolidated financial statements, are recognized at cost and dividend revenue is recognized in the statement of financial performance when receivable.

The principal amount of zero coupon bonds is calculated by discounting the cash flow associated with the ultimate redemption of the investment. The discount is amortized over the period to maturity. The discount rate is that implicit in the transaction.

Borrowings

Loans and debentures are carried at their principal amounts which represent the present value of future cash flows associated with servicing the debt. Interest is accrued over the period it becomes due and is recorded as part of other creditors.

On issue of convertible notes, the fair value of the liability component, being the obligation to make future payments of principal and interest to noteholders, is calculated using a market interest rate for an equivalent non-convertible note. The residual amount, representing the fair value of the conversion option, is included in equity as other equity securities with no recognition of any change in the value of the option in subsequent periods. The liability is included in borrowings and carried on an amortized cost basis with interest on the notes recognized as borrowing costs on an effective yield basis until the liability is extinguished on conversion or maturity of the notes.

Redeemable preference shares which provide for mandatory redemption or which are redeemable at the option of the holder are included in liabilities as they are, in

substance, borrowings. Dividends payable on the shares are recognized in the statement of financial performance as interest and finance charges on an accruals basis.

Derivative Financial Instruments

The entity enters into forward foreign exchange contracts and interest rate swap agreements.

The net amount receivable or payable under interest rate swap agreements is progressively recognized over the period to settlement. The amount recognized is accounted for as an adjustment to interest and finance charges during the period and included in other debtors or other creditors at each reporting date.

Note X2. Financial Risk Management

Financial Risk Factors

The entity's activities expose it to a variety of financial risks, including the effects of: changes in debt and equity market prices, foreign currency exchange rates and interest rates. The entity's overall risk management program focuses on the unpredictability of financial markets and seeks to minimize potential adverse effects on the financial performance of the entity. The entity uses derivative financial instruments such as interest rate swaps and foreign exchange contracts to hedge certain exposures.

Risk management is carried out by a central treasury agency (Treasury Corporation) under policies approved by its Governing Board and consistent with the prudential guidelines set down by the Ministry for Finance. Treasury Corporation identifies, evaluates and hedges financial risks in close co-operation with the operating units. The Board provides written principles for overall risk management, as well as written policies covering specific areas, such as foreign exchange risk, interest rate risk, credit risk, use of derivative financial instruments and investing excess liquidity.

Interest Rate Risk

The entity's revenue and operating cash flows are substantially independent of changes in market interest rates. The entity has no significant interest-bearing assets. The entity's policy is to maintain approximately 80% of its borrowings in fixed rate instruments. At the year end 75% were at fixed rates. The entity sometimes borrows at variable rates and uses interest rate swaps as cash flow hedges of future interest payments, which have the economic effect of converting borrowings from floating rates to fixed rates. The interest rate swaps allow the entity to raise long-term borrowings at floating rates and swap them into fixed rates that are lower than those available if it borrowed at fixed rates directly. Under the interest rate swaps, the entity agrees with other parties to exchange, at specified intervals (mainly quarterly),

the difference between fixed contract rates and floating rate interest amounts calculated by reference to the agreed notional principal amounts.

Credit Risk

The entity has no significant concentrations of credit risk. Derivative counterparties and cash transactions are limited to high credit quality financial institutions. The entity has policies that limit the amount of credit exposure to any one financial institution.

Liquidity Risk

Prudent liquidity risk management includes maintaining sufficient cash and marketable securities, the availability of funding through an adequate amount of committed credit facilities and the ability to close out market positions. Treasury Corporation aims at maintaining flexibility in funding by keeping committed credit lines available.

Fair Value Estimation

The fair value of publicly traded derivatives and trading and available-for-sale securities is based on quoted market prices at the reporting date. The fair value of interest rate swaps is calculated as the present value of the estimated future cash flows. The fair value of forward foreign exchange contracts is determined using forward exchange market rates at the reporting date.

In assessing the fair value of non-traded derivatives and other financial instruments, the entity uses a variety of methods and makes assumptions that are based on market conditions existing at each reporting date. Quoted market prices or dealer quotes for the specific or similar instruments are used for long-term debt. Other techniques, such as option pricing models and estimated discounted value of future cash flows, are used to determine fair value for the remaining financial instruments.

The face values less any estimated credit adjustments for financial assets and liabilities with a maturity of less than one year are assumed to approximate their fair values. The fair value of financial liabilities for disclosure purposes is estimated by discounting the future contractual cash flows at the current market interest rate available to the entity for similar financial instruments.

Note X3. Financial Instruments

(i) Off-balance-sheet Derivative Instruments

The entity is party to derivative financial instruments in the normal course of its operations in order to hedge exposure to fluctuations in interest and foreign exchange rates.

Interest Rate Swap Contracts

Loans of the entity currently bear an average variable interest rate of 8.5%. It is policy to protect part of the loans from exposure to increasing interest rates. Accordingly, the entity has entered into interest rate swap contracts under which it is obliged to receive interest at variable rates and to pay interest at fixed rates. The contracts are settled on a net basis and the net amount receivable or payable at the reporting date is included in other debtors or other creditors.

The contracts require settlement of net interest receivable or payable each 90 days. The settlement dates coincide with the dates on which interest is payable on the underlying debt.

Swaps currently in place cover approximately 60% (20X1–40%) of the loan principal outstanding and are timed to expire as each loan repayment falls due. The fixed interest rates range between 7.8% and 8.3% (20X1–9.0% and 9.6%) and the variable rates are between 0.5% and 1.0% above the 90 day bank bill rate which at the reporting date was 8.2% (20X1–9.4%).

At 30 June 20X2, the notional principal amounts and periods of expiry of the interest rate swap contracts are as follows:

	20X2	**20X1**
	$'000	$'000
Less than 1 year	**30**	20
1–2 years	**250**	170
2–3 years	**250**	170
3–4 years	**300**	80
4–5 years	**180**	–
	1,010	440

Forward Exchange Contracts

The passenger rail system is being substantially upgraded. New rolling stock is being purchased from Country A and Country B. In order to protect against exchange rate movements, the entity has entered into forward exchange contracts to purchase Foreign Currency A (FCA) and Foreign Currency B (FCB).

The contracts are timed to mature when major shipments of rolling stock are scheduled to arrive and cover anticipated purchases for the ensuing financial year.

At the reporting date, the details of outstanding contracts are:

Buy FC_A	**Sell Domestic Currency**		**Average exchange rate**	
	20X2	20X1	**20X2**	20X1
	$'000	$'000		
Maturity				
0–6 months	**2,840**	3,566	**0.7042**	0.7010
6–12 months	**4,152**	1,466	**0.7225**	0.6820

Buy FC_B	**Sell Domestic Currency**		**Average exchange rate**	
	20X2	20X1	**20X2**	20X1
	$'000	$'000		
Maturity				
0–6 months	**4,527**	2,319	**0.6627**	0.6467
6–12 months	**–**	1,262	**–**	0.6337

As these contracts are hedging anticipated future purchases, any unrealized gains and losses on the contracts, together with the cost of the contracts, are deferred and will be recognized in the measurement of the underlying transaction. Included in the amounts deferred are any gains and losses on hedging contracts terminated prior to maturity where the related hedged transaction is still expected to occur.

(ii) Credit Risk Exposures

The credit risk on financial assets of the entity which have been recognized on the statement of financial position, other than investments in shares, is generally the carrying amount, net of any provisions for doubtful debts.

Bills of exchange and zero coupon bonds which have been purchased at a discount to face value, are carried on the statement of financial position at an amount less than the amount realizable at maturity. The total credit risk exposure of the entity could also be considered to include the difference between the carrying amount and the realizable amount.

The recognized financial assets of the consolidated entity include amounts receivable arising from unrealized gains on derivative financial instruments. For off-balance-sheet financial instruments, including derivatives, which are deliverable, credit risk also arises from the potential failure of counterparties to meet their obligations under the respective contracts at maturity. A material exposure arises from forward exchange contracts and the consolidated entity is exposed to loss in the event that counterparties fail to deliver the contracted amount. At the reporting date the following amounts are receivable (domestic currency equivalents):

	20X2	20X1
	$'000	$'000
Domestic Currency	**2,073**	1,422
Foreign Currency	**11,599**	8,613

(iii) Interest Rate Risk Exposures

The entity's exposure to interest rate risk and the effective weighted average interest rate by maturity periods is set out in the following table. For interest rates applicable to each class of asset or liability refer to individual notes to the financial statements [not shown here].

Exposures arise predominantly from assets and liabilities bearing variable interest rates as the entity intends to hold fixed rate assets and liabilities to maturity.

20X2	Floating interest rate $'000	1 year or less $'000	Over 1 to 5 years $'000	More than 5 years $'000	Non-interest bearing $'000	Total $'000
Financial assets						
Cash and deposits	3,952	–	–	–	250	4,202
Receivables	–	386	416	860	5,523	7,185
Other financial assets – investments	–	–	260	–	1,400	1,660
	3,952	386	676	860	7,173	13,047
Weighted average interest rate	7.85%	8.77%	8.69%	8.82%		
Financial liabilities						
Bank overdrafts and loans	2,880	–	–	–	–	2,880
Trade and other creditors	–	–	–	–	3,145	3,145
Bills payable	–	250	–	–	–	250
Convertible notes	–	–	–	1,800	–	1,800
Redeemable preference shares	–	–	–	1,000	–	1,000
Other loans	–	50	180	200	–	430
Debentures	–	200	300	1,500	–	2,000
Lease liabilities	–	80	350	145	–	575
Interest rate swaps*	(1,010)	30	980	–	–	–
	1,870	610	1,810	4,645	3,145	12,080
Weighted average interest rate	8.64%	8.94%	9.24%	7.95%		
Net financial assets (liabilities)	2,082	(224)	(1,134)	(3,785)	4,028	967

* Notional principal amounts.

20X1	Floating interest rate $'000	1 year or less $'000	Over 1 to 5 years $'000	More than 5 years $'000	Non-interest bearing $'000	Total $'000
Financial assets						
Cash and deposits	2,881	–	–	–	200	3,081
Receivables	–	156	70	250	4,059	4,535
Other financial assets – investments	–	–	–	–	500	500
	2,881	156	70	250	4,759	8,116
Weighted average interest rate	8.75%	9.20%	9.83%	5%		
Financial liabilities						
Bank overdrafts and loans	3,150	–	–	–	–	3,150
Trade and other creditors	–	–	–	–	2,412	2,412
Bills payable	–	130	–	–	–	130
Redeemable preference shares	–	–	–	1,000	–	1,000
Other loans	–	50	100	–	–	150
Debentures	–	1,000	800	1,200	–	3,000
Lease liabilities	–	75	365	210	–	650
Interest rate swaps*	(440)	20	420	–	–	–
	2,710	1,275	1,685	2,410	2,412	10,492
Weighted average interest rate	9.98%	10.28%	10.23%	10.25%		
Net financial assets (liabilities)	171	(1,119)	(1,615)	(2,160)	2,347	(2,376)

* Notional principal amounts.

(iv) Net Fair Value of Financial Assets and Liabilities

On-balance-sheet

The net fair value of cash and cash equivalents and non-interest bearing monetary financial assets and financial liabilities of the entity approximates their carrying amounts.

The net fair value of other monetary financial assets and financial liabilities is based upon market prices where a market exists or by discounting the expected future cash flows by the current interest rates for assets and liabilities with similar risk profiles.

Equity investments traded on organised markets have been valued by reference to market prices prevailing at the reporting date. For non-traded equity investments, the net fair value is an assessment by the Treasury Corporation based on the underlying net assets, future maintainable earnings and any special circumstances pertaining to a particular investment.

Off-balance-sheet

The entity has been indemnified against any losses which might be incurred in relation to shares in certain non-government corporations. The net fair value of the indemnity has been taken to be the difference between the carrying amount and the net fair value of the shares.

The call option granting an unrelated party an option to acquire the entity's interest Inter-Provincial Airlines is out-of-the money and the net fair value is immaterial.

Debentures which were the subject of an in-substance defeasance and for which the entity has guaranteed repayment have a net fair value equal to their face value.

The net fair value of financial assets or financial liabilities arising from interest rate swap agreements has been determined as the carrying amount, which represents the amount currently receivable or payable at the reporting date, and the present value of the estimated future cash flows which have not been recognized as an asset or liability.

For forward exchange contracts, the net fair value is taken to be the unrealised gain or loss at the reporting date calculated by reference to the current forward rates for contracts with similar maturity profiles.

The entity has potential financial liabilities which may arise from certain contingencies. No material losses are anticipated in respect of any of those contingencies and the net fair value disclosed below is the Ministry for Finance's estimate of amounts which would be payable by the entity as consideration for the assumption of those contingencies by another party.

The carrying amount and net fair values of financial assets and financial liabilities at the reporting date are:

	20X2		20X1	
	Carrying amount $'000	**Net fair value $'000**	Carrying amount $'000	Net fair value $'000
On-balance-sheet financial instruments				
Financial assets				
Cash	**250**	**250**	200	200
Deposits	**3,952**	**3,952**	2,881	2,881
Trade debtors	**5,374**	**5,374**	3,935	3,935
Bills of exchange	**440**	**437**	140	140
Loans to directors	**147**	**121**	136	107
Other debtors	**424**	**425**	124	124
Loans to related parties	**800**	**800**	200	200
Shares in other related parties	**200**	**227**	200	227
Shares in other corporations	**100**	**100**	200	190
Zero coupon bonds	**60**	**58**	–	–
Non-traded financial assets	**11,747**	**11,744**	8,016	8,004
Traded investments				
Shares in non-government corporations	**1,100**	**900**	100	60
Debentures	**200**	**215**	–	–
	13,047	**12,859**	8,116	8,064
Financial liabilities				
Trade creditors	**2,405**	**2,405**	1,762	1,762
Other creditors	**740**	**740**	650	650
Bank overdraft	**2,350**	**2,350**	2,250	2,250
Bank loans	**530**	**537**	900	898
Bills payable	**250**	**241**	130	130
Convertible notes	**1,800**	**1,760**	–	–
Redeemable preference shares	**1,000**	**875**	1,000	860
Other loans	**430**	**433**	150	150
Lease liabilities	**575**	**570**	650	643
Non-traded financial liabilities	**10,080**	**9,911**	7,492	7,343
Off-balance-sheet financial instruments	**2,000**	**2,072**	3,000	3,018
Financial assets	**12,080**	**11,983**	10,492	10,361

Indemnity received	**–** (i)	**200**	– (i)	40
Forward exchange contracts	**61** (ii)	**61**	26	26
Interest rate swaps	**2** (ii)	**13**	1	2
	63	**274**	27	68
Financial liabilities				
Call options	**–**	**–**	–	–
Debentures defeased	**–**	**1,000**	–	–
Forward exchange contracts	**607** (ii)	**402**	304	231
Contingencies	**–**	**25**	–	30
	607	**1,427**	304	261

(i) Included in the carrying amount of traded investments above.

(ii) The carrying amounts are unrealized gains or losses which have been included in the on-balance-sheet financial assets and liabilities disclosed above.

Other than those classes of assets and liabilities denoted as "traded," none of the classes of financial assets and liabilities are readily traded on organized markets in standardized form.

Although certain financial assets are carried at an amount above net fair value, the Governing Board has not caused those assets to be written down as it is intended to retain those assets to maturity.

Net fair value is exclusive of costs which would be incurred on realization of an asset, and inclusive of costs which would be incurred on settlement of a liability.

Comparison with IAS 32

International Public Sector Accounting Standard (IPSAS) 15, "Financial Instruments: Disclosure and Presentation" is drawn primarily from International Accounting Standard (IAS) 32 (revised 1998), "Financial Instruments: Disclosure and Presentation." The main differences between IPSAS 15 and IAS 32 are as follows:

- IAS 32 was amended in October 2000 to eliminate disclosure requirements that became redundant as a result of Internal Accounting Standard (IAS) 39, "Financial Instruments: Recognition and Measurement." As yet, there is no IPSAS addressing the issue of the recognition and measurement of financial instruments. Consequently, the sections on Hedges of Anticipated Future Transactions and Other Disclosures have been retained in IPSAS 15.
- Commentary additional to that in IAS 32 has been included in IPSAS 15 to clarify the applicability of the standards to accounting by public sector entities.
- IPSAS 15 uses different terminology, in certain instances, from IAS 32. The most significant examples are the use of the terms "entity," "revenue," "statement of financial performance," "statement of financial position" (except for references to "on- and off-balance-sheet") and "net assets/equity" (except for references to "equity instruments") in IPSAS 15. The equivalent terms in IAS 32 are "enterprise," "income," "income statement," "balance sheet" and "equity."
- IPSAS 15 includes a definition of an insurance contract. Insurance contracts are only explained in commentary in IAS 32.
- IPSAS 15 includes an implementation guide to assist preparers of financial statements (Appendix 1). IAS 32 does not include such a guide.
- IPSAS 15 includes an illustration of the disclosures required under the Standard (Appendix 3). No example of disclosure requirements is included in IAS 32.

IPSAS 16—INVESTMENT PROPERTY

Acknowledgment

This International Public Sector Accounting Standard is drawn primarily from International Accounting Standard (IAS) 40 (2000), "Investment Property" 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 IASC. The International Accounting Standards (IASs) issued by IASC remain in force until they are amended or withdrawn by IASB. Extracts from IAS 40 are reproduced in this publication of the Public Sector Committee of the International Federation of Accountants with the permission of IASB.

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December 2001

IPSAS 16—INVESTMENT PROPERTY

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The standards, which have been set in bold type, should be read in the context of the commentary paragraphs in this Standard, which are in plain type, and in the context of the "Preface to International Public Sector Accounting Standards." International Public Sector Accounting Standards are not intended to apply to immaterial items.

Objective

The objective of this International Public Sector Accounting Standard is to prescribe the accounting treatment for investment property and related disclosure requirements.

Scope

1. **An entity which prepares and presents financial statements under the accrual basis of accounting should apply this Standard in accounting for investment property.**

2. **This Standard applies to all public sector entities other than Government Business Enterprises.**

3. This Standard deals with accounting for investment property including the measurement in a lessee's financial statements of investment property held under a finance lease and with the measurement in a lessor's financial statements of investment property leased out under an operating lease. This Standard does not deal with matters covered in International Public Sector Accounting Standard (IPSAS) 13, "Leases," including:

    (a) Classification of leases as finance leases or operating leases;

    (b) Recognition of lease revenue earned on investment property (see also IPSAS 9, "Revenue from Exchange Transactions");

    (c) Measurement in a lessee's financial statements of property held under an operating lease;

    (d) Measurement in a lessor's financial statements of property leased out under a finance lease;

    (e) Accounting for sale and leaseback transactions; and

    (f) Disclosure about finance leases and operating leases.

4. This Standard does not apply to:

    (a) Forests and similar regenerative natural resources; and

    (b) Mineral rights, the exploration for and extraction of minerals, oil, natural gas and similar non-regenerative resources.

5. Government Business Enterprises (GBEs) are required to comply with International Accounting Standards (IASs) issued by the International

Accounting Standards Committee. The Public Sector Committee's Guideline No. 1, "Financial Reporting by Government Business Enterprises" notes that IASs are relevant to all business enterprises, regardless of whether they are in the private or public sector. Accordingly, Guideline No. 1 recommends that GBEs should present financial statements that conform, in all material respects, to IASs.

Definitions

6. **The following terms are used in this Standard with the meanings specified:**

   Carrying amount is (for the purpose of this Standard) the amount at which an asset is recognized in the statement of financial position.

   Cost is 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.

   Fair value is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.

   Investment property is 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.**

   Owner-occupied property is 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.

   Terms defined in other International Public Sector Accounting Standards are used in this Standard with the same meaning as in those other Standards, and are reproduced in the Glossary of Defined Terms published separately.

Investment Property

7. There are a number of circumstances in which public sector entities may hold property to earn rental and for capital appreciation. For example, a public sector entity (other than a GBE) may be established to manage a government's property portfolio on a commercial basis. In this case, the property held by the entity, other than property held for resale in the

ordinary course of operations, meets the definition of an investment property. Other public sector entities may also hold property for rentals or capital appreciation and use the cash generated to finance their other (service delivery) activities. For example, a university or local government may own a building for the purpose of leasing on a commercial basis to external parties to generate funds, rather than to produce or supply goods and services. This property would also meet the definition of investment property.

8. Investment property is held to earn rentals or for capital appreciation or both. Therefore, investment property generates cash flows largely independently of the other assets held by an entity. This distinguishes investment property from other land or buildings controlled by public sector entities, including owner-occupied property. The production or supply of goods or services (or the use of property for administrative purposes) can also generate cash flows. For example, public sector entities may use a building to provide goods and services to recipients in return for full or partial cost recovery. However, the building is held to facilitate the production of goods and services and the cash flows are attributable not merely to the building, but also to other assets used in the production or supply process. IPSAS 17, "Property, Plant and Equipment" applies to owner-occupied property.

9. In some public sector jurisdictions, certain administrative arrangements exist such that an entity may control an asset that may be legally owned by another entity. For example, a government department may control and account for certain buildings that are legally owned by the State. In such circumstances, references to owner-occupied property means property occupied by the entity that recognizes the property in its financial statements.

10. The following are examples of investment property:

    (a) Land held for long-term capital appreciation rather than for short-term sale in the ordinary course of operations. For example, land held by a hospital for capital appreciation which may be sold at a beneficial time in the future;

    (b) Land held for a currently undetermined future use. (If an entity has not determined that it will use the land either as owner-occupied property, including occupation to provide services such as those provided by national parks to current and future generations, or for short-term sale in the ordinary course of operations, the land is considered to be held for capital appreciation);

(c) A building owned by the reporting entity (or held by the reporting entity under a finance lease) and leased out under one or more operating leases on a commercial basis. For example, a university may own a building that it leases on a commercial basis to external parties; and

(d) A building that is vacant but is held to be leased out under one or more operating leases on a commercial basis to external parties.

11. The following are examples of items that are not investment property and therefore fall outside the scope of this Standard:

(a) Property held for sale in the ordinary course of operations or in the process of construction or development for such sale (see IPSAS 12, "Inventories"). For example, a municipal government may routinely supplement rate income by buying and selling property, in which case property held exclusively with a view to subsequent disposal in the near future or for development for resale is classified as inventory. A housing department may routinely sell part of its housing stock in the ordinary course of its operations as a result of changing demographics, in which case any housing stock held for sale is classified as inventory;

(b) Property being constructed or developed on behalf of third parties. For example, a property and service department may enter into construction contracts with entities external to its government (see (see IPSAS 11, "Construction Contracts");

(c) Owner-occupied property (see IPSAS 17), including (among other things) property held for future use as owner-occupied property, property held for future development and subsequent use as owner-occupied property, property occupied by employees such as housing for military personnel (whether or not the employees pay rent at market rates) and owner-occupied property awaiting disposal;

(d) Property that is being constructed or developed for future use as investment property. IPSAS 17 applies to such property until construction or development is complete, at which time the property becomes investment property and this Standard applies. However, this Standard does apply to existing investment property that is being redeveloped for continued future use as investment property (see paragraph 61);

(e) Property held to provide a social service and which also generates cash inflows. For example, a housing department may hold a large housing stock used to provide housing to low income families at below market rental. In this situation, the property is held to provide housing services rather than for rentals or capital appreciation and

rental revenue generated is incidental to the purposes for which the property is held. Such property is not considered an "investment property" and would be accounted for in accordance with IPSAS 17; and

(f) Property held for strategic purposes which would be accounted for in accordance with IPSAS 17.

12. In many jurisdictions, public sector entities will hold property to meet service delivery objectives rather than to earn rental or for capital appreciation. In such situations the property will not meet the definition of investment property. However, where a public sector entity does hold property to earn rental or for capital appreciation, this Standard is applicable. In some cases, public sector entities hold certain property that includes a portion that is held to earn rentals or for capital appreciation rather than to provide services and another portion that is held for use in the production or supply of goods or services or for administrative purposes. For example, a hospital or a university may own a building, part of which is used for administrative purposes, and part of which is leased out as apartments on a commercial basis. If these portions could be sold separately (or leased out separately under a finance lease), an entity accounts for the portions separately. If the portions could not be sold separately, the property is investment property only if an insignificant portion is held for use in the production or supply of goods or services or for administrative purposes.

13. In certain cases, an entity provides ancillary services to the occupants of a property held by the entity. An entity treats such a property as investment property if the services are a relatively insignificant component of the arrangement as a whole. An example would be where a government agency owns an office building which is held exclusively for rental purposes and rented on a commercial basis and also provides security and maintenance services to the lessees who occupy the building.

14. In other cases, the services provided are a more significant component. For example, a government may own a hotel or hostel that it manages through its general property management agency. The services provided to guests are a significant component of the arrangement as a whole. Therefore, an owner-managed hotel or hostel is owner-occupied property, rather than investment property.

15. It may be difficult to determine whether ancillary services are so significant that a property does not qualify as investment property. For example, a government or government agency which is the owner of a hotel may transfer certain responsibilities to third parties under a management contract. The terms of such management contracts vary widely. At one end

of the spectrum, the government's or government agency's position may, in substance, be that of a passive investor. At the other end of the spectrum, the government or government agency may simply have outsourced certain day-to-day functions while retaining significant exposure to variation in the cash flows generated by the operations of the hotel.

16. Judgment is needed to determine whether a property qualifies as investment property. An entity develops criteria so that it can exercise that judgment consistently in accordance with the definition of investment property and with the related guidance in paragraphs 7 to 15. Paragraph 75(a) requires an entity to disclose these criteria when classification is difficult.

17. Under IPSAS 13, a lessee does not capitalize property held under an operating lease. Therefore, the lessee does not treat its interest in such property as investment property.

18. In some cases, an entity owns property that is leased to, and occupied by, its controlling entity or another controlled entity. The property does not qualify as investment property in consolidated financial statements that include both entities, because the property is owner-occupied from the perspective of the economic entity as a whole. However, from the perspective of the individual entity that owns it, the property is investment property if it meets the definition in paragraph 6. Therefore, the lessor treats the property as investment property in its individual financial statements. This situation may arise where a government establishes a property management entity to manage government office buildings. The buildings are then leased out to other government entities on a commercial basis. In the financial statements of the property management entity, the property would be accounted for as investment property. However, in the consolidated financial statements of the government the property would be accounted for as property, plant and equipment in accordance with IPSAS 17.

Recognition

19. **Investment property should be recognized as an asset when, and only when:**

    (a) **It is probable that the future economic benefits or service potential that are associated with the investment property will flow to the entity; and**

    (b) **The cost or fair value of the investment property can be measured reliably.**

20. In determining whether an item satisfies the first criterion for recognition, an entity needs to assess the degree of certainty attaching to the flow of future economic benefits or service potential on the basis of the available

evidence at the time of initial recognition. Existence of sufficient certainty that the future economic benefits or service potential will flow to the entity necessitates an assurance that the entity will receive the rewards attaching to the asset and will undertake the associated risks. This assurance is usually only available when the risks and rewards have passed to the entity. Before this occurs, the transaction to acquire the asset can usually be cancelled without significant penalty and, therefore, the asset is not recognized.

21. The second criterion for recognition is usually readily satisfied because the exchange transaction evidencing the purchase of the asset identifies its cost. As specified in paragraph 23 of this Standard, under certain circumstances an investment property may be acquired at no cost or for a nominal cost. In such cases, cost is the investment property's fair value as at the date of acquisition.

Initial Measurement

22. **Investment property should be measured initially at its cost (transaction costs should be included in this initial measurement).**

23. **Where an investment property is acquired at no cost, or for a nominal cost, its cost is its fair value as at the date of acquisition.**

24. The cost of a purchased investment property comprises its purchase price and any directly attributable expenditure. Directly attributable expenditure includes, for example, professional fees for legal services, property transfer taxes and other transaction costs.

25. The cost of a self-constructed investment property is its cost at the date when the construction or development is complete. Until that date, an entity applies IPSAS 17. At that date, the property becomes investment property and this Standard applies (see paragraphs 59(e) and 69 below).

26. The cost of investment property is not increased by start-up costs (unless they are necessary to bring the property to its working condition), initial operating losses incurred before the investment property achieves the planned level of occupancy or abnormal amounts of wasted material, labor or other resources incurred in constructing or developing the property.

27. If payment for investment property is deferred, its cost is the cash price equivalent. The difference between this amount and the total payments is recognized as interest expense over the period of credit.

28. An investment property may be gifted or contributed to the entity. For example, a national government may transfer at no charge a surplus office building to a local government entity, which then lets it out at market rent.

An investment property may also be acquired for no cost, or for a nominal cost, through the exercise of powers of sequestration. In these circumstances, the cost of the property is its fair value as at the date it is acquired.

29. Where an entity initially recognizes its investment property at fair value in accordance with paragraph 23, the fair value is the cost of the property. The entity may decide, subsequent to initial recognition, to adopt either the fair value model (paragraphs 35 to 57) or the cost model (paragraph 58).

Subsequent Expenditure

30. **Subsequent expenditure relating to an investment property that has already been recognized should be added to the carrying amount of the investment property when it is probable that future economic benefits or service potential over the total life of the investment property, in excess of the most recently assessed standard of performance of the existing investment property, will flow to the entity. All other subsequent expenditure should be recognized as an expense in the period in which it is incurred.**

31. Subsequent expenditure on investment property is only recognized as an asset when the expenditure improves the condition of the asset, measured over its total life, beyond its most recently assessed standard of performance. The appropriate accounting treatment for expenditure incurred subsequent to the acquisition of an investment property depends on the circumstances which were taken into account on the initial measurement and recognition of the related investment and whether subsequent expenditure is recoverable. For instance, when the carrying amount of an investment property already takes into account a loss in future economic benefits or service potential, subsequent expenditure to restore the future economic benefits or service potential expected from the asset is capitalized. This is also the case when the purchase price of an asset reflects the entity's obligation to incur expenditure that is necessary in the future to bring the asset to its working condition. An example of this might be the acquisition of a building requiring renovation. In such circumstances, the subsequent expenditure is added to the carrying amount.

Measurement Subsequent to Initial Recognition

32. **An entity should choose either the fair value model in paragraphs 35 to 57 or the cost model in paragraph 58 as its accounting policy and should apply that policy to all of its investment property.**

33. IPSAS 3, "Net Surplus or Deficit for the Period, Fundamental Errors and Changes in Accounting Policies," states that a voluntary change in accounting policy should be made only if the change will result in a more

appropriate presentation of events or transactions in the financial statements of the entity. It is highly unlikely that a change from the fair value model to the cost model will result in a more appropriate presentation.

34. This Standard requires all entities to determine the fair value of investment property for the purpose of measurement (fair value model) or disclosure (cost model). An entity is encouraged, but not required, to determine the fair value of investment property on the basis of a valuation by an independent valuer who holds a recognized and relevant professional qualification and who has recent experience in the location and category of the investment property being valued.

Fair Value Model

35. **After initial recognition, an entity that chooses the fair value model should measure all of its investment property at its fair value, except in the exceptional cases described in paragraph 55.**

36. **A gain or loss arising from a change in the fair value of investment property should be included in net surplus/deficit for the period in which it arises.**

37. The fair value of investment property is usually its market value. Fair value is measured as the most probable price reasonably obtainable in the market at the reporting date in keeping with the fair value definition. It is the best price reasonably obtainable by the seller and the most advantageous price reasonably obtainable by the buyer. This estimate specifically excludes an estimated price inflated or deflated by special terms or circumstances such as atypical financing, sale and leaseback arrangements, special considerations or concessions granted by anyone associated with the sale.

38. An entity determines fair value without any deduction for transaction costs that the entity may incur on sale or other disposal.

39. **The fair value of investment property should reflect the actual market state and circumstances as of the reporting date, not as of either a past or future date.**

40. The estimated fair value is time specific as of a given date. Because markets and market conditions may change, the estimated value may be incorrect or inappropriate at another time. The definition of fair value also assumes simultaneous exchange and completion of the contract for sale without any variation in price that might be made in an arm's length transaction between knowledgeable, willing parties if exchange and completion are not simultaneous.

41. The fair value of investment property reflects, among other things, rental revenue from current leases and reasonable and supportable assumptions that represent the market's view of what knowledgeable, willing parties would assume about rental revenue from future leases in the light of current market conditions.

42. The definition of fair value refers to "knowledgeable, willing parties." In this context, "knowledgeable" means that both the willing buyer and the willing seller are reasonably informed about the nature and characteristics of the investment property, its actual and potential uses, and the state of the market as of the reporting date.

43. A willing buyer is motivated, but not compelled to buy. This buyer is neither over-eager nor determined to buy at any price. This buyer is also one who purchases in accordance with the realities of the current market, and with the current market expectations, rather than an imaginary or hypothetical market that cannot be demonstrated or anticipated to exist. The assumed buyer would not pay a higher price than the market requires. The present owner of an investment property is included among those who constitute the market.

44. A willing seller is neither an over-eager nor a forced seller, prepared to sell at any price, nor one prepared to hold out for a price not considered reasonable in the current market. The willing seller is motivated to sell the investment property at market terms for the best price obtainable in the open market after proper marketing, whatever that price may be. The factual circumstances of the actual investment property owner are not a part of this consideration because the willing seller is a hypothetical owner.

45. The expression "after proper marketing" means that the investment property would be exposed to the market in the most appropriate manner to effect its disposal at the best price reasonably obtainable. The length of exposure time may vary with market conditions, but must be sufficient to allow the investment property to be brought to the attention of an adequate number of potential purchasers. The exposure period is assumed to occur prior to the reporting date.

46. The definition of fair value refers to an arm's length transaction. An arm's length transaction is one between parties who do not have a particular or special relationship that makes prices of transactions uncharacteristic of the market. The transaction is presumed to be between unrelated parties, each acting independently.

47. The best evidence of fair value is normally given by current prices on an active market for similar property in the same location and condition and

subject to similar lease and other contracts. An entity takes care to identify any differences in the nature, location or condition of the property, or in the contractual terms of the leases and other contracts relating to the property.

48. In the absence of current prices on an active market of the kind described in paragraph 47, an entity considers information from a variety of sources, including:

(a) Current prices on an active market for properties of different nature, condition or location (or subject to different lease or other contracts), adjusted to reflect those differences;

(b) Recent prices on less active markets, with adjustments to reflect any changes in economic conditions since the date of the transactions that occurred at those prices; and

(c) Discounted cash flow projections based on reliable estimates of future cash flows, supported by the terms of any existing lease and other contracts and (where possible) by external evidence such as current market rents for similar properties in the same location and condition, and using discount rates that reflect current market assessments of the uncertainty in the amount and timing of the cash flows.

49. In some cases, the various sources listed in the previous paragraph may suggest different conclusions as to the fair value of an investment property. An entity considers the reasons for those differences, in order to arrive at the most reliable estimate of fair value within a relatively narrow range of reasonable fair value estimates.

50. In exceptional cases, there is clear evidence when an entity first acquires an investment property (or when an existing property first becomes an investment property following the completion of construction or development, or after a change in use) that the variability in the range of reasonable fair value estimates will be so great and the probabilities of the various outcomes will be so difficult to assess, that the usefulness of a single estimate of fair value is negated. This may indicate that the fair value of the property will not be determinable reliably on a continuing basis (see paragraph 55).

51. Fair value differs from value in use, as defined in IAS 36, "Impairment of Assets."[1] Fair value reflects knowledge and estimates of participants in the

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[1] IAS 36, "Impairment of Assets," defines value in use as "the present value of estimated future cash flows expected to arise from the continuing use of an asset and from its disposal at the end of its life." The PSC is currently developing a Standard on impairment of assets. The PSC has issued an

market, as well as factors that are relevant to market participants in general. In contrast, value in use reflects the entity's knowledge and estimates, as well as entity-specific factors that may be specific to the entity and that are not applicable to entities in general. For example, fair value does not reflect any:

(a) Additional value derived from the creation of a portfolio of properties in different locations;

(b) Synergies between investment property and other assets;

(c) Legal rights or legal restrictions that are specific only to the current owner; and

(d) Tax benefits or tax burdens that are specific to the current owner.

52. In determining the fair value of investment property, an entity avoids double counting of assets or liabilities that are recognized in the statement of financial position as separate assets or liabilities. For example:

(a) Equipment such as elevators or air-conditioning is often an integral part of a building and is generally included in the investment property, rather than being recognized separately as property, plant and equipment;

(b) If an office is leased on a furnished basis, the fair value of the office generally includes the fair value of the furniture, because the rental revenue relates to the furnished office. When furniture is included in the fair value of investment property, an entity does not recognize that furniture as a separate asset; and

(c) The fair value of investment property excludes prepaid or accrued operating lease revenue, as the entity recognizes it as a separate liability or asset.

53. The fair value of investment property does not reflect future capital expenditure that will improve or enhance the property and does not reflect the related future benefits from this future expenditure.

54. In some cases, an entity expects that the present value of its payments relating to an investment property (other than payments relating to recognized financial liabilities) will exceed the present value of the related cash receipts. Guidance on accounting for any liability that may arise in this

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Invitation to Comment (ITC) "Impairment of Assets" (issued July 2000). Responses received on this ITC will assist the PSC in developing an International Public Sector Accounting Standard on the impairment of assets.

situation may be found in IPSAS 19, "Provisions, Contingent Liabilities and Contingent Assets."

Inability to Measure Fair Value Reliably

55. **There is a rebuttable presumption that an entity will be able to determine the fair value of an investment property reliably on a continuing basis. However, in exceptional cases, there is clear evidence when an entity first acquires an investment property (or when an existing property first becomes investment property following the completion of construction or development, or after a change in use) that the entity will not be able to determine the fair value of the investment property reliably on a continuing basis. This arises when, and only when, comparable market transactions are infrequent and alternative estimates of fair value (for example, based on discounted cash flow projections) are not available. In such cases, an entity should measure that investment property using the benchmark treatment in IPSAS 17, "Property, Plant and Equipment." The residual value of the investment property should be assumed to be zero. The entity should continue to apply IPSAS 17 until the disposal of the investment property.**

56. In the exceptional cases when an entity is compelled, for the reason given in the previous paragraph, to measure an investment property using the IPSAS 17 benchmark treatment (being the cost model as explained in paragraph 58 below), the entity measures all its other investment property at fair value.

57. **If an entity has previously measured an investment property at fair value, the entity should continue to measure the property at fair value until disposal (or until the property becomes owner-occupied property or the entity begins to develop the property for subsequent sale in the ordinary course of operations) even if comparable market transactions become less frequent or market prices become less readily available.**

Cost Model

58. **After initial recognition, an entity that chooses the cost model should measure all of its investment property using the benchmark treatment in IPSAS 17 "Property, Plant and Equipment," that is, at cost less any accumulated depreciation and any accumulated impairment losses.**

Transfers

59. **Transfers to, or from, investment property should be made when, and only when, there is a change in use, evidenced by:**

(a) **commencement of owner-occupation, for a transfer from investment property to owner-occupied property;**

(b) **commencement of development with a view to sale, for a transfer from investment property to inventories;**

(c) **End of owner-occupation, for a transfer from owner-occupied property to investment property;**

(d) **Commencement of an operating lease (on a commercial basis) to another party, for a transfer from inventories to investment property; or**

(e) **End of construction or development, for a transfer from property in the course of construction or development (covered by IPSAS 17) to investment property.**

60. A government's use of property may change over time. For example, a government may decide to occupy a building currently used as an investment property or to convert a building currently used as naval quarters or for administrative purposes into a hotel and to let that building to private sector operators. In the former case, the building would be accounted for as an investment property until commencement of occupation. In the latter case, the building would be accounted for as property, plant and equipment until its occupation ceased and it is reclassified as an investment property.

61. Paragraph 59(b) above requires an entity to transfer a property from investment property to inventories when, and only when, there is a change in use, evidenced by commencement of development with a view to sale. When an entity decides to dispose of an investment property without development, the entity continues to treat the property as an investment property until it is derecognized (eliminated from the statement of financial position) and does not treat it as inventory. Similarly, if an entity begins to redevelop an existing investment property for continued future use as investment property, it remains an investment property and is not reclassified as owner-occupied property during the redevelopment.

62. A government property department may regularly review its buildings to determine whether they are meeting its requirements, and as part of that process may identify, and hold, certain buildings for sale. In this situation, the building may be considered inventory. However, if the government decided to hold the building for its ability to generate rent revenue and its capital appreciation potential it would be reclassified as an investment property on commencement of any subsequent operating lease.

63. Paragraphs 64 to 69 deal with recognition and measurement issues that apply when an entity uses the fair value model for investment property.

When an entity uses the cost model, transfers between investment property, owner-occupied property and inventories do not change the carrying amount of the property transferred and they do not change the cost of that property for measurement or disclosure purposes.

64. **For a transfer from investment property carried at fair value to owner-occupied property or inventories, the property's cost for subsequent accounting under IPSAS 17 or IPSAS 12, "Inventories" should be its fair value at the date of change in use.**

65. **If an owner-occupied property becomes an investment property that will be carried at fair value, an entity should apply IPSAS 17 up to the date of change in use. The entity should treat any difference at that date between the carrying amount of the property under IPSAS 17 and its fair value in the same way as a revaluation under IPSAS 17.**

66. Up to the date when an owner-occupied property becomes an investment property carried at fair value, an entity continues to depreciate the property and to recognize any impairment losses that have occurred. The entity treats any difference at that date between the carrying amount of the property under IPSAS 17 and its fair value in the same way as a revaluation under IPSAS 17. This means that:

    (a) Any resulting decrease in the carrying amount of the property is recognized in net surplus/deficit for the period. However, to the extent that an amount is included in revaluation surplus for that property, the decrease is charged against that revaluation surplus; and

    (b) Any resulting increase in the carrying amount is treated as follows:

        (i) To the extent that the increase reverses a previous impairment loss for that property, the increase is recognized in net surplus/deficit for the period. The amount recognized in net surplus/deficit for the period does not exceed the amount needed to restore the carrying amount to the carrying amount that would have been determined (net of depreciation) had no impairment loss been recognized; and

        (ii) Any remaining part of the increase is credited directly to equity under the heading of revaluation surplus. On subsequent disposal of the investment property, the revaluation surplus included in equity may be transferred to accumulated surpluses or deficits. The transfer from revaluation surplus to accumulated surpluses or deficits is not made through the statement of financial performance.

67. **For a transfer from inventories to investment property that will be carried at fair value, any difference between the fair value of the property at that date and its previous carrying amount should be recognized in net surplus/deficit for the period.**

68. The treatment of transfers from inventories to investment property that will be carried at fair value is consistent with the treatment of sales of inventories.

69. **When an entity completes the construction or development of a self-constructed investment property that will be carried at fair value, any difference between the fair value of the property at that date and its previous carrying amount should be recognized in net surplus/deficit for the period.**

Disposals

70. **An investment property should be derecognized (eliminated from the statement of financial position) on disposal or when the investment property is permanently withdrawn from use and no future economic benefits or service potential are expected from its disposal.**

71. The disposal of an investment property may occur by sale or by entering into a finance lease. In determining the date of disposal for investment property, an entity applies the criteria in IPSAS 9 for recognizing revenue from the sale of goods and considers the related guidance in the Appendix to IPSAS 9. IPSAS 13 applies on a disposal by entering into a finance lease or by a sale and leaseback.

72. **Gains or losses arising from the retirement or disposal of investment property should be determined as the difference between the net disposal proceeds and the carrying amount of the asset. For the purposes of display in the financial statements, the gain or loss should be included in the statement of financial performance as an item of revenue or expense, as appropriate (unless IPSAS 13 requires otherwise on a sale and leaseback).**

73. The consideration receivable on disposal of an investment property is recognized initially at fair value. In particular, if payment for an investment property is deferred, the consideration received is recognized initially at the cash price equivalent. The difference between the nominal amount of the consideration and the cash price equivalent is recognized as interest revenue under IPSAS 9 on a time proportion basis that takes into account the effective yield on the receivable. (Guidance on accounting for liabilities such as those that the entity retains after disposal of an investment property

may be found in IPSAS 19, on "Provisions, Contingent Assets and Contingent Liabilities").

Disclosure

Fair Value Model and Cost Model

74. The disclosures set out below apply in addition to those in IPSAS 13. Under IPSAS 13 the owner of an investment property gives a lessor's disclosures about operating leases. Under IPSAS 13 an entity that holds an investment property under a finance lease gives a lessee's disclosures about that finance lease and a lessor's disclosure about any operating leases that the entity has granted.

75. **An entity should disclose:**

    (a) **When classification is difficult (see paragraph 16), the criteria developed by the entity to distinguish investment property from owner-occupied property and from property held for sale in the ordinary course of operations;**

    (b) **The methods and significant assumptions applied in determining the fair value of investment property, including a statement whether the determination of fair value was supported by market evidence or was more heavily based on other factors (which the entity should disclose) because of the nature of the property and lack of comparable market data;**

    (c) **The extent to which the fair value of investment property (as measured or disclosed in the financial statements) is based on a valuation by an independent valuer who holds a recognized and relevant professional qualification and who has recent experience in the location and category of the investment property being valued. If there has been no such valuation, that fact should be disclosed;**

    (d) **The amounts included in the statement of financial performance for:**

        (i) **Rental revenue from investment property;**

        (ii) **Direct operating expenses (including repairs and maintenance) arising from investment property that generated rental revenue during the period; and**

        (iii) **Direct operating expenses (including repairs and maintenance) arising from investment property that did not generate rental revenue during the period;**

(e) **The existence and amounts of restrictions on the realizability of investment property or the remittance of revenue and proceeds of disposal; and**

(f) **Material contractual obligations to purchase, construct or develop investment property or for repairs, maintenance or enhancements.**

Fair Value Model

76. **In addition to the disclosure required by paragraph 75, an entity that applies the fair value model in paragraphs 35 to 57 should also disclose a reconciliation of the carrying amount of investment property at the beginning and end of the period showing the following (comparative information is not required):**

(a) **Additions, disclosing separately those additions resulting from acquisitions and those resulting from capitalized subsequent expenditure;**

(b) **Additions resulting from acquisitions through entity combinations;**

(c) **Disposals;**

(d) **Net gains or losses from fair value adjustments;**

(e) **The net exchange differences arising on the translation of the financial statements of a foreign entity;**

(f) **Transfers to and from inventories and owner-occupied property; and**

(g) **Other movements.**

77. **In the exceptional cases when an entity measures investment property using the benchmark treatment in IPSAS (because of the lack of a reliable fair value, see paragraph 55 above), the reconciliation required by the previous paragraph should disclose amounts relating to that investment property separately from amounts relating to other investment property. In addition, an entity should disclose:**

(a) **A description of the investment property;**

(b) **An explanation of why fair value cannot be reliably measured;**

(c) **If possible, the range of estimates within which fair value is highly likely to lie; and**

(d) **On disposal of investment property not carried at fair value:**

(i) **The fact that the entity has disposed of investment property not carried at fair value;**

(ii) **The carrying amount of that investment property at the time of sale; and**

(iii) **The amount of gain or loss recognized.**

Cost Model

78. **In addition to the disclosure required by paragraph 75, an entity that applies the cost model in paragraph 58 should also disclose:**

(a) **The depreciation methods used;**

(b) **The useful lives or the depreciation rates used;**

(c) **The gross carrying amount and the accumulated depreciation (aggregated with accumulated impairment losses) at the beginning and end of the period;**

(d) **A reconciliation of the carrying amount of investment property at the beginning and end of the period showing the following (comparative information is not required):**

(i) **Additions, disclosing separately those additions resulting from acquisitions and those resulting from capitalized subsequent expenditure;**

(ii) **Additions resulting from acquisitions through entity combinations;**

(iii) **Disposals;**

(iv) **Depreciation;**

(v) **The amount of impairment losses recognized, and the amount of impairment losses reversed, during the period;**

(vi) **The net exchange differences arising on the translation of the financial statements of a foreign entity;**

(vii) **Transfers to and from inventories and owner-occupied property; and**

(viii) **Other movements; and**

(e) **the fair value of investment property. In the exceptional cases described in paragraph 55, when an entity cannot determine the fair value of the investment property reliably, the entity should disclose:**

(i) **A description of the investment property;**

(ii) **An explanation of why fair value cannot be determined reliably; and**

(iii) **If possible, the range of estimates within which fair value is highly likely to lie.**

Transitional Provisions

Initial Adoption of Accrual Accounting

79. **Where, on adoption of the accrual basis of accounting for the first time, an entity initially recognizes investment property on adoption of this Standard, the entity should report the effect of the initial recognition of investment property as an adjustment to the opening balance of accumulated surpluses or deficits for the period in which the Standard is first adopted.**

80. **An entity that adopts accrual accounting for the first time in accordance with International Public Sector Accounting Standards may initially recognize investment property at cost or fair value. For investment properties that were acquired at no cost, or for a nominal cost, cost is the investment property's fair value as at the date of acquisition.**

81. When initially adopting this Standard, an entity may control investment property that it has not previously recognized. This Standard allows entities to initially recognize investment property at cost or fair value. Where assets are initially recognized at cost and were acquired at no cost, or for a nominal cost, cost will be determined by reference to the investment property's fair value as at the date of acquisition. Where the cost of acquisition of an investment property is not known, its cost may be estimated by reference to its fair value as at the date of acquisition.

Fair Value Model

82. **Under the fair value model, an entity should report the effect of adopting this Standard on its effective date (or earlier) as an adjustment to the opening balance of accumulated surpluses or deficits for the period in which the Standard is first adopted. In addition:**

    (a) **If the entity has previously disclosed publicly (in financial statements or otherwise) the fair value of its investment property in earlier periods (determined on a basis that satisfies the definition of fair value in paragraph 6 and the guidance in paragraphs 37 to 54), the entity is encouraged, but not required, to:**

    (i) **Adjust the opening balance of accumulated surpluses or deficits for the earliest period presented for which such fair value was disclosed publicly; and**

(ii) **Restate comparative information for those periods; and**

(b) **If the entity has not previously disclosed publicly the information described in (a), the entity should not restate comparative information and should disclose that fact.**

83. On the initial application of this Standard an entity may choose to apply the fair value model in respect of investment property already recognized in its financial statements. When this occurs, this Standard requires any adjustment to the carrying amount of the investment property to be taken to accumulated surplus or deficit for the period in which the Standard is first applied. This Standard requires a different treatment from the benchmark and allowed alternative treatments for changes in accounting policies under IPSAS 3. IPSAS 3 requires comparative information to be restated (benchmark treatment) or additional pro forma comparative information on a restated basis to be disclosed (allowed alternative treatment) unless it is impracticable to do so.

84. When an entity first adopts this Standard, the adjustment to the opening balance of accumulated surpluses or deficits includes the reclassification of any amount held in revaluation surplus for investment property.

Cost Model

85. Prior to initial adoption of this Standard an entity may recognize its investment property on a basis other than cost, for example fair value or some other measurement basis. IPSAS 3 applies to any change in accounting policies that occurs when an entity first adopts this Standard and chooses to use the cost model. The effect of the change in accounting policies includes the reclassification of any amount held in revaluation surplus for investment property.

Effective Date

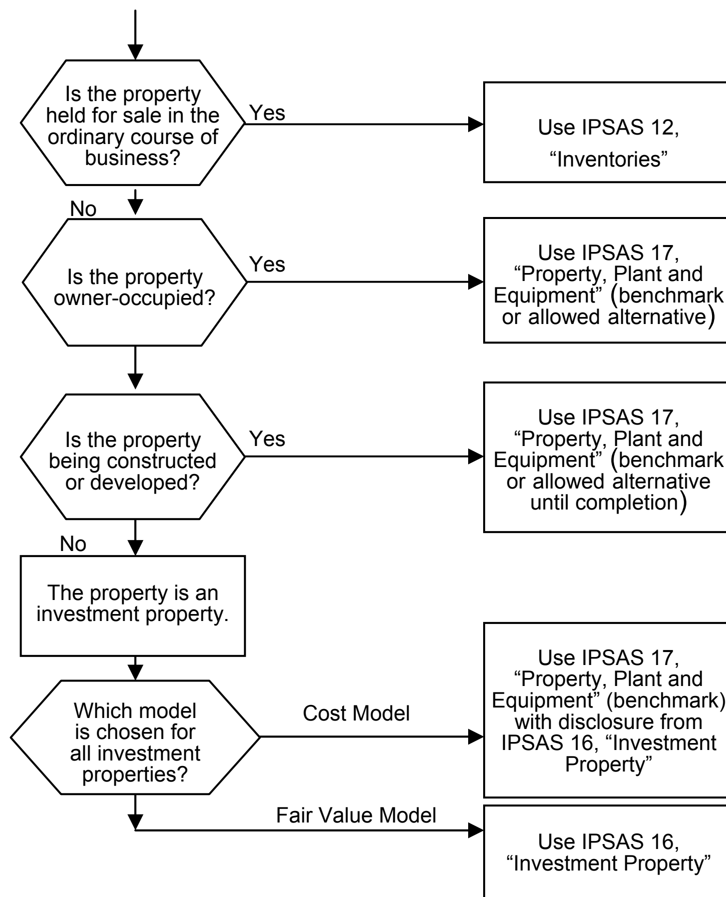
86. **This International Public Sector Accounting Standard becomes effective for annual financial statements covering periods beginning on or after January 1, 2003. Earlier application is encouraged. If an entity applies this Standard for periods beginning before January 1, 2003, it should disclose that fact.**

87. When an entity adopts the accrual basis of accounting, as defined by International Public Sector Accounting Standards, for financial reporting purposes, subsequent to this effective date, this Standard applies to the entity's annual financial statements covering periods beginning on or after the date of adoption.

Appendix

Decision Tree

The purpose of the following decision tree is to summarize which International Public Sector Accounting Standards apply to various kinds of property. This Appendix should be read in the context of the full standards.



Comparison with IAS 40

International Public Sector Accounting Standard (IPSAS) 16 "Investment Property" is drawn primarily from International Accounting Standard (IAS) 40 (2000), "Investment Property." The main differences between IPSAS 16 and IAS 40 are as follows:

- IPSAS 16 requires that investment property initially be measured at cost and specifies that where an asset is acquired for no cost or for a nominal cost, its cost is its fair value as at the date of acquisition. IAS 40 requires investment property to be initially measured at cost.
- There is additional commentary to make clear that IPSAS 16 does not apply to property held to deliver a social service which also generates cash inflows. Such property is accounted for in accordance with IPSAS 17, "Property, Plant and Equipment."
- IAS 40 requires subsequent expenditures on investment property to be capitalized when it is probable that future economic benefits in excess of the originally assessed standard of performance of the existing asset will flow to the entity. IPSAS 16 adopts a similar treatment, but refers to the most recently assessed standard of performance — rather than that originally assessed — as the benchmark.
- IPSAS 16 includes additional transitional provisions which specify that when an entity adopts the accrual basis of accounting for the first time and recognizes investment property that was previously unrecognized, the adjustment should be reported in the opening balance of accumulated surpluses or deficits. The transitional provisions also allow entities to recognize investment property at fair value on first adopting this Standard.
- At the time of issuing this Standard, the PSC has not considered the applicability of IAS 41, "Agriculture," to public sector entities, therefore IPSAS 16 does not reflect amendments made to IAS 40 consequent upon the issuing of International Accounting Standard IAS 41.
- Commentary additional to that in IAS 40 has been included in IPSAS 16 to clarify the applicability of the standards to accounting by public sector entities.
- IPSAS 16 uses different terminology, in certain instances, from IAS 40. The most significant examples are the use of the terms "entity," "revenue," "statement of financial performance" and "statement of financial position" in IPSAS 16. The equivalent terms in IAS 40 are "enterprise," "income," "income statement," and "balance sheet."

IPSAS 17—PROPERTY, PLANT AND EQUIPMENT

Acknowledgment

This International Public Sector Accounting Standard is drawn primarily from International Accounting Standard (IAS) 16 (revised 1998), "Property, Plant and Equipment" 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 IASC. The International Accounting Standards (IASs) issued by IASC remain in force until they are amended or withdrawn by IASB. Extracts from IAS 16 are reproduced in this publication of the Public Sector Committee of the International Federation of Accountants with the permission of IASB.

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IPSAS 17—PROPERTY, PLANT AND EQUIPMENT

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The standards, which have been set in bold type, should be read in the context of the commentary paragraphs in this Standard, which are in plain type, and in the context of the "Preface to International Public Sector Accounting Standards." International Public Sector Accounting Standards are not intended to apply to immaterial items.

Objective

The objective of this Standard is to prescribe the accounting treatment for property, plant and equipment. The principal issues in accounting for property, plant and equipment are the timing of recognition of the assets, the determination of their carrying amounts and the depreciation charges to be recognized in relation to them.

Scope

1. **An entity which prepares and presents financial statements under the accrual basis of accounting should apply this Standard in accounting for property, plant and equipment, except:**

   (a) **When a different accounting treatment has been adopted in accordance with another International Public Sector Accounting Standard; and**

   (b) **In respect of heritage assets. However, the disclosure requirements of paragraphs 73, 74 and 77 apply to those heritage assets that are recognized.**

2. **This Standard applies to all public sector entities other than Government Business Enterprises.**

3. This Standard applies to property, plant and equipment including:

   (a) Specialist military equipment; and

   (b) Infrastructure assets.

   The transitional provisions in paragraphs 80 to 87 provide relief from the requirement to recognize all property, plant and equipment during the five year transitional period.

4. This Standard does not apply to:

   (a) Forests and similar regenerative natural resources; and

   (b) Mineral rights, the exploration for and extraction of minerals, oil, natural gas and similar non-regenerative resources.

   However, this Standard does apply to property, plant and equipment used to develop or maintain the activities or assets covered in 4(a) or 4(b) but which are separable from those activities or assets.

5. This Standard also does not apply where other International Public Sector Accounting Standards or, in the absence of an International Public Sector Accounting Standard, other relevant international guidance, permits the initial recognition of the carrying amount of property, plant and equipment to be determined using an approach different from that prescribed in this Standard. For example, International Accounting Standard (IAS) 22, "Business Combinations" provides guidance on valuing property, plant and equipment when it is acquired in a business combination. However, in such cases all other aspects of the accounting treatment for these assets, including depreciation, are determined by the requirements of this Standard.

6. This Standard does not deal with certain aspects of the application of a comprehensive system reflecting the effects of changing prices (see International Public Sector Accounting Standard (IPSAS) 10, "Financial Reporting in Hyperinflationary Economies"). However, entities applying such a system are required to comply with all aspects of this Standard, except for those that deal with the measurement of property, plant and equipment subsequent to its initial recognition.

Heritage Assets

7. This Standard does not require an entity to recognize heritage assets that would otherwise meet the definition of, and recognition criteria for, property, plant and equipment. If an entity does recognize heritage assets, it must apply the disclosure requirements of this Standard and may, but is not required to, apply the measurement requirements of this Standard.

8. Some assets are described as "heritage assets" because of their cultural, environmental or historical significance. Examples of heritage assets include historical buildings and monuments, archaeological sites, conservation areas and nature reserves, and works of art. Certain characteristics, including the following, are often displayed by heritage assets (although these characteristics are not exclusive to such assets):

   (a) Their value in cultural, environmental, educational and historical terms is unlikely to be fully reflected in a financial value based purely on a market price;

   (b) Legal and/or statutory obligations may impose prohibitions or severe restrictions on disposal by sale;

   (c) They are often irreplaceable and their value may increase over time even if their physical condition deteriorates; and

   (d) It may be difficult to estimate their useful lives, which in some cases could be several hundred years.

Public sector entities may have large holdings of heritage assets that have been acquired over many years and by various means, including purchase, donation, bequest and sequestration. These assets are rarely held for their ability to generate cash inflows, and there may be legal or social obstacles to using them for such purposes.

9. Some heritage assets have service potential other than their heritage value, for example, an historic building being used for office accommodation. In these cases, they may be recognized and measured on the same basis as other items of property, plant and equipment. For other heritage assets, their service potential is limited to their heritage characteristics, for example, monuments and ruins. The existence of alternative service potential can affect the choice of measurement base.

10. The disclosure requirements in paragraphs 73 to 79 require entities to make disclosures about recognized assets. Therefore, entities that recognize heritage assets are required to disclose in respect of those assets such matters as, for example:

    (a) The measurement basis used;

    (b) The depreciation method used, if any;

    (c) The gross carrying amount;

    (d) The accumulated depreciation at the end of the period, if any; and

    (e) A reconciliation of the carrying amount at the beginning and end of the period showing certain components thereof.

Government Business Enterprises

11. Government Business Enterprises (GBEs) are required to comply with International Accounting Standards (IASs) issued by the International Accounting Standards Committee. The Public Sector Committee's Guideline No. 1, "Financial Reporting by Government Business Enterprises" notes that IASs are relevant to all business enterprises, regardless of whether they are in the private or public sector. Accordingly, Guideline No. 1 recommends that GBEs should present financial statements that conform, in all material respects, to IASs.

Definitions

12. **The following terms are used in this Standard with the meanings specified:**

    <u>Class of property, plant and equipment</u> means 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.

Cost is 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.

Depreciation is the systematic allocation of the depreciable amount of an asset over its useful life.

Depreciable amount is the cost of an asset, or other amount substituted for cost in the financial statements, less its residual value.

Fair value is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.

Property, plant and equipment are 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.**

Residual value is 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.

Useful life is either:

(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.**

Terms defined in other International Public Sector Accounting Standards are used in this Standard with the same meaning as in those other Standards, and are reproduced in the Glossary of Defined Terms published separately.

Recognition of Property, Plant and Equipment

13. **An item of property, plant and equipment should be recognized as an asset when:**

    (a) **It is probable that future economic benefits or service potential associated with the asset will flow to the entity; and**

    (b) **The cost or fair value of the asset to the entity can be measured reliably.**

14. Property, plant and equipment is often a major portion of the total assets of an entity, and therefore is significant in the presentation of its financial position. Furthermore, the determination of whether an expenditure represents an asset or an expense can have a significant effect on an entity's reported surplus or deficit from operating activities.

15. In determining whether an item satisfies the first criterion for recognition, an entity needs to assess the degree of certainty attaching to the flow of future economic benefits or service potential on the basis of the available evidence at the time of initial recognition. Existence of sufficient certainty that the future economic benefits or service potential will flow to the entity necessitates an assurance that the entity will receive the rewards attaching to the asset and will undertake the associated risks. This assurance is usually only available when the risks and rewards have passed to the entity. Before this occurs, the transaction to acquire the asset can usually be canceled without significant penalty and, therefore, the asset is not recognized.

16. The second criterion for recognition is usually readily satisfied because the exchange transaction evidencing the purchase of the asset identifies its cost. In the case of a self-constructed asset, a relevant and reliable measurement of the cost can be made from the transactions with parties external to the entity for the acquisition of the materials, labor and other inputs used during the construction process. In addition, as outlined in paragraphs 22 to 25 of this Standard, under certain circumstances cost is determined by reference to fair value.

17. In identifying what constitutes a separate item of property, plant and equipment, judgment is required in applying the criteria in the definition to specific circumstances or specific types of entities. It may be appropriate to aggregate individually insignificant items, such as library books, computer peripherals and small items of equipment, and to apply the criteria to the aggregate value. Most spare parts and servicing equipment are usually carried as inventory and recognized as an expense as consumed. However, major spare parts and stand-by equipment qualify as property, plant and equipment when the entity expects to use them during more than one period. Similarly, if the spare parts and servicing equipment can be used only in connection with an item of property, plant and equipment and their use is expected to be irregular, they are accounted for as property, plant and equipment and are depreciated over a time period not exceeding the useful life of the related asset.

18. In certain circumstances, it is appropriate to allocate the total expenditure on an asset to its component parts and account for each component separately. This is the case when the component assets have different useful

lives or provide economic benefits or service potential to the entity in a different pattern, thus necessitating use of different depreciation rates and methods. For example, the pavements, formation, curbs and channels, footpaths, bridges and lighting may need to be treated as separate items within a road system to the extent that they have different useful lives. Similarly, an aircraft body and its engines need to be treated as separate depreciable assets if they have different useful lives.

19. Property, plant and equipment may be acquired for safety or environmental reasons. The acquisition of such property, plant and equipment, while not directly increasing the future economic benefits or service potential of any particular existing asset, may be necessary in order for the entity to obtain the future economic benefits or service potential from its other assets. When this is the case, such acquisitions of property, plant and equipment qualify for recognition as assets, in that they enable future economic benefits or service potential from related assets to be derived by the entity in excess of what it could derive if they had not been acquired. However, such assets are only recognized to the extent that the resulting carrying amount of such an asset and related assets does not exceed the total economic benefits or service potential that the entity expects to recover from their continued use and ultimate disposal. For example, fire safety regulations may require a hospital to retro-fit new sprinkler systems. These enhancements are recognized as an asset because, without them, the entity is unable to operate the hospital in accordance with the regulations.

20. Specialist military equipment will normally meet the definition of property, plant and equipment and should be recognized as an asset in accordance with this Standard.

Infrastructure Assets

21. Some assets are commonly described as "infrastructure assets." While there is no universally accepted definition of infrastructure assets, these assets usually display some or all of the following characteristics:

    (a) They are part of a system or network;

    (b) They are specialized in nature and do not have alternative uses;

    (c) They are immovable; and

    (d) They may be subject to constraints on disposal.

    Although ownership of infrastructure assets is not confined to entities in the public sector, significant infrastructure assets are frequently found in the public sector. Infrastructure assets meet the definition of property, plant and equipment and should be accounted for in accordance with this Standard.

Examples of infrastructure assets include road networks, sewer systems, water and power supply systems and communication networks.

Initial Measurement of Property, Plant and Equipment

22. **An item of property, plant and equipment which qualifies for recognition as an asset should initially be measured at its cost.**

23. **Where an asset is acquired at no cost, or for a nominal cost, its cost is its fair value as at the date of acquisition.**

24. An item of property, plant and equipment may be gifted or contributed to the entity. For example, land may be contributed to a local government by a developer at nil or nominal consideration, to enable the local government to develop parks, roads and paths in the development. An asset may also be acquired at nil or nominal consideration through the exercise of powers of sequestration. Under these circumstances the cost of the item is its fair value as at the date it is acquired.

25. For the purposes of this Standard, the initial recognition of an item of property, plant and equipment, acquired at no or nominal cost, at its fair value consistent with the requirements of paragraph 23, does not constitute a revaluation. Accordingly, the revaluation requirements in paragraph 39, and the supporting commentary in paragraphs 40 to 45, only apply where an entity elects to revalue an item of property, plant and equipment in subsequent reporting periods.

Components of Cost

26. The cost of an item of property, plant and equipment comprises its purchase price, including import duties and non-refundable purchase taxes, and any directly attributable costs of bringing the asset to working condition for its intended use; any trade discounts and rebates are deducted in arriving at the purchase price. Examples of directly attributable costs are:

    (a) The cost of site preparation;

    (b) Initial delivery and handling costs;

    (c) Installation costs;

    (d) Professional fees such as for architects and engineers; and

    (e) The estimated cost of dismantling the asset and restoring the site, to the extent that it is recognized as a provision. Guidance on accounting for provisions is found in IPSAS 19, “Provisions, Contingent Liabilities and Contingent Assets.”

27. When payment for an item of property, plant and equipment is deferred beyond normal credit terms, its cost is the cash price equivalent; the difference between this amount and the total payments is recognized as interest expense over the period of credit unless it is capitalized in accordance with the allowed alternative treatment in IPSAS 5, "Borrowing Costs."

28. Administration and other general overhead costs are not a component of the cost of property, plant and equipment unless they can be directly attributed to the acquisition of the asset or bringing the asset to its working condition. Similarly, start-up and similar costs do not form part of the cost of an asset unless they are necessary to bring the asset to its working condition. Initial operating losses incurred prior to an asset achieving planned performance are recognized as an expense.

29. The cost of a self-constructed asset is determined using the same principles as for an acquired asset. If an entity makes similar assets for sale in the normal course of business, the cost of the asset is usually the same as the cost of producing the assets for sale (see IPSAS 12, "Inventories"). Therefore, any internal surpluses are eliminated in arriving at such costs. Similarly, the cost of abnormal amounts of wasted material, labor or other resources incurred in the production of a self-constructed asset, is not included in the cost of the asset. IPSAS 5 establishes criteria which need to be satisfied before interest costs can be recognized as a component of property, plant and equipment cost.

30. The cost of an asset held by a lessee under a finance lease is determined using the principles set out in IPSAS 13, "Leases."

Exchanges of Assets

31. An item of property, plant and equipment may be acquired in exchange or part exchange for a dissimilar item of property, plant and equipment or other asset. The cost of such an item is measured at the fair value of the asset received, which is equivalent to the fair value of the asset given up adjusted by the amount of any cash or cash equivalents transferred.

32. An item of property, plant and equipment may be acquired in exchange for a similar asset that has a similar use in the same line of business and which has a similar fair value. An item of property, plant and equipment may also be sold in exchange for an equity interest in a similar asset. In both cases, no gain or loss is recognized on the transaction. Instead, the cost of the new asset is the carrying amount of the asset given up. However, the fair value of the asset received may provide evidence of an impairment in the asset given up. Under these circumstances the asset given up is written down and this written-down value assigned to the new asset. Examples of exchanges

of similar assets include the exchange of buildings and other real estate, machinery, specialized equipment, and aircraft. If other assets such as cash are included as part of the exchange transaction this may indicate that the items exchanged do not have a similar value.

Subsequent Expenditure

33. **Subsequent expenditure relating to an item of property, plant and equipment that has already been recognized should be added to the carrying amount of the asset 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 expenditures should be recognized as expenses in the period in which they are incurred.**

34. Subsequent expenditure on property, plant and equipment is only recognized as an asset when the expenditure improves the condition of the asset, measured over its total life, beyond its most recently assessed standard of performance. Examples of improvements which result in increased future economic benefits or service potential include:

    (a) Modification of an item of plant to extend its useful life, including an increase in its capacity;

    (b) Upgrading machine parts to achieve a substantial improvement in the quality of output; and

    (c) Adoption of new production processes enabling a substantial reduction in recently assessed operating costs.

35. Expenditures related to repairs or maintenance of property, plant and equipment are made to restore or maintain the future economic benefits or service potential that an entity can expect from the most recently assessed standard of performance of the asset. As such, they are usually recognized as an expense when incurred. For example, the cost of servicing or overhauling plant and equipment is usually an expense since it restores, rather than increases, the most recently assessed standard of performance.

36. The appropriate accounting treatment for expenditures incurred subsequent to the acquisition of an item of property, plant and equipment depends on the circumstances which were taken into account on the initial measurement and recognition of the related item of property, plant and equipment and whether the subsequent expenditure is recoverable. For instance, when the carrying amount of the item of property, plant and equipment already takes into account a loss in economic benefits or service potential, the subsequent expenditures to restore the future economic benefits or service potential expected from the asset are capitalized, provided that the carrying amount

does not exceed the total economic benefits or service potential that the entity expects to recover from the continued use and ultimate disposal of the item. This is also the case when the purchase price of an asset already reflects the entity's obligation to incur expenditures in the future, which are necessary to bring the asset to its working condition. An example of this might be the acquisition of a building requiring renovation. In such circumstances, the subsequent expenditures are added to the carrying amount of the asset to the extent that they can be recovered from future use of the asset.

Example

An entity is upgrading a wastewater and effluent treatment plant. The plant was recently assessed to have a total life of 20,000 hours of operating time, and is operated for 6,000 hours over a year, leaving a remaining life of 14,000 hours. The plant then undergoes a major overhaul that adds a further 4,000 hours of operating time to its life. After the overhaul, the plant can be viewed as having a total life of 24,000 hours, which is an improvement on the previously assessed 20,000 hours, and the relevant expenditures are capitalized.

37. Major components of some items of property, plant and equipment may require replacement at regular intervals. For example, a road may need resurfacing every few years, a furnace may require relining after a specified number of hours of usage or aircraft interiors such as seats and galleys may require replacement several times during the life of the airframe. The components are accounted for as separate assets because they have useful lives different from those of the items of property, plant and equipment to which they relate. Therefore, provided the recognition criteria in paragraph 13 are satisfied, the expenditure incurred in replacing or renewing the component is accounted for as the acquisition of a separate asset and the replaced asset is written off.

Measurement Subsequent to Initial Recognition

Benchmark Treatment

38. **Subsequent to initial recognition as an asset, an item of property, plant and equipment should be carried at its cost less any accumulated depreciation and any accumulated impairment losses.**

Allowed Alternative Treatment

39. **Subsequent to initial recognition as an asset, an item of property, plant and equipment should be carried at a revalued amount, being its fair value at the date of the revaluation less any subsequent accumulated**

depreciation and subsequent accumulated impairment losses. Revaluations should be made with sufficient regularity such that the carrying amount does not differ materially from that which would be determined using fair value at the reporting date. The accounting treatment for revaluations is set out in paragraphs 49 to 51.

Revaluations

40. The fair value of items of property, plant and equipment is usually their market value, determined by appraisal. An appraisal of the value of an asset is normally undertaken by a member of the valuation profession, who holds a recognized and relevant professional qualification. For many assets, the fair value will be readily ascertainable by reference to quoted prices in an active and liquid market. For example, current market prices can usually be obtained for land, non-specialized buildings, motor vehicles and many types of plant and equipment.

41. For some public sector assets, it may be difficult to establish their market value because of the absence of market transactions for these assets. Some public sector entities may have significant holdings of such assets.

42. Where no evidence is available to determine the market value in an active and liquid market of an item of property, the fair value of the item may be established by reference to other items with similar characteristics, in similar circumstances and location. For example, the fair value of vacant government land that has been held for a long period during which time there have been few transactions may be estimated by reference to the market value of land with similar features and topography in a similar location for which market evidence is available. In the case of specialized buildings and other man-made structures, fair value may be estimated using depreciated replacement cost. In many cases, the depreciated replacement cost of an asset can be established by reference to the buying price of a similar asset with similar remaining service potential in an active and liquid market. In some cases, an asset's reproduction cost will be the best indicator of its replacement cost. For example, in the event of loss, a parliament building may be reproduced rather than replaced with alternative accommodation because of its significance to the community.

43. For items of plant and equipment of a specialized nature, fair value may be based on, for example, either reproduction cost or on depreciated replacement cost. The depreciated replacement cost of an item of plant or equipment may be established by reference to the market buying price of components used to produce the asset or the indexed price for the same or a similar asset based on a price for a previous period. When the indexed price method is used, judgment is required to determine whether production

technology has changed significantly over the period, and whether the capacity of the reference asset is the same as that of the asset being valued.

44. The frequency of revaluations depends upon the movements in the fair values of the items of property, plant and equipment being revalued. When the fair value of a revalued asset differs materially from its carrying amount, a further revaluation is necessary. Some items of property, plant and equipment may experience significant and volatile movements in fair value, thus necessitating annual revaluation. Such frequent revaluations are unnecessary for items of property, plant and equipment with only insignificant movements in fair value. Instead, revaluation every three or five years may be sufficient.

45. When an item of property, plant and equipment is revalued, any accumulated depreciation at the date of the revaluation is either:

    (a) Restated proportionately with the change in the gross carrying amount of the asset so that the carrying amount of the asset after revaluation equals its revalued amount. This method is often used when an asset is revalued by means of an index to its depreciated replacement cost; or

    (b) Eliminated against the gross carrying amount of the asset and the net amount restated to the revalued amount of the asset. For example, this method is used for buildings which are revalued to their market value.

    The amount of the adjustment arising on the restatement or elimination of accumulated depreciation forms part of the increase or decrease in carrying amount which is dealt with in accordance with paragraphs 49 and 50.

46. **When an item of property, plant and equipment is revalued, the entire class of property, plant and equipment to which that asset belongs should be revalued.**

47. A class of property, plant and equipment is a grouping of assets of a similar nature or function in an entity's operations. The following are examples of separate classes:

    (a) Land;

    (b) Operational buildings;

    (c) Roads;

    (d) Machinery;

    (e) Electricity transmission networks;

(f) Ships;

(g) Aircraft;

(h) Specialist military equipment;

(i) Motor vehicles;

(j) Furniture and fixtures;

(k) Office equipment; and

(l) Oil rigs.

48. The items within the class of property, plant and equipment are revalued simultaneously in order to avoid selective revaluation of assets and the reporting of amounts in the financial statements which are a mixture of costs and values as at different dates. However, a class of assets may be revalued on a rolling basis provided revaluation of the class of assets is completed within a short period of time and provided the revaluations are kept up to date.

49. **When the carrying amount of a class of assets is increased as a result of a revaluation, the increase should be credited directly to revaluation surplus. However, a revaluation increase should be recognized as revenue to the extent that it reverses a revaluation decrease of the same class of assets previously recognized as an expense.**

50. **When the carrying amount of a class of assets is decreased as a result of a revaluation, the decrease should be recognized as an expense. However, a revaluation 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.**

51. **Revaluation increases and decreases relating to individual assets within a class of property, plant and equipment must be offset against one another within that class but must not be offset in respect of assets in different classes.**

52. Some or all of the revaluation surplus included in net assets may be transferred directly to accumulated surpluses or deficits when the surplus is realized. The surplus may be realized, in part or in whole, on the retirement or disposal of some or all of the assets within the class of property, plant and equipment to which the surplus relates. However, some of the surplus may be realized as the assets are used by the entity; in such a case, the amount of the surplus realized is the difference between depreciation based on the revalued carrying amount of the assets and depreciation based on the

assets' original cost. The transfer from revaluation surplus to accumulated surpluses or deficits is not made through the statement of financial performance.

53. Guidance on the effects on taxes on surpluses, if any, resulting from the revaluation of property, plant and equipment can be found in IAS 12, "Income Taxes."

Depreciation

54. **The depreciable amount of an item of property, plant and equipment should be allocated on a systematic basis over its useful life. The depreciation method used should reflect the pattern in which the asset's economic benefits or service potential is consumed by the entity. The depreciation charge for each period should be recognized as an expense unless it is included in the carrying amount of another asset.**

55. As the economic benefits or service potential embodied in an asset is consumed by the entity, the carrying amount of the asset is reduced to reflect this consumption, normally by charging an expense for depreciation. A depreciation charge is made even if the value of the asset exceeds its carrying amount.

56. The economic benefits or service potential embodied in an item of property, plant and equipment is consumed by the entity principally through the use of the asset. However, other factors such as technical obsolescence and wear and tear while an asset remains idle often result in the diminution of the economic benefits or service potential that might have been expected to be available from the asset. Consequently, all the following factors need to be considered in determining the useful life of an asset:

    (a) The expected usage of the asset by the entity. Usage is assessed by reference to the asset's expected capacity or physical output;

    (b) The expected physical wear and tear, which depends on operational factors such as the number of shifts for which the asset is to be used and the repair and maintenance program of the entity, and the care and maintenance of the asset while idle;

    (c) Technical obsolescence arising from changes or improvements in production, or from a change in the market demand for the product or service output of the asset; and

    (d) Legal or similar limits on the use of the asset, such as the expiry dates of related leases.

57. The useful life of an asset is defined in terms of the asset's expected utility to the entity. The asset management policy of an entity may involve the

disposal of assets after a specified time or after consumption of a certain proportion of the economic benefits or service potential embodied in the asset. Therefore, the useful life of an asset may be shorter than its economic life. The estimation of the useful life of an item of property, plant and equipment is a matter of judgment based on the experience of the entity with similar assets.

58. Land and buildings are separable assets and are dealt with separately for accounting purposes, even when they are acquired together. Land normally has an unlimited life and, therefore, is not depreciated. Buildings have a limited life and, therefore, are depreciable assets. An increase in the value of the land on which a building stands does not affect the determination of the useful life of the building.

59. The depreciable amount of an asset is determined after deducting the residual value of the asset. In practice, the residual value of an asset is often insignificant and therefore is immaterial in the calculation of the depreciable amount. When the benchmark treatment is adopted and the residual value is likely to be significant, the residual value is estimated at the date of acquisition and is not subsequently increased for changes in prices. However, when the allowed alternative treatment is adopted, a new estimate is made at the date of any subsequent revaluation of the asset. The estimate is based on the residual value prevailing at the date of the estimate for similar assets which have reached the end of their useful lives and which have operated under conditions similar to those in which the asset will be used.

60. A variety of depreciation methods can be used to allocate the depreciable amount of an asset on a systematic basis over its useful life. These methods include the straight-line method, the diminishing balance method and the sum-of-the-units method. Straight-line depreciation results in a constant charge over the useful life of the asset. The diminishing balance method results in a decreasing charge over the useful life of the asset. The sum-of-the-units method results in a charge based on the expected use or output of the asset. The method used for an asset is selected based on the expected pattern of economic benefits or service potential and is consistently applied from period to period unless there is a change in the expected pattern of economic benefits or service potential from that asset.

61. The depreciation charge for a period is usually recognized as an expense. However, in some circumstances, the economic benefits or service potential embodied in an asset is absorbed by the entity in producing other assets rather than giving rise to an expense. In this case, the depreciation charge comprises part of the cost of the other asset and is included in its carrying amount. For example, the depreciation of manufacturing plant and

equipment is included in the costs of conversion of inventories (see IPSAS 12). Similarly, depreciation of property, plant and equipment used for development activities may be included in the cost of an intangible asset that is recognized in accordance with the relevant international or national accounting standard dealing with intangible assets.

Review of Useful Life

62. **The useful life of an item of property, plant and equipment should be reviewed periodically and, if expectations are significantly different from previous estimates, the depreciation charge for the current and future periods should be adjusted.**

63. During the life of an asset it may become apparent that the estimate of the useful life is inappropriate. For example, the useful life may be extended by subsequent expenditures on the asset which improve the condition of the asset beyond its most recently assessed standard of performance. Alternatively, technological changes or changes in the market for the products may reduce the useful life of the asset. In such cases, the useful life, and therefore the depreciation rate, is adjusted for the current and future periods.

64. The repair and maintenance policy of the entity may also affect the useful life of an asset. The policy may result in an extension of the useful life of the asset or an increase in its residual value. However, the adoption of such a policy does not negate the need to charge depreciation. Conversely, some assets may be poorly maintained or maintenance may be deferred indefinitely because of budgetary constraints. Where asset management policies exacerbate the wear and tear of an asset, its useful life should be reassessed and adjusted accordingly.

Review of Depreciation Method

65. **The depreciation method applied to property, plant and equipment should be reviewed periodically and, if there has been a significant change in the expected pattern of economic benefits or service potential from those assets, the method should be changed to reflect the changed pattern. When such a change in depreciation method is necessary the change should be accounted for as a change in accounting estimate and the depreciation charge for the current and future periods should be adjusted.**

Recoverability of the Carrying Amount—Impairment Losses

66. To determine whether an item is impaired, an entity applies the appropriate international or national accounting standard, dealing with impairment of

assets.[1] IAS 36, "Impairment of Assets" contains guidance on reviewing the carrying amount of assets held for generating positive cash flows, determining the recoverable amount of such assets and the recognition of impairment losses.

67. IAS 22 provides guidance on impairment losses recognized before the end of the first annual accounting period commencing after a business combination that is an acquisition.

Retirements and Disposals

68. **An item of property, plant and equipment should be eliminated from the statement of financial position on disposal or when the asset is permanently withdrawn from use and no future economic benefits or service potential is expected from its disposal.**

69. **Gains or losses arising from the retirement or disposal of an item of property, plant and equipment should be determined as the difference between the estimated net disposal proceeds and the carrying amount of the asset. For the purposes of display in the financial statements, the gain or loss should be included in the statement of financial performance as an item of revenue or expense, as appropriate.**

70. When an item of property, plant and equipment is exchanged for a similar asset under the circumstances described in paragraph 31, the cost of the acquired asset is equal to the carrying amount of the asset disposed of and no gain or loss results.

71. Sale and leaseback transactions are accounted for in accordance with IPSAS 13.

72. Property, plant and equipment which is retired from active use and held for disposal is carried at its carrying amount at the date when the asset is retired from active use. At least at each reporting date, an entity tests the asset for impairment under the relevant international or national accounting standard adopted in relation to impairment of assets and recognizes any impairment loss accordingly.

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[1] The Committee is currently developing a Standard on impairment of assets. The Committee has issued an exposure draft (ED) 23, "Impairment of Assets." Responses received on this ED will assist the Committee in developing an International Public Sector Accounting Standard on the impairment of assets.

Disclosure

73. **The financial statements should disclose, for each class of property, plant and equipment recognized in the financial statements:**

    (a) **The measurement bases used for determining the gross carrying amount. When more than one basis has been used, the gross carrying amount for that basis in each category should be disclosed;**

    (b) **The depreciation methods used;**

    (c) **The useful lives or the depreciation rates used;**

    (d) **The gross carrying amount and the accumulated depreciation (aggregated with accumulated impairment losses) at the beginning and end of the period; and**

    (e) **A reconciliation of the carrying amount at the beginning and end of the period showing:**

        (i) **Additions;**

        (ii) **Disposals;**

        (iii) **Acquisitions through business combinations;**

        (iv) **Increases or decreases during the period resulting from revaluations under paragraphs 39, 49 and 50 and from impairment losses (if any) recognized or reversed directly in net assets/equity under the appropriate international or national accounting standard adopted;**

        (v) **Impairment losses (if any) recognized in the statement of financial performance during the period under the appropriate international or national accounting standard adopted;**

        (vi) **Impairment losses (if any) reversed in the statement of financial performance during the period under the appropriate international or national accounting standard adopted;**

        (vii) **Depreciation;**

        (viii) **The net exchange differences arising on the translation of the financial statements of a foreign entity; and**

        (ix) **Other movements.**

74. **The financial statements should also disclose for each class of property, plant and equipment recognized in the financial statements:**

(a) **The existence and amounts of restrictions on title for property, plant and equipment pledged as securities for liabilities;**

(b) **The accounting policy for the estimated costs of restoring the site of items of property, plant and equipment;**

(c) **The amount of expenditures on account of property, plant and equipment in the course of construction; and**

(d) **The amount of commitments for the acquisition of property, plant and equipment.**

75. The selection of the depreciation method and the estimation of the useful life of the assets are matters of judgment. Therefore, disclosure of the methods adopted and the estimated useful lives or depreciation rates provides users of financial statements with information which allows them to review the policies selected by management and enables comparisons to be made with other entities. For similar reasons, it is necessary to disclose the depreciation allocated in a period and the accumulated depreciation at the end of that period.

76. An entity discloses the nature and effect of a change in an accounting estimate that has a material effect in the current period, or which is expected to have a material effect in subsequent periods, in accordance with IPSAS 3, “Net Surplus or Deficit for the Period, Fundamental Errors and Changes in Accounting Policy.” Such disclosure may arise from changes in estimates with respect to:

(a) Residual values;

(b) The estimated costs of dismantling and removing items of property, plant or equipment and restoring the site;

(c) Useful lives; and

(d) Depreciation method.

77. **When a class of property, plant and equipment is stated at revalued amounts the following should be disclosed:**

(a) **The basis used to revalue the assets within the class;**

(b) **The effective date of the revaluation;**

(c) **Whether an independent valuer was involved;**

(d) **The nature of any indices used to determine replacement cost;**

(e) **The revaluation surplus, indicating the movement for the period and any restrictions on the distribution of the balance to shareholders or other equity holders;**

(f) **The sum of all revaluation surpluses for individual items of property, plant and equipment within that class; and**

(g) **The sum of all revaluation deficits for individual items of property, plant and equipment within that class.**

78. An entity discloses information on impaired property, plant and equipment under the appropriate international or national accounting standard adopted in addition to the information required by paragraph 73(e)(iv) to (vi).

79. Financial statement users also find the following information relevant to their needs:

(a) The carrying amount of temporarily idle property, plant and equipment;

(b) The gross carrying amount of any fully depreciated property, plant and equipment that is still in use;

(c) The carrying amount of property, plant and equipment retired from active use and held for disposal; and

(d) When the benchmark treatment is used, the fair value of property, plant and equipment when this is materially different from the carrying amount.

Therefore, entities are encouraged to disclose these amounts.

Transitional Provisions

80. **Entities are not required to recognize property, plant and equipment for reporting periods beginning on a date within five years following the date of first adoption of this Standard.**

81. **An entity that adopts accrual accounting for the first time in accordance with International Public Sector Accounting Standards may initially recognize property, plant and equipment at cost or fair value. For items of property, plant and equipment that were acquired at no cost, or for a nominal cost, cost is the item's fair value as at the date of acquisition.**

82. Paragraph 13 of this Standard requires items of property, plant and equipment to be recognized when:

(a) It is probable that future economic benefits or service potential associated with the asset will flow to the entity; and

(b) The cost or fair value of the asset to the entity can be measured reliably.

83. The transitional provisions in paragraphs 80 and 81 are intended to give relief in situations where an entity is seeking to comply with the provisions of this Standard, in the context of implementing accrual accounting for the first time in accordance with International Public Sector Accounting Standards, with effect from the effective date of this Standard or subsequently. When entities adopt accrual accounting in accordance with International Public Sector Accounting Standards for the first time, there are often difficulties in compiling comprehensive information on the existence and valuation of assets. For this reason, for a five-year period following the date of first adoption of this Standard, entities are not required to comply fully with the requirements of paragraph 13.

84. Notwithstanding the transitional provisions in paragraphs 80 and 81, entities that are in the process of adopting accrual accounting are encouraged to comply in full with the provisions of this Standard as soon as possible.

85. The exemption from the requirements of paragraph 13 implies that the associated measurement and disclosure provisions of this Standard do not need to be complied with in respect of those assets or classes of asset that are not recognized under paragraphs 80 and 81.

86. When initially adopting this Standard, an entity may control assets that it has not previously recognized. This Standard allows entities to initially recognize items of property, plant and equipment at cost or fair value. Where assets are initially recognised at cost and were acquired at no cost, or for a nominal cost, cost will be determined by reference to the asset's fair value as at the date of acquisition. Where the cost of acquisition of an asset is not known, its cost may be estimated by reference to its fair value as at the date of acquisition.

87. **When an entity takes advantage of the transitional provisions in paragraphs 80 and 81 that fact should be disclosed. Information on the major classes of asset that have not been recognized by virtue of paragraph 80 should also be disclosed. When an entity takes advantage of the transitional provisions for a second or subsequent reporting period, details of the assets or classes of asset that were not recognized at the previous reporting date but which are now recognized should be disclosed.**

Effective Date

88. **This International Public Sector Accounting Standard becomes effective for annual financial statements covering periods beginning on or after January 1, 2003. Earlier application is encouraged.**

89. When an entity adopts the accrual basis of accounting, as defined by International Public Sector Accounting Standards, for financial reporting purposes, subsequent to this effective date, this Standard applies to the entity's annual financial statements covering periods beginning on or after the date of adoption.

Appendix

Illustrative Disclosures

The appendix is illustrative only and does not form part of the standards. The purpose of the appendix is to illustrate the application of the standards to assist in clarifying their meaning.

The Department of the Interior is a public sector entity that controls a wide range of property, plant and equipment and is responsible for replacement and maintenance of the property. The following are extracts from the notes to its Statement of Financial Position for the year ended 31 December 20X1 and illustrate the principal disclosures required under this Standard.

Notes

1. *Land*

   (a) Land consists of twenty thousand hectares at various locations. Land is valued at fair value as at 31 December 20X1, as determined by the Office of the National Valuer, an independent valuer.

   (b) Restrictions on Titles:

   Five hundred hectares of land (carried at 62,500 currency units) is designated as national interest land and may not be sold without the approval of the legislature. Two hundred hectares (carried at 25,000 currency units) of the national interest land and a further two thousand hectares (carried at 250,000 currency units) of other land are subject to title claims by former owners in an international court of human rights and the Court has ordered that the land may not be disposed of until the claim is decided; the Department recognizes the jurisdiction of the Court to hear these cases.

2. *Buildings*

   (a) Buildings consist of office buildings and industrial facilities at various locations.

   (b) Buildings are initially recognized at cost, but are subject to revaluation to fair value on an ongoing basis. The Office of the National Valuer determines fair value on a rolling basis within a short period of time. Revaluations are kept up to date.

   (c) Depreciation is calculated on a straight-line basis over the useful life of the building. Office buildings have a useful life of twenty-five years, and industrial facilities have a useful life of fifteen years.

   (d) The Department recognizes the estimated cost of restoration of building sites in the cost of the buildings, when those costs meet the recognition criteria of a liability.

(e) The Department has entered into five contracts for the construction of new buildings; total contract costs are 250,000 currency units.

3. *Machinery*

(a) Machinery is measured at cost less depreciation.

(b) Depreciation is calculated on a straight-line basis over the useful life of the machine.

(c) The machinery has various useful lives:

Tractors:	*10 years*
Washing Equipment:	*4 years*
Cranes:	*15 years*

(d) The Depart5ment has entered into a contract to replace the cranes it uses to clean and maintain the buildings—the contracted cost is 100,000 currency units.

4. *Furniture and Fixtures*

(a) Furniture and fixtures are measured at cost less depreciation.

(b) Depreciation is calculated on a straight-line basis over the useful life of the furniture and fixtures.

(c) All items within this class have a useful life of five years.

Reconciliations (in '000 of currency units)

	Land		**Buildings**		**Machinery**		**Furniture and Fixtures**	
Reporting Period	**20X1**	**20X0**	**20X1**	**20X0**	**20X1**	**20X0**	**20X1**	**20X0**
Opening Balance	2,250	2,025	2,090	2,260	1,085	1,100	200	150
Additions	-	-	250	100	120	200	20	100
Disposals	-	-	150	40	60	80	20	-
Depreciation (As per Statement of Financial Performance)	-	-	160	180	145	135	50	50
Revaluations (net)	250	225	- 30	- 50	-	-	-	-
Closing Balance (As per Statement of Financial Position	2,500	2,250	2,000	2,090	1,000	1,085	150	200

Sum of Revaluation Surpluses (Paragraph 77(f))	750	500	250	250	-	-	-	-
Sum of Revaluation Deficits (Paragraph 77(g))	25	25	380	350	-	-	-	-

Gross Carrying Amount	2,500	2,250	2,500	2,430	1,500	1,440	250	250
Accumulated Depreciation	-	-	500	340	500	355	100	50
Net Carrying Amount	2,500	2,250	2,000	2,090	1,000	1,085	150	200

Comparison with IAS 16

International Public Sector Accounting Standard (IPSAS) 17, "Property, Plant and Equipment" is drawn primarily from International Accounting Standard (IAS) 16 (revised 1998), "Property, Plant and Equipment." The main differences between IPSAS 17 and IAS 16 are as follows:

- At the time of issuing this Standard, the PSC has not considered the applicability of IAS 41, Agriculture, to public sector entities, therefore IPSAS 17 does not reflect amendments made to IAS 16 consequent upon the issuing of International Accounting Standard IAS 41.
- IPSAS 17 does not require or prohibit the recognition of heritage assets. An entity which recognizes heritage assets is required to comply with the disclosure requirements of this Standard with respect to those heritage assets that have been recognized and may, but is not required to, comply with other requirements of this Standard in respect of those heritage assets. IAS 16 does not have a similar exclusion.
- IAS 16 requires items of property, plant and equipment to be initially measured at cost. IPSAS 17 states that where an item is acquired at no cost, or for a nominal cost, its cost is its fair value as at the date it is acquired.
- IAS 16 requires subsequent expenditures on property, plant and equipment to be capitalized when it is probable that future economic benefits in excess of the originally assessed standard of performance of the existing asset will flow to the entity. IPSAS 17 adopts a similar treatment, but refers to the most recently assessed standard of performance—rather than that originally assessed—as the benchmark.
- IAS 16 requires, where an enterprise adopts the allowed alternative treatment and carries items of property, plant and equipment at revalued amounts, the equivalent historical cost amounts to be disclosed. This requirement is not included in IPSAS 17.
- Under IAS 16, revaluation increases and decreases may only be matched on an individual item basis. Under IPSAS 17, revaluation increases and decreases may be offset on a class of asset basis.
- IPSAS 17 does not provide an exemption from requiring comparative information for the disclosures in paragraph 73, IAS 16 provides an exemption.

- IPSAS 17 contains transitional provisions allowing entities to not recognize property, plant and equipment for reporting periods beginning on a date within five years following the date of first adoption of this Standard. The transitional provisions also allow entities to recognize property, plant and equipment at fair value on first adopting this Standard. IAS 16 does not include these transitional provisions.
- IPSAS 17 contains a different set of definitions of technical terms from IAS 16.
- The IASC Framework defines an asset as a resource controlled by an enterprise as a result of past events and from which future economic benefits are expected to flow to the enterprise. IPSAS 17 adopts a slightly amended definition that incorporates the notion of service potential.
- Commentary additional to that in IAS 16 has been included in IPSAS 17 to clarify the applicability of the standards to accounting by public sector entities.
- IPSAS 17 uses different terminology, in certain instances, from IAS 16. The most significant examples are the use of the terms “entity,” “revenue,” “statement of financial performance,” “statement of financial position” and “net assets/equity” in IPSAS 17. The equivalent terms in IAS 16 are “enterprise,” “income,” “income statement,” “balance sheet” and “equity.”

IPSAS 18—SEGMENT REPORTING

Acknowledgment

This International Public Sector Accounting Standard is drawn primarily from International Accounting Standard IAS 14 (Revised 1997), "Segment Reporting" 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 International Accounting Standards (IASs) issued by IASC remain in force until they are amended or withdrawn by IASB. Extracts from IAS 14 are reproduced in this publication of the Public Sector Committee of the International Federation of Accountants with the permission of IASB.

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June 2000

IPSAS 18—SEGMENT REPORTING

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The standards, which have been set in bold type, should be read in the context of the commentary paragraphs in this Standard, which are in plain type, and in the context of the "Preface to International Public Sector Accounting Standards." International Public Sector Accounting Standards are not intended to apply to immaterial items.

Objective

The objective of this Standard is to establish principles for reporting financial information by segments. The disclosure of this information will:

(a) Help users of the financial statements to better understand the entity's past performance and to identify the resources allocated to support the major activities of the entity; and

(b) Enhance the transparency of financial reporting and enable the entity to better discharge its accountability obligations.

Scope

1. **An entity which prepares and presents financial statements under the accrual basis of accounting should apply this Standard in the presentation of segment information.**

2. **This Standard applies to all public sector entities other than Government Business Enterprises.**

3. Government Business Enterprises (GBEs) are required to comply with International Accounting Standards (IASs) issued by the International Accounting Standards Committee. The Public Sector Committee's Guideline No. 1, "Financial Reporting by Government Business Enterprises" notes that IASs are relevant to all business enterprises, regardless of whether they are in the private or public sector. Accordingly, Guideline No. 1 recommends that GBEs should present financial statements that conform, in all material respects, to IASs.

4. **This Standard should be applied in complete sets of published financial statements that comply with International Public Sector Accounting Standards (IPSASs).**

5. A complete set of financial statements includes a statement of financial position, statement of financial performance, cash flow statement, a statement showing changes in net assets/equity, and notes, as provided in IPSAS 1, "Presentation of Financial Statements."

6. **If both consolidated financial statements of a government or other economic entity and the separate financial statements of the parent**

entity are presented together, segment information need be presented only on the basis of the consolidated financial statements.

7. In some jurisdictions, the consolidated financial statements of the government or other economic entity and the separate financial statements of the controlling entity are compiled and presented together in a single report. Where this occurs, the report which contains the government's or other controlling entity's consolidated financial statements needs to present segment information only for the consolidated financial statements.

Definitions

Definitions from Other International Public Sector Accounting Standards

8. **The following terms are used in this Standard with the meanings specified in International Public Sector Accounting Standards (IPSAS) 2, "Cash Flow Statements;" IPSAS 3, "Net Surplus or Deficit for the Period, Fundamental Errors and Changes in Accounting Policies;" and IPSAS 9, "Revenue from Exchange Transactions."**

    Accounting policies are the specific principles, bases, conventions, rules and practices adopted by an entity in preparing and presenting financial statements.

    Financing activities are activities that result in changes in the size and composition of the contributed capital and borrowings of the entity.

    Investing activities are the acquisition and disposal of long-term assets and other investments not included in cash equivalents.

    Operating activities are the activities of the entity that are not investing or financing activities.

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

    Other terms defined in International Public Sector Accounting Standards are also used in this Standard with the same meaning as in those other Standards. A Glossary of Defined Terms has been published separately.

Definition of a Segment

9. **A segment is a distinguishable activity or group of activities of an entity for which it is appropriate to separately report financial information**

for the purpose of evaluating the entity's past performance in achieving its objectives and for making decisions about the future allocation of resources.

10. Governments and their agencies control significant public resources and operate to provide a wide variety of goods and services to their constituents in differing geographical regions and in regions with differing socio-economic characteristics. These entities are expected, and in some cases formally required, to use those resources efficiently and effectively to achieve the entity's objectives. Entity-wide and consolidated financial statements provide an overview of the assets controlled and liabilities incurred by the reporting entity, the cost of services provided and the taxation revenue, budget allocations and cost recoveries generated to fund the provision of those services. However, this aggregate information does not provide information about the specific operational objectives and major activities of the reporting entity and the resources devoted to, and costs of, those objectives and activities.

11. In most cases, the activities of the entity are so broad, and encompass so wide a range of different geographical regions, or regions with different socio-economic characteristics, that it is necessary to report disaggregated financial and non-financial information about particular segments of the entity to provide relevant information for accountability and decision making purposes.

Reporting by Segments

12. **An entity should identify its separate segments in accordance with the requirements of paragraph 9 of this Standard and should present information about those segments as required by paragraph 51 to 75 of this Standard.**

13. Under this Standard, public sector entities will identify as separate segments each distinguishable activity or group of activities for which financial information should be reported for purposes of evaluating the past performance of the entity in achieving its objectives, and for making decisions about the allocation of resources by the entity. In addition to disclosure of the information required by paragraphs 51 to 75 of this Standard, entities are also encouraged to disclose additional information about reported segments as identified by this Standard or as considered necessary for accountability and decision making purposes.

Reporting Structures

14. In most cases, the major classifications of activities identified in budget documentation will reflect the segments for which information is reported

to the governing body and the most senior manager of the entity. In most cases, the segments reported to the governing body and senior manager will also reflect the segments reported in the financial statements. This is because the governing board and senior manager will require information about segments to enable them to discharge their managerial responsibilities and to evaluate the performance of the entity in achieving its objectives in the past and to make decisions about the allocation of resources by the entity in the future.

15. Determining the activities which should be grouped as separate segments and reported in the financial statements for accountability and decision-making purposes involves judgment. In making that judgment, preparers of the financial statements will consider such matters as:

    (a) The objective of reporting financial information by segment as identified in paragraph 9 above;

    (b) The expectations of members of the community and their elected or appointed representatives regarding the key activities of the entity;

    (c) The qualitative characteristics of financial reporting as identified in Appendix 2 of IPSAS 1. These characteristics are also summarized in the Appendix 3 to this Standard. They include the relevance, reliability, and comparability over time of financial information that is reported about an entity's different segments. (These characteristics are based on the qualitative characteristics of financial statements identified in the IASC "Framework for the Preparation and Presentation of Financial Statements"); and

    (d) Whether a particular segment structure reflects the basis on which the governing body and senior manager require financial information to enable them to assess the past performance of the entity in achieving its objectives and to make decisions about the allocation of resources to achieve entity objectives in the future.

16. At the whole-of-government level, financial information is often aggregated and reported in a manner which reflects, for example:

    (a) Major economic classifications of activities undertaken by general government, such as health, education, defense, and welfare (these may reflect the Government Finance Statistics (GFS) functional classifications of government), and major trading activities undertaken by GBEs, such as state-owned power stations, banks and insurance entities; or

    (b) Portfolio responsibilities of individual ministers or members of executive government. These often, but not always, reflect the economic classifications in (a) above — differences may occur

because portfolio responsibilities may aggregate more than one of the economic classifications or cut across those classifications.

Service Segments and Geographical Segments

17. The types of segments reported to the governing body and senior manager of an entity are frequently referred to as "service segments" or "geographical segments." These terms are used in this Standard with the following meanings:

    (a) A "service segment" refers to a distinguishable component of an entity that is engaged in providing related outputs or achieving particular operating objectives consistent with the overall mission of each entity; and

    (b) A "geographical segment" is a distinguishable component of an entity that is engaged in providing outputs or achieving particular operating objectives within a particular geographical area.

18. Government departments and agencies are usually managed along service lines because this reflects the way in which major outputs are identified, their achievements monitored and their resource needs identified and budgeted. An example of an entity which reports internally on the basis of service lines or service segments is an education department whose organizational structure and internal reporting system reflects primary, secondary and tertiary educational activities and outputs as separate segments. This basis of segmentation may be adopted internally because the skills and facilities necessary to deliver the desired outputs and outcomes for each of these broad educational activities are perceived to be different. In addition, key financial decisions faced by management include determination of the resources to allocate to each of those outputs or activities. In these cases, it is likely that reporting externally on the basis of service segments will also satisfy the requirements of this Standard.

19. Factors that will be considered in determining whether outputs (goods and services) are related and should be grouped as segments for financial reporting purposes include:

    (a) The primary operating objectives of the entity and the goods, services and activities that relate to the achievement of each of those objectives and whether resources are allocated and budgeted on the basis of groups of goods and services;

    (b) The nature of the goods or services provided or activities undertaken;

    (c) The nature of the production process and/or service delivery and distribution process or mechanism;

    (d) The type of customer or consumer for the goods or services;

(e) Whether this reflects the way in which the entity is managed and financial information is reported to senior management and the governing board; and

(f) If applicable, the nature of the regulatory environment, (for example, department or statutory authority) or sector of government (for example finance sector, public utilities, or general government).

20. An entity may be organized and report internally to the governing body and the senior manager on a regional basis — whether within or across national, state, local or other jurisdictional boundaries. Where this occurs the internal reporting system reflects a geographical segment structure.

21. A geographical segment structure may be adopted where, for example, the organizational structure and internal reporting system of an education department is structured on the basis of regional educational outcomes because the key performance assessments and resource allocation decisions to be made by the governing body and senior manager are determined by reference to regional achievements and regional needs. This structure may have been adopted to preserve regional autonomy of educational needs and delivery of education services, or because operating conditions or educational objectives are substantially different from one region to another. It may also have been adopted simply because management believes that an organizational structure based on regional devolution of responsibility better serves the objectives of the organization. In these cases, resource allocation decisions are initially made, and subsequently monitored, by the governing body and the senior manager on a regional basis. Detailed decisions about the allocation of resources to particular functional activities within a geographical region are then made by regional management, consistent with educational needs within that region. In these cases, it is likely that reporting information by geographical segments in the financial statements will also satisfy the requirements of this Standard.

22. Factors that will be considered in determining whether financial information should be reported on a geographical basis include:

(a) Similarity of economic, social and political conditions in different regions;

(b) Relationships between the primary objectives of the entity and the different regions;

(c) Whether service delivery characteristics and operating conditions differ in different regions;

(d) Whether this reflects the way in which the entity is managed and financial information is reported to senior managers and the governing board; and

(e) Special needs, skills or risks associated with operations in a particular area.

Multiple Segmentation

23. In some cases, an entity may report to the governing body and senior manager segment revenue, expense, assets and liabilities on the basis of more than one segment structure, for example by both service and geographical segments. Reporting on the basis of both service segments and geographical segments in the external financial statements often will provide useful information if the achievement of an entity's objectives is strongly affected both by the different products and services it provides and the different geographical areas to which those goods and services are provided. Similarly, at the whole-of-government level, a government may adopt a basis of disclosure which reflects general government, public finance sector and trading sector disclosures, and supplement the general government sector analysis with, for example, segment disclosures of major purpose or functional sub-categories. In these cases, the segments may be reported separately or as a matrix. In addition, a primary and secondary segment reporting structure may be adopted with only limited disclosures made about secondary segments.

Reporting Structures Not Appropriate

24. As noted above, in most cases the segments for which information is reported internally to the governing body and the most senior manager of the entity for the purpose of evaluating the entity's past performance and for making decisions about the future allocation of resources, will reflect those identified in budget documentation and will also be adopted for external reporting purposes in accordance with the requirements of this Standard. However, in some cases an entity's internal reporting to the governing body and the senior manager may be structured to aggregate and report on a basis which distinguishes revenues, expenses, assets and liabilities related to budget-dependent activities from those of trading activities, or which distinguishes budget-dependent entities from GBEs. Reporting segment information in the financial statements on the basis of only these segments is unlikely to meet the objectives specified for this Standard. This is because these segments are unlikely to provide information that is relevant to users about, for example, the performance of the entity in achieving its major operating objectives.

25. In some cases, the disaggregated financial information reported to the governing body and the senior manager may not report expenses, revenues,

assets and liabilities by service segment, geographical segment or by reference to other activities. Such reports may be constructed to reflect only expenditures by nature (for example, wages, rent, supplies and capital acquisitions) on a line item basis that is consistent with the budget appropriation or other funding or expenditure authorization model applicable to the entity. This may occur where the purpose of financial reporting to the governing body and senior management is to evidence compliance with spending mandates rather than for purposes of evaluating the past performance of the entity's major activities in achieving their objectives and for making decisions about the future allocation of resources. When internal reporting to the governing body and senior manager is structured to report only compliance information, reporting externally on the same basis as the internal reporting to the governing body and senior manager will not meet the requirement of this Standard.

26. When an entity's internal reporting structure does not reflect the requirements of this Standard, for external reporting purposes the entity will need to identify segments which satisfy the definition of a segment in paragraph 9 and disclose the information required by paragraphs 51-75.

Definitions of Segment Revenue, Expense, Assets, Liabilities and Accounting Policies

27. **The following additional terms are used in this Standard with the meanings specified:**

Segment revenue is revenue reported in the entity's statement of financial performance that is directly attributable to a segment and the relevant portion of entity revenue that can be allocated on a reasonable basis to a segment, whether from budget appropriations or similar, grants, transfers, fines, fees or sales to external customers or from transactions with other segments of the same entity. Segment revenue does not include:

(a) **Extraordinary items;**

(b) **Interest or dividend revenue, including interest earned on advances or loans to other segments, unless the segment's operations are primarily of a financial nature; or**

(c) **Gains on sales of investments or gains on extinguishment of debt unless the segment's operations are primarily of a financial nature.**

Segment revenue includes an entity's share of net surplus (deficit) of associates, joint ventures, or other investments accounted for under the equity method only if those items are included in consolidated or total entity revenue.

Segment revenue includes a joint venturer's share of the revenue of a jointly controlled entity that is accounted for by proportionate consolidation in accordance with IPSAS 8, "Financial Reporting of Interests in Joint Ventures."

Segment expense is an expense resulting from the operating activities of a segment that is directly attributable to the segment and the relevant portion of an expense that can be allocated on a reasonable basis to the segment, including expenses relating to the provision of goods and services to external parties and expenses relating to transactions with other segments of the same entity. Segment expense does not include:

(a) **Extraordinary items**;

(b) **Interest, including interest incurred on advances or loans from other segments, unless the segment's operations are primarily of a financial nature;**

(c) **Losses on sales of investments or losses on extinguishment of debt unless the segment's operations are primarily of a financial nature;**

(d) **An entity's share of net deficit or losses of associates, joint ventures, or other investments accounted for under the equity method;**

(e) **Income tax or income-tax equivalent expense that is recognized in accordance with accounting standards dealing with obligations to pay income tax or income tax equivalents; or**

(f) **General administrative expenses, head office expenses, and other expenses that arise at the entity level and relate to the entity as a whole. However, costs are sometimes incurred at the entity level on behalf of a segment. Such costs are segment expenses if they relate to the segment's operating activities and they can be directly attributed or allocated to the segment on a reasonable basis.**

Segment expense includes a joint venturer's share of the expenses of a jointly controlled entity that is accounted for by proportionate consolidation in accordance with IPSAS 8.

For a segment's operations that are primarily of a financial nature, interest revenue and interest expense may be reported as a single net amount for segment reporting purposes only if those items are netted in the consolidated or entity financial statements.

Segment assets are those operating assets that are employed by a segment in its operating activities and that either are directly

attributable to the segment or can be allocated to the segment on a reasonable basis.

If a segment's segment revenue includes interest or dividend revenue, its segment assets include the related receivables, loans, investments, or other revenue-producing assets.

Segment assets do not include income tax or income tax equivalent assets that are recognized in accordance with accounting standards dealing with obligations to pay income tax or income tax equivalents.

Segment assets include investments accounted for under the equity method only if the net surplus (deficit) from such investments is included in segment revenue. Segment assets include a joint venturer's share of the operating assets of a jointly controlled entity that is accounted for by proportionate consolidation in accordance with IPSAS 8.

Segment assets are determined after deducting related allowances that are reported as direct offsets in the entity's statement of financial position.

Segment liabilities are those operating liabilities that result from the operating activities of a segment and that either are directly attributable to the segment or can be allocated to the segment on a reasonable basis.

If a segment's segment expense includes interest expense, its segment liabilities include the related interest-bearing liabilities.

Segment liabilities include a joint venturer's share of the liabilities of a jointly controlled entity that is accounted for by proportionate consolidation in accordance with IPSAS 8.

Segment liabilities do not include income tax or income tax equivalent liabilities that are recognized in accordance with accounting standards dealing with obligations to pay income tax or income tax equivalents.

Segment accounting policies are the accounting policies adopted for preparing and presenting the financial statements of the consolidated group or entity as well as those accounting policies that relate specifically to segment reporting.

Attributing Items to Segments

28. The definitions of segment revenue, segment expense, segment assets, and segment liabilities include amounts of such items that are directly attributable to a segment and amounts of such items that can be allocated to a segment on a reasonable basis.

29. An entity looks to its internal financial reporting system as the starting point for identifying those items that can be directly attributed, or reasonably allocated, to segments. That is, where segments used for internal reporting purposes are adopted, or form the basis of segments adopted, for general purpose financial statements, there is a presumption that amounts that have been identified with segments for internal financial reporting purposes are directly attributable or reasonably allocable to segments for the purpose of measuring the segment revenue, segment expense, segment assets and segment liabilities.

30. In some cases, a revenue, expense, asset or liability may have been allocated to segments for internal financial reporting purposes on a basis that is understood by entity management but that could be deemed subjective, arbitrary or difficult to understand by external users of financial statements. Such an allocation would not constitute a reasonable basis under the definitions of segment revenue, segment expense, segment assets and segment liabilities in this Standard. Conversely, an entity may choose not to allocate some item of revenue, expense, asset or liability for internal financial reporting purposes, even though a reasonable basis for doing so exists. Such an item is allocated pursuant to the definitions of segment revenue, segment expense, segment assets and segment liabilities in this Standard.

31. Public sector entities can generally identify the costs of providing certain groups of goods and services or of undertaking certain activities and the assets that are necessary to facilitate those activities. This information is needed for planning and control purposes. However, in many cases the operations of government agencies and other public sector entities are funded by “block” appropriations, or appropriations on a “line item” basis reflecting the nature of the major classes of expenses or expenditures. These “block” or “line item” appropriations may not be related to specific service lines, functional activities or geographical regions. In some cases, it may not be possible to directly attribute revenue to a segment or to allocate it to a segment on a reasonable basis. Similarly, some assets, expenses and liabilities may not be able to be directly attributed, or allocated on a reasonable basis, to individual segments because they support a wide range of service delivery activities across a number of segments or are directly related to general administration activities which are not identified as a separate segment. The unattributed or unallocated revenue, expense, assets and liabilities would be reported as an unallocated amount in reconciling the segment disclosures to the aggregate entity revenue as required by paragraph 64 of this IPSAS.

32. Governments and their agencies may enter into arrangements with private sector entities for the delivery of goods and services or to conduct other

activities. In some jurisdictions, these arrangements take the form of a joint venture or an investment in an associate which is accounted for by the equity method of accounting. Where this is the case, segment revenue will include the segment's share of the equity accounted net surplus (deficit), where the equity accounted surplus (deficit) is included in entity revenue and it can be directly attributed or reliably allocated to the segment on a reasonable basis. In similar circumstances, segment revenue and segment expense will include the segment's share of revenue and expense of a jointly controlled entity which is accounted for by proportionate consolidation.

Segment Assets, Liabilities, Revenue and Expense

33. Examples of segment assets include current assets that are used in the operating activities of the segment; property, plant and equipment; assets that are the subject of finance leases; and intangible assets. If a particular item of depreciation or amortization is included in segment expense, the related asset is also included in segment assets. Segment assets do not include assets used for general entity or head office purposes, for example:

    (a) The office of the central administration and policy development unit of a department of education is not included in segments reflecting the delivery of primary, secondary and tertiary educational services; or

    (b) The parliamentary or other general assembly building is not included in segments reflecting major functional activities such as education, health and defense when reporting at the whole-of-government level.

    Segment assets include operating assets shared by two or more segments if a reasonable basis for allocation exists.

34. The consolidated financial statements of a government or other entity may encompass entities acquired in an entity acquisition which gives rise to purchased goodwill (guidance on accounting for the acquisition of an entity is included in IAS 22, "Business Combinations"). In these cases, segment assets will include goodwill that is directly attributable to a segment or that can be allocated to a segment on a reasonable basis, and segment expense includes related amortization of goodwill.

35. Examples of segment liabilities include trade and other payables, accrued liabilities, advances from members of the community for the provision of partially subsidized goods and services in the future, product warranty provisions arising from any commercial activities of the entity, and other claims relating to the provision of goods and services. Segment liabilities do not include borrowings, liabilities related to assets that are the subject of

finance leases, and other liabilities that are incurred for financing rather than operating purposes. If interest expense is included in segment expense, the related interest-bearing liability is included in segment liabilities.

36. The liabilities of segments whose operations are not primarily of a financial nature do not include borrowings and similar liabilities because segment revenues and expenses do not include financing revenues and expenses. Further, because debt is often issued at the head office level or by a central borrowing authority on an entity-wide or government-wide basis, it is often not possible to directly attribute, or reasonably allocate, the interest-bearing liability to the segment. However, if the financing activities of the entity are identified as a separate segment, as may occur at the whole-of-government level, expenses of the "finance" segment will include interest expense, and the related interest-bearing liabilities will be included in segment liabilities.

37. International or national accounting standards may require adjustments to be made to the carrying amounts of the identifiable assets and liabilities of an entity acquired in an acquisition (see for example IAS 22). Measurements of segment assets and liabilities include any adjustments to the prior carrying amounts of the identifiable segment assets and segment liabilities of an entity acquired in an entity combination accounted for as a purchase, even if those adjustments are made only for the purpose of preparing consolidated financial statements and are not recorded in either the controlling entity's or the controlled entity's separate financial statements. Similarly, if property, plant, and equipment has been revalued subsequent to acquisition in accordance with the alternative accounting treatment allowed by IPSAS 17, "Property, Plant and Equipment," measurements of segment assets reflect those revaluations.

38. In some jurisdictions, a government or government entity may control a GBE or other entity that operates on a commercial basis and is subject to income tax or income tax equivalents. These entities may be required to apply accounting standards such as IAS 12, "Income Taxes" which prescribe the accounting treatment of income taxes or income tax equivalents. Such standards may require the recognition of income tax assets and liabilities in respect of income tax expenses, or income tax equivalent expenses, which are recognized in the current period and are recoverable or repayable in future periods. These assets and liabilities are not included in segment assets or segment liabilities because they arise as a result of all the activities of the entity as a whole and the tax arrangements in place in respect of the entity. However, assets representing taxation revenue receivable which is controlled by a taxing authority will be included in segment assets of the authority if they can be directly attributed to that segment or allocated to it on a reliable basis.

39. Some guidance for cost allocation can be found in other International Public Sector Accounting Standards. For example, IPSAS 12, "Inventories" provides guidance for attributing and allocating costs to inventories, and IPSAS 11, "Construction Contracts" provides guidance for attributing and allocating costs to contracts. That guidance may be useful in attributing and allocating costs to segments.

40. IPSAS 2 provides guidance on whether bank overdrafts should be included as a component of cash or should be reported as borrowings.

41. The financial statements for the whole-of-government, and certain other controlling entities, will require the consolidation of a number of separate entities such as departments, agencies and GBEs. In preparing these consolidated financial statements transactions and balances between controlled entities will be eliminated in accordance with IPSAS 6. However, segment revenue, segment expense, segment assets and segment liabilities are determined before balances and transactions between entities within the economic entity are eliminated as part of the consolidation process, except to the extent that such intra-economic entity balances and transactions are between entities within a single segment.

42. While the accounting policies used in preparing and presenting the financial statements of the entity as a whole are also the fundamental segment accounting policies, segment accounting policies include, in addition, policies that relate specifically to segment reporting, such as the method of pricing inter-segment transfers, and the basis for allocating revenues and expenses to segments.

Segment Accounting Policies

43. **Segment information should be prepared in conformity with the accounting policies adopted for preparing and presenting the financial statements of the consolidated group or entity.**

44. There is a presumption that the accounting policies that the governing body and management of an entity have chosen to use in preparing the consolidated or entity-wide financial statements are those that the governing body and management believe are the most appropriate for external reporting purposes. Since the purpose of segment information is to help users of financial statements better understand and make more informed judgments about the entity as a whole, this Standard requires the use, in preparing segment information, of the accounting policies that the governing body and management have chosen for preparation of the consolidated or entity-wide financial statements. That does not mean, however, that the consolidated or entity accounting policies are to be

applied to segments as if the segments were separate reporting entities. A detailed calculation done in applying a particular accounting policy at the entity-wide level may be allocated to segments if there is a reasonable basis for doing so. Employee entitlement calculations, for example, are often done for an entity as a whole, but the entity-wide figures may be allocated to segments based on salary and demographic data for the segments.

45. As noted in paragraph 42, accounting policies that deal with entity only issues such as inter-segment pricing may need to be developed. IPSAS 1 requires disclosure of accounting policies necessary to understand the financial statements. Consistent with those requirements, segment specific policies may need to be disclosed.

46. This Standard permits the disclosure of additional segment information that is prepared on a basis other than the accounting policies adopted for the consolidated or entity financial statements provided that:

(a) The information is relevant for performance assessment and decision making purposes; and

(b) The basis of measurement for this additional information is clearly described.

Joint Assets

47. **Assets that are jointly used by two or more segments should be allocated to segments if, and only if, their related revenues and expenses are also allocated to those segments.**

48. The way in which asset, liability, revenue and expense items are allocated to segments depends on such factors as the nature of those items, the activities conducted by the segment, and the relative autonomy of that segment. It is not possible or appropriate to specify a single basis of allocation that should be adopted by all entities. Nor is it appropriate to force allocation of entity asset, liability, revenue and expense items that relate jointly to two or more segments, if the only basis for making those allocations is arbitrary or difficult to understand. At the same time, the definitions of segment revenue, segment expense, segment assets and segment liabilities are interrelated, and the resulting allocations should be consistent. Therefore, jointly used assets are allocated to segments if, and only if, their related revenues and expenses are also allocated to those segments. For example, an asset is included in segment assets if, and only if, the related depreciation or amortization is included in measuring segment expense.

Newly Identified Segments

49. **If a segment is identified as a segment for the first time in the current period, prior period segment data that is presented for comparative purposes should be restated to reflect the newly reported segment as a separate segment, unless it is impracticable to do so.**

50. New segments may be reported in financial statements in differing circumstances. For example, an entity may change its internal reporting structure from a service segment structure to a geographical segment structure and management may consider it appropriate that this segment structure also be adopted for external reporting purposes. An entity may also undertake significant new or additional activities, or increase the extent to which an activity previously operating as an internal support service provides services to external parties. In these cases, new segments may be reported for the first time in the general purpose financial statements. Where this occurs, this Standard requires that prior period comparative data should be restated to reflect the current segment structure where practicable.

Disclosure

51. **The disclosure requirements in paragraphs 52–75 should be applied to each segment.**

52. **An entity should disclose segment revenue and segment expense for each segment. Segment revenue from budget appropriation or similar allocation, segment revenue from other external sources and segment revenue from transactions with other segments should be separately reported.**

53. **An entity should disclose the total carrying amount of segment assets for each segment.**

54. **An entity should disclose the total carrying amount of segment liabilities for each segment.**

55. **An entity should disclose the total cost incurred during the period to acquire segment assets that are expected to be used during more than one period for each segment.**

56. An entity is encouraged, but not required, to disclose the nature and amount of any items of segment revenue and segment expense that are of such size, nature, or incidence that their disclosure is relevant to explain the performance of each segment for the period.

57. IPSAS 3 requires that when items of revenue or expense within net surplus (deficit) from ordinary activities are of such size, nature, or incidence that their disclosure is relevant to explain the performance of the entity for the period, the nature and amount of such items should be disclosed separately. IPSAS 3 identifies a number of examples of such items, including write-downs of inventories and property, plant, and equipment; provisions for restructurings; disposals of property, plant, and equipment; privatizations and other disposals of long-term investments; discontinued operations; litigation settlements; and reversals of provisions. The encouragement in paragraph 56 is not intended to change the classification of any such items of revenue or expense from ordinary to extraordinary (as defined in IPSAS 3) or to change the measurement of such items. The disclosure encouraged by that paragraph, however, does change the level at which the significance of such items is evaluated for disclosure purposes from the entity level to the segment level.

58. This Standard does not require a segment result to be disclosed. However, if a segment result is calculated and disclosed it is an operating result which does not include finance charges.

59. An entity is encouraged but not required to disclose segment cash flows consistent with the requirements of IPSAS 2. IPSAS 2 requires that an entity present a cash flow statement that separately reports cash flows from operating, investing, and financing activities. It also requires the disclosure of information about certain cash flows. The disclosure of cash flow information about each segment can be useful in understanding the entity's overall financial position, liquidity and cash flows.

60. An entity which does not disclose segment cash flows in accordance with IPSAS 2 is encouraged, but not required, to disclose for each reportable segment:

    (a) Segment expense for depreciation and amortization of segment assets;

    (b) Other significant non-cash expenses; and

    (c) Significant non-cash revenues that are included in segment revenue.

    This will enable users to determine the major sources and uses of cash in respect of segment activities for the period.

61. **An entity should disclose for each segment the aggregate of the entity's share of the net surplus (deficit) of associates, joint ventures, or other investments accounted for under the equity method if substantially all of those associates' operations are within that single segment.**

62. While a single aggregate amount is disclosed pursuant to the requirements of paragraph 61, each associate, joint venture or other equity method investment is assessed individually to determine whether its operations are substantially all within a segment.

63. **If an entity's aggregate share of the net surplus (deficit) of associates, joint venture, or other investments accounted for under the equity method is disclosed by segment, the aggregate investments in those associates and joint ventures should also be disclosed by segment.**

64. **An entity should present a reconciliation between the information disclosed for segments and the aggregated information in the consolidated or entity financial statements. In presenting the reconciliation, segment revenue should be reconciled to entity revenue from external sources (including disclosure of the amount of entity revenue from external sources not included in any segment's revenue); segment expense should be reconciled to a comparable measure of entity expense; segment assets should be reconciled to entity assets; and segment liabilities should be reconciled to entity liabilities.**

Additional Segment Information

65. As noted previously, it is anticipated that segments will usually be based on the major goods and services the entity provides, the programs it operates or the activities it undertakes. This is because information about these segments provides users with relevant information about the performance of the entity in achieving its objectives and enables the entity to discharge its accountability obligations. However, in some organizations, a geographical or other basis may better reflect the basis on which services are provided and resources allocated within the entity and, therefore, will be adopted for the financial statements.

66. This Standard adopts the view that disclosure of minimum information about both service segments and geographical segments is likely to be useful to users for accountability and decision-making purposes. Therefore, if an entity reports segment information on the basis of:

    (a) The major goods and services the entity provides, the programs it operates, the activities it undertakes or other service segments, it is also encouraged to report the following for each geographical segment that is reported internally to the governing body and the senior manager of the entity:

(i) Segment expense;

(ii) Total carrying amount of segment assets; and

(iii) Total outlay during the period to acquire segment assets that are expected to be used during more than one period (property, plant, equipment and intangible assets); and

(b) Geographical segments or another basis not encompassed by (a), the entity is encouraged to also report the following segment information for each major service segment that is reported internally to the governing body and the senior manager of the entity:

(i) Segment expense;

(ii) Total carrying amount of segment assets; and

(iii) Total outlay during the period to acquire segment assets that are expected to be used during more than one period (property, plant, equipment and intangible assets).

Other Disclosure Matters

67. **In measuring and reporting segment revenue from transactions with other segments, inter-segment transfers should be measured on the basis that they occur. The basis of pricing inter-segment transfers and any change therein should be disclosed in the financial statements.**

68. **Changes in accounting policies adopted for segment reporting that have a material effect on segment information should be disclosed, and prior period segment information presented for comparative purposes should be restated unless it is impracticable to do so. Such disclosure should include a description of the nature of the change, the reasons for the change, the fact that comparative information has been restated or that it is impracticable to do so, and the financial effect of the change if it is reasonably determinable. If an entity changes the identification of its segments and it does not restate prior period segment information on the new basis because it is impracticable to do so, then for the purpose of comparison an entity should report segment data for both the old and the new bases of segmentation in the year in which it changes the identification of its segments.**

69. Changes in accounting policies adopted by the entity are dealt with in IPSAS 3. IPSAS 3 requires that changes in accounting policy should be made only if required by statute, or by an accounting standard-setting body, or if the change will result in a more appropriate presentation of events or transactions in the financial statements of the entity.

70. Changes in accounting policies adopted at the entity level that affect segment information are dealt with in accordance with IPSAS 3. Unless a new International Public Sector Accounting Standard specifies otherwise, IPSAS 3 requires that a change in accounting policy should be applied retrospectively and that prior period information be restated unless it is impracticable to do so (benchmark treatment) or that the cumulative adjustment resulting from the change be included in determining the entity's net surplus (deficit) for the current period (allowed alternative treatment). If the benchmark treatment is followed, prior period segment information will be restated. If the allowed alternative is followed, the cumulative adjustment that is included in determining the entity's net surplus (deficit) is included as an item of segment revenue or expense if it is an operating item that can be attributed or reasonably allocated to segments. In the latter case, IPSAS 3 may require separate disclosure if its size, nature, or incidence is such that the disclosure is relevant to explain the performance of the entity for the period.

71. Some changes in accounting policies relate specifically to segment reporting. Examples include changes in identification of segments and changes in the basis for allocating revenues and expenses to segments. Such changes can have a significant impact on the segment information reported but will not change aggregate financial information reported for the entity. To enable users to understand the changes and to assess trends, prior period segment information that is included in the financial statements for comparative purposes is restated, if practicable, to reflect the new accounting policy.

72. Paragraph 67 requires that, for segment reporting purposes, inter-segment transfers should be measured on the basis that the entity actually used to price those transfers. If an entity changes the method that it actually uses to price inter-segment transfers, that is not a change in accounting policy for which prior period segment data should be restated pursuant to paragraph 68. However, paragraph 67 requires disclosure of the change.

73. **If not otherwise disclosed in the financial statements or elsewhere in the annual report, an entity should indicate:**

    (a) **The types of goods and services included in each reported service segment;**

    (b) **The composition of each reported geographical segment; and**

    (c) **If neither a service nor geographical basis of segmentation is adopted, the nature of the segment and activities encompassed by it.**

Segment Operating Objectives

74. If not otherwise disclosed in the financial statements or elsewhere in the annual report, the entity is encouraged to disclose the broad operating objectives established for each segment at the commencement of the reporting period and to comment on the extent to which those objectives were achieved.

75. To enable users to assess the performance of an entity in achieving its service delivery objectives it is necessary to communicate those objectives to users. The disclosure of information about the composition of each segment, the service delivery objectives of those segments and the extent to which those objectives were achieved will support this assessment. This information will also enable the entity to better discharge its accountability obligations. In many cases, this information will be included in the annual report as part of the report of the governing body or the senior manager. In such cases, disclosure of this information in the financial statements is not necessary.

Effective Date

76. **This International Public Sector Accounting Standard becomes effective for annual financial statements covering periods beginning on or after July 1, 2003. Earlier application is encouraged.**

77. When an entity adopts the accrual basis of accounting, as defined by International Public Sector Accounting Standards, for financial reporting purposes, subsequent to this effective date, this Standard applies to the entity's annual financial statements covering periods beginning on or after the date of adoption.

Appendix 1

Illustrative Segment Disclosures

The appendix is illustrative only and does not form part of the Standard. The purpose of the appendix is to illustrate the application of the standards to assist in clarifying their meaning.

The schedule and related note presented in this appendix illustrate the segment disclosures that this Standard would require for an education authority which is predominantly funded by appropriation but provides some educational services on a commercial basis to the employees of major corporations and has joined with a commercial venture to establish a private education foundation which operates on a commercial basis. The Authority has significant influence over, but does not control that foundation. For illustrative purposes, the example presents comparative data for two years. Segment data is required for each year for which a complete set of financial statements is presented.

SCHEDULE A—INFORMATION ABOUT SEGMENTS (in millions of currency units)

	Primary/Secondary		Tertiary		Special Services		Other Services		Eliminations		Consolidated	
	20X2	20X1	20X2	20X1	20X2	20X1	20X2	20X1	20X2	20X1	20X2	20X1
SEGMENT REVENUE												
Appropriation	48	40	22	23	10	10	7	7				
Fees from external sources	5	4	–	–	9	6	–	–				
Inter-segment transfers	10	6	6	7	2	4	2	2				
Total Segment Revenue	63	50	28	30	21	20	9	9	20	19	101	90
SEGMENT EXPENSE												
Salaries and wages	(39)	(31)	(13)	(13)	(13)	(13)	(2)	(2)				
Depreciation	(9)	(7)	(5)	(7)	(5)	(3)	(1)	(1)				
Other expenses	(12)	(11)	(10)	(9)	(5)	(5)	(2)	(2)				
Total Segment Expenses	(60)	(49)	(28)	(29)	(23)	(21)	(5)	(5)	20	19	(96)	(85)
Unallocated central expenses											(7)	(9)
Deficit from Operating Activities											(2)	(4)
Interest expense											(4)	(3)
Interest revenue											2	3
Share of net surpluses of associates							8	7			8	7
Surplus from Ordinary Activities											4	3
Extraordinary loss: uninsured earthquake damage to facilities		(3)									0	(3)
Net Surplus											4	0

OTHER INFORMATION												
Segment assets	54	50	34	30	10	10	10	9			108	99
Investment in associates (equity method)							32	26			32	26
Unallocated central assets											35	30
Consolidated Total Assets											175	155
Segment liabilities	25	15	8	11	8	8	1	1			42	35
Unallocated corporate liabilities											40	55
Consolidated Total Liabilities											82	90
Capital expenditure	13	10	9	5	4	0	2	3				
Non-cash expense excluding depreciation	(8)	(2)	(3)	(3)	(2)	(2)	(1)	(1)				
Non-cash revenue	–	–	–	–	1	1	–	–				

Note — Segments (all amounts are in millions of currency units)

The Authority is organized and reports to the governing body on the basis of four major functional areas: primary and secondary education; tertiary education; special education services; and other services, each headed by a director. Operations of the special education services segment includes provision of educational services on a commercial basis to the employees of major corporations. In providing these services to external parties the commercial services unit of the segment uses, on a fee for service basis, services provided by the primary/secondary and tertiary segments. These inter segment transfers are eliminated on consolidation.

Information reported about these segments is used by the governing board and senior management as a basis for evaluating the entity's past performance in achieving its objectives and for making decisions about the future allocation of resources. The disclosure of information about these segments is also considered appropriate for external reporting purposes.

The majority of the Authority's operations are domestic except that as part of an aid program it has established facilities in Eastern Europe for the provision of secondary educational services. Total cost of services provided in Eastern Europe is 5 million (4 million in 20X1). Total carrying amount of the educational facilities in Eastern Europe are 3 million (6.5 million in 20X1). There were no outlays on the acquisition of capital assets in Eastern Europe during 20X2 or 20X1.

Inter-segment transfers: segment revenue and segment expense include revenue and expense arising from transfers between segments. Such transfers are usually accounted for at cost and are eliminated on consolidation. The amount of these transfers was 20 million (19 million in 19X1).

Investments in associates are accounted for using the equity method. The Authority owns 40% of the capital stock of EuroED Ltd, a specialist education foundation providing educational services internationally on a commercial basis under contract to multilateral lending agencies. The investment is accounted for by the equity method. The investment in, and the Authority's share of, EuroED's net profit are excluded from segment assets and segment revenue.

However they are shown separately under the other services segment, which is responsible for the administration of the investment in the associate.

Extraordinary loss: the Authority incurred an uninsured loss of 3 million caused by earthquake damage to education facilities in Eastern Europe in November 20X1.

A full report of the objectives established for each segment and the extent to which those objectives have been achieved is included in the Review of Operations, included elsewhere in this report.

Appendix 2

Summary of Required Disclosures

The appendix is illustrative only and does not form part of the Standard. Its purpose is to summarize the disclosures required by paragraphs 52-75.

[¶xx] refers to paragraph xx in the Standard.

Disclosures

Total expense by segment [¶52]

Total revenue by segment [¶52]

Revenue from budget appropriation or similar allocation by segment [¶52]

Revenue from external sources (other than appropriation or similar allocation) by segment [¶52]

Revenue from transactions with other segments by segment [¶52]

Carrying amount of segment assets by segment [¶53]

Segment liabilities by segment [¶54]

Cost to acquire assets by segment [¶55]

Share of net surplus (deficit) of [¶61] and investment in [¶63] equity method associates or joint ventures by segment (if substantially all within a single segment)

Reconciliation of revenue, expense, assets and liabilities by segment [¶64]

Other Disclosures

Basis of pricing inter-segment transfers and any changes therein [¶67]

Changes in segment accounting policies [¶68]

Types of products and services in each service segment [¶73]

Composition of each geographical segment [¶73]

If neither a service nor geographical basis of segmentation is adopted, the nature of the segments and activities encompassed by each segment [¶73]

Appendix 3

Qualitative Characteristics of Financial Reporting

Paragraph 15 of this Standard requires the development of accounting policies to ensure that the financial statements provide information that meets a number of qualitative characteristics. This appendix summarizes the qualitative characteristics of financial reporting.

Qualitative characteristics are the attributes that make the information provided in financial statements useful to users. The four principal qualitative characteristics are understandability, relevance, reliability and comparability.

Understandability

Information is understandable when users might reasonably be expected to comprehend its meaning. For this purpose, users are assumed to have a reasonable knowledge of the entity's activities and the environment in which it operates, and to be willing to study the information.

Information about complex matters should not be excluded from the financial statements merely on the grounds that it may be too difficult for certain users to understand.

Relevance

Information is relevant to users if it can be used to assist in evaluating past, present or future events or in confirming or correcting past evaluations. In order to be relevant, information must also be timely.

Materiality

The relevance of information is affected by its nature and materiality.

Information is material if its omission or misstatement could influence the decisions of users or assessments 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 its omission or misstatement. Thus, materiality provides a threshold or cut-off point rather than being a primary qualitative characteristic which information must have if it is to be useful.

Reliability

Reliable information is free from material error and bias, and can be depended on by users to represent faithfully that which it purports to represent or could reasonably be expected to represent.

Faithful Representation

For information to represent faithfully transactions and other events, it should be presented in accordance with the substance of the transactions and other events, and not merely their legal form.

Substance Over Form

If information is to represent faithfully the transactions and other events that it purports to represent, it is necessary that they are accounted for and presented in accordance with their substance and economic reality and not merely their legal form. The substance of transactions or other events is not always consistent with their legal form.

Neutrality

Information is neutral if it is free from bias. Financial statements are not neutral if the information they contain has been selected or presented in a manner designed to influence the making of a decision or judgment in order to achieve a predetermined result or outcome.

Prudence

Prudence is the inclusion of a degree of caution in the exercise of the judgments needed in making the estimates required under conditions of uncertainty, such that assets or revenue are not overstated and liabilities or expenses are not understated.

However, the exercise of prudence does not allow, for example, the creation of hidden reserves or excessive provisions, the deliberate understatement of assets or revenue, or the deliberate overstatement of liabilities or expenses, because the financial statements would not be neutral and, therefore, not have the quality of reliability.

Completeness

The information in financial statements should be complete within the bounds of materiality and cost.

Comparability

Information in financial statements is comparable when users are able to identify similarities and differences between that information and information in other reports.

Comparability applies to the:

- Comparison of financial statements of different entities; and
- Comparison of the financial statements of the same entity over periods of time.

An important implication of the characteristic of comparability is that users need to be informed of the policies employed in the preparation of financial statements, changes to those policies and the effects of those changes.

Because users wish to compare the performance of an entity over time, it is important that financial statements show corresponding information for preceding periods.

Constraints on Relevant and Reliable Information

Timeliness

If there is an undue delay in the reporting of information it may lose its relevance. To provide information on a timely basis it may often be necessary to report before all aspects of a transaction are known, thus impairing reliability. Conversely, if reporting is delayed until all aspects are known, the information may be highly reliable but of little use to users who have had to make decisions in the interim. In achieving a balance between relevance and reliability, the overriding consideration is how best to satisfy the decision-making needs of users.

Balance between Benefit and Cost

The balance between benefit and cost is a pervasive constraint. The benefits derived from information should exceed the cost of providing it. The evaluation of benefits and costs is, however, substantially a matter of judgment. Furthermore, the costs do not always fall on those users who enjoy the benefits. Benefits may also be enjoyed by users other than those for whom the information was prepared. For these reasons, it is difficult to apply a benefit-cost test in any particular case. Nevertheless, standard-setters, as well as those responsible for the preparation of financial statements and users of financial statements, should be aware of this constraint.

Balance between Qualitative Characteristics

In practice a balancing, or trade-off, between qualitative characteristics is often necessary. Generally the aim is to achieve an appropriate balance among the characteristics in order to meet the objectives of financial statements. The relative importance of the characteristics in different cases is a matter of professional judgment.

Comparison with IAS 14

International Public Sector Accounting Standard (IPSAS) 18, "Segment Reporting" is drawn primarily from International Accounting Standard (IAS) 14, "Segment Reporting" (revised 1997). The main differences between IPSAS 18 and IAS 14 are as follows:

- IPSAS 18 defines segments differently from IAS 14. IPSAS 18 requires entities to report segments on a basis appropriate for assessing past performance and making decision about the allocation of resources. IAS 14 requires business and geographical segments to be reported.
- Commentary additional to that in IAS 14 has been included in IPSAS 18 to clarify the applicability of the standards to accounting by public sector entities.
- IAS 14 requires disclosure of segment result, depreciation and amortization of segment assets and other significant non-cash expenses. IPSAS 18 does not require the disclosure of segment result. IPSAS 18 encourages, but does not require, the disclosure of significant non-cash revenues that are included in segment revenue, segment depreciation and other non-cash expenses or segment cash flows as required by IPSAS 2, "Cash Flow Statements."
- IPSAS 18 does not require the disclosure of information about secondary segments, but encourages certain minimum disclosures about both "service" and "geographical" segments.
- IPSAS 18 does not specify quantitative thresholds that must be applied in identifying reportable segments.
- IPSAS 18 uses different terminology, in certain instances, from IAS 14. The most significant examples are the use of the terms "entity," "revenue," "statement of financial performance," "statement of financial position" and "net assets/equity." The equivalent terms in IAS 14 are "enterprise," "income," "income statement," "balance sheet" and "equity."

IPSAS 19—PROVISIONS, CONTINGENT LIABILITIES AND CONTINGENT ASSETS

Acknowledgment

This International Public Sector Accounting Standard is drawn primarily from International Accounting Standard (IAS) 37 (1998), "Provisions, Contingent Liabilities and Contingent Assets" 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 International Accounting Standards (IASs) issued by IASC remain in force until they are amended or withdrawn by IASB. Extracts from IAS 37 are reproduced in this publication of the Public Sector Committee of the International Federation of Accountants with the permission of IASB.

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IPSAS 19—PROVISIONS, CONTINGENT LIABILITIES AND CONTINGENT ASSETS

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Comparison with IAS 37

The standards, which have been set in bold type, should be read in the context of the commentary paragraphs in this Standard, which are in plain type, and in the context of the "Preface to International Public Sector Accounting Standards." International Public Sector Accounting Standards are not intended to apply to immaterial items.

Objective

The objective of this Standard is to define provisions, contingent liabilities and contingent assets, identify the circumstances in which provisions should be recognized, how they should be measured and the disclosures that should be made about them. The Standard also requires that certain information be disclosed about contingent liabilities and contingent assets in the notes to the financial statements to enable users to understand their nature, timing and amount.

Scope

1. **An entity which prepares and presents financial statements under the accrual basis of accounting should apply this Standard in accounting for provisions, contingent liabilities and contingent assets, except:**

   (a) **Those provisions and contingent liabilities arising from social benefits provided by an entity for which it does not receive consideration that is approximately equal to the value of goods and services provided, directly in return from the recipients of those benefits;**

   (b) **Those resulting from financial instruments that are carried at fair value;**

   (c) **Those resulting from executory contracts, other than where the contract is onerous subject to other provisions of this paragraph;**

   (d) **Those arising in insurance entities from contracts with policyholders;**

   (e) **Those covered by another International Public Sector Accounting Standard;**

   (f) **Those arising in relation to income taxes or income tax equivalents; and**

   (g) **Those arising from employee benefits except employee termination benefits that arise as a result of a restructuring as dealt with in this Standard.**

2. **This Standard applies to all public sector entities other than Government Business Enterprises.**

3. Government Business Enterprises (GBEs) are required to comply with International Accounting Standards (IASs) issued by the International Accounting Standards Committee. The Public Sector Committee's Guideline No. 1, "Financial Reporting by Government Business Enterprises" notes that IASs are relevant to all business enterprises, regardless of whether they are in the private or public sector. Accordingly, Guideline No. 1 recommends that GBEs should present financial statements that conform, in all material respects, to IASs.

4. This Standard applies to financial instruments (including guarantees) that are not carried at fair value.

5. This Standard applies to provisions, contingent liabilities and contingent assets of insurance entities other than those arising from contracts with policyholders.

6. This Standard applies to provisions for restructuring (including discontinuing operations). In some cases, a restructuring may meet the definition of a discontinuing operation. Guidance on disclosing information about discontinuing operations is found in International Accounting Standard (IAS) 35, "Discontinuing Operations."[1]

Social Benefits

7. For the purposes of this Standard "social benefits" refer to goods, services and other benefits provided in the pursuit of the social policy objectives of a government. These benefits may include:

   (a) The delivery of health, education, housing, transport and other social services to the community. In many cases, there is no

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1 The Committee has not yet addressed the issue of discontinuing operations, which is the subject of International Accounting Standard (IAS) 35, "Discontinuing Operations." Consistent with the definition in IAS 35, the term discontinuing operation as used in this Standard refers to a component of an entity:

(a) That the entity, pursuant to a single plan, is:

  (i) Disposing of substantially in its entirety, such as by selling the component in a single transaction, by demerger or spin-off of ownership of the component to the entity's owners;

  (ii) Disposing of piecemeal, such as by selling off the component's assets and settling its liabilities individually; or

  (iii) Terminating through abandonment;

(b) That represents a separate major activity/line of business or geographical area of operations; and

(c) That can be distinguished operationally and for financial reporting purposes.

requirement for the beneficiaries of these services to pay an amount equivalent to the value of these services; and

(b) Payment of benefits to families, the aged, the disabled, the unemployed, veterans and others. That is, 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.

8. In many cases, obligations to provide social benefits arise as a consequence of a government's commitment to undertake particular activities on an on-going basis over the long term in order to provide particular goods and services to the community. The need for, and nature and supply of, goods and services to meet social policy obligations will often depend on a range of demographic and social conditions and are difficult to predict. These benefits generally fall within the "social protection," "education" and "health" classifications under the International Monetary Fund's Government Finance Statistics framework and often require an actuarial assessment to determine the amount of any liability arising in respect of them.

9. For a provision or contingency arising from a social benefit to be excluded from the scope of this Standard, the public sector entity providing the benefit will not receive consideration that is approximately equal to the value of goods and services provided, directly in return from the recipients of the benefit. This exclusion would encompass those circumstances where a charge is levied in respect of the benefit but there is no direct relationship between the charge and the benefit received. The exclusion of these provisions and contingent liabilities from the scope of this Standard reflects the Committee's view that both the determination of what constitutes the "obligating event" and the measurement of the liability require further consideration before proposed Standards are exposed. For example, the Committee is aware that there are differing views about whether the obligating event occurs when the individual meets the eligibility criteria for the benefit or at some earlier stage. Similarly, there are differing views about whether the amount of any obligation reflects an estimate of the current period's entitlement or the present value of all expected future benefits determined on an actuarial basis.

10. Where an entity elects to recognize a provision for such obligations, the entity discloses the basis on which the provisions have been recognized and the measurement basis adopted. The entity also makes other disclosures required by this Standard in respect of those provisions. IPSAS 1, "Presentation of Financial Statements," provides guidance on dealing with matters not specifically dealt with by another IPSAS. IPSAS 1 also

includes requirements relating to the selection and disclosure of accounting policies.

11. In some cases, social benefits may give rise to a liability for which there is:

    (a) Little or no uncertainty as to amount; and

    (b) The timing of the obligation is not uncertain.

    Accordingly, these are not likely to meet the definition of a provision in this Standard. Where such liabilities for social benefits exist, they are recognized where they satisfy the criteria for recognition as liabilities (refer also to paragraph 19). An example would be a period-end accrual for an amount owing to the existing beneficiaries in respect of aged or disability pensions that have been approved for payment consistent with the provisions of a contract or legislation.

Other Exclusions from the Scope of the Standard

12. This Standard does not apply to executory contracts unless they are onerous. Contracts to provide social benefits entered into with the expectation that the entity will not receive consideration that is approximately equal to the value of goods and services provided directly in return from the recipients of those benefits are excluded from the scope of this Standard.

13. Where another International Public Sector Accounting Standard deals with a specific type of provision, contingent liability or contingent asset, an entity applies that Standard instead of this Standard. For example, certain types of provisions are also addressed in Standards on:

    (a) Construction contracts (see IPSAS 11, "Construction Contracts") and

    (b) Leases (see IPSAS 13, "Leases"). However, as IPSAS 13 contains no specific requirements to deal with operating leases that have become onerous, this Standard applies to such cases.

14. This Standard does not apply to provisions for income taxes or income tax equivalents (guidance on accounting for income taxes is found in IAS 12, "Income Taxes"). Nor does it apply to provisions arising from employee benefits (guidance on accounting for employee benefits is found in IAS 19, "Employee Benefits").

15. Some amounts treated as provisions may relate to the recognition of revenue, for example where an entity gives guarantees in exchange for a fee. This Standard does not address the recognition of revenue. IPSAS 9, "Revenue from Exchange Transactions," identifies the circumstances in

which revenue from exchange transactions is recognized and provides practical guidance on the application of the recognition criteria. This Standard does not change the requirements of IPSAS 9.

16. This Standard defines provisions as liabilities of uncertain timing or amount. In some countries the term "provision" is also used in the context of items such as depreciation, impairment of assets and doubtful debts: these are adjustments to the carrying amounts of assets and are not addressed in this Standard.

17. Other International Public Sector Accounting Standards specify whether expenditures are treated as assets or as expenses. These issues are not addressed in this Standard. Accordingly, this Standard neither prohibits nor requires capitalization of the costs recognized when a provision is made.

Definitions

18. **The following terms are used in this Standard with the meanings specified:**

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.**

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.

A contingent liability is:

(a) **A possible obligation 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; or**

(b) **A present obligation that arises from past events but is not recognized because:**

(i) **It is not probable that an outflow of resources embodying economic benefits or service potential will be required to settle the obligation; or**

(ii) **The amount of the obligation cannot be measured with sufficient reliability.**

Executory contracts are contracts under which neither party has performed any of its obligations or both parties have partially performed their obligations to an equal extent.

A legal obligation is an obligation that derives from:

(a) **A contract (through its explicit or implicit terms);**

(b) **Legislation; or**

(c) **Other operation of law.**

Liabilities are present obligations of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits or service potential.

An obligating event is an event that creates a legal or constructive obligation that results in an entity having no realistic alternative to settling that obligation.

An onerous contract is a contract for the exchange of assets or services in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits or service potential expected to be received under it.

A provision is a liability of uncertain timing or amount.

A restructuring is a program that is planned and controlled by management, and materially changes either:

(a) **The scope of an entity's activities; or**

(b) **The manner in which those activities are carried out.**

Provisions and Other Liabilities

19. Provisions can be distinguished from other liabilities such as payables and accruals because there is uncertainty about the timing or amount of the future expenditure required in settlement. By contrast:

(a) Payables are liabilities to pay for goods or services that have been received or supplied and have been invoiced or formally agreed with the supplier (and include payments in respect of social benefits where formal agreements for specified amounts exist); and

(b) Accruals are liabilities to pay for goods or services that have been received or supplied but have not been paid, invoiced or formally agreed with the supplier, including amounts due to employees (for example, amounts relating to accrued vacation pay). Although it is

sometimes necessary to estimate the amount or timing of accruals, the uncertainty is generally much less than for provisions.

Accruals are often reported as part of accounts payable, whereas provisions are reported separately.

Relationship between Provisions and Contingent Liabilities

20. In a general sense, all provisions are contingent because they are uncertain in timing or amount. However, within this Standard the term "contingent" is used for liabilities and assets that are not recognized because their 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. In addition, the term "contingent liability" is used for liabilities that do not meet the recognition criteria.

21. This Standard distinguishes between:

    (a) Provisions—which are recognized as liabilities (assuming that a reliable estimate can be made) because they are present obligations and it is probable that an outflow of resources embodying economic benefits or service potential will be required to settle the obligations; and

    (b) Contingent liabilities—which are not recognized as liabilities because they are either:

        (i) Possible obligations, as it has yet to be confirmed whether the entity has a present obligation that could lead to an outflow of resources embodying economic benefits or service potential; or

        (ii) Present obligations that do not meet the recognition criteria in this Standard (because either it is not probable that an outflow of resources embodying economic benefits or service potential will be required to settle the obligation, or a sufficiently reliable estimate of the amount of the obligation cannot be made).

Recognition

Provisions

22. **A provision should be recognized when:**

    (a) **An entity has a present obligation (legal or constructive) as a result of a past event;**

(b) **It is probable that an outflow of resources embodying economic benefits or service potential will be required to settle the obligation; and**

(c) **A reliable estimate can be made of the amount of the obligation.**

If these conditions are not met, no provision should be recognized.

Present Obligation

23. **In some cases it is not clear whether there is a present obligation. In these cases, 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.**

24. In most cases it will be clear whether a past event has given rise to a present obligation. In other cases, for example in a lawsuit, it may be disputed either whether certain events have occurred or whether those events result in a present obligation. In such cases, an entity determines whether a present obligation exists at the reporting date by taking account of all available evidence, including, for example, the opinion of experts. The evidence considered includes any additional evidence provided by events after the reporting date. On the basis of such evidence:

(a) Where it is more likely than not that a present obligation exists at the reporting date, the entity recognizes a provision (if the recognition criteria are met); and

(b) Where it is more likely that no present obligation exists at the reporting date, the entity discloses a contingent liability, unless the possibility of an outflow of resources embodying economic benefits or service potential is remote (see paragraph 100).

Past Event

25. A past event that leads to a present obligation is called an obligating event. For an event to be an obligating event, it is necessary that the entity has no realistic alternative to settling the obligation created by the event. This is the case only:

(a) Where the settlement of the obligation can be enforced by law; or

(b) In the case of a constructive obligation, where the event (which may be an action of the entity) creates valid expectations in other parties that the entity will discharge the obligation.

26. Financial statements deal with the financial position of an entity at the end of its reporting period and not its possible position in the future. Therefore, no provision is recognized for costs that need to be incurred to continue an entity's ongoing activities in the future. The only liabilities recognized in

an entity's statement of financial position are those that exist at the reporting date.

27. It is only those obligations arising from past events existing independently of an entity's future actions (that is, the future conduct of its activities) that are recognized as provisions. Examples of such obligations are penalties or clean-up costs for unlawful environmental damage imposed by legislation on a public sector entity. Both of these obligations would lead to an outflow of resources embodying economic benefits or service potential in settlement regardless of the future actions of that public sector entity. Similarly, a public sector entity would recognize a provision for the decommissioning costs of a defense installation or a government-owned nuclear power station to the extent that the public sector entity is obliged to rectify damage already caused IPSAS 17, "Property, Plant and Equipment," deals with items, including dismantling and site restoring costs, that are included in the cost of an asset). In contrast, because of legal requirements, pressure from constituents, or a desire to demonstrate community leadership, an entity may intend or need to carry out expenditure to operate in a particular way in the future. An example would be where a public sector entity decides to fit emission controls on certain of its vehicles or a government laboratory decides to install extraction units to protect employees from the fumes of certain chemicals. Because the entities can avoid the future expenditure by their future actions — for example, by changing their method of operation, they have no present obligation for that future expenditure and no provision is recognized.

28. An obligation always involves another party to whom the obligation is owed. It is not necessary, however, to know the identity of the party to whom the obligation is owed — indeed the obligation may be to the public at large. Because an obligation always involves a commitment to another party, it follows that a decision by an entity's management, governing body or controlling entity does not give rise to a constructive obligation at the reporting date unless the decision has been communicated before the reporting date to those affected by it in a sufficiently specific manner to raise a valid expectation in them that the entity will discharge its responsibilities.

29. An event that does not give rise to an obligation immediately may do so at a later date, because of changes in the law or because an act (for example, a sufficiently specific public statement) by the entity gives rise to a constructive obligation. For example, when environmental damage is caused by a government agency there may be no obligation to remedy the consequences. However, the causing of the damage will become an obligating event when a new law requires the existing damage to be rectified or when the controlling government or the individual agency

publicly accepts responsibility for rectification in a way that creates a constructive obligation.

30. Where details of a proposed new law have yet to be finalized, an obligation arises only when the legislation is virtually certain to be enacted as drafted. For the purpose of this Standard, such an obligation is treated as a legal obligation. However, differences in circumstances surrounding enactment often make it impossible to specify a single event that would make the enactment of a law virtually certain. In many cases, it is not possible to judge whether a proposed new law is virtually certain to be enacted as drafted and any decision about the existence of an obligation should await the enactment of the proposed law.

Probable Outflow of Resources Embodying Economic Benefits or Service Potential

31. For a liability to qualify for recognition there must be not only a present obligation but also the probability of an outflow of resources embodying economic benefits or service potential to settle that obligation. For the purpose of this Standard, an outflow of resources or other event is regarded as probable if the event is more likely than not to occur, that is, the probability that the event will occur is greater than the probability that it will not. Where it is not probable that a present obligation exists, an entity discloses a contingent liability, unless the possibility of an outflow of resources embodying economic benefits or service potential is remote (see paragraph 100).

32. Where there are a number of similar obligations (for example, a government's obligation to compensate individuals who have received contaminated blood from a government-owned hospital) the probability that an outflow will be required in settlement is determined by considering the class of obligations as a whole. Although the likelihood of outflow for any one item may be small, it may well be probable that some outflow of resources will be needed to settle the class of obligations as a whole. If that is the case, a provision is recognized (if the other recognition criteria are met).

Reliable Estimate of the Obligation

33. The use of estimates is an essential part of the preparation of financial statements and does not undermine their reliability. This is especially true in the case of provisions, which by their nature are more uncertain than most other assets or liabilities. Except in extremely rare cases, an entity will be able to determine a range of possible outcomes and can therefore make an estimate of the obligation that is sufficiently reliable to use in recognizing a provision.

34. In the extremely rare case where no reliable estimate can be made, a liability exists that cannot be recognized. That liability is disclosed as a contingent liability (see paragraph 100).

Contingent Liabilities

35. **An entity should not recognize a contingent liability.**

36. A contingent liability is disclosed, as required by paragraph 100, unless the possibility of an outflow of resources embodying economic benefits or service potential is remote.

37. Where an entity is jointly and severally liable for an obligation the part of the obligation that is expected to be met by other parties is treated as a contingent liability. For example, in the case of joint venture debt, that part of the obligation that is to be met by other joint venture participants is treated as a contingent liability. The entity recognizes a provision for the part of the obligation for which an outflow of resources embodying economic benefits or service potential is probable, except in the rare circumstances where no reliable estimate can be made.

38. Contingent liabilities may develop in a way not initially expected. Therefore, they are assessed continually to determine whether an outflow of resources embodying economic benefits or service potential has become probable. 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). For example, a local government entity may have breached an environmental law but it remains unclear whether any damage was caused to the environment. Where, subsequently it becomes clear that damage was caused and remediation will be required, the entity would recognize a provision because an outflow of economic benefits is now probable.

Contingent Assets

39. **An entity should not recognize a contingent asset.**

40. Contingent assets usually arise from unplanned or other unexpected events that are not wholly within the control of the entity and give rise to the possibility of an inflow of economic benefits or service potential to the entity. An example is a claim that an entity is pursuing through legal processes, where the outcome is uncertain.

41. Contingent assets are not recognized in financial statements since this may result in the recognition of revenue that may never be realized. However,

when the realization of revenue is virtually certain, then the related asset is not a contingent asset and its recognition is appropriate.

42. A contingent asset is disclosed, as required by paragraph 105, where an inflow of economic benefits or service potential is probable.

43. Contingent assets are assessed continually to ensure that developments are appropriately reflected in the financial statements. If it has become virtually certain that an inflow of economic benefits or service potential will arise and the asset's value can be measured reliably, the asset and the related revenue are recognized in the financial statements of the period in which the change occurs. If an inflow of economic benefits or service potential has become probable, an entity discloses the contingent asset (see paragraph 105).

Measurement

Best Estimate

44. **The amount recognized as a provision should be the best estimate of the expenditure required to settle the present obligation at the reporting date.**

45. The best estimate of the expenditure required to settle the present obligation is the amount that an entity would rationally pay to settle the obligation at the reporting date or to transfer it to a third party at that time. It will often be impossible or prohibitively expensive to settle or transfer an obligation at the reporting date. However, the estimate of the amount that an entity would rationally pay to settle or transfer the obligation gives the best estimate of the expenditure required to settle the present obligation at the reporting date.

46. The estimates of outcome and financial effect are determined by the judgment of the management of the entity, supplemented by experience of similar transactions and, in some cases, reports from independent experts. The evidence considered includes any additional evidence provided by events after the reporting date.

> *Example*
>
> A government medical laboratory provides diagnostic ultrasound scanners to both government owned and privately owned medical centers and hospitals on a full cost recovery basis. The equipment is provided with a warranty under which the medical centers and hospitals are covered for the cost of repairs of any defects that become apparent within the first six months after purchase. If minor defects were detected

> in all equipment provided, repair costs of 1 million currency units would result. If major defects were detected in all equipment provided, repair costs of 4 million currency units would result. The laboratory's past experience and future expectations indicate that, for the coming year, 75% of the equipment will have no defects, 20% of the equipment will have minor defects and 5% of the equipment will have major defects. In accordance with paragraph 32, the laboratory assesses the probability of an outflow for the warranty obligations as a whole.
>
> The expected value of the cost of repairs is:
>
> (75% of nil) + (20% of 1m) + (5% of 4m) = 400,000

47. Uncertainties surrounding the amount to be recognized as a provision are dealt with by various means according to the circumstances. Where the provision being measured involves a large population of items, the obligation is estimated by weighting all possible outcomes by their associated probabilities. The name for this statistical method of estimation is "expected value." The provision will therefore be different depending on whether the probability of a loss of a given amount is, for example, 60% or 90%. Where there is a continuous range of possible outcomes, and each point in that range is as likely as any other, the mid-point of the range is used.

48. Where a single obligation is being measured, the individual most likely outcome may be the best estimate of the liability. However, even in such a case, the entity considers other possible outcomes. Where other possible outcomes are either mostly higher or mostly lower than the most likely outcome, the best estimate will be a higher or lower amount. For example, if a government has to rectify a serious fault in a defense vessel that it has constructed for another government, the individual most likely outcome may be for the repair to succeed at the first attempt at a cost of 100,000 currency units, but a provision for a larger amount is made if there is a significant chance that further attempts will be necessary.

49. The provision is measured before tax or tax equivalents. Guidance on dealing with the tax consequences of a provision, and changes in it, is found in IAS 12, "Income Taxes."

Risks and Uncertainties

50. **The risks and uncertainties that inevitably surround many events and circumstances should be taken into account in reaching the best estimate of a provision.**

51. Risk describes variability of outcome. A risk adjustment may increase the amount at which a liability is measured. Caution is needed in making judgments under conditions of uncertainty, so that revenue or assets are not overstated and expenses or liabilities are not understated. However, uncertainty does not justify the creation of excessive provisions or a deliberate overstatement of liabilities. For example, if the projected costs of a particularly adverse outcome are estimated on a prudent basis, that outcome is not then deliberately treated as more probable than is realistically the case. Care is needed to avoid duplicating adjustments for risk and uncertainty with consequent overstatement of a provision.

52. Disclosure of the uncertainties surrounding the amount of the expenditure is made under paragraph 98(b).

Present Value

53. **Where the effect of the time value of money is material, the amount of a provision should be the present value of the expenditures expected to be required to settle the obligation.**

54. Because of the time value of money, provisions relating to cash outflows that arise soon after the reporting date are more onerous than those where cash outflows of the same amount arise later. Provisions are therefore discounted, where the effect is material.

55. When a provision is discounted over a number of years, the present value of the provision will increase each year as the provision comes closer to the expected time of settlement (refer to Appendix E). Paragraph 97(e) of this Standard requires disclosure of the increase during the period in the discounted amount arising from the passage of time.

56. **The discount rate (or rates) should be a pre-tax rate (or rates) that reflect(s) current market assessments of the time value of money and the risks specific to the liability. The discount rate(s) should not reflect risks for which future cash flow estimates have been adjusted.**

57. In some jurisdictions, income taxes or income tax equivalents are levied on a public sector entity's surplus for the period. Where such income taxes are levied on public sector entities, the discount rate selected should be a pre-tax rate.

Future Events

58. **Future events that may affect the amount required to settle an obligation should be reflected in the amount of a provision where there is sufficient objective evidence that they will occur.**

59. Expected future events may be particularly important in measuring provisions. For example, certain obligations may be index linked to compensate recipients for the effects of inflation or other specific price changes. If there is sufficient evidence of likely expected rates of inflation this should be reflected in the amount of the provision. Another example of future events affecting the amount of a provision is where a government believes that the cost of cleaning up the tar, ash and other pollutants associated with a gasworks' site at the end of its life will be reduced by future changes in technology. In this case, the amount recognized reflects the cost that technically qualified, objective observers reasonably expect to be incurred, taking account of all available evidence as to the technology that will be available at the time of the clean-up. Thus it is appropriate to include, for example, expected cost reductions associated with increased experience in applying existing technology or the expected cost of applying existing technology to a larger or more complex clean-up operation than has previously been carried out. However, an entity does not anticipate the development of a completely new technology for cleaning up unless it is supported by sufficient objective evidence.

60. The effect of possible new legislation which may affect the amount of an existing obligation of a government or an individual public sector entity is taken into consideration in measuring that obligation when sufficient objective evidence exists that the legislation is virtually certain to be enacted. The variety of circumstances that arise in practice makes it impossible to specify a single event that will provide sufficient, objective evidence in every case. Evidence is required both of what legislation will demand and of whether it is virtually certain to be enacted and implemented in due course. In many cases, sufficient objective evidence will not exist until the new legislation is enacted.

Expected Disposal of Assets

61. **Gains from the expected disposal of assets should not be taken into account in measuring a provision.**

62. Gains on the expected disposal of assets are not taken into account in measuring a provision, even if the expected disposal is closely linked to the event giving rise to the provision. Instead, an entity recognizes gains on expected disposals of assets at the time specified by the International Public Sector Accounting Standard dealing with the assets concerned.

Reimbursements

63. **Where some or all of the expenditure required to settle a provision is expected to be reimbursed by another party, the reimbursement should be recognized when, and only when, it is virtually certain that**

reimbursement will be received if the entity settles the obligation. The reimbursement should be treated as a separate asset. The amount recognized for the reimbursement should not exceed the amount of the provision.

64. **In the statement of financial performance, the expense relating to a provision may be presented net of the amount recognized for a reimbursement.**

65. Sometimes, an entity is able to look to another party to pay part or all of the expenditure required to settle a provision (for example, through insurance contracts, indemnity clauses or suppliers' warranties). The other party may either reimburse amounts paid by the entity or pay the amounts directly. For example, a government agency may have legal liability to an individual as a result of misleading advice provided by its employees. However, the agency may be able to recover some of the expenditure from professional indemnity insurance.

66. In most cases, the entity will remain liable for the whole of the amount in question so that the entity would have to settle the full amount if the third party failed to pay for any reason. In this situation, a provision is recognized for the full amount of the liability, and a separate asset for the expected reimbursement is recognized when it is virtually certain that reimbursement will be received if the entity settles the liability.

67. In some cases, the entity will not be liable for the costs in question if the third party fails to pay. In such a case, the entity has no liability for those costs and they are not included in the provision.

68. As noted in paragraph 37, an obligation for which an entity is jointly and severally liable is a contingent liability to the extent that it is expected that the obligation will be settled by the other parties.

Changes in Provisions

69. **Provisions should be reviewed at each reporting date and adjusted to reflect the current best estimate. If it is no longer probable that an outflow of resources embodying economic benefits or service potential will be required to settle the obligation, the provision should be reversed.**

70. Where discounting is used, the carrying amount of a provision increases in each period to reflect the passage of time. This increase is recognized as an interest expense.

Use of Provisions

71. **A provision should be used only for expenditures for which the provision was originally recognized.**

72. Only expenditures that relate to the original provision are set against it. Setting expenditures against a provision that was originally recognized for another purpose would conceal the impact of two different events.

Application of the Recognition and Measurement Rules

Future Operating Net Deficits

73. **Provisions should not be recognized for net deficits from future operating activities.**

74. Net deficits from future operating activities do not meet the definition of liabilities in paragraph 18 and the general recognition criteria set out for provisions in paragraph 22.

75. An expectation of net deficits from future operating activities is an indication that certain assets used in these activities may be impaired. An entity tests these assets for impairment. Guidance on accounting for impairment is found in IAS 36, "Impairment of Assets."

Onerous Contracts

76. **If an entity has a contract that is onerous, the present obligation (net of recoveries) under the contract should be recognized and measured as a provision.**

77. Paragraph 76 of this Standard applies only to contracts that are onerous. Contracts to provide social benefits entered into with the expectation that the entity does not receive consideration that is approximately equal to the value of goods and services provided, directly in return from the recipients of those benefits are excluded from the scope of this Standard.

78. Many contracts evidencing exchange transactions (for example, some routine purchase orders) can be canceled without paying compensation to the other party, and therefore there is no obligation. Other contracts establish both rights and obligations for each of the contracting parties. Where events make such a contract onerous, the contract falls within the scope of this Standard and a liability exists which is recognized. Executory contracts that are not onerous fall outside the scope of this Standard.

79. This Standard defines an onerous contract as a contract in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits or service potential expected to be received under it

which includes amounts recoverable. Therefore, it is the present obligation net of recoveries that is recognized as a provision under paragraph 76. The unavoidable costs under a contract reflect the least net cost of exiting from the contract, which is the lower of the cost of fulfilling it and any compensation or penalties arising from failure to fulfill it.

80. Before a separate provision for an onerous contract is established, an entity recognizes any impairment loss that has occurred on assets dedicated to that contract.

Restructuring

81. The following are examples of events that may fall under the definition of restructuring:

    (a) Termination or disposal of an activity or service;

    (b) The closure of a branch office or termination of activities of a government agency in a specific location or region or the relocation of activities from one region to another;

    (c) Changes in management structure, for example, eliminating a layer of management or executive service; and

    (d) Fundamental reorganizations that have a material effect on the nature and focus of the entity's operations.

82. A provision for restructuring costs is recognized only when the general recognition criteria for provisions set out in paragraph 22 are met. Paragraphs 83 to 96 set out how the general recognition criteria apply to restructurings.

83. **A constructive obligation to restructure arises only when an entity:**

    (a) **Has a detailed formal plan for the restructuring identifying at least:**

        (i) **The activity/operating unit or part of an activity/operating unit concerned;**

        (ii) **The principal locations affected;**

        (iii) **The location, function, and approximate number of employees who will be compensated for terminating their services;**

        (iv) **The expenditures that will be undertaken; and**

        (v) **When the plan will be implemented; and**

(b) **Has raised a valid expectation in those affected that it will carry out the restructuring by starting to implement that plan or announcing its main features to those affected by it.**

84. Within the public sector, restructuring may occur at the whole-of-government, portfolio or ministry, or agency level.

85. Evidence that a government or an individual entity has started to implement a restructuring plan would be provided, for example, by the public announcement of the main features of the plan, the sale or transfer of assets, notification of intention to cancel leases or the establishment of alternative arrangements for clients of services. A public announcement of a detailed plan to restructure constitutes a constructive obligation to restructure only if it is made in such a way and in sufficient detail (that is, setting out the main features of the plan) that it gives rise to valid expectations in other parties such as users of the service, suppliers and employees (or their representatives) that the government or the entity will carry out the restructuring.

86. For a plan to be sufficient to give rise to a constructive obligation when communicated to those affected by it, its implementation needs to be planned to begin as soon as possible and to be completed in a timeframe that makes significant changes to the plan unlikely. If it is expected that there will be a long delay before the restructuring begins or that the restructuring will take an unreasonably long time, it is unlikely that the plan will raise a valid expectation on the part of others that the government or individual entity is at present committed to restructuring, because the timeframe allows opportunities for the government or entity to change its plans.

87. A decision by management or the governing body to restructure taken before the reporting date does not give rise to a constructive obligation at the reporting date unless the entity has, before the reporting date:

(a) Started to implement the restructuring plan; or

(b) Announced the main features of the restructuring plan to those affected by it in a sufficiently specific manner to raise a valid expectation in them that the entity will carry out the restructuring.

In some cases, an entity starts to implement a restructuring plan, or announces its main features to those affected, only after the reporting date. Disclosure may be required under IPSAS 14, "Events After the Reporting Date," if the restructuring is of such importance that its non-disclosure would affect the ability of the users of the financial statements to make proper evaluations and decisions.

88. Although a constructive obligation is not created solely by a management or governing body decision, an obligation may result from other earlier events together with such a decision. For example, negotiations with employee representatives for termination payments, or with purchasers for the sale or transfer of an operation, may have been concluded subject only to governing body or board approval. Once that approval has been obtained and communicated to the other parties, the entity has a constructive obligation to restructure, if the conditions of paragraph 83 are met.

89. In some countries, the ultimate authority for making decisions about a public sector entity is vested in a governing body or board whose membership includes representatives of interests other than those of management (for example, employees) or notification to these representatives may be necessary before the governing body or board decision is taken. Because a decision by such a governing body or board involves communication to these representatives, it may result in a constructive obligation to restructure.

Sale or Transfer of Operations

90. **No obligation arises as a consequence of the sale or transfer of an operation until the entity is committed to the sale or transfer, that is, there is a binding agreement.**

91. Even when an entity has taken a decision to sell an operation and announced that decision publicly, it cannot be committed to the sale until a purchaser has been identified and there is a binding sale agreement. Until there is a binding sale agreement, the entity will be able to change its mind and indeed will have to take another course of action if a purchaser cannot be found on acceptable terms. When a sale is only part of a restructuring, a constructive obligation can arise for the other parts of the restructuring before a binding sale agreement exists.

92. Restructuring within the public sector often involves the transfer of operations from one controlled entity to another and may involve the transfer of operations at no or nominal consideration. Such transfers will often take place under a government directive and will not involve binding agreements as described in paragraph 90. An obligation exists only when there is a binding transfer agreement. Even where proposed transfers do not lead to the recognition of a provision, the planned transaction may require disclosure under other International Public Sector Accounting Standards or proposed Standards such as the IPSAS 14, “Events After the Reporting Date” and IPSAS 20, “Related Party Disclosures.”

Restructuring Provisions

93. **A restructuring provision should include only the direct expenditures arising from the restructuring, which are those that are both:**

    (a) **Necessarily entailed by the restructuring; and**

    (b) **Not associated with the ongoing activities of the entity.**

94. A restructuring provision does not include such costs as:

    (a) Retraining or relocating continuing staff;

    (b) Marketing; or

    (c) Investment in new systems and distribution networks.

    These expenditures relate to the future conduct of an activity and are not liabilities for restructuring at the reporting date. Such expenditures are recognized on the same basis as if they arose independently of a restructuring.

95. Identifiable future operating net deficits up to the date of a restructuring are not included in a provision, unless they relate to an onerous contract as defined in paragraph 18.

96. As required by paragraph 61, gains on the expected disposal of assets are not taken into account in measuring a restructuring provision, even if the sale of assets is envisaged as part of the restructuring.

Disclosure

97. **For each class of provision, an entity should disclose:**

    (a) **The carrying amount at the beginning and end of the period;**

    (b) **Additional provisions made in the period, including increases to existing provisions;**

    (c) **Amounts used (that is, incurred and charged against the provision) during the period;**

    (d) **Unused amounts reversed during the period; and**

    (e) **The increase during the period in the discounted amount arising from the passage of time and the effect of any change in the discount rate.**

Comparative information is not required.

98. **An entity should disclose the following for each class of provision:**

(a) **A brief description of the nature of the obligation and the expected timing of any resulting outflows of economic benefits or service potential;**

(b) **An indication of the uncertainties about the amount or timing of those outflows. Where necessary to provide adequate information, an entity should disclose the major assumptions made concerning future events, as addressed in paragraph 58; and**

(c) **The amount of any expected reimbursement, stating the amount of any asset that has been recognized for that expected reimbursement.**

99. **Where an entity elects to recognize in its financial statements provisions for social benefits for which it does not receive consideration that is approximately equal to the value of goods and services provided, directly in return from the recipients of those benefits, it should make the disclosures required in paragraphs 97 and 98 in respect of those provisions.**

100. **Unless the possibility of any outflow in settlement is remote, an entity should disclose for each class of contingent liability at the reporting date a brief description of the nature of the contingent liability and, where practicable:**

(a) **An estimate of its financial effect, measured under paragraphs 44 to 62;**

(b) **An indication of the uncertainties relating to the amount or timing of any outflow; and**

(c) **The possibility of any reimbursement.**

101. In determining which provisions or contingent liabilities may be aggregated to form a class, it is necessary to consider whether the nature of the items is sufficiently similar for a single statement about them to fulfill the requirements of paragraphs 98(a) and (b) and 100(a) and (b). Thus, it may be appropriate to treat as a single class of provision amounts relating to one type of obligation, but it would not be appropriate to treat as a single class amounts relating to environmental restoration costs and amounts that are subject to legal proceedings.

102. Where a provision and a contingent liability arise from the same set of circumstances, an entity makes the disclosures required by paragraphs 97, 98 and 100 in a way that shows the link between the provision and the contingent liability.

103. An entity may in certain circumstances use external valuation to measure a provision. In such cases, information relating to the valuation can usefully be disclosed.

104. The disclosure requirements in paragraph 100 do not apply to contingent liabilities that arise from social benefits provided by an entity for which it does not receive consideration that is approximately equal to the value of goods or services provided, directly in return from the recipients of those benefits (see paragraphs 1(a) and 7–11 for a discussion of the exclusion of social benefits from this Standard).

105. **Where an inflow of economic benefits or service potential is probable, an entity should disclose a brief description of the nature of the contingent assets at the reporting date, and, where practicable, an estimate of their financial effect, measured using the principles set out for provisions in paragraphs 44 to 62.**

106. The disclosure requirements in paragraph 105 are only intended to apply to those contingent assets where there is a reasonable expectation that benefits will flow to the entity. That is, there is no requirement to disclose this information about all contingent assets (see paragraphs 39 to 43 for a discussion of contingent assets). It is important that disclosures for contingent assets avoid giving misleading indications of the likelihood of revenue arising. For example, a contingent asset would arise from a contract where a public sector entity allows a private sector company to mine one of its properties in exchange for a royalty based on a set price per ton extracted and the company has commenced mining. In addition to disclosing the nature of the arrangement, the contingent asset should be quantified where a reasonable estimate can be made of the quantity of mineral to be extracted and the timing of the expected cash inflows. If there were no proven reserves or some other circumstances prevailed that indicated that it would be unlikely that any minerals would be extracted, the public sector entity would not disclose information required by paragraph 105 as there is no probable flow of benefits.

107. The disclosure requirements in paragraph 105 encompass contingent assets from both exchange and non-exchange transactions. Whether a contingent asset exists in relation to taxation revenues rests on the interpretation of what constitutes a "taxable event." The determination of the taxable event for taxation revenue and its possible implications for the disclosure of contingent assets related to taxation revenues are to be dealt with as a part of a separate project on non-exchange revenue.

108. **Where any of the information required by paragraphs 100 and 105 is not disclosed because it is not practicable to do so, that fact should be stated.**

109. **In extremely rare cases, disclosure of some or all of the information required by paragraphs 97 to 107 can be expected to prejudice seriously the position of the entity in a dispute with other parties on the subject matter of the provision, contingent liability or contingent asset. In such cases, an entity need not disclose the information, but should disclose the general nature of the dispute, together with the fact that, and reason why, the information has not been disclosed.**

Transitional Provisions

110. **The effect of adopting this Standard on its effective date (or earlier) should be reported as an adjustment to the opening balance of accumulated surpluses/(deficits) for the period in which the Standard is first adopted. Entities are encouraged, but not required, to adjust the opening balance of accumulated surpluses/(deficits) for the earliest period presented and to restate comparative information. If comparative information is not restated, this fact should be disclosed.**

111. The Standard requires a different treatment from IPSAS 3, "Net Surplus or Deficit for the Period, Fundamental Errors and Changes in Accounting Policies." IPSAS 3 requires comparative information to be restated (benchmark treatment) or additional pro forma comparative information on a restated basis to be disclosed (allowed alternative treatment) unless it is impracticable to do so. This Standard requires that any prior period adjustment resulting from the adoption of this Standard for the first time be made directly against the opening balance of accumulated surpluses/(deficits) (benchmark treatment under IPSAS 3).

Effective Date

112. **This International Public Sector Accounting Standard becomes effective for annual financial statements covering periods beginning on or after January 1, 2004. Earlier application is encouraged.**

113. When an entity adopts the accrual basis of accounting, as defined by International Public Sector Accounting Standards, for financial reporting purposes, subsequent to this effective date, this Standard applies to the entity's annual financial statements covering periods beginning on or after the date of adoption.

Appendix A

Tables—Provisions, Contingent Liabilities, Contingent Assets and Reimbursements

The purpose of this appendix is to summarize the main requirements of the standards. It does not form part of the standards and should be read in the context of the full text of the standards.

Provisions and Contingent Liabilities

Where, as a result of past events, there may be an outflow of resources embodying future economic benefits or service potential in settlement of: (a) a present obligation; or (b) a possible obligation 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.		
There is a present obligation that probably requires an outflow of resources.	**There is a possible obligation or a present obligation that may, but probably will not, require an outflow of resources.**	**There is a possible obligation or a present obligation where the likelihood of an outflow of resources is remote.**
A provision is recognized (paragraph 22). Disclosures are required for the provision (paragraphs 97 and 98).	No provision is recognized (paragraph 35). Disclosures are required for the contingent liability (paragraph 100).	No provision is recognized (paragraph 35). No disclosure is required (paragraph 100).

A contingent liability also arises in the extremely rare case where there is a liability that cannot be recognized because it cannot be measured reliably. Disclosures are required for the contingent liability.

Contingent Assets

Where, as a result of past events, there is a possible asset 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.		
The inflow of economic benefits or service potential is virtually certain.	**The inflow of economic benefits or service potential is probable, but not virtually certain.**	**The inflow of economic benefits or service potential is not probable.**
The asset is not contingent (paragraph 41).	No asset is recognized (paragraph 39). Disclosures are required (paragraph 105).	No asset is recognized (paragraph 39). No disclosure is required (paragraph 105).

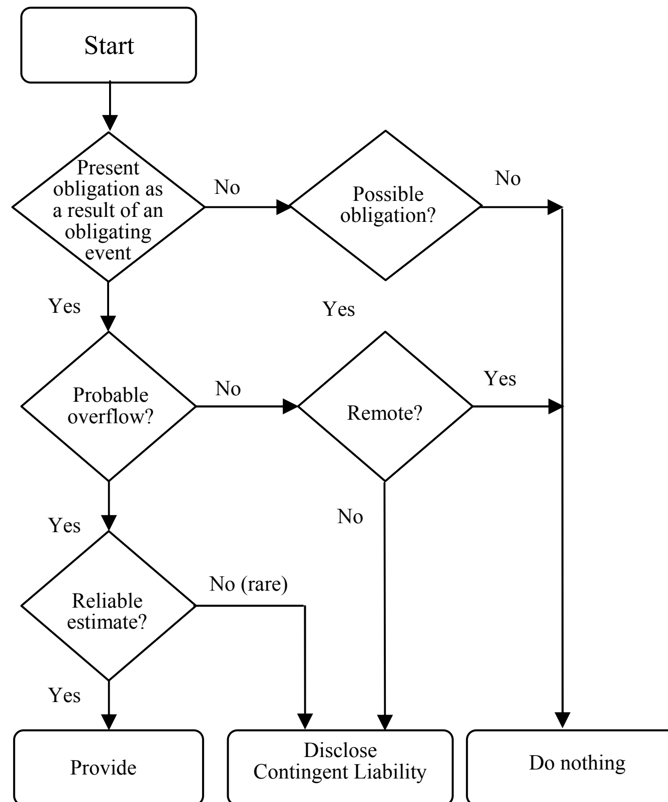
Reimbursements

Some or all of the expenditure required to settle a provision is expected to be reimbursed by another party.		
The entity has no obligation for the part of the expenditure to be reimbursed by the other party.	**The obligation for the amount expected to be reimbursed remains with the entity and it is virtually certain that reimbursement will be received if the entity settles the provision.**	**The obligation for the amount expected to be reimbursed remains with the entity and the reimbursement is not virtually certain if the entity settles the provision.**
The entity has no liability for the amount to be reimbursed (paragraph 67).	The reimbursement is recognized as a separate asset in the statement of financial position and may be offset against the expense in the statement of financial performance. The amount recognized for the expected reimbursement does not exceed the liability (paragraphs 63 and 64).	The expected reimbursement is not recognized as an asset (paragraph 63).
No disclosure is required.	The reimbursement is disclosed together with the amount recognized for the reimbursement (paragraph 98(c)).	The expected reimbursement is disclosed (paragraph 98(c)).

Appendix B

Decision Tree

The purpose of the decision tree is to summarize the main recognition requirements of the standards for provisions and contingent liabilities that fall within the scope of the Standard. The decision tree does not form part of the standards and should be read in the context of the full text of the standards. Note: in some cases, it is not clear whether there is a present obligation. In these cases, 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 (paragraph 23 of the Standard).



Appendix C

Examples: Recognition

This appendix illustrates the application of the standards to assist in clarifying their meaning. It does not form part of the standards.

All the entities in the examples have a reporting date of December 31. In all cases, it is assumed that a reliable estimate can be made of any outflows expected. In some examples the circumstances described may have resulted in impairment of the assets — this aspect is not dealt with in the examples.

The cross-references provided in the examples indicate paragraphs of the Standard that are particularly relevant. The appendix should be read in the context of the full text of the standards.

References to "best estimate" are to the present value amount, where the effect of the time value of money is material.

Example 1: Warranties

Government Department A manufactures search and rescue equipment for use within the Government and for sale to the public. At the time of sale the Department gives warranties to purchasers in relation to certain products. Under the terms of the sale the Department undertakes to make good, by repair or replacement, manufacturing defects that become apparent within three years from the date of sale. On past experience, it is probable (that is, more likely than not) that there will be some claims under the warranties.

ANALYSIS

Present obligation as a result of a past obligating event — The obligating event is the sale of the product with a warranty, which gives rise to a legal obligation.

An outflow of resources embodying economic benefits or service potential in settlement—Probable for the warranties as a whole (see paragraph 32).

Conclusion—A provision is recognized for the best estimate of the costs of making good under the warranty products sold on or before the reporting date (see paragraphs 22 and 32).

Example 2A: Contaminated Land—Legislation Virtually Certain to be Enacted

A provincial government owns a warehouse on land near a port. The provincial government has retained ownership of the land because it may require the land for future expansion of its port operations. For the past ten years a group of farmers have leased the property as a storage facility for agricultural chemicals. The national government announces its intention to enact environmental legislation requiring property owners to accept liability for environmental pollution, including the cost of

cleaning-up contaminated land. As a result, the provincial government introduces a hazardous chemical policy and begins applying the policy to its activities and properties. At this stage it becomes apparent that the agricultural chemicals have contaminated the land surrounding the warehouse. The provincial government has no recourse against the farmers or its insurance company for the clean-up costs. At December 31, 2001 it is virtually certain that a draft law requiring a clean-up of land already contaminated will be enacted shortly after the year end.

ANALYSIS

Present obligation as a result of a past obligating event—The obligating event is the contamination of the land because of the virtual certainty of legislation requiring the clean-up.

An outflow of resources embodying economic benefits or service potential in settlement1—Probable.

Conclusion—A provision is recognized for the best estimate of the costs of the clean-up (see paragraphs 22 and 30).

Example 2B: Contamination and Constructive Obligation

A government has a widely published environmental policy in which it undertakes to clean up all contamination that it causes. The government has a record of honoring this published policy. There is no environmental legislation in place in the jurisdiction. During the course of a naval exercise a vessel is damaged and leaks a substantial amount of oil. The government agrees to pay for the costs of the immediate clean-up and the ongoing costs of monitoring and assisting marine animals and birds.

ANALYSIS

Present obligation as a result of a past obligating event — The obligating event is the contamination of the environment, which gives rise to a constructive obligation because the policy and previous conduct of the government has created a valid expectation that the government will clean up the contamination.

An outflow of resources embodying economic benefits or service potential in settlement—Probable.

Conclusion—A provision is recognized for the best estimate of the costs of the clean-up (see paragraphs 22 and 30).

Example 3: Gravel Quarry

A government operates a gravel quarry on land that it leases on a commercial basis from a private sector company. The gravel is used for the construction and maintenance of roads. The agreement with the landowners requires the government to restore the quarry site by removing all buildings, reshaping the land and replacing all topsoil. 60% of the eventual restoration costs relate to the removal of the quarry

buildings and restoration of the site, and 40% arise through the extraction of gravel. At the reporting date, the quarry buildings have been constructed and excavation of the site has begun but no gravel has been extracted.

ANALYSIS

Present obligation as a result of a past obligating event—The construction of buildings and the excavation of the quarry creates a legal obligation under the terms of the agreement to remove the buildings and restore the site and is thus an obligating event. At the reporting date, however, there is no obligation to rectify the damage that will be caused by extraction of the gravel.

An outflow of resources embodying economic benefits or service potential in settlement—Probable.

Conclusion—A provision is recognized for the best estimate of 60% of the eventual costs that relate to the removal of the buildings and restoration of the site (see paragraph 22). These costs are included as part of the cost of the quarry. The 40% of costs that arise through the extraction of gravel are recognized as a liability progressively when the gravel is extracted.

Example 4: Refunds Policy

A government stores agency operates as a centralized purchasing agency and allows the public to purchase surplus supplies. It has a policy of refunding purchases by dissatisfied customers, even though it is under no legal obligation to do so. Its policy of making refunds is generally known.

ANALYSIS

Present obligation as a result of a past obligating event—The obligating event is the sale of the supplies, which gives rise to a constructive obligation because the conduct of the agency has created a valid expectation on the part of its customers that the agency will refund purchases.

An outflow of resources embodying economic benefits or service potential in settlement—Probable that a proportion of goods are returned for refund (see paragraph 32).

Conclusion—A provision is recognized for the best estimate of the costs of refunds (see paragraphs 18 (the definition of a constructive obligation), 22, 25 and 32).

Example 5A: Closure of a Division—No Implementation before Reporting Date

On 12 December 2004 a government decides to close down a division of a government agency. The decision was not communicated to any of those affected before the reporting date (December 31, 2004) and no other steps were taken to implement the decision.

ANALYSIS

Present obligation as a result of a past obligating event—There has been no obligating event and so there is no obligation.

Conclusion—No provision is recognized (see paragraphs 22 and 83).

Example 5B: Outsourcing of a Division—Implementation Before the Reporting Date

On December 12, 2004, a government decided to outsource a division of a government department. On December 20, 2004 a detailed plan for outsourcing the division was agreed by the government, and redundancy notices were sent to the staff of the division.

ANALYSIS

Present obligation as a result of a past obligating event—The obligating event is the communication of the decision to employees, which gives rise to a constructive obligation from that date, because it creates a valid expectation that the division will be outsourced.

An outflow of resources embodying economic benefits or service potential in settlement—Probable.

Conclusion—A provision is recognized at December 31, 2004 for the best estimate of the costs of outsourcing the division (see paragraphs 22 and 83).

Example 6: Legal Requirement to Fit Air Filters

Under new legislation, a local government entity is required to fit new air filters to its public buildings by 30 June 2005. The entity has not fitted the air filters.

ANALYSIS

(a) At the reporting date of December 31, 2004

Present obligation as a result of a past obligating event—There is no obligation because there is no obligating event either for the costs of fitting air filters or for fines under the legislation.

Conclusion—No provision is recognized for the cost of fitting the filters (see paragraphs 22 and 25–27).

(b) At the reporting date of December 31, 2005

Present obligation as a result of a past obligating event—There is still no obligation for the costs of fitting air filters because no obligating event has occurred (the fitting of the filters). However, an obligation might arise to pay fines or penalties under the legislation because the obligating event has occurred (the non-compliance of the public buildings).

An outflow of resources embodying economic benefits or service potential in settlement—Assessment of probability of incurring fines and penalties for non-

compliance depends on the details of the legislation and the stringency of the enforcement regime.

Conclusion—No provision is recognized for the costs of fitting air filters. However, a provision is recognized for the best estimate of any fines and penalties that are more likely than not to be imposed (see paragraphs 22 and 25–27).

Example 7: Staff Retraining as a Result of Changes in the Income Tax System

The government introduces a number of changes to the income tax system. As a result of these changes, the taxation department (reporting entity) will need to retrain a large proportion of its administrative and compliance staff in order to ensure continued compliance with financial services regulation. At the reporting date, no retraining of staff has taken place.

ANALYSIS

Present obligation as a result of a past obligating event—There is no obligation because no obligating event (retraining) has taken place.

Conclusion—No provision is recognized (see paragraphs 22 and 25–27).

Example 8: An Onerous Contract

A hospital laundry operates from a building that the hospital (the reporting entity) has leased under an operating lease. During December 2004 the laundry relocates to a new building. The lease on the old building continues for the next four years: it cannot be canceled. The hospital has no alternative use for the building and the building cannot be re-let to another user.

ANALYSIS

Present obligation as a result of a past obligating event—The obligating event is the signing of the lease contract, which gives rise to a legal obligation.

An outflow of resources embodying economic benefits or service potential in settlement—When the lease becomes onerous, an outflow of resources embodying economic benefits is probable. (Until the lease becomes onerous, the hospital accounts for the lease under IPSAS 13, “Leases”).

Conclusion—A provision is recognized for the best estimate of the unavoidable lease payments (see paragraphs 13(b), 22 and 76).

Example 9: A Single Guarantee

During 2004, a provincial government gives a guarantee of certain borrowings of a private sector operator providing public services for a fee, whose financial condition at that time is sound. During 2005, the financial condition of the operator deteriorates and at June 30, 2005 the operator files for protection from its creditors.

ANALYSIS

(a) At December 31, 2004

Present obligation as a result of a past obligating event—The obligating event is the giving of the guarantee, which gives rise to a legal obligation.

An outflow of resources embodying economic benefits or service potential in settlement—No outflow of benefits is probable at December 31, 2004.

Conclusion—No provision is recognized (see paragraphs 22 and 31). The guarantee is disclosed as a contingent liability unless the probability of any outflow is regarded as remote (see paragraphs 100 and 109).

(b) At December 31, 2005

Present obligation as a result of a past obligating event—The obligating event is the giving of the guarantee, which gives rise to a legal obligation.

An outflow of resources embodying economic benefits or service potential in settlement—At December 31, 2005, it is probable that an outflow of resources embodying economic benefits or service potential will be required to settle the obligation.

Conclusion—A provision is recognized for the best estimate of the obligation (see paragraphs 22, 31 and 109).

Note: This example deals with a single guarantee. If an entity has a portfolio of similar guarantees, it will assess that portfolio as a whole in determining whether an outflow of resources embodying economic benefits or service potential is probable (see paragraph 32). Where an entity gives guarantees in exchange for a fee, revenue is recognized under IPSAS 9, "Revenue from Exchange Transactions."

Example 10: A Court Case

After a luncheon in 2004, ten people died, possibly as a result of food poisoning from products sold by a restaurant at a public museum (the reporting entity). Legal proceedings are started seeking damages from the entity but it disputes liability. Up to the date of authorization of the financial statements for the year to 31 December 2004 for issue, the entity's lawyers advise that it is probable that the entity will not be found liable. However, when the entity prepares the financial statements for the year to December 31, 2005, its lawyers advise that, owing to developments in the case, it is probable that the entity will be found liable.

ANALYSIS

(a) At December 31, 2004

Present obligation as a result of a past obligating event—On the basis of the evidence available when the financial statements were approved, there is no obligation as a result of past events.

Conclusion—No provision is recognized by the museum (see paragraphs 23 and 24). The matter is disclosed as a contingent liability unless the probability of any outflow is regarded as remote (paragraphs 100 and 109).

(b) At December 31, 2005

Present obligation as a result of a past obligating event—On the basis of the evidence available, there is a present obligation.

An outflow of resources embodying economic benefits or service potential in settlement—Probable.

Conclusion—A provision is recognized for the best estimate of the amount to settle the obligation (paragraphs 22–24 and 109).

Example 11: Repairs and Maintenance

Some assets require, in addition to routine maintenance, substantial expenditure every few years for major refits or refurbishment and the replacement of major components. IPSAS 17, "Property, Plant and Equipment," gives guidance on allocating expenditure on an asset to its component parts where these components have different useful lives or provide benefits in a different pattern.

Example 11A: Refurbishment Costs – No Legislative Requirement

A furnace for heating a building that is leased out by a government department to a number of public sector tenants has a lining that needs to be replaced every five years for technical reasons. At the reporting date, the lining has been in use for three years.

ANALYSIS

Present obligation as a result of a past obligating event—There is no present obligation.

Conclusion—No provision is recognized (see paragraphs 22 and 25–27).

The cost of replacing the lining is not recognized because, at the reporting date, no obligation to replace the lining exists independently of the entity's future actions — even the intention to incur the expenditure depends on the entity deciding to continue operating the furnace or to replace the lining. Instead of a provision being recognized, the depreciation of the lining takes account of its consumption, that is, it is depreciated over five years. The re-lining costs then incurred are capitalized with the consumption of each new lining shown by depreciation over the subsequent five years.

Example 11B: Refurbishment Costs—Legislative Requirement

A government cartography service is required by law to overhaul its aircraft used for aerial mapping once every three years.

ANALYSIS

Present obligation as a result of a past obligating event—There is no present obligation.

Conclusion—No provision is recognized (see paragraphs 22 and 25–27).

The costs of overhauling aircraft are not recognized as a provision for the same reasons as the cost of replacing the lining is not recognized as a provision in Example 11A. Even a legal requirement to overhaul does not make the costs of overhaul a liability, because no obligation exists to overhaul the aircraft independently of the entity's future actions — the entity could avoid the future expenditure by its future actions, for example by selling the aircraft.

Appendix D

Examples: Disclosures

The appendix is illustrative only and does not form part of the standards. The purpose of the appendix is to illustrate the application of the standards to assist in clarifying their meaning.

Two examples of the disclosures required by paragraph 98 are provided below and on the following page.

Example 1: Warranties

A government department with responsibility for the prevention of workplace accidents gives warranties at the time of sale to purchasers of its safety products. Under the terms of the warranty, the department undertakes to repair or replace items that fail to perform satisfactorily for two years from the date of sale. At the reporting date, a provision of 60,000 currency units has been recognized. The provision has not been discounted as the effect of discounting is not material. The following information is disclosed:

A provision of 60,000 currency units has been recognized for expected warranty claims on products sold during the last three financial years. It is expected that the majority of this expenditure will be incurred in the next financial year, and all will be incurred within two years of the reporting date.

Example 2: Decommissioning Costs

In 2005, a state-owned research facility, which uses a nuclear reactor to develop radio isotopes that are used for medical purposes, recognizes a provision for decommissioning costs of 300 million currency units. The provision is estimated using the assumption that decommissioning will take place in 60–70 years' time. However, there is a possibility that it will not take place until 100–110 years' time, in which case the present value of the costs will be significantly reduced. The following information is disclosed:

A provision of 300 million currency units has been recognized for decommissioning costs. These costs are expected to be incurred between 2065 and 2075; however, there is a possibility that decommissioning will not take place until 2105–2115. If the costs were measured based upon the expectation that they would not be incurred until 2105–2115 the provision would be reduced to 136 million. The provision has been estimated using existing technology, at current prices, and discounted using a real discount rate of 2%.

An example is given below of the disclosures required by paragraph 109 where some of the information required is not given because it can be expected to prejudice seriously the position of the entity.

Example 3: Disclosure Exemption

A government research agency is involved in a dispute with a company, which is alleging that the research agency has infringed copyright in its use of genetic material and is seeking damages of 100 million currency units. The research agency recognizes a provision for its best estimate of the obligation, but discloses none of the information required by paragraphs 97 and 98 of the Standard. The following information is disclosed:

Litigation is in process against the agency relating to a dispute with a company that alleges that the agency has infringed patents and is seeking damages of 100 million currency units. The information usually required by IPSAS 19, "Provisions, Contingent Liabilities and Contingent Assets," is not disclosed on the grounds that it can be expected to prejudice seriously the outcome of the litigation. The board is of the opinion that the claim can be successfully defended by the agency.

Appendix E

Example: Present Value of a Provision

The appendix is illustrative only and does not form part of the standards. The purpose of the appendix is to illustrate the application of the standards to assist in clarifying their meaning.

The following example illustrates the journal entries made on initial recognition of the present value of a provision and the subsequent recognition of increases in the present value of that provision. The increase in the provision is recognized as an interest expense (paragraph 70).

The expected value of a provision at the end of year 5 is 2000 currency units. This expected value has not been risk adjusted. An appropriate discount rate which takes account of the risk associated with this cash flow has been estimated at 12%.

Journal entries to record the provision and changes in the value of the provision each year are as follows:

End of current reporting period

DR	Expense	1134.85	
CR	Provision		1134.85

End of Year 1

DR	Interest Expense	136.18	
CR	Provision		136.18

End of Year 2

DR	Interest Expense	152.52	
CR	Provision		152.52

End of Year 3

DR	Interest Expense	170.83	
CR	Provision		170.83

End of Year 4

DR	Interest Expense	191.33	
CR	Provision		191.33

End of Year 5

DR	Interest Expense	214.29	
CR	Provision		214.29

Calculations:		Increase
Current time:	Present value = 2000/(1.12)5 = 1134.85	
End of Year 1:	Present value = 2000/(1.12)4 = 1271.04	136.18
End of Year 2:	Present value = 2000/(1.12)3 = 1423.56	152.52
End of Year 3:	Present value = 2000/(1.12)2 = 1594.39	170.83
End of Year 4:	Present value = 2000/(1.12)1 = 1785.71	191.33
End of Year 5:	Present value = 2000/(1.12)0 = 2000.00	214.29

Comparison with IAS 37

International Public Sector Accounting Standard (IPSAS) 19, "Provisions, Contingent Liabilities and Contingent Assets" is drawn primarily from International Accounting Standard (IAS) 37, "Provisions, Contingent Liabilities and Contingent Assets" (1998). The main differences between IPSAS 19 and IAS 37 are as follows:

- IPSAS 19 includes commentary additional to that in IAS 37 to clarify the applicability of the standards to accounting by public sector entities. In particular, the scope of IPSAS 19 clarifies that it does not apply to provisions and contingent liabilities arising from social benefits provided by an entity for which it does not receive consideration that is approximately equal to the value of the goods and services provided directly in return from recipients of those benefits. However, if the entity elects to recognize provisions for social benefits, IPSAS 19 requires certain disclosures in this respect.
- Black letter in IAS 37 has been modified and commentary additional to that in IAS 37 has been included in IPSAS 19 to clarify that, in the case of onerous contracts, it is the present obligation net of recoveries that is recognized as a provision.
- The scope paragraph in IPSAS 19 makes it clear that while provisions, contingent liabilities and contingent assets arising from employee benefits are excluded from the scope of the Standard, the Standard, however, applies to provisions, contingent liabilities and contingent assets arising from termination benefits that result from a restructuring dealt with in the Standard.
- IPSAS 19 uses different terminology, in certain instances, from IAS 37. The most significant examples are the use of the terms "entity," "revenue," "statement of financial performance," and "statement of financial position" in IPSAS 19. The equivalent terms in IAS 37 are "enterprise," "income," "income statement," and "balance sheet."
- IPSAS 19 contains the definitions of technical terms used in IAS 37 and an additional definition for "executory contracts."
- The Appendix C examples have been amended to be more reflective of the public sector.
- IPSAS 19 contains an additional appendix (Appendix E) which illustrates the journal entries for recognition of the change in the value of a provision over time, due to the impact of the discount factor.

IPSAS 20—RELATED PARTY DISCLOSURES

Acknowledgment

This International Public Sector Accounting Standard is drawn primarily from International Accounting Standard (IAS) 24 (reformatted 1994), "Related Party Disclosures" 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 IASC. The International Accounting Standards (IASs) issued by IASC remain in force until they are amended or withdrawn by IASB. Extracts from IAS 24 are reproduced in this publication of the Public Sector Committee of the International Federation of Accountants with the permission of IASB.

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October 2002

IPSAS 20—RELATED PARTY DISCLOSURES

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The standards, which have been set in bold type, should be read in the context of the commentary paragraphs in this Standard, which are in plain type, and in the context of the "Preface to International Public Sector Accounting Standards." International Public Sector Accounting Standards are not intended to apply to immaterial items.

Objective

The objective of this Standard is to require the disclosure of the existence of related party relationships where control exists and the disclosure of information about transactions between the entity and its related parties in certain circumstances. This information is required for accountability purposes and to facilitate a better understanding of the financial position and performance of the reporting entity. The principal issues in disclosing information about related parties are identifying which parties control or significantly influence the reporting entity and determining what information should be disclosed about transactions with those parties.

Scope

1. **An entity which prepares and presents financial statements under the accrual basis of accounting should apply this Standard in disclosing information about related party relationships and certain transactions with related parties.**

2. **This Standard applies to all public sector entities other than Government Business Enterprises.**

3. Government Business Enterprises (GBEs) are required to comply with International Accounting Standards (IASs) issued by the International Accounting Standards Committee. The Public Sector Committee's Guideline No. 1, "Financial Reporting by Government Business Enterprises" notes that IASs are relevant to all business enterprises, regardless of whether they are in the private or public sector. Accordingly, Guideline No. 1, recommends that GBEs should present financial statements that conform, in all material respects, to IASs.

Definitions

4. **The following terms are used in this Standard with the meanings specified:**

   Close members of the family of an individual are close relatives of the individual or members of the individual's immediate family who can be expected to influence, or be influenced by, that individual in their dealings with the entity.

   Key management personnel are:

   (a) **All directors or members of the governing body of the entity; and**

(b) **Other persons having the authority and responsibility for planning, directing and controlling the activities of the reporting entity. Where they meet this requirement key management personnel include:**

(i) **Where there is a member of the governing body of a whole-of-government entity who has the authority and responsibility for planning, directing and controlling the activities of the reporting entity, that member;**

(ii) **Any key advisors of that member; and**

(iii) **Unless already included in (a), the senior management group of the reporting entity, including the chief executive or permanent head of the reporting entity.**

<u>Oversight</u> means the supervision of the activities of an entity, with the authority and responsibility to control, or exercise significant influence over, the financial and operating decisions of the entity.

<u>Related party</u> — parties are considered to be related if one party has the ability to control the other party or exercise significant influence over the other party in making financial and operating decisions or if the related party entity and another entity are subject to common control. Related parties include:

(a) **Entities that directly, or indirectly through one or more intermediaries, control, or are controlled by the reporting entity;**

(b) **Associates (see International Public Sector Accounting Standard (IPSAS) 7, "Accounting for Investments in Associates");**

(c) **Individuals owning, directly or indirectly, an interest in the reporting entity that gives them significant influence over the entity, and close members of the family of any such individual;**

(d) **Key management personnel, and close members of the family of key management personnel; and**

(e) **Entities in which a substantial ownership interest is held, directly or indirectly, by any person described in (c) or (d), or over which such a person is able to exercise significant influence.**

<u>Related party transaction</u> is a transfer of resources or obligations between related parties, regardless of whether a price is charged. Related party transactions exclude transactions with any other entity

that is a related party solely because of its economic dependence on the reporting entity or the government of which it forms part.

Remuneration of key management personnel is any consideration or benefit derived directly or indirectly by key management personnel from the reporting entity for services provided in their capacity as members of the governing body or otherwise as employees of the reporting entity.

Significant influence (for the purpose of this Standard) is the power to participate in the financial and operating policy decisions of an entity, but not control those policies. Significant influence may be exercised in several ways, usually by representation on the board of directors or equivalent governing body but also by, for example, participation in the policy making process, material transactions between entities within an economic entity, interchange of managerial personnel or dependence on technical information. Significant influence may be gained by an ownership interest, statute or agreement. With regard to an ownership interest, significant influence is presumed in accordance with the definition contained in IPSAS 7, "Accounting for Investments in Associates."

Terms defined in other International Public Sector Accounting Standards are used in this Standard with the same meaning as in those other Standards, and are reproduced in the Glossary of Defined Terms published separately.

Close Member of the Family of an Individual

5. Judgment will be necessary in determining whether an individual should be identified as a close member of the family of an individual for purposes of application of this Standard. In the absence of information to the contrary, such as that a spouse or other relative is estranged from the individual, the following immediate family members and close relatives are presumed to have, or be subject to, such influence as to satisfy the definition of close members of the family of an individual:

   (a) A spouse, domestic partner, dependent child or relative living in a common household;

   (b) A grandparent, parent, nondependent child, grandchild, brother or sister; and

   (c) The spouse or domestic partner of a child, a parent-in-law, a brother-in-law or a sister-in-law.

Key Management Personnel

6. Key management personnel include all directors or members of the governing body of the reporting entity where that body has the authority

and responsibility for planning, directing and controlling the activities of the entity. At the whole-of-government level, the governing body may consist of elected or appointed representatives (for example, a president or governor, ministers, councilors and aldermen or their nominees).

7. Where an entity is subject to the oversight of an elected or appointed representative of the governing body of the government to which the entity belongs, that person is included in key management personnel if the oversight function includes the authority and responsibility for planning, directing and controlling the activities of the entity. In many jurisdictions, key advisors of that person may not possess sufficient authority, legal or otherwise, to satisfy the definition of key management personnel. In other jurisdictions, key advisors of that person may be deemed to be key management personnel because they have a special working relationship with an individual who has control over an entity. They therefore have access to privileged information and may also be able to exercise control or significant influence over an entity. Judgment is required in assessing whether an individual is a key advisor and whether that advisor satisfies the definition of key management personnel, or is a related party.

8. The governing body, together with the chief executive and senior management group has the authority and responsibility to plan and control the activities of the entity, to manage the resources of the entity and for the overall achievement of entity objectives. Therefore, key management personnel will include the chief executive and senior management group of the reporting entity. In some jurisdictions, civil servants will not have sufficient authority and responsibility to qualify as key management personnel (as defined by this Standard) of the whole-of-government reporting entity. In these cases, key management personnel will consist only of those elected members of the governing body who have the greatest responsibility for the government, often these persons are referred to as "Cabinet Ministers."

9. The senior management group of an economic entity may comprise individuals from both the controlling entity and other entities that collectively make up the economic entity.

Related Parties

10. In considering each possible related party relationship, attention is directed to the substance of the relationship, and not merely the legal form.

11. Where two entities have a member of key management personnel in common, it is necessary to consider the possibility, and to assess the likelihood, that this person would be able to affect the policies of both entities in their mutual dealings. However, the mere fact that there is a

member of key management personnel in common does not necessarily create a related party relationship.

12. In the context of this Standard, the following are deemed not to be related parties:

    (a) (i) Providers of finance in the course of their business in that regard; and

        (ii) Trade unions;

        in the course of their normal dealings with an entity by virtue only of those dealings (although they may circumscribe the freedom of action of an entity or participate in its decision-making process); and

    (b) An entity with which the relationship is solely that of an agency.

13. Related party relationships may arise when an individual is either a member of the governing body or is involved in the financial and operating decisions of the reporting entity. Related party relationships may also arise through external operating relationships between the reporting entity and the related party. Such relationships will often involve a degree of economic dependency.

14. Economic dependency, where one entity is dependent on another in that it relies on the latter for a significant volume of its funding or sale of its goods and services, would on its own be unlikely to lead to control or significant influence and is therefore unlikely to give rise to a related party relationship. As such, a single customer, supplier, franchisor, distributor, or general agent with whom a public sector entity transacts a significant volume of business will not be a related party merely by virtue of the resulting economic dependency. However, economic dependency, together with other factors, may give rise to significant influence and therefore a related party relationship. Judgment is required in assessing the impact of economic dependence on a relationship. Where the reporting entity is economically dependent on another entity, the reporting entity is encouraged to disclose the existence of that dependency.

15. The definition of related party includes entities owned by key management personnel, close family members of such individuals or major shareholders (or equivalent where the entity does not have a formal equity structure) of the reporting entity. The definition of related party also includes circumstances in which one party has the ability to exercise significant influence over the other party. In the public sector, an individual or entity may be given oversight responsibility for a reporting entity, which gives them significant influence, but not control, over the financial and operating decisions of the reporting entity. For the purposes of this Standard,

significant influence is defined to encompass entities subject to joint control.

Remuneration of Key Management Personnel

16. Remuneration of key management personnel includes remuneration derived by individuals from the reporting entity for services provided to the reporting entity in their capacity as members of the governing body or employees. Benefits derived directly or indirectly from the entity for services in any capacity other than as an employee or a member of the governing body do not satisfy the definition of remuneration of key management personnel in this Standard. However, paragraph 34 requires disclosures to be made about certain of these other benefits. Remuneration of key management personnel excludes any consideration provided solely as a reimbursement for expenditure incurred by those individuals for the benefit of the reporting entity such as, for example, the reimbursement of accommodation costs associated with work-related travel.

Voting Power

17. The definition of related party will include any individuals owning, directly or indirectly, an interest in the voting power of the reporting entity that gives them significant influence over the entity. The holding of an interest in the voting power of an entity can arise when a public sector entity has a corporate structure and a minister or government agency holds shares in the entity.

The Related Party Issue

18. Related party relationships exist throughout the public sector, because:

    (a) Administrative units are subject to the overall direction of the executive government and, ultimately, the Parliament or similar body of elected or appointed officials, and operate together to achieve the policies of the government;

    (b) Government departments and agencies frequently conduct activities necessary for the achievement of different components of their responsibilities and objectives through separate controlled entities, and through entities over which they have significant influence; and

    (c) Ministers or other elected or appointed members of the government and senior management group can exert significant influence over the operations of a department or agency.

19. Disclosure of certain related party relationships and related party transactions and the relationship underlying those transactions is necessary for accountability purposes and enables users to better understand the financial statements of the reporting entity because:

(a) Related party relationships can influence the way in which an entity operates with other entities in achieving its individual objectives, and the way in which it co-operates with other entities in achieving common or collective objectives;

(b) Related party relationships might expose an entity to risks or provide opportunities that would not have existed in the absence of the relationship;

(c) Related parties may enter into transactions that unrelated parties would not enter into, or may agree to transactions on different terms and conditions than those that would normally be available to unrelated parties. This occurs frequently in government departments and agencies where goods and services are transferred between departments at less than full cost recovery as a part of normal operating procedures consistent with the achievement of the objectives of the reporting entity and the government. Governments and individual public sector entities are expected to use resources efficiently, effectively and in the manner intended, and to deal with public monies with the highest levels of integrity. The existence of related party relationships means that one party can control or significantly influence the activities of another party. This provides the opportunity for transactions to occur on a basis that may advantage one party inappropriately at the expense of another.

20. Disclosure of certain types of related party transactions that occur and the terms and conditions on which they were conducted allows users to assess the impact of those transactions on the financial position and performance of an entity and its ability to deliver agreed services. This disclosure also ensures that the entity is transparent about its dealings with related parties.

Remuneration of Key Management Personnel

21. Key management personnel hold positions of responsibility within an entity. They are responsible for the strategic direction and operational management of an entity and are entrusted with significant authority. Their salaries are often established by statute or an independent tribunal or other body independent of the reporting entity. However, their responsibilities may enable them to influence the benefits of office that flow to them or their related parties. This Standard requires certain disclosures to be made about the remuneration of key management personnel and close members of the family of key management personnel during the reporting period, loans made to them and the consideration provided to them for services they provide to the entity other than as a member of the governing body or an employee. The disclosures required by this Standard will ensure that appropriate minimum levels of transparency are applied to the remuneration

of key management personnel and close members of the family of key management personnel.

Materiality

22. IPSAS 1, "Presentation of Financial Statements" requires the separate disclosure of material items. The materiality of an item is determined with reference to the nature or size of that item. When assessing the materiality of related party transactions, the nature of the relationship between the reporting entity and the related party and the nature of the transaction may mean that a transaction is material regardless of its size.

Disclosure

23. In many countries, the laws, and other authoritative financial reporting rules, require financial statements of private sector entities and government business enterprises to disclose information about certain categories of related parties and related party transactions. In particular, attention is focused on the entity's transactions with its directors or members of its governing body and with its senior management group, especially their remuneration and borrowings. This is because of the fiduciary responsibilities of directors, members of the governing body and senior management group, and because they have extensive powers over the deployment of entity resources. In some jurisdictions, similar requirements are included in the statutes and regulations applicable to public sector entities.

24. Some International Public Sector Accounting Standards also require disclosure of transactions with related parties. For example, IPSAS 1 requires disclosure of amounts payable to and receivable from controlling entities, fellow controlled entities, associates and other related parties. IPSAS 6, "Consolidated Financial Statements and Accounting for Controlled Entities" and IPSAS 7 require disclosure of a list of significant controlled entities and associates. IPSAS 3, "Net Surplus or Deficit for the Period, Fundamental Errors and Changes in Accounting Policies" requires disclosure of extraordinary items and items of revenue and expense within surplus or deficit from ordinary activities that are of such size, nature or incidence that their disclosure is relevant to explain the performance of the entity for the period.

Disclosure of Control

25. **Related party relationships where control exists should be disclosed irrespective of whether there have been transactions between the related parties.**

26. In order for a reader of financial statements to form a view about the effects of related party relationships on a reporting entity, it is appropriate to disclose related party relationships where control exists, irrespective of whether there have been transactions between the related parties. This would involve the disclosure of the names of any controlled entities, the name of the immediate controlling entity and the name of the ultimate controlling entity, if any.

Disclosure of Related Party Transactions

27. **In respect of transactions between related parties other than transactions that would occur within a normal supplier or client/recipient relationship on terms and conditions no more or less favorable than those which it is reasonable to expect the entity would have adopted if dealing with that individual or entity at arm's length in the same circumstances, the reporting entity should disclose:**

    (a) **The nature of the related party relationships;**

    (b) **The types of transactions that have occurred; and**

    (c) **The elements of the transactions necessary to clarify the significance of these transactions to its operations and sufficient to enable the financial statements to provide relevant and reliable information for decision making and accountability purposes.**

28. The following are examples of situations where related party transactions may lead to disclosures by a reporting entity:

    (a) Rendering or receiving of services;

    (b) Purchases or transfers/sales of goods (finished or unfinished);

    (c) Purchases or transfers/sales of property and other assets;

    (d) Agency arrangements;

    (e) Leasing arrangements;

    (f) Transfer of research and development;

    (g) License agreements;

    (h) Finance (including loans, capital contributions, grants whether in cash or in kind and other financial support including cost sharing arrangements); and

    (i) Guarantees and collaterals.

29. Public sector entities transact extensively with each other on a daily basis. These transactions may occur at cost, less than cost or free-of-charge. For

example, a government department of administrative services may provide office accommodation free-of-charge to other departments, or a public sector entity may act as a purchasing agent for other public sector entities. In some models of government there may be the capacity for recovery of more than the full cost of service delivery. Departments are related parties because they are subject to common control and these transactions meet the definition of related party transactions. However, disclosure of information about transactions between these entities is not required where the transactions are consistent with normal operating relationships between the entities, and are undertaken on terms and conditions that are normal for such transactions in these circumstances. The exclusion of these related party transactions from the disclosure requirements of paragraph 27 reflects that public sector entities operate together to achieve common objectives, and acknowledges that different mechanisms may be adopted for the delivery of services by public sector entities in different jurisdictions. This Standard requires disclosures of related party transactions only when those transactions occur other than in accordance with the operating parameters established in that jurisdiction.

30. The information about related party transactions that would need to be disclosed to meet the objectives of general purpose financial reporting would normally include:

    (a) A description of the nature of the relationship with related parties involved in these transactions. For example, whether the relationship was one of a controlling entity, a controlled entity, an entity under common control, or key management personnel;

    (b) A description of the related party transactions within each broad class of transaction and an indication of the volume of the classes, either as a specific monetary amount or as a proportion of that class of transactions and/or balances;

    (c) A summary of the broad terms and conditions of transactions with related parties, including disclosure of how these terms and conditions differ from those normally associated with similar transactions with unrelated parties; and

    (d) Amounts or appropriate proportions of outstanding items.

31. Paragraph 34 of this Standard requires additional disclosures to be made about certain transactions between an entity and key management personnel and/or the close members of the family of key management personnel.

32. **Items of a similar nature may be disclosed in aggregate except when separate disclosure is necessary to provide relevant and reliable information for decision making and accountability purposes.**

33. Disclosure of related party transactions between members of an economic entity is unnecessary in consolidated financial statements because consolidated financial statements present information about the controlling entity and controlled entities as a single reporting entity. Related party transactions that occur between entities within an economic entity are eliminated on consolidation in accordance with IPSAS 6. Transactions with associated entities accounted for under the equity method are not eliminated and therefore require separate disclosure as related party transactions.

Disclosure — Key Management Personnel

34. **An entity shall disclose:**

 (a) **The aggregate remuneration of key management personnel and the number of individuals, determined on a full time equivalent basis, receiving remuneration within this category, showing separately major classes of key management personnel and including a description of each class;**

 (b) **The total amount of all other remuneration and compensation provided to key management personnel, and close members of the family of key management personnel, by the reporting entity during the reporting period showing separately the aggregate amounts provided to:**

  (i) **Key management personnel; and**

  (ii) **Close members of the family of key management personnel; and**

 (c) **In respect of loans which are not widely available to persons who are not key management personnel and loans whose availability is not widely known by members of the public, for each individual member of key management personnel and each close member of the family of key management personnel:**

  (i) **The amount of loans advanced during the period and terms and conditions thereof;**

  (ii) **The amount of loans repaid during the period;**

  (iii) **The amount of the closing balance of all loans and receivables; and**

  (iv) **Where the individual is not a director or member of the governing body or senior management group of the entity, the relationship of the individual to such.**

35. Paragraph 27 of this Standard requires the disclosure of related party transactions which have occurred other than on an "arm's length" basis

consistent with the operating conditions established for the entity. This Standard also requires the disclosure of information about certain transactions with key management personnel identified in paragraph 34, whether or not they have occurred on an arm's length basis consistent with the operating conditions that apply in respect of the entity.

36. Persons who are key management personnel may be employed on a full or part time basis. The number of individuals disclosed as receiving remuneration in accordance with paragraph 34(a) needs to be estimated on a full time equivalent basis. Entities will make separate disclosures about the major classes of key management personnel that they have. For example, where an entity has a governing body that is separate from its senior management group, disclosures about remuneration of the two groups will be made separately. Where an individual is a member of both the governing body and the senior management group, that individual will be included in only one of those groups for the purposes of this Standard. The categories of key management personnel identified in the definition of "key management personnel" provide a guide to identifying classes of key management personnel.

37. Remuneration of key management personnel can include a variety of direct and indirect benefits. Where the cost of these benefits is determinable, that cost will be included in the aggregate remuneration disclosed. Where the cost of these benefits is not determinable, a best estimate of the cost to the reporting entity or entities will be made and included in the aggregate remuneration disclosed.

38. There is currently no International Public Sector Accounting Standard on the measurement of employee benefits. Guidance on the measurement of certain employee benefits is found in International Accounting Standard (IAS) 19, "Employee Benefits." When non-monetary remuneration that is able to be reliably measured has been included in the aggregate amount of remuneration of key management personnel disclosed for the period, disclosure would also be made in the notes to the financial statements of the basis of measurement of the non-monetary remuneration.

39. This Standard requires the disclosure of certain information about the terms and conditions of loans made to key management personnel and close members of the family of key management personnel, where these loans

    (a) Are not widely available to persons outside the key management group; and

    (b) May be widely available outside the key management group but whose availability is not widely known to members of the public.

The disclosure of this information is required for accountability purposes. The exercise of judgment may be necessary in determining which loans should be disclosed to satisfy the requirements of this Standard. That judgment should be exercised after consideration of the relevant facts and in a manner consistent with the achievement of the objectives of financial reporting.

40. Paragraph 34(a) of this Standard requires disclosure of the aggregate remuneration of key management personnel. Key management personnel include directors or members of the governing body and members of the senior management group of the entity. Directors or members of the governing body of the entity may also receive remuneration or compensation from the entity for services provided in a capacity other than as director or member of the governing body of the entity or as an employee of the entity. Paragraph 34(b)(i) of this Standard requires the disclosure of the total amount of this other remuneration or compensation.

41. Close members of the family of key management personnel may influence, or be influenced by, key management personnel in their transactions with the reporting entity. Paragraph 34(b)(ii) of this Standard requires the disclosure of the total remuneration and compensation provided during the period to close members of the family of key management personnel.

Effective Date

42. **This International Public Sector Accounting Standard becomes effective for annual financial statements covering periods beginning on or after January 1, 2004. Earlier application is encouraged.**

43. When an entity adopts the accrual basis of accounting, as defined by International Public Sector Accounting Standards, for financial reporting purposes, subsequent to this effective date, this Standard applies to the entity's annual financial statements covering periods beginning on or after the date of adoption.

Appendix

The appendix is illustrative only and does not form part of the standards. The purpose of the appendix is to illustrate the application of the standards to assist in clarifying their meaning.

Disclosures — Government X

The following disclosures are made in the financial statements of Government X.

Controlled Entities (Paragraph 25)

The Government controls the following reporting entities:

Government Departments and Agencies: Education, Welfare, Police, Post, Works and Services, Defense, Justice, Treasury/Finance, Department X, Agency XYZ (identify all departments and agencies).

Government Business Enterprises: Government Electricity Company, Government Telecommunications Agency (identify all GBEs).

(Note: International Public Sector Accounting Standard (IPSAS) 6, "Consolidated Financial Statements and Accounting for Controlled Entities" requires that certain disclosures be made about significant controlled entities.)

Related Party Transactions (Paragraph 27)

A member of Cabinet was provided with a house, rent free, in the national Capital City. Houses similar to that provided to the Minister rent for approximately Z currency units per annum. The provision of accommodation is not part of the remuneration package of the Minister and the Government does not generally provide free accommodation to ministers. However, in this case it was necessary to provide a residence for the Minister in the Capital City.

The partner of another member of Cabinet was provided with a motor vehicle, rent free. Cars similar to that provided normally rent for K currency units per annum. The government does not generally provide motor vehicles, rent free, to the domestic partners of ministers.

Key Management Personnel (Paragraph 34)

Remuneration (Paragraph 34(a))

The key management personnel (as defined by IPSAS 20, "Related Party Disclosures") are the members of Cabinet, who together constitute the governing body of Government X. The aggregate remuneration of members of the Cabinet and the number of individuals determined on a full-time equivalent basis receiving remuneration from Government X are:

Aggregate remuneration	X million.
Number of persons	Y persons.

Loans which are not widely available (and/or widely known) to persons outside the key management group (Paragraph 34(c))

Amounts of such loans advanced and repaid during the period, and the balances outstanding at the end of the period are outlined below:

Individual	Advanced	Repaid	Balance
The Honorable ABC	J	K	L
Ms. VSL	M	N	P
The Honorable D	Q	R	Z
The Honorable E	S	T	U

Terms and Conditions

The Honorable ABC, Minister of Transport, received a loan at X% per annum, which is Y% below the market rate. The term of the loan is for Z years.

Ms. VSL, partner of the Minister of Health, received a government loan. The loan is for N years at X% per annum, the current government borrowing rate.

The salary packages of Cabinet Ministers the Honorable D and E allow them to take out a government loan for up to A years at Y% per annum to purchase a car.

Other remuneration and compensation provided to key management personnel and their close family members (Paragraph 34(b))

During the reporting period total compensation of X amount (currency units) was provided to members of the Cabinet for consulting services provided to particular government agencies.

During the reporting period the government provided total remuneration and compensation of Y amount (currency units) to close family members of key management personnel. This amount consists of the remuneration of government employees who are close members of the family of members of the Cabinet.

Disclosure – Government Agency XYZ

These disclosures are made in the financial statements of Government Agency XYZ, which is a separate reporting entity.

Controlled Entities (Paragraph 25)

The Agency is controlled by Department X. Department X is controlled by Government X.

The Agency controls the Administration Services Unit which is a government business enterprise (GBE).

(Note: IPSAS 6, "Consolidated Financial Statements and Accounting for Controlled Entities" requires that certain disclosures be made about significant controlled entities.)

Related Party Transactions (Paragraph 27)

The Agency provided a house, rent free, to the Minister. Houses similar to that provided to the Minister rent for approximately Z currency units per annum. The house is not part of the remuneration package of the Minister and, as a matter of operating procedure, government agencies do not provide residential accommodation to ministers. However, Government X advised that the house should be provided on this occasion.

Key Management Personnel (Paragraph 34)

Remuneration (Paragraph 34(a))

The key management personnel (as defined by IPSAS 20, "Related Party Disclosures") of Agency XYZ are: the Minister, the members of the governing body and the members of the senior management group. The governing body consists of members appointed by Government X; the chief executive officer and the chief financial officer attend meetings of the governing body but are not members of the governing body. The Minister is not remunerated by Agency XYZ. The aggregate remuneration of members of the governing body and the number of members determined on a full time equivalent basis receiving remuneration within this category, are:

Aggregate remuneration	AX million.
Number of persons	AY persons.

The senior management group consists of the Agency's chief executive officer, the chief financial officer, and the AZ heads of division. The aggregate remuneration of members of the senior management group and the number of managers determined on a full-time equivalent basis receiving remuneration within this category are:

Aggregate remuneration	AP million.
Number of persons	AQ persons.

Two division heads are on secondment from Department X and are remunerated by Department X.

Loans which are not widely available (and/or widely known) to persons outside the key management group (Paragraph 34(c))

Amounts advanced and repaid during the period and balance outstanding at the end of the period:

Individual	Advanced	Repaid	Balance
The Minister	J	K	L
Mr. G	M	N	P
Ms. H	Q	R	Z

Terms and conditions

The Minister received a loan of J currency units, at X% per annum, which is Y% below the market rate. The term of the loan is for Z years.

The salary package of senior staff members Mr. G and Ms. H allows them to take out a government loan for up to N years at Y% per annum to purchase a car.

Remuneration and compensation provided to close family members of key management personnel (Paragraph 34(b))

During the reporting period total remuneration and compensation of F amount (currency units) was provided by the Agency to employees who are close family members of key management personnel.

Comparison with IAS 24

International Public Sector Accounting Standard (IPSAS) 20, "Related Party Disclosures" is drawn primarily from International Accounting Standard (IAS) 24 (reformatted 1994), "Related Party Disclosures." The main differences between IPSAS 20 and IAS 24 are as follows:

- The structure of IPSAS 20 differs substantially from that of IAS 24.
- The exclusion from the scope of IAS 24 of wholly-owned subsidiaries where the parent entity is domiciled in the same country and provides consolidated financial statements in that country has not been adopted in IPSAS 20.
- Commentary which identifies key management personnel in IAS 24 has been included in a formal definition of "key management personnel" in IPSAS 20. The commentary in IAS 24 includes "close members of the family," the definition of "key management personnel" in IPSAS 20 does not include "close members of the family."
- The definition of "related party" in IPSAS 20 includes related party relationships which are only noted in commentary in IAS 24.
- IPSAS 20 includes a definition of "remuneration of key management personnel." IAS 24 does not include this definition.
- IPSAS 20 contains additional disclosure requirements in relation to the remuneration of key management personnel and their close family members and certain other transactions between an entity and its key management personnel and their close family members.
- Commentary additional to that in IAS 24 has been included in IPSAS 20 to clarify the applicability of the standards to accounting by public sector entities.
- Except for limited disclosures about the remuneration of, and certain other specified transactions with, key management personnel, IPSAS 20 does not require the disclosure of information about transactions between related parties which occur on normal terms and conditions. IAS 24 has more limited exclusions for related party transactions which occur in the course of normal dealings between the parties.
- IPSAS 20 uses different terminology, in certain instances, from IAS 24. The most significant examples are the use of the terms "entity" and "members of the governing body" in IPSAS 20. The equivalent terms in IAS 24 are "enterprise" and "directors."

IPSAS 21—IMPAIRMENT OF NON-CASH-GENERATING ASSETS

Acknowledgment

This International Public Sector Accounting Standard deals with the impairment of non-cash-generating assets in the public sector. This Standard is drawn primarily from IAS 36, which was published by the International Accounting Standards Board (IASB). Extracts from International Accounting Standard IAS 36 (2004), "Impairment of Assets" are reproduced in this publication of the International Public Sector Accounting Standards Board of the International Federation of Accountants with the permission of the International Accounting Standards Committee Foundation (IASCF).

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IPSAS 21—IMPAIRMENT OF NON-CASH-GENERATING ASSETS

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Objective

1. The objective of this Standard is to prescribe the procedures that an entity applies to determine whether a non-cash-generating asset is impaired and to ensure that impairment losses are recognized. The Standard also specifies when an entity would reverse an impairment loss and prescribes disclosures.

Scope

2. **An entity which prepares and presents financial statements under the accrual basis of accounting shall apply this Standard in accounting for impairment of non-cash-generating assets, except:**

   (a) **Inventories (see IPSAS 12, "Inventories");**

   (b) **Assets arising from construction contracts (see IPSAS 11, "Construction Contracts");**

   (c) **Financial assets that are included in the scope of IPSAS 15, "Financial Instruments: Disclosure and Presentation";**

   (d) **Investment property that is measured using the fair value model (see IPSAS 16, "Investment Property");**

   (e) **Non-cash-generating property, plant and equipment that is measured at revalued amounts (see IPSAS 17, "Property, Plant and Equipment"); and**

   (f) **Other assets in respect of which accounting requirements for impairment are included in another International Public Sector Accounting Standard.**

3. **This Standard applies to all public sector entities other than Government Business Enterprises (GBEs).**

4. **Public sector entities that hold cash-generating assets as defined in paragraph 14 shall apply International Accounting Standard IAS 36, "Impairment of Assets" to such assets. Public sector entities that hold non-cash-generating assets shall apply the requirements of this Standard to non-cash-generating assets.**

5. This Standard excludes from its scope the impairment of assets that are dealt with in another International Public Sector Accounting Standard. GBEs apply IAS 36 and therefore are not subject to the provisions of this Standard. Public sector entities other than GBEs apply IAS 36 to their cash-generating assets and apply this Standard to their non-cash-generating assets. Paragraphs 6 to 13 explain the scope of the Standard in greater detail.

6. This Standard includes non-cash-generating intangible assets within its scope. Entities apply the requirements of this Standard to recognizing and measuring impairment losses, and reversals of impairment losses, related to non-cash-generating intangible assets.

7. This Standard does not apply to inventories and assets arising from construction contracts because existing International Public Sector Accounting Standards applicable to these assets contain requirements for recognizing and measuring these assets.

8. This Standard does not apply to financial assets that are included in the scope of IPSAS 15, "Financial Instruments: Disclosure and Presentation." Impairment of these assets will be dealt with in any International Public Sector Accounting Standard that the IPSASB develops on the basis of IAS 39, "Financial Instruments: Recognition and Measurement" to deal with the recognition and measurement of financial instruments.

9. This Standard does not require the application of an impairment test to an investment property that is carried at fair value in accordance with IPSAS 16, "Investment Property". This is because under the fair value model in IPSAS 16, an investment property is carried at fair value at the reporting date and any impairment will be taken into account in the valuation.

10. This Standard does not require the application of an impairment test to non-cash-generating assets that are carried at revalued amounts under the allowed alternative treatment in IPSAS 17, "Property, Plant and Equipment". This is because under the allowed alternative treatment in IPSAS 17, assets will be revalued with sufficient regularity to ensure that they are carried at an amount that is not materially different from their fair value at the reporting date and any impairment will be taken into account in the valuation. In addition, the approach adopted in this Standard to measuring an asset's recoverable service amount means that it is unlikely that the recoverable service amount of an asset will be materially less than an asset's revalued amount and that any such differences would relate to the costs of disposal of the asset.

11. Consistent with the requirements of paragraph 4 above, items of property, plant and equipment that are classified as cash-generating assets including those that are carried at revalued amounts under the allowed alternative treatment in IPSAS 17, are dealt with under IAS 36.

12. Investments in:

    (a) Controlled entities, as defined in IPSAS 6, "Consolidated Financial Statements and Accounting for Controlled Entities;"

    (b) Associates, as defined in IPSAS 7, "Accounting for Investments in Associates;" and

    (c) Joint ventures, as defined in IPSAS 8, "Financial Reporting of Interests in Joint Ventures;"

    are financial assets that are excluded from the scope of IPSAS 15. Where such investments are classified as cash-generating assets, they are dealt with under IAS 36. Where these assets are non-cash-generating assets, they are dealt with under this Standard.

13. The *Preface to International Financial Reporting Standards* issued by the International Accounting Standards Board (IASB) explains that International Financial Reporting Standards (IFRSs) are designed to apply to the general purpose financial statements of all profit-oriented entities. GBEs are defined in paragraph 14 below. They are profit-oriented entities. Accordingly, they are required to comply with IFRSs.

Definitions

14. **The following terms are used in this Standard with the meanings specified:**

    An active market is a market in which all the following conditions exist:

    (a) **The items traded within the market are homogeneous;**

    (b) **Willing buyers and sellers can normally be found at any time; and**

    (c) **Prices are available to the public.**

    Carrying amount is the amount at which an asset is recognized in the statement of financial position after deducting any accumulated depreciation and accumulated impairment losses thereon.

    Cash-generating assets are assets held to generate a commercial return.

    Costs of disposal are incremental costs directly attributable to the disposal of an asset, excluding finance costs and income tax expense.

    Depreciation (Amortization) is the systematic allocation of the depreciable amount of an asset over its useful life.

Fair value less costs to sell is the amount obtainable from the sale of an asset in an arm's length transaction between knowledgeable, willing parties, less the costs of disposal.

Government Business Enterprise means an entity that has all the following characteristics:

(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.**

An impairment is a loss in the future economic benefits or service potential of an asset, over and above the systematic recognition of the loss of the asset's future economic benefits or service potential through depreciation.

An impairment loss of a non-cash-generating asset is the amount by which the carrying amount of an asset exceeds its recoverable service amount.

Non-cash-generating assets are assets other than cash-generating assets.

Recoverable service amount is the higher of a non-cash-generating asset's fair value less costs to sell and its value in use.

Useful life is either:

(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.**

Value in use of a non-cash-generating asset is the present value of the asset's remaining service potential.

Government Business Enterprises

15. 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.

Cash-Generating Assets

16. Cash-generating assets are those that are held to generate a commercial return. An asset generates a commercial return when it is deployed in a manner consistent with that adopted by a profit-oriented entity. Holding an asset to generate a "commercial return" indicates that an entity intends to generate positive cash inflows from the asset (or of the unit of which the asset is a part) and earn a return that reflects the risk involved in holding the asset.

17. Assets held by GBEs are cash-generating assets. Public sector entities other than GBEs may hold assets to generate a commercial return. For the purposes of this Standard, an asset held by a non-GBE public sector entity is classified as a cash-generating asset if the asset (or unit of which the asset is a part) is operated with the objective of generating a commercial return through the provision of goods and or services to external parties.

Depreciation

18. Depreciation and amortization are the systematic allocation of the depreciable amount of an asset over its useful life. In the case of an intangible asset, the term "amortization" is generally used instead of "depreciation". Both terms have the same meaning.

Impairment

19. This Standard defines an "impairment" as a loss in the future economic benefits or service potential of an asset, over and above the systematic recognition of the loss of the asset's future economic benefits or service potential through depreciation (amortization). Impairment, therefore, reflects a decline in the utility of an asset to the entity that controls it. For example, an entity may have a purpose-built military storage facility that it no longer uses. In addition, because of the specialized nature of the facility and its location, it is unlikely that it can be leased out or sold and therefore the entity is unable to generate cash flows from leasing or disposing of the asset. The asset is regarded as impaired as it is no longer capable of providing the entity with service potential – it has little, or no, utility for the entity in contributing to the achievement of its objectives.

Identifying an Asset that may be Impaired

20. Paragraphs 22 to 30 specify when recoverable service amount would be determined.

21. A non-cash-generating asset is impaired when the carrying amount of the asset exceeds its recoverable service amount. Paragraph 23 identifies key indications that an impairment loss may have occurred. If any of those indications are present, an entity is required to make a formal estimate of recoverable service amount. If no indication of a potential impairment loss is present, this Standard does not require an entity to make a formal estimate of recoverable service amount.

22. **An entity shall assess at each reporting date whether there is any indication that an asset may be impaired. If any such indication exists, the entity shall estimate the recoverable service amount of the asset.**

23. **In assessing whether there is any indication that an asset may be impaired, an entity shall consider, as a minimum, the following indications:**

<u>External sources of information</u>

(a) **Cessation, or near cessation, of the demand or need for services provided by the asset.**

(b) **Significant long-term changes with an adverse effect on the entity have taken place during the period or will take place in the near future, in the technological, legal or government policy environment in which the entity operates.**

<u>Internal sources of information</u>

(c) **Evidence is available of physical damage of an asset.**

(d) **Significant long-term changes with an adverse effect on the entity have taken place during the period, or are expected to take place in the near future, in the extent to which, or manner in which, an asset is used or is expected to be used. These changes include the asset becoming idle, plans to discontinue or restructure the operation to which an asset belongs, or plans to dispose of an asset before the previously expected date.**

(e) **A decision to halt the construction of the asset before it is complete or in a usable condition.**

(f) **Evidence is available from internal reporting that indicates that the service performance of an asset is, or will be, significantly worse than expected.**

24. The demand or need for services may fluctuate over time, which will affect the extent to which non-cash-generating assets are utilized in providing those services, but negative fluctuations in demand are not necessarily indications of impairment. Where demand for services ceases, or nearly ceases, the assets used to provide those services may be impaired. Demand may be considered to have "nearly" ceased when it is so low that the entity would not have attempted to respond to that demand, or would have responded by not acquiring the asset being considered for impairment testing.

25. The list in paragraph 23 is not exhaustive. There may be other indications that an asset may be impaired. The existence of other indications may result in the entity estimating the asset's recoverable service amount. For example, any of the following may be an indication of impairment:

    (a) During the period, an asset's market value has declined significantly more than would be expected as a result of the passage of time or normal use; or

    (b) A significant long-term decline (but not necessarily cessation or near cessation) in the demand for or need for services provided by the asset.

26. The events or circumstances that may indicate an impairment of an asset will be significant and will often have prompted discussion by the governing board, management, or media. A change in a parameter such as demand for the service, extent or manner of use, legal environment or government policy environment would indicate impairment only if such a change was significant and had or was anticipated to have a long-term adverse effect. A change in the technological environment may indicate that an asset is obsolete, and requires testing for impairment. A change in the use of an asset during the period may also be an indication of impairment. This may occur when, for example, a building used as a school undergoes a change in use and is used for storage. In assessing whether an impairment has occurred, the entity needs to assess changes in service potential over the long term. This underlines the fact that the changes are seen within the context of the anticipated long-term use of the asset. However, the expectations of long-term use can change and the entity's assessments at each reporting date would reflect that. Appendix A sets out examples of impairment indications referred to in paragraph 23.

27. In assessing whether a halt in construction would trigger an impairment test, the entity would consider whether construction has simply been delayed or postponed, whether there is an intention to resume construction in the near future, or whether the construction work will not be completed in the foreseeable future. Where construction is delayed or postponed to a specific

future date, the project may be treated as work in progress and is not considered as halted.

28. Evidence from internal reporting that indicates that an asset may be impaired, as referred to in paragraph 23(f) above, relates to the ability of the asset to provide goods or services rather than to a decline in the demand for the goods or services provided by the asset. This includes the existence of:

    (a) Significantly higher costs of operating or maintaining the asset, compared with those originally budgeted; and

    (b) Significantly lower service or output levels provided by the asset compared with those originally expected due to poor operating performance.

    A significant increase in operating costs of an asset may indicate that the asset is not as efficient or productive as initially anticipated in output standards set by the manufacturer, in accordance with which the operating budget was drawn up. Similarly, a significant increase in maintenance costs may indicate that higher costs need to be incurred to maintain the asset's performance at a level indicated by its most recently assessed standard of performance. In other cases, direct quantitative evidence of an impairment may be indicated by a significant long-term fall in the expected service or output levels provided by the asset.

29. The concept of materiality applies in identifying whether the recoverable service amount of an asset needs to be estimated. For example, if previous assessments show that an asset's recoverable service amount is significantly greater than its carrying amount, the entity need not re-estimate the asset's recoverable service amount if no events have occurred that would eliminate that difference. Similarly, previous analysis may show that an asset's recoverable service amount is not sensitive to one (or more) of the indications listed in paragraph 23.

30. If there is an indication that an asset may be impaired, this may indicate that the remaining useful life, the depreciation (amortization) method or the residual value for the asset need to be reviewed and adjusted in accordance with the International Public Sector Accounting Standard applicable to the asset, even if no impairment loss is recognized for the asset.

Measuring Recoverable Service Amount

31. This Standard defines recoverable service amount as the higher of an asset's fair value less costs to sell and its value in use. Paragraphs 32 to 46 set out the basis for measuring recoverable service amount.

32. It is not always necessary to determine both an asset's fair value less costs to sell and its value in use. If either of these amounts exceeds the asset's carrying amount, the asset is not impaired and it is not necessary to estimate the other amount.

33. It may be possible to determine fair value less costs to sell, even if an asset is not traded in an active market. Paragraph 38 sets out possible alternative bases for estimating fair value less costs to sell when an active market for the asset does not exist. However, sometimes it will not be possible to determine fair value less costs to sell because there is no basis for making a reliable estimate of the amount obtainable from the sale of the asset in an arm's length transaction between knowledgeable and willing parties. In this case, the entity may use the asset's value in use as its recoverable service amount.

34. If there is no reason to believe that an asset's value in use materially exceeds its fair value less costs to sell, the asset's fair value less costs to sell may be used as its recoverable service amount. This will often be the case for an asset that is held for disposal. This is because the value in use of an asset held for disposal will consist mainly of the net disposal proceeds. However, for many public sector non-cash-generating assets which are held on an ongoing basis to provide specialized services or public goods to the community, the value in use of the asset is likely to be greater than its fair value less costs to sell.

35. In some cases, estimates, averages and computational short cuts may provide reasonable approximations of the detailed computations illustrated in this Standard for determining fair value less costs to sell or value in use.

Fair value less Costs to Sell

36. The best evidence of an asset's fair value less costs to sell is a price in a binding sale agreement in an arm's length transaction, adjusted for incremental costs that would be directly attributable to the disposal of the asset.

37. If there is no binding sale agreement but an asset is traded in an active market, fair value less costs to sell is the asset's market price less the costs of disposal. The appropriate market price is usually the current bid price. When current bid prices are unavailable, the price of the most recent transaction may provide a basis from which to estimate fair value less costs to sell, provided that there has not been a significant change in economic

circumstances between the transaction date and the date as at which the estimate is made.

38. If there is no binding sale agreement or active market for an asset, fair value less costs to sell is based on the best information available to reflect the amount that an entity could obtain, at reporting date, from the disposal of the asset in an arm's length transaction between knowledgeable, willing parties, after deducting the costs of disposal. In determining this amount, an entity could consider the outcome of recent transactions for similar assets within the same industry. Fair value less costs to sell does not reflect a forced sale, unless management or the governing body is compelled to sell immediately.

39. Costs of disposal, other than those that have been recognized as liabilities, are deducted in determining fair value less costs to sell. Examples of such costs are legal costs, stamp duty and similar transaction taxes, costs of removing the asset, and direct incremental costs to bring an asset into condition for its sale. However, termination benefits (as defined in IAS 19, "Employee Benefits"[1]) and costs associated with reducing or reorganizing a business following the disposal of an asset are not direct incremental costs to dispose of the asset.

Value in Use

40. This Standard defines the value in use of a non-cash-generating asset as the present value of the asset's remaining service potential. "Value in use" in this Standard refers to "value in use of a non-cash-generating asset" unless otherwise specified. The present value of the remaining service potential of the asset is determined using any one of the approaches identified in paragraphs 41 to 45, as appropriate.

Depreciated Replacement Cost Approach

41. Under this approach, the present value of the remaining service potential of an asset is determined as the depreciated replacement cost of the asset. The replacement cost of an asset is the cost to replace the asset's gross service potential. This cost is depreciated to reflect the asset in its used condition. An asset may be replaced either through reproduction (replication) of the existing asset or through replacement of its gross service potential. The depreciated replacement cost is measured as the reproduction or replacement cost of the asset, whichever is lower, less accumulated depreciation calculated on the basis of such cost, to reflect the already consumed or expired service potential of the asset.

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1 The IPSASB has included the development of an IPSAS on "employee benefits" in its work program. It is expected that the project will be activated after the completion of the review of IAS 19 by the IASB.

42. The replacement cost and reproduction cost of an asset are determined on an "optimized" basis. The rationale is that the entity would not replace or reproduce the asset with a like asset if the asset to be replaced or reproduced is an overdesigned or overcapacity asset. Overdesigned assets contain features which are unnecessary for the goods or services the asset provides. Overcapacity assets are assets that have a greater capacity than is necessary to meet the demand for goods or services the asset provides. The determination of the replacement cost or reproduction cost of an asset on an optimized basis thus reflects the service potential required of the asset.

43. In certain cases, standby or surplus capacity is held for safety or other reasons. This arises from the need to ensure that adequate service capacity is available in the particular circumstances of the entity. For example, the fire department needs to have fire engines on standby to deliver services in emergencies. Such surplus or standby capacity is part of the required service potential of the asset.

Restoration Cost Approach

44. Restoration cost is the cost of restoring the service potential of an asset to its pre-impaired level. Under this approach, the present value of the remaining service potential of the asset is determined by subtracting the estimated restoration cost of the asset from the current cost of replacing the remaining service potential of the asset before impairment. The latter cost is usually determined as the depreciated reproduction or replacement cost of the asset whichever is lower. Paragraphs 41 and 43 include additional guidance on determining the replacement cost or reproduction cost of an asset.

Service Units Approach

45. Under this approach, the present value of the remaining service potential of the asset is determined by reducing the current cost of the remaining service potential of the asset before impairment to conform with the reduced number of service units expected from the asset in its impaired state. As in the restoration cost approach, the current cost of replacing the remaining service potential of the asset before impairment is usually determined as the depreciated reproduction or replacement cost of the asset before impairment, whichever is lower.

Application of Approaches

46. The choice of the most appropriate approach to measuring value in use depends on the availability of data and the nature of the impairment:

    (a) Impairments identified from significant long-term changes in the technological, legal or government policy environment are generally measurable using a depreciated replacement cost approach or a service units approach, when appropriate;

(b) Impairments identified from a significant long-term change in the extent or manner of use, including that identified from the cessation or near cessation of demand, are generally measurable using a depreciated replacement cost or a service units approach when appropriate; and

(c) Impairments identified from physical damage are generally measurable using a restoration cost approach or a depreciated replacement cost approach when appropriate.

Recognizing and Measuring an Impairment Loss

47. Paragraphs 48 to 53 set out the requirements for recognizing and measuring impairment losses for an asset. In this standard "impairment loss" refers to "impairment loss of a non-cash-generating asset" unless otherwise specified.

48. **If, and only if, the recoverable service amount of an asset is less than its carrying amount, the carrying amount of the asset shall be reduced to its recoverable service amount. That reduction is an impairment loss.**

49. As noted in paragraph 22, this Standard requires an entity to make a formal estimate of recoverable service amount only if an indication of a potential impairment loss is present. Paragraphs 23 to 29 identify key indications that an impairment loss may have occurred.

50. **An impairment loss shall be recognized immediately in net surplus/deficit.**

51. **When the amount estimated for an impairment loss is greater than the carrying amount of the asset to which it relates, an entity shall recognize a liability if, and only if, that is required by another International Public Sector Accounting Standard.**

52. Where the estimated impairment loss is greater than the carrying amount of the asset, the carrying amount of the asset is reduced to zero with a corresponding amount recognized in net surplus/deficit. A liability would be recognized only if another International Public Sector Accounting Standard so requires. An example is when a purpose-built military installation is no longer used and the entity is required by law to remove such installations if not usable. The entity may need to make a provision for dismantling costs if required by IPSAS 19, "Provisions, Contingent Liabilities and Contingent Assets."

53. **After the recognition of an impairment loss, the depreciation (amortization) charge for the asset shall be adjusted in future periods**

to allocate the asset's revised carrying amount, less its residual value (if any), on a systematic basis over its remaining useful life.

Reversing an Impairment Loss

54. Paragraphs 55 to 66 set out the requirements for reversing an impairment loss recognized for an asset in prior periods.

55. **An entity shall assess at each reporting date whether there is any indication that an impairment loss recognized in prior periods for an asset may no longer exist or may have decreased. If any such indication exists, the entity shall estimate the recoverable service amount of that asset.**

56. **In assessing whether there is any indication that an impairment loss recognized in prior periods for an asset may no longer exist or may have decreased, an entity shall consider, as a minimum, the following indications:**

    External sources of information

    (a) **Resurgence of the demand or need for services provided by the asset.**

    (b) **Significant long-term changes with a favorable effect on the entity have taken place during the period, or will take place in the near future, in the technological, legal or government policy environment in which the entity operates.**

    Internal sources of information

    (c) **Significant long-term changes with a favorable effect on the entity have taken place during the period, or are expected to take place in the near future, in the extent to which, or manner in which, the asset is used or is expected to be used. These changes include costs incurred during the period to improve or enhance an asset's performance or restructure the operation to which the asset belongs.**

    (d) **A decision to resume construction of the asset that was previously halted before it was completed or in a usable condition.**

    (e) **Evidence is available from internal reporting that indicates that the service performance of the asset is, or will be, significantly better than expected.**

57. Indications of a potential decrease in an impairment loss in paragraph 56 mainly mirror the indications of a potential impairment loss in paragraph 23.

58. The list in paragraph 56 is not exhaustive. An entity may identify other indications of a reversal of an impairment loss that would also require the entity to re-estimate the asset's recoverable service amount. For example, any of the following may be an indication that the impairment loss may have reversed:

    (a) A significant rise in an asset's market value; or

    (b) A significant long-term increase in the demand or need for the services provided by the asset.

59. A commitment to discontinue or restructure an operation in the near future is an indication of a reversal of an impairment loss of an asset belonging to the operation where such a commitment constitutes a significant long-term change, with a favorable effect on the entity, in the extent or manner of use of that asset. Circumstances where such a commitment would be an indication of reversal of impairment often relate to cases where the expected discontinuance or restructuring of the operation would create opportunities to enhance the utilization of the asset. An example is an x-ray machine that has been underutilized by a clinic managed by a public hospital and, as a result of restructuring, is expected to be transferred to the main radiology department of the hospital where it will have significantly better utilization. In such a case, the commitment to discontinue or restructure the clinic's operation may be an indication that an impairment loss recognized for the asset in prior periods may have to be reversed.

60. If there is an indication that an impairment loss recognized for an asset may no longer exist or may have decreased, this may indicate that the remaining useful life, the depreciation (amortization) method or the residual value may need to be reviewed and adjusted in accordance with the International Public Sector Accounting Standard applicable to the asset, even if no impairment loss is reversed for the asset.

61. **An impairment loss recognized in prior periods for an asset shall be reversed if, and only if, there has been a change in the estimates used to determine the asset's recoverable service amount since the last impairment loss was recognized. If this is the case, the carrying amount of the asset shall, except as described in paragraph 64, be increased to its recoverable service amount. That increase is a reversal of an impairment loss.**

62. This Standard requires an entity to make a formal estimate of recoverable service amount only if an indication of a reversal of an impairment loss is present. Paragraph 56 identifies key indications that an impairment loss recognized for an asset in prior periods may no longer exist or may have decreased.

63. A reversal of an impairment loss reflects an increase in the estimated recoverable service amount of an asset, either from use or from sale, since the date when an entity last recognized an impairment loss for that asset. Paragraph 72 requires an entity to identify the change in estimates that causes the increase in recoverable service amount. Examples of changes in estimates include:

    (a) A change in the basis for recoverable service amount (i.e. whether recoverable service amount is based on fair value less costs to sell or value in use);

    (b) If recoverable service amount was based on value in use, a change in estimate of the components of value in use; or

    (c) If recoverable service amount was based on fair value less costs to sell, a change in estimate of the components of fair value less costs to sell.

64. **The increased carrying amount of an asset attributable to a reversal of an impairment loss shall not exceed the carrying amount that would have been determined (net of depreciation or amortization) had no impairment loss been recognized for the asset in prior periods.**

65. **A reversal of an impairment loss for an asset shall be recognized immediately in net surplus/deficit.**

66. **After a reversal of an impairment loss is recognized, the depreciation (amortization) charge for the asset shall be adjusted in future periods to allocate the asset's revised carrying amount, less its residual value (if any), on a systematic basis over its remaining useful life.**

Redesignation of Assets

67. The redesignation of assets from cash-generating assets to non-cash-generating assets or from non-cash-generating assets to cash-generating assets shall only occur when there is clear evidence that such a redesignation is appropriate. A redesignation, by itself, does not necessarily trigger an impairment test or a reversal of an impairment loss. Instead, the indication for an impairment test or a reversal of an impairment loss arises from, as a minimum, the listed indications applicable to the asset after redesignation.

Disclosure

68. **An entity shall disclose the following for each class of assets:**

    (a) **The amount of impairment losses recognized in net surplus/deficit during the period and the line item(s) of the**

statement of financial performance in which those impairment losses are included.

(b) **The amount of reversals of impairment losses recognized in net surplus/deficit during the period and the line item(s) of the statement of financial performance in which those impairment losses are reversed.**

69. A class of assets is a grouping of assets of similar nature and use in an entity's operations.

70. The information required in paragraph 68 may be presented with other information disclosed for the class of assets. For example, this information may be included in a reconciliation of the carrying amount of property, plant and equipment, at the beginning and end of the period, as required by IPSAS 17, "Property, Plant and Equipment".

71. **An entity that reports segment information in accordance with IPSAS 18, "Segment Reporting" shall disclose the following for each segment reported by the entity:**

(a) **The amount of impairment losses recognized in net surplus/deficit during the period.**

(b) **The amount of reversals of impairment losses recognized in net surplus/deficit during the period.**

72. **An entity shall disclose the following for each material impairment loss recognized or reversed during the period:**

(a) **The events and circumstances that led to the recognition or reversal of the impairment loss.**

(b) **The amount of the impairment loss recognized or reversed.**

(c) **The nature of the asset.**

(d) **The segment to which the asset belongs, if the entity reports segment information in accordance with IPSAS 18.**

(e) **Whether the recoverable service amount of the asset is its fair value less costs to sell or its value in use.**

(f) **If the recoverable service amount is fair value less costs to sell, the basis used to determine fair value less costs to sell (such as whether fair value was determined by reference to an active market).**

(g) **If the recoverable service amount is value in use, the approach used to determine value in use.**

73. **An entity shall disclose the following information for the aggregate of impairment losses and aggregate reversals of impairment losses recognized during the period for which no information is disclosed in accordance with paragraph 72:**

    (a) **The main classes of assets affected by impairment losses (and the main classes of assets affected by reversals of impairment losses).**

    (b) **The main events and circumstances that led to the recognition of these impairment losses and reversals of impairment losses.**

74. An entity is encouraged to disclose key assumptions used to determine the recoverable service amount of assets during the period.

Transitional Provisions

75. **This Standard shall be applied prospectively from the date of its application. Impairment losses (reversals of impairment losses) that result from adoption of this International Public Sector Accounting Standard shall be recognized in accordance with this Standard (i.e. in net surplus/deficit).**

76. Before the adoption of this Standard, entities may have adopted accounting policies for the recognition and reversal of impairment losses. On adoption of this Standard, a change in accounting policy may arise. It would be difficult to determine the amount of adjustments resulting from a retrospective application of the change in accounting policy. Therefore, on adoption of this Standard, an entity shall not apply the benchmark or the allowed alternative treatment for other changes in accounting policies in IPSAS 3, "Net Surplus or Deficit for the Period, Fundamental Errors and Changes in Accounting Policies."

Effective Date

77. **An entity shall apply this International Public Sector Accounting Standard for annual periods beginning on or after January 1, 2006. Earlier application is encouraged. If an entity applies this Standard for an earlier period it shall disclose that fact.**

78. When an entity adopts the accrual basis of accounting, as defined by International Public Sector Accounting Standards, for financial reporting purposes, subsequent to this effective date, this Standard applies to the entity's annual financial statements covering periods beginning on or after the date of adoption.

Appendix A

Indications of Impairment — Examples

This appendix sets out examples of impairment indications discussed in the Standard to assist in clarifying their meaning. It does not form part of the Standard.

External sources of information

(a) **Cessation, or near cessation, of the demand or need for services provided by the asset.**

The asset still maintains the same service potential, but demand for that service has ceased or nearly ceased. Examples of assets impaired in this manner include:

(i) A school closed because of a lack of demand for school services arising from a population shift to other areas. It is not anticipated that this demographic trend affecting the demand for the school services will reverse in the foreseeable future;

(ii) A school designed for 1,500 students currently has an enrollment of 150 students – the school cannot be closed because the nearest alternative school is 100 kilometers away. The entity does not envisage the enrollment increasing. At the time of establishment enrollment was 1,400 students – the entity would have acquired a much smaller facility had future enrollment been envisaged to be 150 students. The entity determines that demand has nearly ceased and the recoverable service amount of the school should be compared with its carrying amount;

(iii) A railway line closed due to lack of patronage (for example, the population in a rural area has substantially moved to the city due to successive years of drought, and those that have stayed behind use the cheaper bus service); and

(iv) A stadium whose principal occupant does not renew its occupancy agreement with the result that the facility is expected to close.

(b) **Significant long-term changes with an adverse effect on the entity in the technological, legal or government policy environment in which the entity operates.**

Technological Environment

The service utility of an asset may be reduced if technology has advanced to produce alternatives that provide better or more efficient service. Examples of assets impaired in this manner are:

(i) Medical diagnostic equipment that is rarely or never used because a newer machine embodying more advanced technology provides more accurate results (would also meet indication (a) above);

(ii) Software that is no longer being supported by the external supplier because of technological advances and the entity does not have the personnel to maintain the software; and

(iii) Computer hardware that has become obsolete as the result of technological development.

Legal or Government Policy Environment

An asset's service potential may be reduced as a result of a change in a law or regulation. Examples of impairments identified by this indication include:

(iv) An automobile that does not meet new emission standards or a plane that does not meet new noise standards;

(iv) A school that can no longer be used for instruction purposes due to new safety regulations regarding its building materials or emergency exits; and

(v) A drinking water plant that cannot be used because it does not meet new environmental standards.

Internal sources of information

(c) **Evidence is available of physical damage of an asset.**

Physical damage would likely result in the asset being unable to provide the level of service that it once was able to provide. Examples of assets impaired in this way include:

(i) A building damaged by fire or flood or other factors;

(ii) A building that is closed due to identification of structural deficiencies;

(iii) Sections of an elevated roadway that have sagged, indicating that these sections of roadway will need to be replaced in 15 years rather than the original design life of 30 years;

(iv) A dam whose spillway has been reduced as a result of a structural assessment;

(v) A water treatment plant whose capacity has been reduced by an intake blockage and the removal of the blockage is not economical;

(vi) A bridge that is weight-restricted due to identification of structural deficiencies;

(vii) A navy destroyer damaged in a collision; and

(viii) Equipment that is damaged and can no longer be repaired or for which repairs are not economically feasible.

(d) **Significant long-term changes, with an adverse effect on the entity, in the extent to which an asset is used, or is expected to be used.**

The asset still maintains the same service potential, but long term changes have an adverse effect on the extent to which the asset is used. Examples of circumstances in which assets may be impaired in this manner include:

(i) If an asset is not being used to the same degree as it was when originally put into service, or the expected useful life of the asset is shorter than originally estimated, the asset may be impaired. An example of an asset that might be identified as potentially being impaired by this indication is a mainframe computer that is underutilized because many applications have been converted or developed to operate on servers or PC platforms. A significant long-term decline in the demand for an asset's services may translate itself into a significant long-term change in the extent to which the asset is used.

(ii) If the asset is not being used in the same way as it was when originally put into service, the asset may be impaired. An example of an impaired asset that might be identified by this indication is a school building that is being used for storage rather than for educational purposes.

(e) **A decision to halt the construction of the asset before it is complete or in a usable condition.**

An asset that will not be completed cannot provide the service intended. Examples of assets impaired in this manner include those where:

(i) Construction was stopped due to identification of an archaeological discovery or environmental condition such as nesting ground for a threatened or endangered species; and

(ii) Construction was stopped due to a decline in the economy.

The circumstances that led to the halting of construction will also be considered. If construction is deferred, that is, postponed to a specific future date, the project could still be treated as work in progress and is not considered as halted.

(f) **Evidence is available from internal reporting that indicates that the service performance of an asset is, or will be, significantly worse than expected.**

Internal reports may indicate that an asset is not performing as expected or its performance is deteriorating over time. For example, an internal health department report on operations of a rural clinic may indicate that an x-ray machine used by the clinic is impaired because the cost of maintaining the machine has significantly exceeded that originally budgeted.

Appendix B

Measurement of Impairment Loss — Examples

This appendix illustrates the application of the provisions of the Standard to assist in clarifying their meaning. It does not form part of the Standard. The facts assumed in these examples are illustrative only and are not intended to modify or limit the requirements of the Standard or to indicate the IPSASB's endorsement of the situations or methods illustrated. Application of the provisions of this Standard may require assessment of facts and circumstances other than those illustrated here.

Note: In the following examples, it is assumed that the fair value less costs to sell of the asset tested for impairment is less than its value in use or is not determinable, unless otherwise indicated. Therefore, the asset's recoverable service amount is equal to its value in use. In these examples the straight line method of depreciation is used.

Example 1: Depreciated Replacement Cost Approach

Significant Long-term Change with Adverse Effect on the Entity in the Technological Environment — Underutilized mainframe computer

In 1999, the City of Kermann purchased a new mainframe computer at a cost of CU10 million[2]. Kermann estimated that the useful life of the computer would be seven years and that on average 80 percent of central processing unit (CPU) capacity would be used by the various departments. A buffer of excess CPU time of 20 percent was expected and needed to accommodate scheduling jobs to meet peak period deadlines. Within a few months after acquisition, CPU usage reached 80 percent, but declined to 20 percent in 2003 because many applications of the departments were converted to run on desktop computers or servers. A computer is available on the market at a price of CU500,000 that can provide the remaining service potential of the mainframe computer using the remaining applications.

Evaluation of Impairment

The indication of impairment is the significant long-term change in the technological environment resulting in conversion of applications from the mainframe to other platforms and therefore decreased usage of the mainframe computer. (Alternatively it can be argued that a significant decline in the extent of use of the mainframe indicates impairment.) Impairment loss is determined using the depreciated replacement cost approach as follows:

a	**Acquisition cost, 1999**	**10,000,000**
	Accumulated depreciation, 2003 (a × 4 ÷ 7)	**5,714,286**
b	**Carrying amount, 2003**	**4,285,714**
c	**Replacement cost**	**500,000**
	Accumulated depreciation(c × 4 ÷ 7)	**285,714**
d	**Recoverable Service Amount**	**214,286**
	Impairment loss (b – d)	**4,071,428**

2 In these examples monetary amounts are denominated in "currency units" (CU).

Example 2: Depreciated Replacement Cost Approach

Near cessation in demand for the services provided by a non-cash-generating asset – Underutilized Mainframe Software Application

In 1999, the City of Kermann purchased a software license for an application for its new mainframe computer for CU350,000. Kermann estimated that the useful life of the software would be seven years and that it would receive economic benefits and service potential from the software on a straight-line basis over the life of the software. By 2003, usage of the application had declined to 15 percent of its originally anticipated demand. A license for a software application to replace the remaining service potential of the impaired software application costs CU70,000.

Evaluation of Impairment

The indication of impairment is technological change, brought about by the loss of mainframe computer capacity.

a	**Acquisition cost, 1999**	**350,000**
	Accumulated depreciation, 2003 (a × 4 ÷ 7)	**200,000**
b	**Carrying amount, 2003**	**150,000**
c	**Replacement cost**	**70,000**
	Accumulated amortization (c × 4 ÷ 7)	**40,000**
d	**Recoverable Service Amount**	**30,000**
	Impairment loss (b – d)	**120,000**

Example 3: Depreciated Replacement Cost Approach

Significant Long-term Change with Adverse Effect on the Entity in the Manner of Use — School used as warehouse

In 1997, Lunden School District constructed an elementary school at a cost of CU10 million. The estimated useful life of the school is fifty years. In 2003, the school is closed because enrollments in the district declined unexpectedly due to a population shift caused by the bankruptcy of a major employer in the area. The school is converted to use as a storage warehouse, and Lunden School District has no expectation that enrollments will increase in the future such that the building would be reopened for use as a school. The current replacement cost for a warehouse with the same storage capacity as the school is CU4.2 million.

Evaluation of Impairment

Impairment is indicated because the purpose for which the building is used has changed significantly from a place for instructing students to a storage facility and this is not anticipated to change for the foreseeable future. An impairment loss using depreciated replacement cost approach would be determined as follows:

a	**Historical cost, 1997**	**10,000,000**
	Accumulated depreciation, 2003 (a × 6 ÷ 50)	**1,200,000**
b	**Carrying amount, 2003**	**8,800,000**
c	**Replacement cost of a storage facility of similar capacity**	**4,200,000**
	Accumulated depreciation (c × 6 ÷ 50)	**504,000**
d	**Recoverable Service Amount**	**3,696,000**
	Impairment loss (b - d)	**5,104,000**

Example 4: Depreciated Replacement Cost Approach

Significant Long-term Change with Adverse Effect on the Entity in the Extent of Use — School partially closed due to decline in enrollment

In 1983, the Lutton School District constructed a school at the cost of CU2.5 million. The entity estimated the school would be used for 40 years. In 2003, the enrollment declined from 1000 to 200 students as the result of population shift caused by the bankruptcy of a major employer in the area. The management decided to close the top two floors of the three story school building. Lutton School District has no expectation that enrollments will increase in the future such that the upper stories would be reopened. The current replacement cost of the one story school is estimated at CU1.3 million.

Evaluation of Impairment

Impairment is indicated because the extent of use of the school has changed from three floors to one floor as the result of a reduction in the number of students from 1000 to 200 students. The reduction in the extent of use is significant and the enrollment is expected to remain at the reduced level for the foreseeable future. Impairment loss using a depreciated replacement cost approach would be determined as follows:

a	**Acquisition cost, 1983**	**2,500,000**
	Accumulated depreciation, 2003 (a × 20 ÷ 40)	**1,250,000**
b	**Carrying amount, 2003**	**1,250,000**
c	**Replacement cost**	**1,300,000**
	Accumulated depreciation (c × 20 ÷ 40)	**650,000**
d	**Recoverable Service Amount**	**650,000**
	Impairment loss (b - d)	**600,000**

Example 5: Restoration Cost Approach

Physical Damage — School bus damaged in road accident

In 1998, North District Primary School acquired a bus at the cost of CU200,000 to help students from a nearby village to commute free of charge. The school estimated a useful life of 10 years for the bus. In 2003, the bus sustained damage in a road accident requiring CU40,000 to be restored to a usable condition. The restoration will not affect the useful life of the asset. The cost of a new bus to deliver a similar service is CU250,000 in 2003.

Evaluation of Impairment

Impairment is indicated because the bus has sustained physical damage in the road accident. Impairment loss using the restoration cost approach would be determined as follows:

a	**Acquisition cost, 1998**	**200,000**
	Accumulated depreciation, 2003 (a × 5 ÷ 10)	**100,000**
b	**Carrying amount, 2003**	**100,000**
c	**Replacement cost**	**250,000**
	Accumulated depreciation (c × 5 ÷ 10)	**125,000**
d	**Depreciated replacement cost (undamaged state)**	**125,000**
	Less: restoration cost	**40,000**
e	**Recoverable Service Amount**	**85,000**
	Impairment loss (b - e)	**15,000**

Example 6: Restoration Cost Approach

Physical Damage — Building damaged by fire

In 1984, the City of Moorland built an office building at a cost of CU50 million. The building was expected to provide service for 40 years. In 2003, after 19 years of use, fire caused severe structural problems. Due to safety reasons, the office building is closed and structural repairs costing CU35.5 million are to be made to restore the office building to an occupiable condition. The replacement cost of a new office building is CU100 million.

Evaluation of Impairment

Impairment is indicated because the office building has sustained physical damage due to the fire. Impairment loss using a restoration cost approach would be determined as follows:

a	**Acquisition cost, 1984**	**50,000,000**
	Accumulated depreciation, 2003 (a × 19 ÷ 40)	**23,750,000**
b	**Carrying amount, 2003**	**26,250,000**
c	**Replacement cost (of a new building)**	**100,000,000**
d	**Accumulated depreciation (c × 19 ÷ 40)**	**47,500,000**
	Depreciated replacement cost (undamaged)	**52,500,000**
	Less: restoration cost	**35,500,000**
e	**Recoverable Service Amount**	**17,000,000**
	Impairment loss (b– e)	**9,250,000**

Example 7: Service Units Approach

Significant Long-term Change with Adverse Effect on the Entity in the Extent of Use — High rise building partially unoccupied for the foreseeable future

In 1988, Ornong City Council constructed a 20 story office building for use by the Council in downtown Ornong at the cost of CU80 million. The building was expected to have a useful life of 40 years. In 2003, National Safety Regulations required that the top 4 stories of high rise buildings should be left unoccupied for the foreseeable future. The building has a fair value less costs to sell of CU45 million in 2003 after regulations came into force. The current replacement cost of a similar 20 story building is CU85 million.

Evaluation of Impairment

Impairment is indicated because the extent of use of the office building has changed from 20 floors to 16 floors as the result of new National Safety Regulations. The reduction in the extent of use is significant and the occupation of the building is expected to remain at the reduced level (16 floors) for the foreseeable future. Impairment loss using the service units approach would be determined as follows:

a	**Acquisition cost, 1988**	**80,000,000**
	Accumulated depreciation, 2003 (a × 15 ÷ 40)	**30,000,000**
b	**Carrying amount, 2003**	**50,000,000**
c	**Replacement cost (20 story building)**	**85,000,000**
	Accumulated depreciation (c × 15 ÷ 40)	**31,875,000**
d	**Depreciated replacement cost before adjustment for remaining service units**	**53,125,000**
e	**Value in Use of the building after the regulation came into force (d × 16 ÷ 20)**	**42,500,000**
f	**Fair value less costs to sell of the building after regulation came into force**	**45,000,000**
g	**Recoverable service amount (higher of e and f)**	**45,000,000**
	Impairment loss (b - g)	**5,000,000**

Example 8: Service Units Approach

Evidence from Internal Reporting — Higher cost of operating the printing machine

In 1998, Country X Education Department purchased a new printing machine at a cost of CU40 million. The Department estimated that the useful life of the machine would be 40 million copies of books to be printed over 10 years for use by elementary school students. In 2003, it was reported that an automated feature of the machine's function does not operate as expected resulting in a 25 percent reduction in the machine's annual output level over the remaining 5 years of the useful life of the asset. The replacement cost of a new printing machine is CU45 million in 2003.

Evaluation of Impairment

Impairment is indicated by evidence from internal reporting that the service performance of the printing machine is worse than expected. Circumstances suggest that the decline in the service potential of the asset is significant and of long-term nature. Impairment loss using a service units approach is determined as follows:

a	**Acquisition cost, 1998**	**40,000,000**
	Accumulated depreciation (a × 5 ÷ 10)	**20,000,000**
b	**Carrying amount, 2003**	**20,000,000**
c	**Replacement cost**	**45,000,000**
	Accumulated depreciation (c × 5 ÷ 10)	**22,500,000**
d	**Depreciated replacement cost before adjustment for remaining service units**	**22,500,000**
e	**Recoverable Service Amount (d × 75%)**	**16,875,000**
	Impairment loss (b - e)	**3,125,000**

Appendix C

Basis for Conclusions

This appendix gives the International Public Sector Accounting Standards Board's (IPSASB's) reasons for supporting or rejecting certain solutions related to the accounting for non-cash-generating impairment of assets. It also identifies circumstances in which the requirements of this IPSAS depart from the requirements of IAS 36 and the reasons for such departure. This appendix does not form part of the Standard.

Introduction

C1. The accrual International Public Sector Accounting Standards are based on the International Financial Reporting Standards (IFRSs) issued by the International Accounting Standards Board (IASB), to the extent that the requirements of those Standards are applicable to the public sector. The requirements of this Standard have been developed consistent with that policy. International Accounting Standard IAS 36, "Impairment of Assets" requires entities to determine the recoverable amount of an asset if there are indications that the asset is impaired. The recoverable amount of an asset is defined as the higher of value in use and fair value less costs to sell of the asset. This Standard includes a similar definition.

C2. IAS 36 applies to cash-generating assets and cash-generating units, whilst this Standard applies to individual non-cash-generating assets. This results in a number of differences between the two Standards. The main differences are:

(a) The method of measurement of value in use of a non-cash-generating asset under this Standard is different to that applied to a cash-generating asset under IAS 36;

(b) This Standard does not require entities to apply an impairment test to property, plant and equipment carried at revalued amounts; and

(c) This Standard does not include "a decrease in market value significantly greater than would be expected as a result of the passage of time or normal use" as a minimum indication of impairment. This indication is included as an additional indication that impairment may exist.

The IPSASB's reasons for making these departures from the requirements of IAS 36 are explained in the paragraphs below.

C3. An Invitation to Comment, (ITC) "Impairment of Assets" issued in 2000 proposed an approach to accounting for impairment of the assets of public

sector entities that applied IAS 36 to the extent that it was appropriate. ED 23 "Impairment of Assets" was developed after consideration of responses to the ITC and issued in 2003. This Standard was developed after consideration of the responses to ED 23.

Cash-Generating Assets

C4. IAS 36 requires an entity to determine value in use as the present value of estimated future cash flows expected to be derived from the continuing use of the asset, or cash-generating unit, and from its disposal at the end of its useful life. The service potential of cash-generating assets is reflected by their ability to generate future cash flows. The requirements of IAS 36 are applicable to cash-generating assets held by public sector entities. This Standard requires entities to apply IAS 36 to account for impairment of cash-generating assets in the public sector.

Non-Cash-Generating Assets

C5. In considering the principles underpinning a value in use concept applicable to non-cash-generating assets, the IPSASB agreed that the value in use of a non-cash-generating asset should be measured by reference to the present value of the remaining service potential of the asset. This replicates the approach taken by IAS 36.

Determination of Value in Use

C6. Determining value in use (present value of remaining service potential) of a non-cash-generating asset, may be approached in a number of ways. One approach that replicates IAS 36 involves estimating and discounting cash inflows that would have arisen had the entity sold its services or other outputs in the market. However, the IPSASB is of the view that it is unlikely that this approach could be used in practice due to the complexities involved in determining the appropriate prices at which to value the service or other output units and estimating the appropriate discount rate.

C7. Other approaches reflect an implicit determination of value in use. In this respect, the IPSASB considered the market value approach, and approaches that measure depreciated replacement cost, and include consideration of restoration cost and service units.

Market value approach

C8. Under this approach, where an active market exists for the asset, the value in use of the non-cash-generating asset is measured at the observable market value of the asset. Where an active market for the asset is not available, the entity uses the best available market evidence of the price at which the asset could be exchanged between knowledgeable, willing parties in an arm's length transaction, having regard to the highest and best use of the asset for which market participants would be prepared to pay in the prevailing

circumstances. The IPSASB noted that the use of the observable market value as a proxy for value in use was redundant since market value differed from the fair value less costs to sell (the other arm of the recoverable service amount estimate) of the asset only by the amount of the costs of disposal. Therefore the market value would be effectively captured by the fair value less costs to sell arm of recoverable service amount.

Depreciated replacement cost approach

C9. Under this approach, the value in use of the asset is determined as the lowest cost at which the gross service potential embodied in the asset could be obtained in the normal course of operations less the value of the service potential already consumed. This approach assumes that the entity replaces the remaining service potential of the asset if it is deprived of it. An asset may be replaced either through reproduction (such as specialized assets) or through replacement of its gross service potential. Therefore, value in use is measured as the reproduction or replacement cost of the asset, whichever is lower, less accumulated depreciation calculated on the basis of such cost to reflect the already consumed or expired service potential of the asset.

Restoration cost approach

C10. This approach is usually used when impairment losses arise from damage. Under this approach, the value in use of the asset is determined by subtracting the estimated restoration cost of the asset from the depreciated replacement or reproduction cost of the asset before impairment.

Service units approach

C11. This approach determines the value in use of the asset by reducing the depreciated replacement or reproduction cost of the asset before impairment to conform to the reduced number of service units expected from the asset in its impaired state.

Approaches adopted

C12. The IPSASB agreed that the value in use of a non-cash-generating asset will be measured using the depreciated replacement cost, the restoration cost or the service units approaches cited above as appropriate.

Other Assets

C13. IAS 36 contains specific requirements for testing intangible assets for impairment, and for recognizing and measuring impairment losses related to intangible assets. These requirements complement the requirements of IAS 38, “Intangible Assets.” The IPSASB has not issued an IPSAS on intangible assets, so has not considered the applicability of the IAS 36 impairment requirements to non-cash-generating intangible assets in the public sector. Non-cash-generating intangible assets are not excluded from the scope of this Standard. Therefore this Standard applies to those assets. Public sector

intangible assets such as those reflecting the entity's ability to issue licenses may arise in a cash-generating context. Other intangible assets may arise in a non-cash-generating context and should be tested for impairment according to the requirements of this Standard.

Group of Assets and Corporate Assets

C14. Under IAS 36, where it is not possible to determine the recoverable amount for an individual asset, then the recoverable amount for the asset's cash-generating unit (CGU) will be determined. The CGU is the smallest identifiable group of assets that generates cash inflows from continuing use, and that is largely independent of the cash inflows from other assets or groups of assets. The IPSASB considered the concept of a service-generating unit in a non-cash-generating context. It noted that as the requirements in this Standard are applied to individual assets, the adoption of such a concept by analogy to the CGU concept in IAS 36 is unnecessary because it is possible to identify the service potential of individual assets. Moreover, its adoption would introduce undue complexities in accounting for impairment of non-cash-generating assets.

C15. Under IAS 36, assets other than goodwill that contribute to the future cash flows of two or more CGUs are regarded as "corporate assets." In a cash-generating context, because corporate assets do not generate separate cash inflows, the impairment of corporate assets are dealt with as part of the impairment of the cash-generating unit to which the corporate assets belong. The IPSASB observed that in a non-cash-generating context, the concept of a service-generating unit is not warranted as noted in paragraph C14 above. The IPSASB further noted that such assets are often an integral part of the service delivery function and their impairment is to be dealt with as for any other non-cash-generating assets of the entity.

Property, Plant and Equipment

C16. The Standard does not require the application of an impairment test to non-cash-generating assets that are carried at revalued amounts under the allowed alternative treatment in IPSAS 17, "Property, Plant and Equipment." The IPSASB is of the view that under the allowed alternative treatment in IPSAS 17, assets will be revalued with sufficient regularity to ensure that they are carried at an amount that is not materially different from their fair value as at the reporting date and any impairment will be taken into account in the valuation. Therefore any difference between the asset's carrying amount and its fair value less costs to sell will be the disposal costs. The IPSASB is of the view that, in most cases, these will not be material and, from a practical viewpoint, it is not necessary to measure an asset's recoverable service amount and to recognize an impairment loss for the disposal costs of a non-cash-generating asset.

C17. In contrast to this Standard, IAS 36 requires entities to test revalued property, plant and equipment for impairment after they had been revalued. The rationale for this difference can be explained by reference to the factors set out in paragraphs C18 and C19 below.

C18. Firstly, there are different methods of determining recoverable service amount under this Standard and of determining recoverable amount under IAS 36. "Recoverable service amount" is defined in this Standard as "the higher of a non-cash-generating asset's fair value less costs to sell and its value in use." Under this Standard, an entity determines an asset's value in use by determining the current cost to replace the asset's remaining service potential. The current cost to replace the asset's remaining service potential is determined using the depreciated replacement cost approach, and approaches described as the restoration cost approach, and the service units approach. These approaches may also be adopted to measure fair value under IPSAS 17 – therefore the value in use is a measure of fair value. "Recoverable amount" is defined in IAS 36 as "the higher of an asset's fair value less costs to sell and its value in use". Value in use under IAS 36 is determined using the present value of the cash flows expected to be derived from continued use of the asset and its eventual disposal. IAS 36 states that the value in use may be different from the fair value of the asset.

C19. Secondly, the requirement under IAS 36 to combine non-cash-generating assets with cash-generating assets to form a cash-generating unit is not replicated in this Standard. Under IAS 36, where an asset does not produce cash inflows it is combined with other assets to form a cash-generating unit, the value in use of which is then measured. The sum of the fair values of the assets that make up a cash-generating unit may be different to the value in use of the cash-generating unit.

C20. This Standard requires the impairment of cash-generating assets to be dealt with under IAS 36. IAS 36 applies to property, plant and equipment carried at revalued amounts. Therefore, this Standard does not exempt cash-generating property, plant and equipment carried at revalued amounts from an impairment test.

Impairment of Non-Cash-Generating Assets Held by Government Business Enterprises

C21. This Standard requires that the impairment of all assets held by Government Business Enterprises (GBEs) be accounted for under IAS 36. GBEs are profit-oriented entities and the assets employed by them are primarily cash-generating assets. The *Preface to International Financial Reporting Standards* has made it clear that IASB Standards are to be applied by profit-oriented entities. GBEs are profit-oriented entities and are therefore required to comply with IFRSs and IASs. Individual International Public Sector Accounting Standards make it explicit that IFRSs apply to GBEs.

Accordingly, non-cash-generating assets are expected to be appropriately grouped with cash-generating assets of GBEs to form a cash-generating unit to be tested for impairment in accordance with IAS 36.

Indications of Impairment – Changes in Market Value

C22. IAS 36 includes as a minimum indication of impairment "an asset's market value has declined significantly more than would be expected as a result of the passage of time or normal use". The IPSASB has included this as an additional indication of impairment, but not as a minimum indication of impairment. The IPSASB is of the view that these changes in market value do not necessarily indicate that a non-cash-generating asset is impaired. This is because non-cash-generating assets are held for reasons other than generating a commercial return, therefore a change in market value may not reflect a change in the amount of service that the entity will recover from continued use of the asset.

Reversal of Impairment

C23. Paragraph 56(a) includes "resurgence of demand or need for services provided by the asset" as a minimum indication of reversal of impairment, whilst paragraph 58(b) includes "a significant long-term increase in demand or need for the services provided by the asset" as an additional indication of possible reversal of impairment. The wording of these two indications is similar, however they can be distinguished from each other because paragraph 56(a) refers to a resurgence of the demand that had declined and resulted in the recognition of an impairment loss. Paragraph 58(b) refers to new demand, and may be unrelated to the reason an impairment loss was recognized in respect of the asset.

C24. Paragraph 58(a) includes "a significant rise in an asset's market value" as an additional indication of reversal of impairment. This does not mirror the indication of impairment in paragraph 23(a), which requires that the decline in market value be "significantly more than would be expected as a result of the passage of time or normal use." This difference means that the increase in market value may be expected or unexpected.

C25. Paragraph 23(c) includes "evidence is available of physical damage of an asset" as a minimum indication of impairment. Paragraph 56 does not include an indication of reversal of impairment that mirrors this indication of impairment. The IPSASB has not included "repair of an asset" as an indication of reversal because IPSAS 17 requires entities to add subsequent expenditure to the carrying amount of an item of property, plant and equipment 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. This requirement also applies to investment property that is measured using the cost model under IPSAS 16, "Investment Property."

The IPSASB is of the view that these requirements negate the need for an indication of reversal of impairment that mirrors the physical damage indication of impairment. The IPSASB also noted that restoration or repair of damage does not constitute a change in the estimate of the asset's recoverable service amount after impairment as specified by paragraph 61 of this IPSAS.

Comparison with IAS 36 (2004)

International Public Sector Accounting Standard IPSAS 21, "Impairment of Non-Cash-Generating Assets" deals with the impairment of non-cash-generating assets in the public sector. The main differences between IPSAS 21 and International Accounting Standard IAS 36 (2004), "Impairment of Assets" are as follows:

- IPSAS 21 deals with the impairment of non-cash-generating assets of public sector entities while IAS 36 deals with the impairment of cash-generating assets of profit-oriented entities. IPSAS 21, however, requires that the impairment of cash-generating assets of public sector entities be accounted for under IAS 36.
- IPSAS 21 does not apply to non-cash-generating assets carried at revalued amounts at the reporting date under the allowed alternative treatment in International Public Sector Accounting Standard IPSAS 17, "Property, Plant and Equipment." IAS 36 does not exclude from its scope cash-generating property, plant and equipment carried at revalued amounts at the reporting date.
- The method of measurement of value in use of a non-cash-generating asset under IPSAS 21 is different from that applied to a cash-generating asset under IAS 36. IPSAS 21 measures the value in use of a non-cash-generating asset as the present value of the asset's remaining service potential using a number of approaches. IAS 36 measures the value in use of a cash-generating asset as the present value of future cash flows from the asset.
- IPSAS 21 does not include a change in the market value of the asset as a "black letter" indication of impairment. A significant, unexpected decline in market value appears in black letter in IAS 36 as part of the minimum set of indications of impairment while IPSAS 21 refers to it in commentary.
- IPSAS 21 includes a decision to halt the construction of an asset before completion as a black-letter indication of impairment and the resumption of the construction of the asset as an indication of reversal of the impairment loss. There are no equivalents in IAS 36.
- The scope of IAS 36 excludes certain classes of assets that are not excluded from the scope of IPSAS 21. These exclusions relate to classes of assets which are the subject of specific impairment requirements under other IFRSs. These have not been excluded from IPSAS 21 because there are not equivalent IPSASs. These exclusions include biological assets related to agricultural activity, deferred tax assets, deferred acquisition costs and intangible assets arising from an insurer's contractual rights under insurance contracts within the scope of IFRS 4, "Insurance Contracts" and non-current assets (or disposal groups) classified as held for sale in accordance with IFRS 5, "Non-current Assets Held for Sale and Discontinued Operations."
- IPSAS 21 deals with the impairment of individual assets. There is no equivalent in IPSAS 21 for a cash-generating unit as defined in IAS 36.

- IPSAS 21 deals with "corporate assets" in the same manner as other non-cash-generating assets while IAS 36 deals with them as part of related cash-generating units.
- IPSAS 21 uses different terminology, in certain instances, from IAS 36. The most significant examples are the use of the terms "revenue," "recoverable service amount," "statement of financial performance" and "statement of financial position" in IPSAS 21. The equivalent terms in IAS 36 are "income," "recoverable amount," "income statement" and "balance sheet."

INTRODUCTION

Accounting Standards for the Public Sector

The International Federation of Accountants — Public Sector Committee (the Committee) develops accounting standards for public sector entities referred to as International Public Sector Accounting Standards (IPSASs). The Committee recognizes the significant benefits of achieving consistent and comparable financial information across jurisdictions and it believes that the IPSASs will play a key role in enabling these benefits to be realized. The adoption of IPSASs by governments will improve both the quality and comparability of financial information reported by public sector entities around the world.

IPSASs are being prepared for application by entities adopting the accrual basis of accounting and for application by entities adopting the cash basis of accounting.

The Committee recognizes the right of governments and national standard setters to establish guidelines and accounting standards for financial reporting. The Committee considers that this Standard is an important step forward in improving the consistency and comparability of financial reporting under the cash basis of accounting and encourages the adoption of this Standard. Financial statements should be described as complying with this IPSAS only if they comply with all the requirements of Part 1 of this IPSAS.

The Committee encourages governments to progress to the accrual basis of accounting and to harmonize national requirements with the IPSASs prepared for application by entities adopting the accrual basis of accounting. Entities intending to adopt the accrual basis of accounting at some time in the future may find other publications of the Committee helpful, particularly Study 14 *Transition to the Accrual Basis of Accounting: Guidance for Governments and Government Entities*.

FINANCIAL REPORTING UNDER THE CASH BASIS OF ACCOUNTING

Structure of the Standard

This Standard comprises two parts:

- Part 1 is mandatory. It sets out the requirements which are applicable to all entities preparing general purpose financial statements under the cash basis of accounting. It defines the cash basis of accounting, establishes requirements for the disclosure of information in the financial statements and supporting notes, and deals with a number of specific reporting issues. The requirements in this part of the Standard must be complied with by entities which claim to be reporting in accordance with the International Public Sector Accounting Standard *Financial Reporting Under The Cash Basis of Accounting*.
- Part 2 is not mandatory. It identifies additional accounting policies and disclosures that an entity is encouraged to adopt to enhance its financial accountability and the transparency of its financial statements. It includes explanations of alternative methods of presenting certain information.

FINANCIAL REPORTING UNDER THE CASH BASIS OF ACCOUNTING

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INTERNATIONAL PUBLIC SECTOR ACCOUNTING STANDARD

Financial Reporting Under The Cash Basis of Accounting

PART 1: REQUIREMENTS

Part 1 of this Standard sets out the requirements for reporting under the cash basis of accounting.

The standards, which have been set in bold type, should be read in the context of the commentary paragraphs in this Standard, which are in plain type, and in the context of the "Preface to International Public Sector Accounting Standards". International Public Sector Accounting Standards are not intended to apply to immaterial items.

Objective

The purpose of this Standard is to prescribe the manner in which general purpose financial statements should be presented under the cash basis of accounting.

Information about the cash receipts, cash payments and cash balances of an entity is necessary for accountability purposes and provides input useful for assessments of the ability of the entity to generate adequate cash in the future and the likely sources and uses of cash. In making and evaluating decisions about the allocation of cash resources and the sustainability of the entity's activities, users require an understanding of the timing and certainty of cash receipts and cash payments.

Compliance with the requirements and encouragements of this Standard will enhance comprehensive and transparent financial reporting of the cash receipts, cash payments and cash balances of the entity. It will also enhance comparability with the entity's own financial statements of previous periods and with the financial statements of other entities which adopt the cash basis of accounting.

1.1 Scope of the Requirements

1.1.1 **An entity which prepares and presents financial statements under the cash basis of accounting, as defined in this Standard, should apply the requirements of Part 1 of this Standard in the presentation of its general purpose annual financial statements.**

1.1.2 General purpose financial statements are those intended to meet the needs of users who are not in a position to demand reports tailored to meet their specific information needs. Users of general purpose financial statements include taxpayers and ratepayers, members of the legislature, creditors, suppliers, the media and employees. General purpose financial statements include those financial statements that are presented separately or within another public document such as an annual report.

1.1.3 This Standard applies equally to the general purpose financial statements of an individual entity and to the consolidated general purpose financial statements of an economic entity such as a whole-of-government. It requires the preparation of a statement of cash receipts and payments which recognizes the cash controlled by the reporting entity, and the disclosure of accounting policies and explanatory notes. It also requires that amounts settled on behalf of the reporting entity by third parties be disclosed on the face of the statement of cash receipts and payments.

1.1.4 **An entity whose financial statements comply with the requirements of Part 1 of this Standard should disclose that fact. Financial statements should not be described as complying with this Standard unless they comply with all the requirements in Part 1 of the Standard.**

1.1.5 **This Standard applies to all public sector entities other than Government Business Enterprises.**

1.1.6 The *Preface to International Financial Reporting Standards* issued by the International Accounting Standards Board (IASB) explains that International Financial Reporting Standards (IFRSs) are designed to apply to the general purpose financial statements of all profit-oriented entities. Government Business Enterprises (GBEs) are defined in paragraph 1.2.1 below. They are profit-oriented entities. Accordingly, they are required to comply with IFRSs and International Accounting Standards (IASs).

1.1.7 The International Accounting Standards Board (IASB) was established in 2001 to replace the International Accounting Standards Committee (IASC). The IASs issued by the IASC remain in force until they are amended or withdrawn by the IASB.

1.2 The Cash Basis

Definitions

1.2.1 **The following terms are used in this Standard with the meaning specified:**

Cash comprises cash on hand, demand deposits and cash equivalents.

Cash basis means a basis of accounting that recognizes transactions and other events only when cash is received or paid.

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.

Cash flows are inflows and outflows of cash.

Cash payments are cash outflows.

Cash receipts are cash inflows.

Control of cash arises when the entity can use or otherwise benefit from the cash in pursuit of its objectives and can exclude or regulate the access of others to that benefit.

Government Business Enterprise means an entity that has all the following characteristics:

(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.**

Cash Basis of Accounting

1.2.2 The cash basis of accounting recognizes transactions and events only when cash (including cash equivalents) is received or paid by the entity. Financial statements prepared under the cash basis provide readers with information about the sources of cash raised during the period, the purposes for which cash was used and the cash balances at the reporting date. The measurement focus in the financial statements is balances of cash and changes therein. Notes to the financial statements may provide additional information about liabilities, such as payables and borrowings, and some non-cash assets, such as receivables, investments and property, plant and equipment.

Cash Equivalents

1.2.3 Cash equivalents are held for the purpose of meeting short-term cash commitments rather than for investment or other purposes. For an investment to qualify as a cash equivalent it must be readily convertible to a known amount of cash and be subject to an insignificant risk of changes in value. Therefore, an investment normally qualifies as a cash equivalent only when it has a short maturity of, say, three months or less from the date of acquisition. Equity investments are excluded from cash equivalents unless they are, in substance, cash equivalents.

1.2.4 Bank borrowings are generally considered to give rise to cash inflows. However, in some jurisdictions, bank overdrafts which are repayable on demand form an integral part of an entity's cash management. In these circumstances, bank overdrafts are included as a component of cash. A characteristic of such banking arrangements is that the bank balance often fluctuates from being positive to overdrawn.

1.2.5 Cash flows exclude movements between items that constitute cash because these components are part of the cash management of an entity rather than increases or decreases in the cash it controls. Cash management includes the investment of excess cash on hand in cash equivalents.

Cash Controlled by the Reporting Entity

1.2.6 Cash is controlled by an entity when the entity can use the cash for the achievement of its own objectives or otherwise benefit from the cash and exclude or regulate the access of others to that benefit. Cash collected by, or appropriated or granted to, an entity which the entity can use to fund its operating objectives, acquire capital assets or repay its debt is controlled by the entity.

1.2.7 Amounts deposited in the bank account of an entity are controlled by that entity. In some cases, cash which a government entity:

(a) collects on behalf of its government (or another entity) is deposited in its own bank account before transfer to consolidated revenue or another general government account; and

(b) is to transfer to third parties on behalf of its government is initially deposited in its own bank account prior to transfer to the authorized recipient.

In these cases, the entity will control the cash for only the period during which the cash resides in its bank account prior to transfer to consolidated revenue or another government controlled bank account, or to third parties. Paragraph 1.4.9 requires the disclosure of cash balances held by an entity at reporting date that are not available for use by the entity or are subject to external restrictions. Additional guidance on the treatment of cash flows that

an entity administers on behalf of other entities is included in paragraphs 2.1.15 to 2.1.22 of Part 2 of this Standard.

1.2.8 In some jurisdictions, a government will manage the expenditure of its individual departments and other entities through a centralized treasury function, often referred to as a "single account" basis. Under these arrangements, individual departments and entities do not control their own bank accounts. Rather, government monies are managed by a central entity through a "single" government account or series of accounts. The central entity will make payments on behalf of individual departments and entities after appropriate authorization and documentation. Consequently, individual departments and entities do not control the cash that they have been appropriated or otherwise authorized to expend. In these cases, the expenditures made by individual departments and entities will be reported in a separate column headed "treasury account" (or a similarly described column) in the statement of cash receipts and payments in accordance with the requirements of paragraph 1.3.24(a).

1.2.9 In some cases, the centralized treasury function will be undertaken by an entity which controls the bank account(s) from which payments on behalf of the individual operating departments and other entities are made. In these cases, transfers to and payments from those bank accounts reflect cash receipts and payments which the central entity administers on behalf of the individual operating departments and other entities. Paragraph 1.3.13 specifies that cash receipts and payments which arise from transactions the entity administers on behalf of other entities and which are recognized in the primary financial statements may be reported on a net basis. Paragraph 1.4.9 requires the disclosure of cash balances held by an entity at reporting date that are not available for use by the entity or are subject to external restrictions.

1.3 Presentation and Disclosure Requirements

Definitions

1.3.1 **The following terms are used in this Standard with the meanings specified:**

Accounting policies are the specific principles, bases, conventions, rules and practices adopted by an entity in preparing and presenting financial statements.

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.

Reporting date means the date of the last day of the reporting period to which financial statements relate.

Economic entity means a group of entities comprising a controlling entity and one or more controlled entities.

1.3.2 Financial statements result from processing large quantities of transactions that are structured by being aggregated into groups according to their nature or function. The final stage in the process of aggregation and classification is the presentation of condensed and classified data that form line items either on the face of the financial statements or in the notes. If a line item is not individually material, it is aggregated with other items either on the face of the financial statements or in the notes. An item that is not sufficiently material to warrant separate presentation on the face of the financial statements may nevertheless be sufficiently material that it should be presented separately in the notes.

1.3.3 The principle of materiality provides that the specific disclosure requirements of International Public Sector Accounting Standards need not be met if the resulting information is not material.

Financial Statements

1.3.4 **An entity should prepare and present general purpose financial statements which include the following components:**

(a) **a statement of cash receipts and payments which:**

(i) **recognizes all cash receipts, cash payments and cash balances controlled by the entity; and**

(ii) **separately identifies payments made by third parties on behalf of the entity in accordance with paragraph 1.3.24 of this Standard; and**

(b) **accounting policies and explanatory notes.**

1.3.5 **When an entity elects to disclose information prepared on a different basis from the cash basis of accounting as defined in this Standard or otherwise required by paragraph 1.3.4(a), such information should be disclosed in the notes to the financial statements.**

1.3.6 The general purpose financial statements comprises the statement of cash receipts and payments and other statements that disclose additional information about the cash receipts, payments and balances controlled by the entity and accounting policies and notes. In accordance with the requirements of paragraph 1.3.4(a) (i) above, only cash receipts, cash payments and cash balances controlled by the reporting entity will be recognized as such in the statement of cash receipts and payments or other statements that might be prepared.

1.3.7 Paragraph 1.3.24 of this Standard requires disclosure on the face of the statement of cash receipts and payments of certain payments made by third parties on behalf of the reporting entity. Payments made by third parties will not satisfy the definition of cash, cash payments and cash receipts as defined in paragraph 1.2.1 of this Standard and will not be presented as cash receipts and payments controlled by the reporting entity in the statement of cash receipts and payments or other statements that might be prepared by the reporting entity.

1.3.8 Notes to the financial statements include narrative descriptions or more detailed schedules or analyses of amounts shown on the face of the financial statements, as well as additional information. They include information required and encouraged to be disclosed by this Standard, and can include other disclosures considered necessary to achieve a fair presentation and enhance accountability.

1.3.9 This Standard does not preclude an entity from including in its general purpose financial statements, statements in addition to the statement of cash receipts and payments as specified in paragraph 1.3.4 above. Consequently, general purpose financial statements may also include statements which, for example:

(a) report cash receipts, cash payments and cash balances for major fund categories such as the consolidated revenue fund; or

(b) provide additional information about the sources and deployment of borrowings and the nature and type of cash payments.

In accordance with the requirements of paragraph 1.3.5 above, any additional statements will only report cash receipts, payments and balances which are controlled by the entity.

1.3.10 Entities that report using the cash basis of accounting frequently collect information on items that are not recognized under cash accounting. Examples of the type of information that may be collected include details of:

(a) receivables, payables, borrowings and other liabilities, non-cash assets and accruing revenues and expenses;

(b) commitments and contingent liabilities; and

(c) performance indicators and the achievement of service delivery objectives.

1.3.11 Entities preparing general purpose financial statements in accordance with this Standard may disclose such information in the notes to the financial statements where that information is likely to be useful to users. Where such disclosures are made they should be clearly described and readily understandable. If not disclosed in the financial statements themselves,

comparisons with budget may also be included in the notes. Part 2 of this Standard encourages inclusion of information about non-cash assets and liabilities and a comparison with budget in general purpose financial statements.

Information to be Presented in the Statement of Cash Receipts and Payments

1.3.12 **The statement of cash receipts and payments should present the following amounts for the reporting period:**

(a) **total cash receipts of the entity showing separately a sub-classification of total cash receipts using a classification basis appropriate to the entity's operations;**

(b) **total cash payments of the entity showing separately a sub-classification of total cash payments using a classification basis appropriate to the entity's operations; and**

(c) **beginning and closing cash balances of the entity.**

1.3.13 **Total cash receipts and total cash payments, and cash receipts and cash payments for each sub-classification of cash receipt and payment, should be reported on a gross basis, except that cash receipts and payments may be reported on a net basis when:**

(a) **they arise from transactions which the entity administers on behalf of other parties and which are recognized in the statement of cash receipts and payments; or**

(b) **they are for items in which the turnover is quick, the amounts are large, and the maturities are short.**

1.3.14 **Line items, headings and sub-totals should be presented in the statement of cash receipts and payments when such presentation is necessary to present fairly the entity's cash receipts, cash payments and cash balances.**

1.3.15 This Standard requires all entities to present a statement of cash receipts and payments which discloses beginning and closing cash balances of the entity, total cash receipts and total cash payments over the reporting period, and major sub-classifications thereof. This will ensure that the financial statements provide comprehensive information about the cash balances of the entity and changes therein over the period in a format that is accessible and understandable to users.

1.3.16 Disclosure of information about such matters as the cash balances of the entity, whether cash is generated from taxes, fines, fees, and/or borrowings and whether it was expended to meet operating costs, for the acquisition of

capital assets or for the retirement of debt will enhance transparency and accountability of financial reporting. These disclosures will also facilitate more informed analysis and assessments of the entity's current cash resources and the likely sources and sustainability of future cash inflows.

Classification

1.3.17 The sub-classifications (or classes) of total cash receipts and payments which will be disclosed in accordance with paragraphs 1.3.12 and 1.3.14 are a matter of professional judgment. That judgment will be applied in the context of the objective and qualitative characteristics of financial reporting under the cash basis of accounting. Appendix 4 of this Standard summarizes the qualitative characteristics of financial reporting. Total cash receipts may be classified to, for example, separately identify cash receipts from: taxation or appropriation; grants and donations; borrowings; proceeds from the disposal of property, plant and equipment; and other ongoing service delivery and trading activities. Total cash payments may be classified to, for example, separately identify cash payments in respect of: ongoing service delivery activities including transfers to constituents or other governments or entities; debt reduction programs; acquisitions of property, plant and equipment; and any trading activities. Alternative presentations are also possible, for example total cash receipts may be classified by reference to their source and cash payments may be sub-classified by reference to either the nature of the payments or their function or program within the entity, as appropriate.

Line items, headings and sub-totals

1.3.18 Factors to be taken into consideration in determining which line items, headings and sub-totals should be presented within each sub-classification in accordance with the requirements of paragraph 1.3.14 above include: assessments of the likely materiality of the disclosures to users; and the extent to which necessary explanations and disclosures are made in the notes to the financial statements. Paragraphs 2.1.23 to 2.1.30 of Part 2 of this Standard set out additional disclosures that an entity is encouraged to make in the notes to the financial statements or in the financial statements themselves. It is likely that in many, but not necessarily all, cases these disclosures will satisfy the requirements of paragraph 1.3.12 above.

Reporting on a net basis

1.3.19 This Standard requires the reporting of cash receipts, payments and balances on a gross basis except in the circumstances identified by paragraph 1.3.13 above. Paragraphs 1.3.20 to 1.3.21 below further elaborate on those circumstances in which reporting on a net basis may be justified.

1.3.20 Governments and government departments and other government entities may administer transactions and otherwise act as agents on behalf of others. These administered and agency transactions may encompass the collection of revenues on behalf of another entity, the transfer of funds to eligible beneficiaries or the safekeeping of monies on behalf of constituents. Examples of such activities may include:

(a) the collection of taxes by one level of government for another level of government, not including taxes collected by a government for its own use as part of a tax sharing arrangement;

(b) the acceptance and repayment of demand deposits of a financial institution;

(c) funds held for customers by an investment or trust entity;

(d) rents collected on behalf of, and paid over to, the owners of properties;

(e) transfers by a government department to third parties consistent with legislation or other government authority; and

(f) funds administered by a central entity under the "single account" basis for management of government expenditure (as referred to in paragraph 1.2.8).

1.3.21 In many cases, the cash an entity receives in respect of transactions it administers as an agent for others will be deposited in trust accounts for, or directly in the bank account of, the ultimate recipients of the cash. In these cases, the entity will not control the cash it receives in respect of the transactions it administers and these cash flows will not form part of the cash receipts, cash payments or cash balances of the entity. However, in other cases the cash received will be deposited in bank accounts controlled by the entity acting as an agent and the receipt and transfer of that cash will be reported in the statement of cash receipts and payments of the entity.

1.3.22 In some cases, the amounts of the cash flows arising from administered transactions which "pass-through" the bank account of the reporting entity may be large relative to the entity's own transactions, and control may occur for only a short time before the amounts are transferred to the ultimate recipients. This may also be true for other cash flows including for example, advances made for, and the repayment of:

(a) the purchase and sale of investments; and

(b) other short-term borrowings, for example, those which have a maturity period of three months or less.

1.3.23 The recognition of these transactions on a gross basis may undermine the ability of the financial statements of some governments and government entities to communicate information about cash receipts and cash payments resulting from the entity's own activities. Accordingly, this Standard permits cash receipts and cash payments to be offset and reported on a net basis in the statement of cash receipts and payments in the circumstances identified in paragraph 1.3.13 above.

Payments by third parties on behalf of the entity

1.3.24 **Where, during a reporting period, a third party directly settles the obligations of an entity or purchases goods and services for the benefit of the entity, the entity should disclose in separate columns on the face of the statement of cash receipts and payments**:

(a) **total payments made by third parties which are part of the economic entity to which the reporting entity belongs, showing separately a sub-classification of the sources and uses of total payments using a classification basis appropriate to the entity's operations; and**

(b) **total payments made by third parties which are not part of the economic entity to which the reporting entity belongs, showing separately a sub-classification of the sources and uses of total payments using a classification basis appropriate to the entity's operation.**

Such disclosure should only be made when during the reporting period the entity has been formally advised by the third party or the recipient that such payment has been made or has otherwise verified the payment.

1.3.25 Where a government manages the expenditure of its individual departments and other entities through a centralized treasury function or a "single account" arrangement, payments are made on behalf of those departments and entities by a central entity after appropriate authorization and documentation from the department. In these cases, the department or other entity does not control cash inflows, cash outflows and cash balances. However, the department or other entity benefits from the payments being made on its behalf, and knowledge of the amount of these payments is relevant to users in identifying the cash resources the government has applied to the entity's activities during the period. Consistent with paragraph 1.3.24(a) above, the department or other entity reports in a separate column on the face of the statement of cash receipts and payments, the amount of

payments made by the central entity on its behalf, and the sources and uses of the amount expended sub-classified on a basis appropriate for the department or other entity. These disclosures will enable users to identify the total amount of payments made, the purposes for which they were made and whether, for example, the payments were made from amounts allocated or appropriated from general revenue or from special purpose funds or other sources.

1.3.26 In some jurisdictions, government departments or other entities may be established with their own bank accounts and will control certain cash inflows, cash outflows and cash balances. In these jurisdictions, government directions or instructions may also require one department or other government entity to settle certain obligations of another department or entity, or to purchase certain goods or services on behalf of another department or entity. Consistent with paragraph 1.3.24(a) above the reporting entity reports in a separate column on the face of the statement of cash receipts and payments the amount, sources and uses of such expenditures made on its behalf during the reporting period. This will assist users in identifying the total cash resources of the economic entity which have been applied to the entity's activities during the reporting period, and the sources and uses of those cash resources.

1.3.27 In some cases, third parties which are not part of the economic entity to which the reporting entity belongs purchase goods or services on behalf of the entity or settle obligations of the entity. For example, a national government may fund the operation of a health or education program of an independent provincial or municipal government by directly paying service providers and acquiring and transferring to the other government the necessary supplies during the period. Similarly, a national government or independent aid agency may pay a construction company directly for building a road for a particular government rather than providing the funds directly to the government itself. These payments may be made by way of a grant or other aid, or as a loan which is to be repaid. In these cases, the provincial or municipal government does not receive cash (including cash equivalents) directly from, or gain control of a bank account or similar facility established for its benefit by, the other entity. Therefore, the amount settled or paid on its behalf does not constitute "cash" as defined in this Standard. However, the government benefits from the cash payments being made on its behalf.

1.3.28 Paragraph 1.3.24(b) above requires that an entity report in a separate column on the face of its statement of cash receipts and payments, the amount, sources and uses of expenditures made by third parties which are not part of the economic entity to which it belongs. This will enable users to identify the total cash resources being applied to the entity's activities during the reporting period, and the extent to which those resources are

provided from parties which are, and which are not, part of the government to which the reporting entity belongs. In some cases, as at reporting date an entity may not be aware that payments have been made on their behalf by third parties during the reporting period. This may occur where the entity has not been formally advised of the third party payment or cannot otherwise verify that an expected payment has occurred. Paragraph 1.3.24 above requires that third party payments only be disclosed on the face of the statement of cash receipts and payments when during the reporting period the entity has been formally advised that such payments have been made or otherwise verifies their occurrence.

1.3.29 The sub-classifications (or classes) of sources and uses of third party payments which will be disclosed in accordance with paragraphs 1.3.24(a) and 1.3.24(b) are a matter of professional judgment. The factors that will be considered in exercising that judgment are outlined in paragraph 1.3.17.

Accounting Policies and Explanatory Notes

Structure of the Notes

1.3.30 **The notes to the financial statements of an entity should:**

(a) **present information about the basis of preparation of the financial statements and the specific accounting policies selected and applied for significant transactions and other events; and**

(b) **provide additional information which is not presented on the face of the financial statements but is necessary for a fair presentation of the entity's cash receipts, cash payments and cash balances.**

1.3.31 **Notes to the financial statements should be presented in a systematic manner. Each item on the face of the statement of cash receipts and payments and other financial statements should be cross-referenced to any related information in the notes.**

Selection and Disclosure of Accounting Policies

1.3.32 **General purpose financial statements should present information that is:**

(a) **understandable;**

(b) **relevant to the decision-making and accountability needs of users; and**

(c) **reliable in that it:**

(i) **represents faithfully the cash receipts, cash payments and cash balances of the entity and the other information disclosed;**

(ii) **is neutral, that is, free from bias; and**

(iii) **is complete in all material respects.**

1.3.33 The quality of information provided in general purpose financial statements determines the usefulness of that statement to users. Paragraph 1.3.32 requires the development of accounting policies to ensure that the financial statements provide information that meets a number of qualitative characteristics. Appendix 4 of this Standard summarizes the qualitative characteristics of financial reporting. The appendix also notes that the timeliness of information may impact upon both the relevance and reliability of the financial information. The maintenance of complete and accurate accounting records during the reporting period is essential for timely production of the general purpose financial statement.

1.3.34 **The accounting policies section of the notes to the financial statements should describe each specific accounting policy that is necessary for a proper understanding of the financial statements, including the extent to which the entity has applied any transitional provisions in this Standard.**

1.3.35 **Inappropriate accounting treatments are not rectified either by disclosure of the accounting policies used, or by notes or explanatory material.**

1.3.36 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 cash receipts, payments and balances. An accounting policy may be significant even if amounts shown for current and prior periods are not material. Paragraph 1.3.4 of this Standard specifies that general purpose financial statements include accounting policies and explanatory notes. Consequently, the requirements of paragraph 1.3.34 above also apply to notes to the financial statements.

1.3.37 **Where an entity elects to include in its financial statements any disclosures encouraged in Part 2 of this Standard, those disclosures should comply with the requirements of paragraph 1.3.32 above.**

1.3.38 Part 2 of this Standard encourages the disclosure of additional information in notes to the financial statements. Where such disclosures are made, they will need to be understandable and to satisfy the other qualitative characteristics of financial information.

1.4 General Considerations

Reporting Period

1.4.1 **The general purpose financial statements should be presented at least annually. When, in exceptional circumstances, an entity's reporting date changes and the annual financial statements are presented for a period longer or shorter than one year, an entity should disclose in addition to the period covered by the financial statements:**

(a) **the reason(s) for a period other than one year being used; and**

(b) **the fact that comparative amounts may not be comparable.**

1.4.2 The reporting date is the date of the last day of the reporting period to which the financial statements relate. In exceptional circumstances an entity may be required to, or decide to, change its reporting date to, for example, align the reporting cycle more closely with the budgeting cycle. When this is the case, it is important that the reason for the change in reporting date is disclosed and that users are aware that the amounts shown for the current period and the comparative amounts are not comparable.

1.4.3 Normally, the financial statements are consistently prepared covering a one-year period. However, some entities prefer to report, for example, for a 52 week period for practical reasons. This Standard does not preclude this practice, as the resulting financial statements are unlikely to be materially different from that which would be presented for one year.

Timeliness

1.4.4 The usefulness of the financial statements are impaired if they are not made available to users within a reasonable period after the reporting date. An entity should be in a position to issue its financial statements within six months of the reporting date, although a timeframe of no more than three months is strongly encouraged. Ongoing factors such as the complexity of an entity's operations are not sufficient reason for failing to report on a timely basis. More specific deadlines are dealt with by legislation and regulations in many jurisdictions.

Authorization Date

1.4.5 **An entity should disclose the date when the financial statements were authorized for issue and who gave that authorization. If another body has the power to amend the financial statements after issuance, the entity should disclose that fact.**

1.4.6 The authorization date is the date on which the financial statements have received approval from the individual or body with the authority to finalize those statements for issue. It is important for users to know when the

financial statements were authorized for issue, because the financial statements do not reflect events after this date. It is also important for users to know of the rare circumstances in which any persons or organizations have the authority to amend the financial statements after issuance. Examples of individuals or bodies that may have the power to amend the financial statements after issuance are Ministers, the government of which the entity forms part, Parliament or an elected body of representatives. If changes are made, the amended financial statements are a new set of financial statements.

Information about the Entity

1.4.7 **An entity should disclose the following if not disclosed elsewhere in information published with the financial statements:**

(a) **the domicile and legal form of the entity, and the jurisdiction within which it operates;**

(b) **a description of the nature of the entity's operations and principal activities;**

(c) **a reference to the relevant legislation governing the entity's operations, if any; and**

(d) **the name of the controlling entity and the ultimate controlling entity of the economic entity (where applicable, if any).**

1.4.8 The disclosure of the information required by paragraph 1.4.7 will enable users to identify the nature of the entity's operations and gain an understanding of the legislative and institutional environment within which it operates. This is necessary for accountability purposes and will assist users in understanding and evaluating the financial statements of the entity.

Restrictions on Cash Balances and Access to Borrowings

1.4.9 **An entity should disclose in the notes to the financial statements together with a commentary, the nature and amount of:**

(a) **significant cash balances that are not available for use by the entity;**

(b) **significant cash balances that are subject to external restrictions; and**

(c) **undrawn borrowing facilities that may be available for future operating activities and to settle capital commitments, indicating any restrictions on the use of these facilities.**

1.4.10 Cash balances held by an entity would not be available for use by the entity when, for example, a controlled entity operates in a country where exchange

controls or other legal restrictions apply and the balances are not available for general use by the controlling entity or other controlled entities.

1.4.11 Cash balances controlled by an entity may be subject to restrictions which limit the purpose or timing of their use. This situation often exists when an entity receives a grant or donation which must be used for a specific purpose. It may also exist where, at reporting date, an entity holds in its own bank accounts cash it has collected for other parties in its capacity as an agent but not yet transferred to those parties. Although these balances are controlled by the entity and reported as a cash balance of the entity, separate disclosure of the amount of such items is helpful to readers.

1.4.12 Undrawn borrowing facilities represent a potential source of cash for an entity. Disclosure of the amount of these facilities by significant type allows readers to assess the availability of such cash, and the extent to which the entity has made use of them during the reporting period.

Consistency of Presentation

1.4.13 The presentation and classification of items in the financial statements should be retained from one period to the next unless:

(a) **a significant change in the nature of the operations of the entity or a review of its financial statements presentation demonstrates that the change will result in a more appropriate presentation of events or transactions; or**

(b) **a change in presentation is required by a future amendment to this Standard.**

1.4.14 A major restructuring of service delivery arrangements; the creation of a new, or termination of a major existing, government entity; a significant acquisition or disposal; or a review of the overall presentation of the entity's general purpose financial statements might suggest that the statement of cash receipts and payments or other individual financial statements should be presented differently. For example, a government may dispose of a government savings bank that represents one of its most significant controlled entities and the remaining economic entity conducts mainly administrative and policy advice services. In this case, the presentation of the financial statements identifying a financial institution as a principal activity of the government is unlikely to be relevant.

1.4.15 Only if the revised structure is likely to continue, or if the benefit of an alternative presentation is clear, should an entity change the presentation of its financial statements. When such changes in presentation are made, an entity reclassifies its comparative information in accordance with paragraph 1.4.19. Where an entity complies with this International Public Sector Accounting Standard, a change in presentation to comply with

national requirements is permitted as long as the revised presentation is consistent with the requirements of this Standard.

Comparative Information

1.4.16 **Unless a provision of this Standard permits or requires otherwise, comparative information should be disclosed in respect of the previous period for all numerical information required by this Standard to be disclosed in the financial statements, except in respect of the financial statements for the reporting period to which this Standard is first applied. Comparative information should be included in narrative and descriptive information when it is relevant to an understanding of the current period's financial statements.**

1.4.17 This Standard requires the presentation of a statement of cash receipts and payments and specifies certain disclosures that are required to be made in that statement and notes thereto. This Standard does not preclude the preparation of additional financial statements. Part 2 of this Standard encourages certain additional disclosures. Where financial statements in addition to the statement of cash receipts and payments are prepared or disclosures encouraged by Part 2 of this Standard are made, the disclosure of comparative information is also encouraged.

1.4.18 In some cases, narrative information provided in the financial statements for the previous period(s) continues to be relevant in the current period. For example, details of a legal dispute, the outcome of which was uncertain at the last reporting date and is yet to be resolved, may be disclosed in the current period. Users benefit from knowing that the uncertainty existed at the last reporting date, and the steps that have been taken during the period to resolve the uncertainty.

1.4.19 **When the presentation or classification of items required to be disclosed in the financial statements is amended, comparative amounts should be reclassified, unless it is impracticable to do so, to ensure comparability with the current period, and the nature, amount of, and reason for any reclassification should be disclosed. When it is impracticable to reclassify comparative amounts, an entity should disclose the reason for not reclassifying and the nature of the changes that would have been made if amounts were reclassified.**

1.4.20 Circumstances may exist when it is impracticable to reclassify comparative information to achieve comparability with the current period. For example, data may not have been collected in the previous period(s) in a way which allows reclassification, and it may not be practicable to recreate the information. In such circumstances, the nature of the adjustments to comparative amounts that would have been made is disclosed.

Identification of Financial Statements

1.4.21 **The financial statements should be clearly identified and distinguished from other information in the same published document.**

1.4.22 This Standard applies only to the financial statements, and not to other information presented in an annual report or other document. Therefore, it is important that users are able to distinguish information that is prepared using this Standard from other information that may be useful to users but that is not the subject of this Standard.

1.4.23 **Each component of the financial statements should be clearly identified. In addition, the following information should be prominently displayed and repeated when it is necessary for a proper understanding of the information presented:**

(a) **the name of the reporting entity or other means of identification;**

(b) **whether the financial statements cover the individual entity or the economic entity;**

(c) **the reporting date or the period covered by the financial statements, whichever is appropriate to the related component of the financial statements;**

(d) **the reporting currency; and**

(e) **the level of precision used in the presentation of figures in the financial statements.**

1.4.24 The requirements in paragraph 1.4.23 are normally met by presenting page headings and abbreviated column headings on each page of the financial statements. Judgment is required in determining the best way of presenting such information. For example, when the financial statements are read electronically, separate pages may not be used. In such cases, the items identified in paragraph 1.4.23 are presented frequently enough to ensure a proper understanding of the information given.

1.4.25 Financial statements are often made more understandable by presenting information in thousands or millions of units of the reporting currency. This is acceptable as long as the level of precision in presentation is disclosed and relevant information is not lost.

1.5 Correction of Errors

1.5.1 **When an error arises in relation to a cash balance reported in the financial statements, the amount of the error that relates to prior periods should be reported by adjusting the cash at the beginning of the period. Comparative information should be restated, unless it is impracticable to do so.**

1.5.2 **An entity should disclose in the notes to the financial statements the following:**

(a) **the nature of the error;**

(b) **the amount of the correction; and**

(c) **the fact that comparative information has been restated or that it is impracticable to do so.**

1.5.3 Errors in the preparation of the financial statements of one or more prior periods may be discovered in the current period. Errors may occur as a result of mathematical mistakes, mistakes in applying accounting policies, misinterpretation of facts, fraud or oversights. When an error is identified in respect of a previous period, the opening balance of cash is adjusted to correct the error and the financial statements, including the comparative information for prior periods, is presented as if the error had been corrected in the period in which it was made. An explanation of the error and its adjustment is included in the notes.

1.5.4 The restatement of comparative information does not necessarily give rise to the amendment of financial statements which have been approved by the governing body or registered or filed with regulatory authorities. However, national laws may require the amendment of such financial statements.

1.5.5 This Standard requires the presentation of a statement of cash receipts and payments, and does not preclude the presentation of other financial statements. Where financial statements in addition to the statement of cash receipts and payments are presented, the requirements in paragraphs 1.5.1 and 1.5.2 for correction of errors will also apply to those statements.

1.6 Consolidated Financial Statements

Definitions

1.6.1 **The following terms are used in this Standard with the meanings specified:**

Consolidated financial statements are the financial statements of an economic entity presented as that of a single entity.

Control of an entity is the power to govern the financial and operating policies of another entity so as to benefit from its activities.

Controlled entity is an entity that is under the control of another entity (known as the controlling entity).

Controlling entity is an entity that has one or more controlled entities.

Economic entity means a group of entities comprising a controlling entity and one or more controlled entities.

Economic Entity

1.6.2 The term "economic entity" is used in this Standard to define, for financial reporting purposes, a group of entities comprising the controlling entity and any controlled entities.

1.6.3 Other terms sometimes used to refer to an economic entity include "administrative entity", "financial reporting entity", "consolidated entity" and "group".

1.6.4 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.

Scope of Consolidated Financial Statements

1.6.5 **A controlling entity, other than a controlling entity identified in paragraphs 1.6.7 and 1.6.8, should issue consolidated financial statements which consolidates all controlled entities, foreign and domestic, other than those referred to in paragraph 1.6.6.**

1.6.6 **A controlled entity should be excluded from consolidation when it operates under severe external long-term restrictions which prevent the controlling entity from benefiting from its activities.**

1.6.7 **A controlling entity that is a wholly owned controlled entity need not present consolidated financial statements provided users of such financial statements are unlikely to exist or their information needs are met by the controlling entity's consolidated financial statements.**

1.6.8 **A controlling entity that is virtually wholly owned need not present consolidated financial statements provided the controlling entity obtains the approval of the owners of the minority interest.**

1.6.9 Users of the financial statements of a government or other public sector controlling entity are usually concerned with, and need to be informed about, the cash resources controlled by the economic entity as a whole. This need is served by consolidated financial statements which present financial information about the economic entity as a single entity without regard for the legal boundaries of the separate legal entities.

1.6.10 Paragraph 1.3.4 of this Standard requires that a reporting entity prepare a statement of cash receipts and payments. Consistent with the requirements of paragraph 1.6.5 above, the statement of cash receipts and payments prepared by a government or other public sector reporting entity which is a controlling entity, will consolidate the cash receipts, cash payments and cash balances of all the entities it controls. The note disclosures required by

Part 1 of this Standard will also be presented on a consolidated basis. Appendix 5 of this Statement illustrates the application of the concept of control in determining the financial reporting entity.

1.6.11 This Standard does not preclude the preparation of financial statements additional to the statement of cash receipts and payments. Those additional statements may, for example, disclose additional information about receipts and payments related to certain fund groups or provide additional details about certain types of cash flows. Part 2 of this Standard identifies additional disclosures that an entity is encouraged to make. The additional statements and disclosures will also report consolidated information where appropriate.

1.6.12 For financial reporting purposes, the reporting entity (financial reporting entity) may consist of a number of controlled entities including government departments, agencies and Government Business Enterprises (GBEs). Determining the scope of the financial reporting entity can be difficult due to the large number of potential entities. For this reason, financial reporting entities are often determined by legislation. In some cases, the financial reporting entity required by this Standard may differ from the reporting entity specified by legislation and additional disclosures may be necessary to satisfy the legislative reporting requirements.

1.6.13 A controlling entity that is itself wholly owned by another entity (such as a government agency which is wholly owned by the government), is not required to present consolidated financial statements when such statements are not required by its controlling entity and the needs of other users may be best served by the consolidated financial statements of its controlling entity. However, in the public sector, many controlling entities that are either wholly owned or virtually wholly owned represent key sectors or activities of a government. In these cases, the information needs of certain users may not be served by the presentation of a consolidated financial statement at a whole-of-government level alone, and the purpose of this Standard is not to exempt such entities from preparing consolidated financial statements. In many jurisdictions, governments have acknowledged this and have legislated the financial reporting requirements of such entities.

1.6.14 In some jurisdictions, a controlling entity which is virtually wholly owned by another entity (such as a government enterprise which has some minor ownership from the private sector) is also exempted from presenting consolidated financial statements if the controlling entity obtains the approval of the owners of the minority interest. Virtually wholly owned is often taken to mean that the controlling entity owns 90% or more of the voting power. For the purpose of this Standard, the minority interest is that part of a controlled entity attributable to interests which are not owned, directly or indirectly through controlled entities, by the controlling entity.

1.6.15 In some instances, an economic entity will include a number of intermediate controlling entities. For example, whilst a department of health may be the controlling entity, there may be intermediate controlling entities at the local or regional health authority level. Accountability and reporting requirements in each jurisdiction may specify which entities are required to (or exempted from the requirement to) prepare a consolidated financial statement. Where there is no requirement for an intermediate controlling entity to prepare consolidated financial statements but users of general purpose financial statements of the economic entity are likely to exist, intermediate controlling entities are encouraged to prepare and publish such a statement.

Consolidation Procedures

1.6.16 **The following consolidation procedures apply:**

(a) **cash balances and cash transactions between entities within the economic entity should be eliminated in full;**

(b) **when the financial statements used in a consolidation are drawn up to different reporting dates, adjustments should be made for the effects of significant cash transactions that have occurred between those dates and the date of the controlling entity's financial statements. In any case, the difference between the reporting dates should be no more than three months; and**

(c) **consolidated financial statements should be prepared using uniform accounting policies for like cash transactions. If it is not practicable to use uniform accounting policies 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.**

1.6.17 The consolidation procedures outlined in paragraph 1.6.16 provide the basis for preparing consolidated financial statements for all the entities within the economic entity as a single economic unit.

1.6.18 The consolidated financial statements should only reflect transactions between the economic entity and other entities external to it. Accordingly, transactions between entities within the economic entity are eliminated to avoid double-counting. For example, a government department may sell a physical asset to another government department. Because the net cash effect on the whole-of-government reporting entity is zero, this transaction needs to be eliminated to avoid overstating the cash receipts and cash payments of the whole-of-government reporting entity. A government entity may hold funds with a public sector financial institution. These balances would be eliminated at the whole-of-government level because they represent balances within the economic entity. Similarly, a GBE operating

overseas may make a payment to a government department which remains in transit at the reporting date. In this case, failure to eliminate the transaction would result in understating the cash balance of the economic entity and overstating its cash payments.

1.6.19 Individual entities within the economic entity may adopt different policies for the classification of cash receipts and cash payments and the presentation of their financial statements. Cash receipts or cash payments arising from like transactions are classified and presented in a uniform manner in the consolidated financial statements where practicable.

Consolidation Disclosures

1.6.20 **The following disclosures should be made in consolidated financial statements:**

(a) **a listing of significant controlled entities including the name, the jurisdiction in which the controlled entity operates (when it is different from that of the controlling entity); and**

(b) **the reasons for not consolidating a controlled entity.**

Transitional Provisions

1.6.21 Controlling entities that adopt this Standard may have large numbers of controlled entities with significant volumes of transactions between those entities. Accordingly, it may be difficult to identify all the transactions and balances that need to be eliminated for the purpose of preparing the consolidated financial statements of the economic entity. For this reason, paragraph 1.8.2 provides relief, during the transitional period, from the requirement to eliminate all cash balances and transactions between entities within the economic entity. However, paragraph 1.8.3 requires that entities which apply the transitional provision should disclose the fact that not all balances and transactions between entities within the economic entity have been eliminated.

1.7 Foreign Currency

Definitions

1.7.1 **The following terms are used in this Standard with the meanings specified:**

Closing rate is the spot exchange rate at the reporting date.

Exchange difference is the difference resulting from reporting the same number of units of a foreign currency in the reporting currency at different exchange rates.

Exchange rate is the ratio for exchange of two currencies.

Foreign currency is a currency other than the reporting currency of an entity.

Reporting currency is the currency used in presenting the financial statements.

Treatment of Foreign Currency Cash Receipts, Payments and Balances

1.7.2 **Cash receipts and payments arising from transactions in a foreign currency should be recorded in an entity's reporting currency by applying to the foreign currency amount the exchange rate between the reporting currency and the foreign currency at the date of the receipts and payments.**

1.7.3 **Cash balances held in a foreign currency should be reported using the closing rate.**

1.7.4 **The cash receipts and cash payments of a foreign controlled entity should be translated at the exchange rates between the reporting currency and the foreign currency at the dates of the receipts and payments.**

1.7.5 **An entity should disclose the amount of exchange differences included as reconciling items between opening and closing cash balances for the period.**

1.7.6 **When the reporting currency is different from the currency of the country in which the entity is domiciled, the reason for using a different currency should be disclosed. The reason for any change in the reporting currency should also be disclosed.**

1.7.7 Governments and government entities may have transactions in foreign currencies such as borrowing an amount of foreign currency or purchasing goods and services where the purchase price is designated as a foreign currency amount. They may also have foreign operations and transfer cash to and receive cash from those foreign operations. In order to include foreign currency transactions and foreign operations in financial statements the entity must express cash receipts, payments and balances in reporting currency terms.

1.7.8 Unrealized gains and losses arising from changes in foreign currency exchange rates are not cash receipts and payments. However, the effect of exchange rate changes on cash held in a foreign currency is reported in the statement of cash receipts and payments in order to reconcile cash at the beginning and the end of the period. This amount is presented separately from cash receipts and payments and includes the differences, if any, had those cash receipts payments and balances been reported at end-of-period exchange rates.

1.8 Effective Date of Part 1 and Transitional Provisions

Effective Date

1.8.1 **Part 1 of this International Public Sector Accounting Standard becomes effective for annual financial statements covering periods beginning on or after 1 January 2004. Earlier application is encouraged.**

Transitional Provisions - Consolidated Financial Statements

1.8.2 **Entities are not required to comply with the requirement in paragraph 1.6.16(a) concerning the elimination of cash balances and transactions between entities within the economic entity for reporting periods beginning on a date within three years following the date of first adoption of this Standard.**

1.8.3 **Where entities apply the transitional provision in paragraph 1.8.2, they should disclose the fact that not all balances and transactions between entities within the economic entity have been eliminated.**

Appendix 1

Illustration of the Requirements of Part 1 of the Standard

This appendix is illustrative only and does not form part of the standards. It illustrates only Part 1 of this Standard. Its purpose is to assist in clarifying the meaning of the standards by illustrating their application in the preparation and presentation of general purpose financial statements under the cash basis of accounting:

(a) *Government;*

(b) *Governmental Entity which controls its own bank account; and*

(c) *Governmental Department which operates under a "single account" system such that a central entity administers cash receipts and payment on behalf of the Department.*

APPENDIX 1A – A GOVERNMENT

CONSOLIDATED FINANCIAL STATEMENTS FOR GOVERNMENT X

CONSOLIDATED STATEMENT OF CASH RECEIPTS AND PAYMENTS FOR YEAR ENDED 31 DECEMBER 200X

	Note	**<-----------200X---------->**		**<-----------200X-1---------->**	
(in thousands of currency units)		**Receipts/ (Payments) controlled by entity**	**Payments by third parties**	**Receipts/ (Payments) controlled by entity**	**Payments by third parties**
RECEIPTS					
Taxation					
Income tax		X	-	X	-
Value-added tax		X	-	X	-
Property tax		X	-	X	-
Other taxes		X	-	X	-
		X	-	X	-
Grants and Aid					
International agencies		X	X	X	X
Other Grants and Aid		X	X	X	X
		X	X	X	X
Borrowings					
Proceeds from borrowings	3	X	X	X	X
Capital Receipts					
Proceeds from disposal of plant and equipment		X	-	X	-
Trading Activities					
Receipts from trading					

(in thousands of currency units)	**Note**	**<-----------200X---------->**		**<-----------200X-1---------->**	
		Receipts/ (Payments) controlled by entity	**Payments by third parties**	**Receipts/ (Payments) controlled by entity**	**Payments by third parties**
activities		X	-	X	-
Other receipts	4	X	X	X	X
Total receipts		**X**	**X**	**X**	**X**

PAYMENTS

Operations				
Wages, salaries and employee benefits	(X)	(X)	(X)	(X)
Supplies and consumables	(X)	(X)	(X)	(X)
	(X)	(X)	(X)	(X)
Transfers				
Grants	(X)	-	(X)	-
Other transfer payments	(X)	-	(X)	-
	(X)	-	(X)	-
Capital Expenditures				
Purchase/construction of plant and equipment	(X)	(X)	(X)	(X)
Purchase of financial instruments	(X)	-	(X)	-
	(X)	(X)	(X)	(X)

	Note	**<-----------200X---------->**		**<-----------200X-1---------->**	
(in thousands of currency units)		**Receipts/ (Payments) controlled by entity**	**Payments by third parties**	**Receipts/ (Payments) controlled by entity**	**Payments by third parties**
Loan and Interest Repayments					
Repayment of borrowings		(X)	-	(X)	-
Interest payments		(X)	-	(X)	-
		(X)	-	(X)	-
Other payments	5	(X)	(X)	(X)	(X)
Total payments		**(X)**	**(X)**	**(X)**	**(X)**
Increase/(Decrease) in Cash		**X**	-	**X**	-
Cash at beginning of year	2	**X**	**N/A***	**X**	**N/A**
Increase/(Decrease) in Cash		**X**	**N/A**	**X**	**N/A**
Cash at end of year	2	**X**	**N/A**	**X**	**N/A**

* N/A = Not applicable

ADDITIONAL FINANCIAL STATEMENTS (OPTIONAL)

Additional financial statements may be prepared to provide details of amounts included in the consolidated statement of cash receipts and payments: for example, to disclose information by major fund groups or to disclose expenditures by major functions or programs, or to provide details of sources of borrowings. Columns disclosing budgeted amounts may also be included.

STATEMENT OF CASH RECEIPTS BY FUND CLASSIFICATION

(in thousands of currency units)	**200X** **Receipts controlled by entity**	**200X-1** **Receipts controlled by entity**
RECEIPTS		
Consolidated Funds	X	X
Special Funds	X	X
Trading Funds	X	X
Loans	X	X
Total receipts	**X**	**X**

PROCEEDS OF BORROWINGS

	Note	<-----------200X--------->		<-----------200X-1---------->	
(in thousands of currency units)		**Cash Receipts controlled by entity**	**Resulting from Payments by third parties**	**Receipts controlled by entity**	**Resulting from Payments by third parties**
BORROWINGS					
Domestic Commercial Institution		X	-	X	-
Offshore Commercial Institution		X	-	X	-
Development Banks and Similar Lending Agencies		X	X	X	X
Total borrowings	3	**X**	**X**	**X**	**X**

STATEMENT OF PAYMENTS BY PROGRAMS/ACTIVITIES/FUNCTION OF GOVERNMENT

	<-----------200X---------->		<-----------200X-1---------->	
(in thousands of currency units)	**Payments controlled by entity**	**Payments by third parties**	**Payments controlled by entity**	**Payments by third parties**
PAYMENTS/EXPENDITURE – Operating Account				
Education Services	X	X	X	X
Health Services	X	X	X	X
Social Security and Welfare	X	-	X	-
Defense	X	-	X	-
Public Order and Safety	X	X	X	X
Recreation, Culture and Religion	X	X	X	X
Economic Services	X	-	X	-
Other	X	X	X	X
Total payments/expenditure	**X**	**X**	**X**	**X**
PAYMENTS/EXPENDITURE – Capital Account				
Education Services	X	X	X	X
Health Services	X	X	X	X
Social Security and Welfare	X	-	X	-
Defense	X	-	X	-
Public Order and Safety	X	X	X	X
Recreation, Culture and Religion	X	X	X	X
Other	X	X	X	X
Total payments/expenditure	**X**	**X**	**X**	**X**
Total Operating and Capital Accounts	**X**	**X**	**X**	**X**

PUBLIC SECTOR ENTITY – WHOLE-OF-GOVERNMENT

Notes to the Financial Statements

<u>1 Accounting Policies</u>

Basis of preparation

The financial statements have been prepared in accordance with Cash Basis IPSAS *Financial Reporting Under The Cash Basis of Accounting*.

The accounting policies have been applied consistently throughout the period.

Reporting entity

The financial statements are for the national government of Country A. The financial statements encompass the reporting entity as specified in the relevant legislation (Public Finance Act 20XX). This comprises:

(i) central government ministries; and

(ii) government business enterprises and trading funds that are under the control of the entity.

The consolidated financial statements include all entities controlled during the year. A list of significant controlled entities is shown in Note 7 to the financial statements.

Payments by Third Parties

The government also benefits from goods and services purchased on its behalf as a result of cash payments made by third parties during the period by way of loans and contributions. The payments made by the third parties do not constitute cash receipts or payments by the government but do benefit the government. They are disclosed in the *Payments by third parties* column in the Consolidated Statement of Cash Receipts and Payments and other financial statements.

Reporting currency

The reporting currency is (currency of Country A).

2 Cash

Cash comprises cash on hand, demand deposits and cash equivalents. Demand deposits and cash equivalents consist of balances with banks and investments in short-term money market instruments.

Cash included in the statement of cash receipts and payments comprise the following amounts:

(in thousands of currency units)	**200X**	**200X-1**
Cash on hand and balances with banks	X	X
Short-term investments	X	X
	X	X

Included in the amount stated above is X currency units provided by the International Agency XX that is restricted to the construction of road infrastructure.

3 Borrowings

Borrowings comprise cash inflows from banks, similar lending agencies and commercial institutions and amounts owing in respect of non-cash assistance provided by third parties.

4 Other Receipts

Included in other receipts are fees, fines, penalties and miscellaneous receipts.

5 Other Payments/Expenditure

Included in other payments are dividends, distributions paid, legal settlements of lawsuits and miscellaneous payments.

6 Undrawn Borrowing Facilities

(in thousands of currency units)	200X	200X-1
Movement in Undrawn Borrowing Facilities		
Undrawn borrowing facilities at 1.1.0X	X	X
Additional loan facility	X	X
Total available	X	X
Amount drawn	(X)	(X)
Facility closure/cancellations	(X)	(X)
Undrawn borrowing facilities at 31.12.0X.	X	X

(in thousands of currency units)	200X	200X-1
Undrawn Borrowing Facilities		
Multilateral Development Bank A	X	X
Multilateral Development Bank B	X	X
Regional Development Banks	X	X
Commercial Financial Institutions	X	X
Total undrawn borrowing facilities	X	X

Undrawn borrowing facilities include an amount of XX from Multilateral Development Bank A and YY from Multilateral Development Bank B which is stipulated for use for social infrastructure development. The details of the restrictions are (specify details).

7 Significant Controlled Entities

Entity	Jurisdiction
Entity A	X
Entity B	X
Entity C	X
Entity D	X

8 Authorization Date

The financial statement was authorized for publication on XX *Month* 200X+1 by Mr YY, the Treasurer of Country A.

APPENDIX 1b – GOVERNMENT ENTITY AB

(This Entity controls its own bank account and also benefits from payments made by third parties.)

CONSOLIDATED STATEMENT OF CASH RECEIPTS AND PAYMENTS

FOR YEAR ENDED 31 DECEMBER 200X

(in thousands of currency units)	Note	<------200X------>			<------200X-1------>		
		Receipts/ (Payments) controlled by entity	Payments by other government entities	Payments by external third parties	Receipts/ (Payments) controlled by entity	Payments by other government entities	Payments by external third parties
RECEIPTS							
Authorized allocations/Appropriations		X	X	-	X	X	-
Other receipts		X	-	-	X	-	-
Grants/Assistance		-	-	X	-	-	X
Total receipts		**X**	**X**	**X**	**X**	**X**	**X**
PAYMENTS							

(in thousands of currency units)	Note	200X			200X-1		
		Receipts/ (Payments) controlled by entity	**Payments by other government entities**	**Payments by external third parties**	**Receipts/ (Payments) controlled by entity**	**Payments by other government entities**	**Payments by external third parties**
Wages, salaries and employee benefits		(X)	-	-	(X)	-	-
Rent		(X)	(X)	-	(X)	(X)	-
Capital Expenditure		(X)	(X)	(X)	(X)	(X)	(X)
Transfers	3	(X)	(X)	(X)	(X)	(X)	(X)
Total payments		**(X)**	**(X)**	**(X)**	**(X)**	**(X)**	**(X)**
Increase/(Decrease) in Cash		**X**	**X**	**(X)**	**X**	**(X)**	**X**
Cash at beginning of year	2	**X**	**N/A***	**N/A**	**X**	**N/A**	**N/A**
Increase/(Decrease) in Cash		**X**	**N/A**	**N/A**	**X**	**N/A**	**N/A**
Cash at end of year	*2*	**X**	**N/A**	**N/A**	**X**	**N/A**	**N/A**

- N/A = Not Applicable

Additional Financial Statements (Optional)

Additional financial statements may be prepared, for example, to disclose budget information by major fund groups if applicable or to display expenditures by major functions. An example of a statement by function is included below.

STATEMENT OF PAYMENTS BY FUNCTION

	Note	**<----------200X---------->**			**<----------200X-1---------->**		
(in thousands of currency units)		**Payments controlled by entity**	**Payments by other government entities**	**Payments by external third parties**	**Payments controlled by entity**	**Payments by other government entities**	**Payments by external third parties**
PAYMENTS/EXPENDITURE							
Program I		(X)	(X)	(X)	(X)	(X)	(X)
Program II		(X)	(X)	(X)	(X)	(X)	(X)
Program III		(X)	(X)	(X)	(X)	(X)	(X)
Program IV		(X)	(X)	(X)	(X)	(X)	(X)
Other payments/expenditure		(X)	(X)	(X)	(X)	(X)	(X)
Total payments/expenditure		**(X)**	**(X)**	**(X)**	**(X)**	**(X)**	**(X)**

GOVERNMENT ENTITY AB

Notes to the Financial Statements

1 Accounting Policies

Basis of preparation

The financial statements have been prepared in accordance with Cash Basis IPSAS *Financial Reporting Under The Cash Basis of Accounting*.

The accounting policies have been applied consistently throughout the period.

Reporting entity

The financial statements are for a public sector entity (Government Entity AB). The financial statements encompass the reporting entity as specified in the relevant legislation (Public Finance Act 20XX). This comprises Government Entity AB and its controlled entities. Government Entity AB is controlled by the national government of Country A.

Government Entity AB's principal activity is to provide [identify type of] services to constituents. The Entity controls its own bank account. Appropriations and other cash receipts are deposited into its bank accounts.

Payments by other government entities

The Entity benefits from payments made by its controlling entity (Government A) and other government entities on its behalf.

Payments by external third parties

The Entity also benefits from payments made by external third parties (entities external to the economic entity) for goods and services. These payments do not constitute cash receipts or payments of the Entity, but do benefit the Entity. They are disclosed in the *Payments by external third parties* column in the Statement of Cash Receipts and Payments and in other financial statements.

Reporting currency

The reporting currency is (currency of Country A).

2 Cash

Cash comprises cash on hand, demand deposits and cash equivalents. Demand deposits and cash equivalents comprise balances with banks and investments in short-term money market instruments.

Amounts appropriated to the Entity are deposited in the Entity's bank account and are controlled by the entity. All borrowings are undertaken by a central finance entity.

Receipts from exchange transactions are deposited in trading fund accounts controlled by the Entity. They are transferred to consolidated revenue at year end.

Cash included in the statement of cash receipts and payments comprise the following amounts:

(in thousands of currency units)	**200X**	**200X-1**
Cash on hand and balances with banks	X	X
Short-term investments	X	X
	X	X

3 Transfers

Amounts are transferred to eligible recipients in accordance with operating mandate and authority of the entity.

4 Significant Controlled Entities

Entity	**Jurisdiction**
Entity A	X
Entity B	X

5 Authorization Date

The financial statements were authorized for issue on XX *Month* 200X+1 by Mr YY, Minister of XXXXX for Entity AB.

APPENDIX 1c – GOVERNMENT DEPARTMENT AC

(The Government operates a centralized single account system– the Entity does not control amounts appropriated for its use.)

STATEMENT OF CASH RECEIPTS AND PAYMENTS

FOR YEAR ENDED 31 DECEMBER 200X

	Note	**<-----------200X----------->**		**<-----------200X-1----------->**	
(in thousands of currency units)		**Treasury Account/ Single Control Account**	**Payments by external third parties**	**Treasury Account/ Single Control Account**	**Payments by external third parties**
RECEIPTS					
Allocations/Appropriations	2	X	-	X	-
Other receipts		X	-	X	-
Assistance		-	X	-	X
Total receipts		**X**	**X**	**X**	**X**
PAYMENTS					
Wages, salaries and employee benefits		(X)	-	(X)	-
Rent		(X)	-	(X)	-
Capital Expenditure		(X)	(X)	(X)	(X)
Transfers	3	(X)	(X)	(X)	(X)
Total payments		**(X)**	**(X)**	**(X)**	**(X)**

ADDITIONAL FINANCIAL STATEMENTS (OPTIONAL)

Additional financial statements may be prepared, for example, to disclose budget information by major fund groups if applicable or to display expenditures by major functions or payments. An example of a statement by function is included below.

STATEMENT OF PAYMENTS BY FUNCTION

	Note	<-----------200X----------->		<-----------200X-1----------->	
(in thousands of currency units)		**Treasury Account/ Single Control Account**	**Payments by external third parties**	**Treasury Account/ Single Control Account**	**Payments by external third parties**
PAYMENTS					
Program I		X	X	X	X
Program II		X	X	X	X
Program III		X	X	X	X
Program IV		X	X	X	X
Other payments		X	X	X	X
Total payments		**X**	**X**	**X**	**X**

GOVERNMENT DEPARTMENT AC

Notes to the Financial Statements

1 Accounting Policies

Basis of preparation

The financial statements have been prepared in accordance with Cash Basis IPSAS *Financial Reporting Under The Cash Basis of Accounting*.

The accounting policies have been applied consistently throughout the period.

Reporting entity

The financial statements are for a public sector entity: Government Department AC. The financial statements encompass the reporting entity as specified in the relevant legislation (Public Finance Act 20XX). This comprises Government Department AC. Government Department AC is controlled by the national government of Country A.

Government Department AC's principal activity is to provide services to constituents.

Government Department AC does not operate its own bank account. The Government operates a centralized treasury function which administers cash expenditures incurred by all departments during the financial year. Payments made on this account in respect of the Department are disclosed in the Treasury Account column in the Statement of Cash Receipts and Payments and other financial statements.

Payments by external third parties

Government Department AC benefits from goods and services purchased on its behalf as a result of cash payments made by third parties external to the Government during the reporting period. The payments made by the third parties do not constitute cash receipts or payments of the Department but do benefit the Department. They are disclosed in the *Payments by external third parties* column in the Statement of Cash Receipts and Payments and other financial statements.

Reporting currency

The reporting currency is (currency of Country A).

2 Appropriations

Amounts appropriated to Government Department AC are managed through a central account administered by the Office of the Treasury. These amounts are not controlled by Department AC but are deployed on the Department's behalf by the central account administrator on presentation of appropriate documentation and authorization. All borrowings are undertaken by a central finance entity. The amount reported as allocations/appropriations in the statement of cash receipts and payments

is the amount the Office of the Treasury has expended for the benefit of Department AC (the amount "drawn down").

3 Transfers

Amounts are transferred to eligible recipients in accordance with the operating mandate and authority of Department AC.

4 Authorization Date

The financial statements were authorized on XX *Month* 200X+1 by Mr YY, Minister of XXXXX for Government Department AC.

PART 2: ENCOURAGED ADDITIONAL DISCLOSURES

This part of the Standard is not mandatory. It sets out encouraged additional disclosures for reporting under the cash basis. It should be read together with Part 1 of this Standard, which sets out the requirements for reporting under the cash basis of accounting. The encouraged disclosures, which have been set in italic, should be read in the context of the commentary paragraphs in this part of the Standard, which are in plain type.

FINANCIAL REPORTING UNDER THE CASH BASIS OF ACCOUNTING PART 2: ENCOURAGED ADDITIONAL DISCLOSURES

2.1 Encouraged Additional Disclosures

Definitions

2.1.1 *The following terms are used in this part of the Standard with the meanings specified:*

Accrual basis means 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.

Assets are resources controlled by an entity as a result of past events and from which future economic benefits or service potential are expected to flow to the entity.

Borrowing costs are interest and other expenses incurred by an entity in connection with the borrowing of funds.

Closing rate is the spot exchange rate at the reporting date.

Distributions to owners are 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.

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

Extraordinary items are (for the purposes of this Standard) cash flows 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.

A financial asset is 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.*

Liabilities are present obligations of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits or service potential.

Ordinary activities are 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.

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

Terms defined in Part 1 of this Standard are used in this part of the Standard with their defined meaning.

Future Economic Benefits or Service Potential

2.1.2 Assets, including cash and other resources, 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 Standard uses the term "future economic benefits or service potential" to describe the essential characteristic of assets.

Going Concern

2.1.3 *When preparing the financial statements of an entity, those responsible for the preparation of the financial statements are encouraged to make an assessment of the entity's ability to continue as a going concern. When those responsible for the preparation of the financial statements are aware, in making their assessment, of material uncertainties related to events or conditions which may cast significant doubt upon the entity's ability to continue as a going concern, the disclosure of those uncertainties is encouraged.*

2.1.4 The determination of whether an entity is a going concern is primarily relevant for individual entities rather than for the government as a whole. For individual entities, in assessing whether the entity is a going concern, those responsible for the preparation of the financial statements:

(a) will need to take into account all available information for the foreseeable future which will include, but will not necessarily be limited to, twelve months from the approval of the financial statements; and

(b) may need to consider a wide range of factors surrounding current and expected performance, potential and announced restructurings of organizational units, estimates of receipts or the likelihood of continued government funding, and potential sources of replacement financing before it is appropriate to conclude that the entity is a going concern.

2.1.5 There may be circumstances where the usual going concern tests of liquidity and solvency as applied to business enterprises appear unfavorable, but other factors suggest that the entity is nonetheless a going concern. For example:

(a) in assessing whether the government is a going concern, the power to levy rates or taxes may enable some entities to be considered as a going concern even though their cash payments may exceed their cash receipts for extended periods; and

(b) for an individual entity, an assessment of its cash flows for a reporting period may suggest that the entity is not a going concern. However, there may be multi-year funding agreements in place with the government that will ensure the continued operation of the entity.

Extraordinary Items

2.1.6 *An entity is encouraged to separately disclose the nature and amount of each extraordinary item. The disclosure may be made on the face of the statement of cash receipts and payments, or in other financial statements or in the notes to the financial statements.*

2.1.7 Extraordinary items are characterized by the fact that they arise from events or transactions that are distinct from an entity's ordinary activities, are not expected to recur frequently or regularly and are outside the control or influence of the entity. Accordingly, extraordinary items are rare, unusual and material.

Distinct from Ordinary Activities

2.1.8 Whether an event or transaction is clearly distinct from the ordinary activities of the entity is determined by the nature of the event or transaction in relation to the activities ordinarily carried on by the entity rather than by the frequency with which such events are expected to occur. An event or transaction may be extraordinary for one entity or level of government, but not extraordinary for another entity or level of government, because of the

differences between their respective ordinary activities. In the context of whole-of-government reporting, extraordinary items will be extremely rare.

Not Expected to Recur in the Foreseeable Future

2.1.9 The event or transaction will be of a type that would not reasonably be expected to recur in the foreseeable future, taking into account the environment in which the entity operates. The nature of extraordinary items is such that they would not normally be anticipated at the beginning of a reporting period and therefore would not be included in a budget. Inclusion of an item in a budget suggests that the occurrence of the specific item is foreseen and therefore not extraordinary.

Outside the Control or Influence of the Entity

2.1.10 The event or transaction will be outside the control or influence of the entity. A transaction or event is presumed to be outside the control or influence of an entity if the decisions or determinations of the entity do not normally influence the occurrence of that transaction or event.

Identifying Extraordinary Items

2.1.11 Whether or not an item is extraordinary will be considered in the context of the entity's operating environment and the level of government within which it operates. Judgment will be exercised in each case.

2.1.12 Examples of cash flows associated with events or transactions that may, although not necessarily, give rise to extraordinary items for some public sector entities or levels of government are:

(a) short-term cash flows associated with the provision of services to refugees where the need for such services was unforeseen at the beginning of the period, outside the ordinary scope of activities for the entity and outside the control of the entity. If such services were predictable or occurring in more than one reporting period they would not generally be classified as extraordinary; and

(b) the cash flows associated with the provision of services following a natural or man-made disaster, for example, the provision of shelter to homeless people following an earthquake. In order for a particular earthquake to qualify as an extraordinary event it would need to be of a magnitude that would not normally be expected in either the geographic area in which it occurred or the geographic area associated with the entity, and the provision of emergency services or the restoration of essential services would need to be outside the scope of ordinary activities of the entity concerned. Where an entity has responsibility for providing assistance to those affected by

natural disasters, the costs associated with this activity would not generally meet the definition of an extraordinary item.

2.1.13 The restructuring of activities is an example of an event which would normally not be extraordinary for either an individual public sector entity or the whole-of-government entity which incorporates that government body. All three criteria within the definition of an extraordinary item must be satisfied before an item can be classified as extraordinary. A restructuring may clearly be distinct from the ordinary activities of the entity. However, at the whole-of-government level, restructuring may occur frequently. More importantly, restructuring is usually within the control or influence of a whole-of-government entity. It is only in circumstances where the restructuring is imposed by another level of government or by an external regulator or other external authority that it could be classified as outside the control or influence of the whole-of-government entity.

2.1.14 The disclosure of the nature and amount of each extraordinary item may be made on the face of the statement of cash receipts and payments or other financial statements that might be prepared or in the notes to those financial statements. An entity may also decide to disclose only the total amount of extraordinary items on the face of the statement of cash receipts and payments and the details in the notes.

Administered Transactions

2.1.15 *An entity is encouraged to disclose in the notes to the financial statements, the amount and nature of cash flows and cash balances resulting from transactions administered by the entity as an agent on behalf of others where those amounts are outside the control of the entity.*

2.1.16 The cash flows associated with transactions administered by an entity acting as an agent on behalf of others may not pass through a bank account controlled by the reporting entity. In these cases, the entity cannot use, or otherwise benefit from, the cash it administers in the pursuit of its own objectives. These cash flows are not controlled by the entity and therefore are not included in the totals shown on the face of the statement of cash receipts and payments or other financial statements that might be prepared. However, disclosure of the amount and nature of these transactions by major type is encouraged because it provides useful information on the scope of the entity's activities and it is relevant for an assessment of an entity's performance.

2.1.17 Where such cash receipts and payments pass through a bank account controlled by the entity, they are treated as cash flows and balances of the entity itself and included in the totals shown on the face of the statement of cash receipts and payments. Paragraph 1.3.13(a) of Part 1 of this Standard permits such cash receipts and payments to be reported on a net basis.

Paragraphs 2.1.18 to 2.1.22 below provide guidance on the cash receipts, payments and balances that:

(a) may be controlled by a government or government entity and will be reported in the statement of cash receipts and payments in accordance with Part 1 of this Standard; and

(b) are administered transactions which will not be included on the face of the statement of cash receipts and payments or other financial statements that might be prepared but for which disclosure is encouraged.

Revenue Collection

2.1.18 Public sector entities may control cash or administer cash receipts or payments on behalf of the government or other governments or government entities. For example, a government Department of Taxation (or revenue collection agency) may be established with its own bank account and provided with an appropriation to fund its operations. The operations of the Department will include administering certain aspects of the Taxation Act and may encompass the collection of taxes on behalf of the government.

2.1.19 A Department of Taxation can use cash appropriated to it and deposited in a bank account which it controls to achieve its operating objectives as mandated, and can exclude others from using or benefiting from that cash. In these cases, the Department will control the cash appropriated for its own use. However, the cash the Department collects on behalf of the government through its tax collection activities is usually deposited in a specified government trust fund or transferred to a government bank account administered by the Treasury or similar department. In these circumstances, the cash collected cannot be used to support achievement of the objectives of the Department of Taxation, or otherwise deployed at the discretion of the Department's management without specific appropriation or other authorization by the government or relevant body. Therefore, the cash collected is not controlled by the Department of Taxation and would not form part of the cash receipts or cash balances of the Department. As a consequence of a government decision, some of the amounts collected may be appropriated or otherwise allocated for use by the Department. However, it is the government's decision to authorize the expenditure of the funds by the Department of Taxation, rather than the collection of the cash, that gives rise to the control.

2.1.20 Similar circumstances may arise when one government, for example a state or local government, collects cash on behalf of another government (such as a national government). In these cases, the government is acting as an agent for others in the collection of cash. The cash that arises as a result of managing transactions as an agent for others would not usually be deposited

in a bank account of the collection agency and therefore would not form part of the cash receipts, cash payments or cash balances of the reporting entity.

"Pass-through" Cash Flows

2.1.21 In some cases, the administrative arrangements in place in respect of the revenue collection activities a government or government entity undertakes as an agent of another party may provide for the cash collected to be initially deposited in the entity's own bank account before it is transferred to the ultimate recipient. Cash flows arising as a consequence of these transactions are sometimes termed "pass-through" cash flows. In these cases, the entity will:

(a) control the cash it collects in its capacity as an agent for the, usually short, period the cash is deposited in the entity's bank account prior to transfer to third parties;

(b) usually benefit from any interest arising from amounts deposited in interest bearing accounts prior to its transfer to the other entity; and

(c) have an obligation to transfer the cash collected to third parties in accordance with legislative requirements or administrative arrangements.

When cash inflows from administered transactions pass through a bank account controlled by the reporting entity, the cash receipts, cash transfers and cash balances arising from the collection activity will be included in the entity's statement of cash receipts and payments in accordance with paragraph 1.3.4(a)(i) of Part 1 of this Standard. Paragraph 1.3.13(a) of Part 1 of this Standard specifies that cash receipts and payments which arise from transactions the entity administers on behalf of other parties and which are recognized in the financial statements may be reported on a net basis.

Transfer Payments

2.1.22 Consistent with a government's objectives and with legislation or other authority, amounts appropriated to a government entity (a department, agency or similar) may include amounts to be transferred to third parties in respect of, for example, unemployment benefits, age or invalid pensions, family allowances and other social security and community benefit payments. In some cases, these amounts will pass through a bank account controlled by the entity. Where this occurs, the entity will recognize the cash appropriated for transfer during the reporting period as a cash receipt, the amounts transferred during that reporting period as a cash payment and any amounts held at the end of the reporting period for transfer in the future as part of closing balance of cash.

Disclosure of Major Classes of Cash Flows

2.1.23 *An entity is encouraged to disclose, either on the face of the statement of cash receipts and payments or other financial statements or in the notes to those statements:*

(a) *an analysis of total cash payments and payments by third parties using a classification based on either the nature of the payments or their function within the entity, as appropriate; and*

(b) *proceeds from borrowings. In addition, the amount of borrowings may be further classified into type and source.*

2.1.24 The sub-classifications encouraged in paragraph 2.1.23(a) may be presented on the face of the statement of cash receipts and payments in accordance with the requirements of paragraphs 1.3.12 and 1.3.24 of Part 1 of this Standard. Where a different classification basis is adopted in the statement of cash receipts and payments, additional disaggregated disclosures reflecting the encouragement in paragraph 2.1.23(a) above is encouraged either as a separate statement or by way of note.

2.1.25 Cash payment items and payments by third parties may be further sub-classified in order to highlight the costs and cost recoveries of particular programs, activities or other relevant segments of the reporting entity. An entity is encouraged to present this information in at least one of the following two ways.

2.1.26 The first method is referred to as the nature of payments method. Payments are aggregated in the statement of cash receipts and payments according to their nature (for example, purchases of materials, transport costs, wages and salaries), and are not reallocated amongst various functions within the entity. An example of a classification using the nature of payments method is as follows:

	Cash payments	Payments by third parties
Wages and salaries	(X)	(X)
Transport costs	(X)	(X)
Capital acquisitions	(X)	(X)
Borrowing costs	(X)	(X)
Other	(X)	(X)
Total payments	(X)	(X)

2.1.27 The second method, referred to as the functional method of classification, classifies payments according to the program or purpose for which they

were made. This presentation often provides more relevant information to users, although the allocation of payments to functions can be arbitrary and may involve considerable judgment. An example of a functional classification of cash payments is as follows:

	Cash payments	Payments by third parties
Health services	(X)	(X)
Education services	(X)	(X)
Capital acquisitions	(X)	(X)
Borrowing costs	(X)	(X)
Other	(X)	(X)
Total payments	(X)	(X)

2.1.28 Under this method, the cash payments associated with the main functions undertaken by the entity are shown separately. In this example, the entity has functions related to the provision of health services and education services. The entity would present cash payment line items for each of these functions.

2.1.29 Entities classifying cash payments by function are encouraged to disclose additional information on the nature of payments, including payments made for salaries and other employee benefits.

2.1.30 Paragraph 1.3.12 of Part 1 of this Standard requires the disclosure of total cash receipts of the entity showing separately a sub-classification of total cash receipts using a classification basis appropriate to the entity's operations. The sub-classification of cash receipts into appropriate classes will depend upon the size, nature and function of the amounts involved. In addition to disclosure of the amount of receipts from borrowings, the following sub-classifications may be appropriate:

(a) receipts from taxation (these may be further sub-classified into types of taxes);

(b) receipts from fees, fines, penalties and licenses;

(c) receipts from exchange transactions including receipts from the sale of goods and services and user charges (where these are classified as exchange transactions);

(d) receipts from grants, transfers, or budget appropriations (possibly classified by source);

(e) receipts from interest and dividends; and

(f) receipts from gifts and donations.

Related Party Disclosures

2.1.31 *An entity is encouraged to disclose in the notes to the financial statements information required by International Public Sector Accounting Standard IPSAS 20 Related Party Disclosures.*

2.1.32 IPSAS 20 *Related Party Disclosures* in the accrual based series of IPSASs defines related parties and other relevant terms, requires the disclosure of related party relationships where control exists and requires the disclosure of certain information about related party transactions, including information about aggregate remuneration of key management personnel.

Disclosure of Assets, Liabilities and Comparison with Budgets

2.1.33 *An entity is encouraged to disclose in the notes to the financial statements:*

(a) *information about the assets and liabilities of the entity; and*

(b) *a comparison with budgets.*

2.1.34 Governments and government entities control significant resources in addition to cash and deploy those resources in the achievement of service delivery objectives. They also borrow to fund their activities, incur other debts and liabilities in the course of their operations and make commitments to expend money in the future on the acquisition of capital assets. Non-cash assets and liabilities will not be reported on the face of the statement of cash receipts and payments or other financial statements that might be prepared under the cash basis of accounting. However, governments maintain records of, and monitor and manage, their debt and other liabilities and their non-cash assets. The disclosure of information about assets and liabilities and the costs of particular programs and activities will enhance accountability and is encouraged by this Standard.

2.1.35 Entities that make such disclosures are encouraged to identify assets and liabilities by type, for example, by classifying:

(a) assets as receivables, investments or property plant and equipment; and

(b) liabilities as payables, borrowings by type or source and other liabilities.

While such disclosures may not be comprehensive in the first instance, entities are encouraged to progressively develop and build on them. In order to comply with the requirements of paragraphs 1.3.5 and 1.3.37 of Part 1 of this Standard, these disclosures will need to comply with qualitative characteristics of financial information and should be clearly described and readily understood. Accrual basis IPSASs including IPSAS 13 *Leases*,

IPSAS 17 *Property, Plant and Equipment* and IPSAS 19 *Provisions, Contingent Liabilities and Contingent Assets* can provide useful guidance to entities disclosing additional information about assets and liabilities.

Comparison with Budgets

2.1.36 Public sector entities are typically subject to budgetary limits in the form of appropriations or other budgetary authority which may be given effect through authorizing legislation. One of the objectives of financial reporting by public sector entities is to report on whether cash was obtained and used in accordance with the legally adopted budget. In some jurisdictions, this requirement is reflected in legislation. This Standard encourages the disclosure of a comparison of actual with the budgeted amounts for the reporting period. Reporting against budgets may be presented in different ways, including:

(a) the preparation of a note with separate columns for budgeted amounts and actual amounts. A column showing any variances from the budget or appropriation may also be presented for completeness; and

(b) a statement by the individual(s) responsible for the preparation of the financial statements that the budgeted amounts have not been exceeded. If any budgeted amounts or appropriations have been exceeded, or payments made without appropriation or other form of authority, then details may be disclosed by way of note to the relevant item in the financial statements.

Consolidated Financial Statements

2.1.37 *An entity is encouraged to disclose in the notes to the financial statements:*

(a) *the proportion of ownership interest in controlled entities and, where that interest is in the form of shares, the proportion of voting power held (only where this is different from the proportionate ownership interest);*

(b) *where applicable:*

(i) *the name of any controlled entity in which the controlling entity holds an ownership interest and/or voting rights of 50% or less, together with an explanation of how control exists; and*

(ii) *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; and*

(c) *in the controlling entity's separate financial statements, a description of the method used to account for controlled entities.*

2.1.38 *A controlling entity which does not present a consolidated statement of cash receipts and payments is encouraged to disclose the reasons why the consolidated financial statements have not been presented together with the bases on which controlled entities are accounted for in its separate financial statements. It is also encouraged to disclose the name and the principal address of its controlling entity that publishes consolidated financial statements.*

2.1.39 Paragraph 1.6.20(b) of Part 1 of this Standard requires that the reasons for non-consolidation of a controlled entity should be disclosed. Paragraphs 1.6.7 and 1.6.8 of Part 1 of the Standard also provide that a controlling entity that is itself a wholly owned entity or a controlling entity that is virtually wholly owned, need not present a consolidated financial statement. When this occurs, the disclosure of the information in paragraph 2.1.38 above is encouraged.

Acquisitions and Disposals of Controlled Entities and Other Operating Units

2.1.40 *An entity is encouraged to disclose and present separately the aggregate cash flows arising from acquisitions and from disposals of controlled entities or other operating units.*

2.1.41 *An entity is encouraged to disclose in the notes to the financial statements, in aggregate in respect of both acquisitions and disposals of controlled entities or other operating units during the period, each of the following:*

(a) *the total purchase or disposal consideration (including cash or other assets);*

(b) *the portion of the purchase or disposal consideration discharged by means of cash; and*

(c) *the amount of cash in the controlled entity or operating unit acquired or disposed of.*

2.1.42 The separate presentation of the cash flow effects of acquisitions and disposals of controlled entities and other operations, together with the separate disclosure of the amounts of assets and liabilities acquired or disposed of, helps to distinguish those cash flows from cash receipts and payments arising from the other activities of the entity. To enable users to identify the effects of both acquisitions and disposals, the cash flow effects of disposals would not be deducted from those acquisitions.

2.1.43 The aggregate amount of the cash paid or received as purchase or sale consideration is reported in the statement of cash receipts and payments net of cash acquired or disposed of.

2.1.44 Paragraph 2.1.33 encourages the disclosure of assets and liabilities of the entity. Assets and liabilities other than cash of a controlled entity or operating unit acquired or disposed of may also be separately disclosed, summarized by each major category. Consistent with the requirement of paragraph 1.3.37 of Part 1 of this Standard, where such disclosure is made, the assets and liabilities should be clearly identified and the basis on which they are recognized and measured explained.

Joint Ventures

2.1.45 *An entity is encouraged to make disclosures about joint ventures which are necessary for a fair presentation of the cash receipts and payments of the entity during the period and the balances of cash as at reporting date.*

2.1.46 Many public sector entities establish joint ventures to undertake a variety of activities. The nature of these activities range from commercial undertakings to provision of community services at no charge. The terms of a joint venture are set out in a contract or other binding arrangement and usually specify the initial contribution from each joint venturer and the share of revenues or other benefits (if any) and expenses of each of the joint venturers. Entities which report on a cash basis will generally report:

(a) as cash payments, the cash expended in the acquisition of an interest in a joint venture and in the ongoing operations of the joint venture; and

(b) as cash receipts, the cash received from the joint venture.

Disclosures about joint ventures may include a listing and description of interests in significant joint ventures. International Public Sector Accounting Standard IPSAS 8 *Financial Reporting of Interests in Joint Ventures* in the accrual based series of IPSASs provides guidance on the different forms and structures that joint ventures may take and potential additional disclosures that might be made.

Financial Reporting in Hyperinflationary Economies

2.1.47 In a hyperinflationary economy, the presentation of the financial statements in the local currency without restatement is not useful. Money loses purchasing power at such a rate that comparison of amounts from transactions and other events that have occurred at different times, even within the same accounting period, is misleading.

2.1.48 This Standard does not identify an absolute rate at which hyperinflation is deemed to arise. It is a matter of judgment when restatement of financial statements in accordance with the encouragements in this Standard would become necessary. Hyperinflation is indicated by characteristics of the

economic environment of a country which include, but are not limited to, the following:

(a) the general population prefers to keep its wealth in non-monetary assets or in a relatively stable foreign currency. Amounts of local currency held are immediately invested to maintain purchasing power;

(b) the general population regards monetary amounts not in terms of the local currency but in terms of a relatively stable foreign currency. Prices may be quoted in that currency;

(c) sales and purchases on credit take place at prices that compensate for the expected loss of purchasing power during the credit period, even if the period is short;

(d) interest rates, wages and prices are linked to a price index; and

(e) the cumulative inflation rate over three years is approaching, or exceeds, 100%.

The Restatement of Financial Statements

2.1.49 *An entity that reports in the currency of a hyperinflationary economy is encouraged to:*

(a) *restate its statement of cash receipts and payments and other financial statements in terms of the measuring unit current at the reporting date;*

(b) *restate the comparative information for the previous period, and any information in respect of earlier periods in terms of the measuring unit current at the reporting date; and*

(c) *use a general price index that reflects changes in general purchasing power. It is preferable that all entities that report in the currency of the same economy use the same index.*

2.1.50 *The entity is encouraged to make the following disclosures:*

(a) *the fact that the statement of cash receipts and payments and other financial statements, and the corresponding figures for previous periods, have been restated for the changes in the general purchasing power of the reporting currency and, as a result, are stated in terms of the measuring unit current at the reporting date; and*

(b) *the identity and level of the price index at the reporting date and the movement in the index during the current and the previous reporting period.*

2.1.51 Prices change over time as the result of various political, economic and social forces. Specific forces such as changes in supply and demand, and technological changes may cause individual prices to increase or decrease significantly and independently of each other. In addition, general economic forces may result in changes in the general level of prices and therefore in the general purchasing power of money.

2.1.52 In a hyperinflationary economy, the usefulness of financial statements is substantially increased if they are expressed in terms of the measuring unit current at the reporting date. As a result, the treatments and disclosures in paragraphs 2.1.49 and 2.1.50 above are encouraged. Presentation of this information as the primary presentation rather than as a supplement to financial statements which have not been restated is encouraged. Separate presentation of the statement of cash receipts and payments and other financial statements before restatement is discouraged.

2.1.53 All items in the statement of cash receipts and payments will be expressed in terms of the measuring unit current at the reporting date. Therefore, all amounts, including any payments by third parties disclosed on the face of the statement of cash receipts and payments or in other financial statements, would be restated by applying the change in the general price index from the dates when the payments and receipts were initially recorded.

2.1.54 Many entities in the public sector include in their financial statements the related budgetary information, to facilitate comparisons with the budget. Where this occurs, this Standard encourages restatement of the budgetary information in accordance with this Standard.

Comparative Information

2.1.55 If comparisons with previous periods are to be meaningful, comparative information for the previous reporting period will be restated by applying a general price index so that the comparative financial statements are presented in terms of the measurement unit current at the end of the reporting period. Information that is disclosed in respect of earlier periods is also expressed in terms of the measurement unit current at the end of the reporting period.

Consolidated Financial Statements

2.1.56 A controlling entity that reports in the currency of a hyperinflationary economy may have controlled entities that also report in the currencies of hyperinflationary economies. If the statement of cash receipts and payments and other financial statements are to be prepared on a consistent basis, the financial statements of any such controlled entity will be restated by applying a general price index of the country in whose currency it reports before they are included in the consolidated financial statements issued by

its controlling entity. Where such a controlled entity is a foreign controlled entity, its restated financial statements are translated at closing rates.

2.1.57 If financial statements with different reporting dates are consolidated, all items, whether non-monetary or monetary, need to be restated into the measuring unit current at the date of the consolidated financial statement.

Selection and Use of the General Price Index

2.1.58 The restatement of financial statements in accordance with the approach encouraged by this Standard requires the use of a general price index that reflects changes in general purchasing power. It is preferable that all entities that report in the currency of the same economy use the same index.

2.1.59 The disclosures encouraged by this Standard are intended to make clear the basis of dealing with the effects of hyperinflation in the financial statements. They are also intended to provide other information necessary to understand that basis and the resulting amounts.

2.2 Governments and Other Public Sector Entities Intending to Migrate to the Accrual Basis of Accounting

Presentation of the Statement of Cash Receipts and Payments

2.2.1 *An entity which intends to migrate to the accrual basis of accounting is encouraged to present a statement of cash receipts and payments in the same format as that required by International Public Sector Accounting Standard IPSAS 2 Cash Flow Statements.*

2.2.2 IPSAS 2 *Cash Flow Statements* provides guidance on classifying cash flows as operating, financing and investing and includes requirements for preparing a statement of cash flows which reports these classes separately on the face of the statement. A summary of key aspects of IPSAS 2 and guidance on their application for financial reporting under this Standard is included in Appendix 3. Part 2 of this Standard encourages disclosure of information additional to that required by IPSAS 2. Entities which adopt the format of IPSAS 2 for the presentation of the statement of cash receipts and payments are encouraged to also make the additional disclosures identified in Part 2 of this Standard.

Scope of Consolidated Statements – Exclusions from the Economic Entity

2.2.3 When an entity adopts the accrual basis of accounting in accordance with the accrual IPSASs, it will not consolidate entities in which 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.

Temporary control may occur where, for example, a national government intends to transfer its interest in a controlled entity to a local government.

2.2.4 Part 1 of this Standard does not provide for such entities to be excluded from the consolidated financial statements prepared under the cash basis. This is because:

(a) the cash of an entity which is controlled on only a temporary basis can be used for the benefit of the economic entity during the period of temporary control; and

(b) the potentially complex consolidation adjustments that may be necessary under the accrual basis will not arise under the cash basis.

2.2.5 For this exemption from consolidation to apply under the accrual IPSASs, the controlling entity must be demonstrably committed to a formal plan to dispose of, or no longer control, the entity that is subject to temporary control. For the exemption to apply at more than one successive reporting date, the controlling entity must demonstrate an ongoing intent to dispose of, or no longer control, the entity that is subject to temporary control. An entity is demonstrably committed to dispose of, or no longer control, another entity when it has a formal plan to do so and there is no realistic possibility of withdrawal from that plan.

2.2.6 Entities preparing to migrate to the accrual basis will need to be aware of this difference in consolidation requirements of the accrual and cash basis IPSASs, and to determine whether, for any controlled entities included in the consolidated statement of receipts and payments, control is temporary.

Appendix 2

Illustration of Certain Disclosures Encouraged in Part 2 of the Standard

This appendix is illustrative only. The purpose of the appendix is to illustrate the application of the encouragements and to assist in clarifying their meaning.

Extract from notes to financial statements of Entity ABC

Administered Transactions (paragraph 2.1.15)

Administered transactions comprise cash flows resulting from transactions administered by the Entity as an agent on behalf of the government and specific government bodies. All cash collected in the capacity of an agent is deposited in the consolidated revenue fund and/or trust account (name of account), as appropriate. These accounts are not controlled by the Entity and the cash deposited in them cannot be used by the Entity without specific authorization by the relevant government body.

(in thousands of currency units)	**Nature of Transaction**	**200X**	**200X-1**
Cash collected on behalf of			
The Executive/Crown	Collection of taxation	X	X
Agency EF	Collection of utility service fee	X	X
		X	X
Cash transferred to respective entities		(X)	(X)
		-	-

Related Party Transactions (paragraph 2.1.31)

The key management personnel (as defined by International Public Sector Accounting Standard IPSAS 20 *Related Party Disclosures*) of Entity ABC are the Minister, the members of the governing body and the members of the senior management group. The governing body consists of members appointed by Government A. The chief executive officer and the chief financial officer attend

meetings of the governing body but are not members of the governing body. The Minister is not remunerated by Entity ABC. The aggregate remuneration of members of the governing body and the number of members determined on a full time equivalent basis receiving remuneration within this category, are:

Aggregate remuneration	AX million.
Number of persons	AY persons.

The senior management group consists of the Entity's chief executive officer, the chief financial officer, and the heads of division. The aggregate remuneration of members of the senior management group and the number of managers determined on a full-time equivalent basis receiving remuneration within this category are:

Aggregate remuneration	AP million.
Number of persons	AQ persons.

Extract from notes to financial statements of Government X

Assets and Liabilities (paragraph 2.1.33(a))

Property, plant and equipment

The Government commenced the process of identifying and valuing major classes of its property, plant and equipment. The assets are stated at historical cost or valuation. The valuations were performed by an independent professional valuer. The valuation bases used for each class of assets are as follows:

Plant & Equipment	Cost
Land	Current Value
Buildings	Cost or Market Value

(in thousands of currency units)	**200X**	**200X-1**
Plant and equipment	X	X
Land and buildings		
Property within city limits	X	X
Buildings at cost	X	X
Buildings at valuation	X	X
	X	X

(Extract from notes to financial statements of Government X: Assets and Liabilities (paragraph 2.1.33(a) continued) **–**

Borrowings

The borrowings of the Government are listed below:

(in thousands of currency units)	**200X**	**200X-1**
Balance at beginning of year	X	X
PROCEEDS		
Domestic Commercial Institution	X	X
Offshore Commercial Institution	X	X
Development Banks and Similar Lending Agencies	X	X
Total borrowings	**X**	**X**
REPAYMENTS		
Domestic Commercial Institution	(X)	(X)
Offshore Commercial Institution	(X)	(X)
Development Banks and Similar Lending Agencies	(X)	(X)
Total repayments	**(X)**	**(X)**
Balance at end of year	X	X

(*Extract from notes to financial statements of Government X continued*)

Comparison with budgets (paragraph 2.1.33 (b))

(in thousands of currency units)		**Actual**		**Budgeted**		**Variance**
RECEIPTS						
Taxation						
Income tax	X		X		X	
Value-added tax	X		X		(X)	
Property tax	X		X		X	
Other taxes	X		X		(X)	
		X		X		X
Aid Agreements						
International agencies	X		X		-	
Other Grants and Aid	X		X		-	
		X		X		-
Borrowings						
Proceeds from borrowings		X		X		(X)
Capital Receipts						
Proceeds from disposal of plant and equipment		X		X		X
Trading Activities						
Receipts from trading activities		X		X		X
Other receipts		X		X		X
Total receipts		**X**		**X**		**X**
PAYMENTS						
Operations						

Wages, salaries and employee benefits	(X)	(X)	(X)
Supplies and consumables	(X)	(X)	X
	(X)	(X)	(X)
Transfers			
Grants	(X)	(X)	-
Other transfers	(X)	(X)	-
	(X)	(X)	-
Capital Expenditures			
Purchase/construction of plant and equipment	(X)	(X)	(X)
Purchase of financial instruments	(X)	(X)	-
	(X)	(X)	(X)
Loan and Interest Repayments			
Repayment of borrowings	(X)	(X)	-
Interest payments	(X)	(X)	-
	(X)	(X)	-
Other payments	(X)	(X)	X
Total payments	**(X)**	**(X)**	**(X)**
NET RECEIPTS/(PAYMENTS)	**X**	**X**	**X**

Extract from notes to financial statements of Entity XYZ

Controlled Entities (paragraphs 2.1.37, 2.1.40, and 2.1.41)

Entity XYZ has the power to govern the financial and operating policies so as to benefit from the activities of other entities. These are controlled entities. All controlled entities are included in the consolidated financial statements. (Paragraph 1.6.20(a) in Part 1 of this Standard requires that a list of significant controlled entities be disclosed.)

Control of government entities arises by way of statute or other enabling legislation. Control of government business enterprises arises by way of statute and in the case of Enterprise C and D, by way of ownership interest. Entity XYZ retains control of Enterprise E through legislative authority although the majority of the equity of Enterprise E has been sold to private investors.

Enterprise	**Ownership Interest (%)**	**Voting Power (%)**
Enterprise E	XX	XX

Acquisitions of Controlled Entities and Operating Units

Names of Enterprises acquired	**Proportion of shares acquired %**	**Purchase consideration (in thousands of currency units)**	**Cash portion of purchase consideration (in thousands of currency units)**	**Cash balances acquired (in thousands of currency units)**
Enterprise C	XX	X	X	X
Enterprise D	XX	X	X	X
		X	X	X

Disposals of Controlled Entities and Other Operating Units

Name of Enterprise disposed of	Proportion of shares disposed of %	Disposal consideration (in thousands of currency units)	Cash portion of disposal consideration (in thousands of currency units)	Cash balance disposed of (in thousands of currency units)
Enterprise F	XX	X	X	X

(Extract from notes to financial statements of Entity XYZ continued)

Significant Joint Ventures (paragraph 2.1.45)

Name of Joint Venture	Principal Activity	Output Interest	
		200X %	200X-1 %
Regional Water Board	Water provision	XX	XX
Regional Electricity Board	Provision of utility services	XX	XX

Appendix 3

Presentation of the Statement of Cash Receipts and Payments in the Format Required by IPSAS 2 Statement of Cash Flows

Paragraph 2.2.1 of Part 2 of this Standard encourages an entity which intends to migrate to the accrual basis of accounting to present a statement of cash receipts and payments in the same format as that required by IPSAS 2 Statement of Cash Flows. IPSAS 2 is applied by an entity which reports on an accrual basis of accounting in accordance with International Public Sector Accounting Standards.

This appendix provides a summary of key aspects of IPSAS 2 and guidance on their application for financial reporting under the cash basis of accounting as required by this Standard. Entities intending to present a statement of cash receipts and payments in accordance with the requirements of IPSAS 2 as far as is appropriate will need to refer to that IPSAS.

Presentation in the Format Required by IPSAS 2 Statement of Cash Flows

1. IPSAS 2 *Statement of Cash Flows* requires an entity which prepares and presents financial statements under the accrual basis of accounting to prepare a cash flow statement which reports cash flows during the period classified by operating, investing and financing activities as defined below.

Definitions

2. *Financing activities are activities that result in changes in the size and composition of the contributed capital and borrowings of the entity.*

   Investing activities are the acquisition and disposal of long-term assets and other investments not included in cash equivalents.

   Operating activities are the activities of the entity that are not investing or financing activities.

Components of the Financial Statements

3. In presenting a statement of cash receipts and payments in this format it may be necessary to classify cash flows arising from a single transaction in different ways. (The term cash flow statement is used in the remainder of this appendix for a statement of cash receipts and payments presented in the same format as that required by IPSAS 2.) For example, when the cash repayment of a loan includes both interest and capital, the interest element may be classified as an operating activity and the capital element may be classified as a financing activity. An entity presenting information by way of a cash flow statement presents its cash flows from operating, investing and financing activities in a manner which is most appropriate to its activities.

4. A cash flow statement will include line items which present the following amounts:

   (a) total receipts from operating activities;

   (b) total payments on operating activities;

   (c) net cash flows from operating activities;

   (d) net cash flows from investing activities;

   (e) net cash flows from financing activities;

   (f) beginning and closing balances of cash; and

   (g) net increase or decrease in cash .

   Additional line items, headings and sub-totals will also be presented on the face of the statement when such presentation is necessary to present fairly the entity's cash flows.

5. An entity will also present on the face of the cash flow statement or in the notes:

   (a) major classes of gross cash receipts and gross cash payments arising from operating, investing and financing activities, except to the extent that paragraph 1.3.13 of Part 1 of this Standard allows reporting on a net basis;

   (b) a sub-classification of total cash receipts from operations in a manner appropriate to an entity's operations; and

   (c) an analysis of payments on operating activities using a classification based on either the nature of payments or their function within the entity, as appropriate.

   Separate disclosure of payments made for capital acquisitions and for interest and dividends is also consistent with the requirements of IPSAS 2.

6. Disclosure of information about such matters as whether cash is generated from taxes, fines, fees (operating activities), the sale of capital assets (investing activities) and/or borrowings (financing activities) and whether it was expended to meet operating costs, for the acquisition of capital assets (investing activities) or for the retirement of debt (financing activities) will enhance transparency and accountability of financial reports. These disclosures will also facilitate more informed analysis and assessments of the entity's current cash resources and the likely sources and sustainability of future cash inflows. Accordingly, this Standard encourages all entities to disclose this information in the financial statements and/or related notes.

Operating Activities

7. The amount of net cash flows arising from operating activities is a key indicator of the extent to which the operations of the entity are funded:

   (a) by way of taxes (directly and indirectly); and

   (b) from the recipients of goods and services provided by the entity.

   The disclosure of the amount of net cash flows from operating activities also assists in identifying the extent to which operations of the entity generate cash that can be deployed to repay obligations, pay a dividend/distribution to its owner and make new investments without recourse to external sources of financing. The consolidated whole-of-government operating cash flows provide an indication of the extent to which a government has financed its current activities through taxation and charges. Information about the specific components of historical operating cash flows is useful, in conjunction with other information, in forecasting future operating cash flows.

8. Cash flows from operating activities are primarily derived from the principal cash-generating activities of the entity. Examples of cash flows from operating activities are:

   (a) cash receipts from taxes, levies and fines;

   (b) cash receipts from charges for goods and services provided by the entity;

   (c) cash receipts from grants, or transfers and other appropriations or budget authorizations made by central government or other public sector entities, including those made for the acquisition of capital assets;

   (d) cash receipts from royalties, fees and commissions;

   (e) cash payments to other public sector entities to finance their operations (not including loans or equity injections);

   (f) cash payments to suppliers for goods and services;

   (g) cash payments to and on behalf of employees;

   (h) cash receipts and cash payments of a public sector insurance entity for premiums and claims, annuities and other policy benefits;

   (i) cash payments of local property taxes or income taxes (where appropriate) in relation to operating activities;

   (j) cash receipts and payments from contracts held for dealing or trading purposes;

   (k) cash receipts or payments from discontinuing operations; and

(l) cash receipts or payments in relation to litigation settlements.

9. An entity may hold securities and loans for dealing or trading purposes, in which case they are similar to inventory acquired specifically for resale. Therefore, cash flows arising from the purchase and sale of dealing or trading securities are classified as operating activities. Similarly, cash advances and loans made by public financial institutions are usually classified as operating activities since they relate to the main cash-generating activity of that entity.

10. In some jurisdictions, governments or other public sector entities will appropriate or authorize funds to entities to finance the operations of the entity, and no clear distinction is made for the disposition of those funds between current activities, capital works and contributed capital. Where an entity is unable to separately identify appropriations or budget authorizations as current activities, capital works (operating activities) and contributed capital (investing activities), IPSAS 2 explains that the entity should classify the appropriation or budget authorization as cash flows from operations, and disclose this in the notes to the statement of cash flows.

Investing Activities

11. The separate disclosure of cash flows arising from investing activities identifies the extent to which cash outflows have been made for resources which are intended to contribute to the entity's future service delivery. Examples of cash flows arising from investing activities are:

(a) cash payments to acquire property, plant and equipment, intangibles and other long-term assets. These payments include those relating to capitalized development costs and self-constructed property, plant and equipment;

(b) cash receipts from sales of property, plant and equipment, intangibles and other long-term assets;

(c) cash payments to acquire equity or debt instruments of other entities and interests in joint ventures (other than payments for those instruments considered to be cash equivalents or those held for dealing or trading purposes);

(d) cash receipts from sales of equity or debt instruments of other entities and interests in joint ventures (other than receipts for those instruments considered to be cash equivalents and those held for dealing or trading purposes);

(e) cash advances and loans made to other parties (other than advances and loans made by a public financial institution);

(f) cash receipts from the repayment of advances and loans made to other parties (other than advances and loans of a public financial institution);

(g) cash payments for futures contracts, forward contracts, option contracts and swap contracts except when the contracts are held for dealing or trading purposes, or the payments are classified as financing activities; and

(h) cash receipts from futures contracts, forward contracts, option contracts and swap contracts except when the contracts are held for dealing or trading purposes, or the receipts are classified as financing activities.

When a contract is designated as a hedge of an identifiable position, the cash flows of the contract are classified in the same manner as the cash flows of the position being hedged.

Financing Activities

12. The separate disclosure of cash flows arising from financing activities is useful in predicting claims on future cash flows by providers of capital to the entity. Examples of cash flows arising from financing activities are:

(a) cash proceeds from issuing debentures, loans, notes, bonds, mortgages and other short or long-term borrowings;

(b) cash repayments of amounts borrowed;

(c) cash payments by a lessee for the reduction of the outstanding liability relating to a finance lease; and

(d) cash receipts and payments relating to the issue of and redemption of currency.

Interest and Dividends

13. IPSAS 2 requires the separate disclosure of cash flows from interest and dividends received and paid. IPSAS 2 also requires that where such disclosures are made they should be classified in a consistent manner from period to period as either operating, investing or financing activities.

14. The total amounts of interest and dividends paid and received during a period are disclosed in the cash flow statement. Interest paid and interest and dividends received are usually classified as operating cash flows for a public financial institution. However, there is no consensus on the classification of the cash flows associated with interest and dividends received and paid for other entities. Interest and dividends paid and interest and dividends received may be classified as operating cash flows. Alternatively, interest and

dividends paid and interest and dividends received may be classified as financing cash flows and investing cash flows respectively, because they are costs of obtaining financial resources or returns on investments.

Reporting Major Classes of Receipts and Payments

15. The sub-classification of receipts depends upon the size, nature and function of the amounts involved. Depending upon the nature of the entity, the following sub-classifications may be appropriate:

    (a) receipts from taxation (these may be further sub-classified into types of taxes);

    (b) receipts from fees, fines, penalties and licenses;

    (c) receipts from exchange transactions including receipts from the sale of goods and services and user charges (where these are classified as exchange transactions);

    (d) receipts from grants, transfers, or budget appropriations (possibly classified by source); and

    (e) receipts from interest and dividends.

16. Payment items are sub-classified in order to highlight the costs and cost recoveries of particular programs, activities or other relevant segments of the reporting entity. Examples of classification of payments by nature and function are included in Part 1 of this Standard.

Appendix 4

Qualitative Characteristics of Financial Reporting

Paragraph 1.3.32 of Part 1 of this Standard requires that the financial statements provide information that meets a number of qualitative characteristics. This appendix summarizes the qualitative characteristics of financial reporting.

Qualitative characteristics are the attributes that make the information provided in financial statements useful to users. They are applicable to financial statements, regardless of the basis of accounting used to prepare the financial statements. The four principal qualitative characteristics are understandability, relevance, reliability and comparability.

Understandability

Information is understandable when users might reasonably be expected to comprehend its meaning. For this purpose, users are assumed to have a reasonable knowledge of the entity's activities and the environment in which it operates, and to be willing to study the information.

Information about complex matters should not be excluded from the financial statements merely on the grounds that it may be too difficult for certain users to understand.

Relevance

Information is relevant to users if it can be used to assist in evaluating past, present or future events or in confirming, or correcting, past evaluations. In order to be relevant, information must also be timely.

Materiality

The relevance of information is affected by its nature and materiality.

Information is material if its omission or misstatement could influence the decisions of users or assessments made on the basis of the financial statement. Materiality depends on the nature or size of the item or error judged in the particular circumstances of its omission or misstatement. Thus, materiality provides a threshold or cut-off point rather than being a primary qualitative characteristic which information must have if it is to be useful.

Reliability

Reliable information is free from material error and bias, and can be depended on by users to represent faithfully that which it purports to represent or could reasonably be expected to represent.

Faithful Representation

For information to represent faithfully transactions and other events, it should be presented in accordance with the substance of the transactions and other events, and not merely their legal form.

Substance Over Form

If information is to represent faithfully the transactions and other events that it purports to represent, it is necessary that they are accounted for and presented in accordance with their substance and economic reality and not merely their legal form. The substance of transactions or other events is not always consistent with their legal form.

Neutrality

Information is neutral if it is free from bias. Financial statements are not neutral if the information they contain has been selected or presented in a manner designed to influence the making of a decision or judgment in order to achieve a predetermined result or outcome.

Prudence

Prudence is the inclusion of a degree of caution in the exercise of the judgments needed in making the estimates required under conditions of uncertainty, such that assets or revenue are not overstated and liabilities or expenses are not understated.

Completeness

The information in financial statements should be complete within the bounds of materiality and cost.

Comparability

Information in financial statements is comparable when users are able to identify similarities and differences between that information and information in other reports.

Comparability applies to the:

- comparison of financial statements of different entities; and
- comparison of the financial statements of the same entity over periods of time.

An important implication of the characteristic of comparability is that users need to be informed of the policies employed in the preparation of financial statements, changes to those policies and the effects of those changes.

Because users wish to compare the performance of an entity over time, it is important that the financial statements show corresponding information for preceding periods.

Constraints on Relevant and Reliable Information

Timeliness

If there is an undue delay in the reporting of information it may lose its relevance. To provide information on a timely basis it may often be necessary to report before all aspects of a transaction are known, thus impairing reliability. Conversely, if reporting is delayed until all aspects are known, the information may be highly reliable but of little use to users who have had to make decisions in the interim. In achieving a balance between relevance and reliability, the overriding consideration is how best to satisfy the decision-making needs of users.

Balance between Benefit and Cost

The balance between benefit and cost is a pervasive constraint. The benefits derived from information should exceed the cost of providing it. The evaluation of benefits and costs is, however, substantially a matter of judgment. Furthermore, the costs do not always fall on those users who enjoy the benefits. Benefits may also be enjoyed by users other than those for whom the information was prepared. For these reasons, it is difficult to apply a benefit-cost test in any particular case. Nevertheless, standard setters, as well as those responsible for the preparation of financial statements and users of financial statements, should be aware of this constraint.

Balance between Qualitative Characteristics

In practice a balancing, or trade-off, between qualitative characteristics is often necessary. Generally the aim is to achieve an appropriate balance among the characteristics in order to meet the objectives of financial statements. The relative importance of the characteristics in different cases is a matter of professional judgment.

Appendix 5

Establishing Control of Another Entity for Financial Reporting Purposes

1. Whether an entity controls another entity for financial reporting purposes is a matter of judgment based on the definition of control in this Standard and the particular circumstances of each case. That is, consideration needs to be given to the nature of the relationship between the two entities. In particular, the two elements of the definition of control in this Standard need to be considered. These are the power element (the power to govern the financial and operating policies of another entity) and the benefit element (which represents the ability of the controlling entity to benefit from the activities of the other entity).

2. For the purposes of establishing control, the controlling entity needs to benefit from the activities of the other entity. For example, an entity may benefit from the activities of another entity in terms of a distribution of its surpluses (such as a dividend) and is exposed to the risk of a potential loss. In other cases, an entity may not obtain any financial benefits from the other entity but may benefit from its ability to direct the other entity to work with it to achieve its objectives. It may also be possible for an entity to derive both financial and non-financial benefits from the activities of another entity. For example, a Government Business Enterprise (GBE) may provide a controlling entity with a dividend and also enable it to achieve some of its social policy objectives.

Control for Financial Reporting Purposes

3. For the purposes of financial reporting, control stems from an entity's power to govern the financial and operating policies of another entity and does not necessarily require an entity to hold a majority shareholding or other equity interest in the other entity. The power to control must be presently exercisable. That is, the entity must already have had this power conferred upon it by legislation or some formal agreement. The power to control is not presently exercisable if it requires changing legislation or renegotiating agreements in order to be effective. This should be distinguished from the fact that the existence of the power to control another entity is not dependent upon the probability or likelihood of that power being exercised.

4. Similarly, the existence of control does not require an entity to have responsibility for the management of (or involvement in) the day-to-day operations of the other entity. In many cases, an entity may only exercise its power to control another entity where there is a breach or revocation of an agreement between a controlled entity and its controlling entity.

5. For example, a government department may have an ownership interest in a rail authority, which operates as a GBE. The rail authority is allowed to operate autonomously and does not rely on the government for funding but has raised capital through significant borrowings that are guaranteed by the government. The rail authority has not returned a dividend to government for several years. The government has the power to appoint and remove a majority of the members of the governing body of the rail authority. The government has never exercised the power to remove members of the governing body and would be reluctant to do so because of sensitivity in the electorate regarding the previous government's involvement in the operation of the rail network. In this case, the power to control is presently exercisable but under the existing relationship between the controlled entity and controlling entity, an event has not occurred to warrant the controlling entity exercising its powers over the controlled entity. Accordingly, control exists because the power to control is sufficient even though the controlling entity may choose not to exercise that power.

6. The existence of separate legislative powers does not, of itself, preclude an entity from being controlled by another entity. For example, the Office of Government Statistician usually has statutory powers to operate independently of the government. That is, the Office of Government Statistician may have the power to obtain information and report on its findings without recourse to government or any other body. The existence of control does not require an entity to have responsibility over the day-to-day operations of another entity or the manner in which professional functions are performed by the entity.

7. The power of one entity to govern decision-making in relation to the financial and operating policies of another entity is insufficient, in itself, to ensure the existence of control as defined in this Standard. The controlling entity needs to be able to govern decision-making so as to be able to benefit from its activities, for example by enabling the other entity to operate with it as part of an economic entity in pursuing its objectives. This will have the effect of excluding from the definitions of a "controlling entity" and "controlled entity" relationships which do not extend beyond, for instance, that of a liquidator and the entity being liquidated, and would normally exclude a lender and borrower relationship. Similarly, a trustee whose relationship with a trust does not extend beyond the normal responsibilities of a trustee would not be considered to control the trust for the purposes of this Standard.

Regulatory and Purchase Power

8. Governments and government entities have the power to regulate the behavior of many entities by use of their sovereign or legislative powers. Regulatory and purchase powers do not constitute control for the purposes

of financial reporting. To ensure that the financial statements of a public sector entity include only those resources (cash, including cash equivalents) that it controls and can benefit from, the meaning of control for the purposes of this Standard does not extend to:

(a) the power of the legislature to establish the regulatory framework within which entities operate and to impose conditions or sanctions on their operations. Such power does not constitute control by a public sector entity of the assets deployed by these entities. For example, a pollution control authority may have the power to close down the operations of entities that are not complying with environmental regulations. However, this power does not constitute control because the pollution control authority only has the power to regulate; or

(b) entities that are economically dependent on a public sector entity. That is, where an entity retains discretion as to whether it will take funding from, or do business with, a public sector entity, that entity has the ultimate power to govern its own financial or operating policies, and accordingly is not controlled by the public sector entity. For example, a government department may be able to influence the financial and operating policies of an entity which is dependent on it for funding (such as a charity) or a profit-orientated entity that is economically dependent on business from it. Accordingly, the government department has some power as a purchaser but not to govern the entity's financial and operating policies.

Determining Whether Control Exists for Financial Reporting Purposes

9. Public sector entities may create other entities to achieve some of their objectives. In some cases, it may be clear that an entity is controlled, and hence should be consolidated. In other cases it may not be clear. Paragraphs 10 and 11 below provide guidance to help determine whether or not control exists for financial reporting purposes.

10. In examining the relationship between two entities, control is presumed to exist when at least one of the following power conditions and one of the following benefit conditions exists, unless there is clear evidence of control being held by another entity.

Power conditions

(a) The entity has, directly or indirectly through controlled entities, ownership of a majority voting interest in the other entity.

(b) The entity has the power, either granted by or exercised within existing legislation, to appoint or remove a majority of the members of the governing body of the other entity.

(c) The entity has the power to cast, or regulate the casting of, a majority of the votes that are likely to be cast at a general meeting of the other entity.

(d) The entity has the power to cast the majority of votes at meetings of the board of directors or equivalent governing body.

Benefit conditions

(a) The entity has the power to dissolve the other entity and obtain a significant level of the residual economic benefits or bear significant obligations. For example, the benefit condition may be met if an entity had responsibility for the residual liabilities of another entity.

(b) The entity has the power to extract distributions of assets from the other entity, and/or may be liable for certain obligations of the other entity.

11. When one or more of the conditions listed in paragraph 10 do not exist, the following factors are likely, either individually or collectively, to be indicative of the existence of control.

Power indicators

(a) The entity has the ability to veto operating and capital budgets of the other entity.

(b) The entity has the ability to veto, overrule, or modify governing body decisions of the other entity.

(c) The entity has the ability to approve the hiring, reassignment and removal of key personnel of the other entity.

(d) The mandate of the other entity is established and limited by legislation.

(e) The entity holds a "golden share"[1] (or equivalent) in the other entity that confers rights to govern the financial and operating policies of that other entity.

Benefit indicators

(a) The entity holds direct or indirect title to the net assets/equity of the other entity with an ongoing right to access these.

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1 "Golden share" refers to a class of share that entitles the holder to specified powers or rights generally exceeding those normally associated with the holder's ownership interest or representation on the governing body.

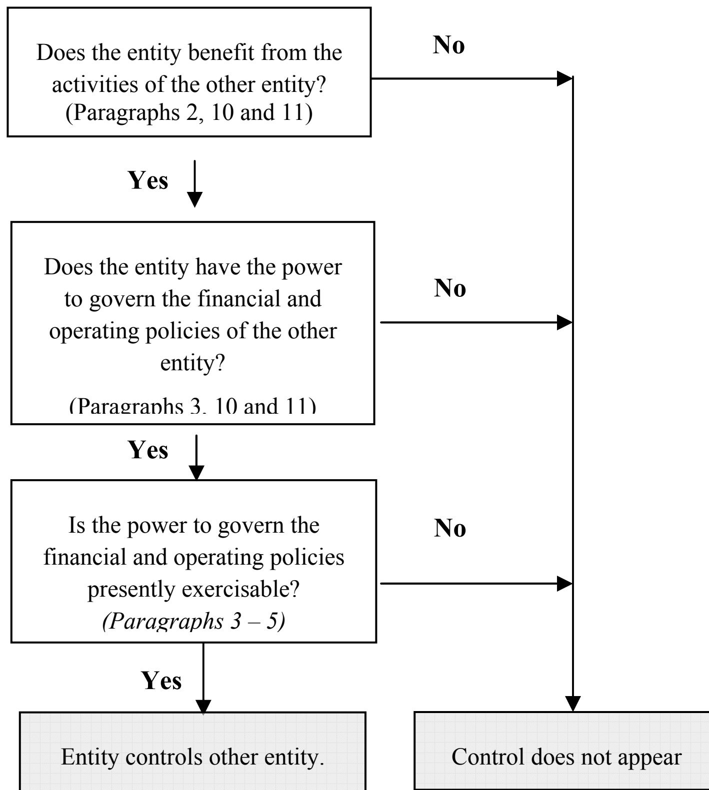
(b) The entity has a right to a significant level of the net assets/equity of the other entity in the event of a liquidation or in a distribution other than a liquidation.

(c) The entity is able to direct the other entity to co-operate with it in achieving its objectives.

(d) The entity is exposed to the residual liabilities of the other entity.

12. The following diagram indicates the basic steps involved in establishing control of another entity. It should be read in conjunction with paragraphs 1 to 11 of this appendix.

Establishing Control of another Entity for Financial Reporting Purposes



13. Sometimes a controlled entity is excluded from consolidation when its activities are dissimilar to those of other entities within the economic entity, for example, the consolidation of GBEs with entities in the budget sector. Exclusion on these grounds is not justified because better information would be provided by consolidating such controlled entities and disclosing additional information in the consolidated financial statements about the different activities of controlled entities.

Glossary of Defined Terms

This Glossary contains all terms defined in the 21 accrual basis International Public Sector Accounting Standards (IPSASs) on issue as at 31 December 2003. A list of these IPSASs is located on the inside back cover of the Glossary. This Glossary does not include terms defined in the Cash Basis IPSAS *Financial Reporting Under The Cash Basis of Accounting*. Users should refer to that Cash Basis IPSAS for these terms.

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

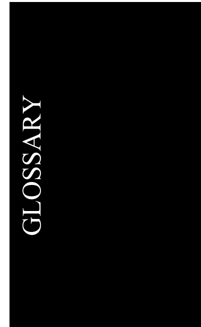
References to accrual basis IPSASs are by Standard number and paragraph number. For example, '1.6' refers users to International Public Sector Accounting Standard IPSAS 1 *Presentation of Financial Statements*, paragraph 6. References set out in brackets indicate a minor variation in wording.

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, 18.8
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)
active market	A market in which all the following conditions exist: (a) The items traded within the market are homogeneous; (b) Willing buyers and sellers can normally be found at any time; and (c) Prices are available to the public.	21.14

Term	Definition	Location
assets[1]	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.	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
carrying amount (of investment property)	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, 21.14
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	1.6, 2.8, 3.6, 4.9,

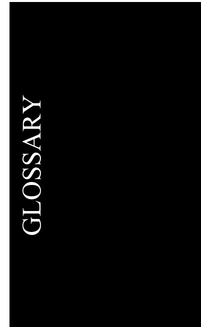
1 *Commentary:* Assets provide a means for entities to achieve their objectives. Assets that are used to deliver goods and services in accordance with an entity's objectives but which do not directly generate net cash inflows are often described as embodying "service potential". Assets that are used 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.

Term	Definition	Location
	equivalents.	8.5
cash-generating assets	Assets held to generate a commercial return.	21.14
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
close members of the family of an individual	Close relatives of the individual or members of the individual's immediate family who can be expected to influence, or be influenced by, that individual in their dealings with the entity.	20.4
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
constructive obligation	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.	19.18



Term	Definition	Location
contingent asset	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.	19.18
contingent liability	(a) a possible obligation 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; or (b) a present obligation that arises from past events but is not recognized because: (i) it is not probable that an outflow of resources embodying economic benefits or service potential will be required to settle the obligation; or (ii) the amount of the obligation cannot be measured with sufficient reliability.	19.18
contingent rent	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
contributions from owners	Future economic benefits or service potential that has been contributed to the entity by parties external to the entity, other than those that result in liabilities of the entity, that establish a financial interest in the net assets/equity of the entity, which: (a) conveys entitlement both to distributions of future economic benefits or service potential by the entity during its life, such distributions	1.6, 2.8, 3.6, 4.9, 5.5, 6.8, 7.6, 8.5

Term	Definition	Location
	being at the discretion of the owners or their representatives, and to distributions of any excess of assets over liabilities in the event of the entity being wound up; and/or (b) can be sold, exchanged, transferred or redeemed.	
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



Term	Definition	Location
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
costs of disposal	Incremental costs directly attributable to the disposal of an asset, excluding finance costs and income tax expense.	21.14
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 (amortization)	The systematic allocation of the depreciable amount of an asset over its useful life.	17.12, 21.14
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[2]	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

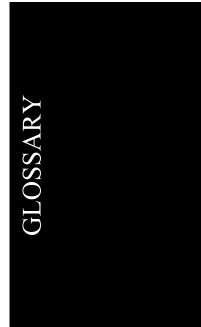
2 *Commentary:* The term "economic entity" is used in this series of Standards to define, for financial reporting purposes, a group of entities comprising the controlling entity and any controlled entities. Other terms sometimes used to refer to an economic entity include "administrative entity", "financial 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

Term	Definition	Location
economic life	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.	1.6, 2.8, 4.9, 6.8, 7.6
	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.	8.5

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 (adjusting events after the reporting date); and (b) those that are indicative of conditions that arose after the reporting date (non-adjusting events after the reporting date).	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
executory contracts	Contracts under which neither party has performed any of its obligations or both parties have partially performed their obligations to an equal extent.	19.18
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	1.6, 4.9, 7.6, 9.11, 15.9, 16.6,

Term	Definition	Location
	length transaction.	17.12
fair value less costs to sell (of an asset)	The amount obtainable from the sale of an asset in an arm's length transaction between knowledgeable, willing parties, less the costs of disposal.	21.14
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
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



Term	Definition	Location
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, 18.8
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

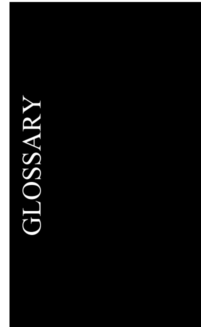
Term	Definition	Location
foreign operation	A controlled entity, associate, joint venture or branch of the reporting entity, the activities of which are based or conducted in a country other than the country of the reporting entity.	1.6, 3.6, 4.9
fundamental errors	Errors discovered in the current period 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[3]	An entity that has all the following characteristics: (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, 21.14
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	(a) in the case of the lessee, that part of the residual value which is guaranteed	13.7

GLOSSARY

[3] *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.

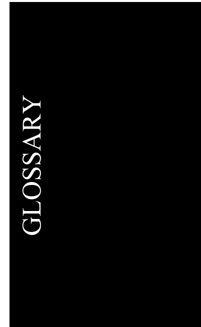
Term	Definition	Location
residual value	by the lessee or by a party related to the lessee (the amount of the guarantee being the maximum amount that could, in any event, become payable); and (b) in the case of the lessor, that part of the residual value which is guaranteed by the lessee or by a third party unrelated to the lessor who is financially capable of discharging the obligations under the guarantee.	
impairment	A loss in the future economic benefits or service potential of an asset, over and above the systematic recognition of the loss of the asset's future economic benefits or service potential through depreciation.	21.14
impairment loss of a non-cash-generating asset	The amount by which the carrying amount of an asset exceeds its recoverable service amount.	21.14
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
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	13.7

Term	Definition	Location
	asset.	
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, 18.8
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
key management personnel	(a) all directors or members of the governing body of the entity; and (b) other persons having the authority and responsibility for planning, directing	20.4



Term	Definition	Location
	and controlling the activities of the reporting entity. Where they meet this requirement key management personnel include: (i) where there is a member of the governing body of a whole-of-government entity who has the authority and responsibility for planning, directing and controlling the activities of the reporting entity, that member; (ii) any key advisors of that member; and (iii) unless already included in (a), the senior management group of the reporting entity, including the chief executive or permanent head of the reporting entity.	
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
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
legal obligation	An obligation that derives from: (a) a contract (through its explicit or implicit terms); (b) legislation; or (c) other operation of law.	19.18
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	13.7

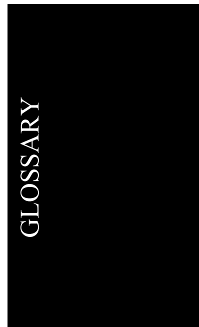
Term	Definition	Location
	similar security, the funds necessary to purchase the asset.	
liabilities	Present obligations of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits or service potential.	1.6, 2.8, 3.6, 4.9, 5.5, 6.8, 7.6, 8.5, 19.18
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
minimum lease payments	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: (a) in the case of the lessee, any amounts guaranteed by the lessee or by a party related to the lessee; or (b) in the case of the lessor, any residual value guaranteed to the lessor by either: (i) the lessee; (ii) a party related to the lessee; or (iii) an independent third party financially capable of meeting this guarantee. However, if the lessee has an option to purchase the asset at a price which is expected to be sufficiently lower than the	13.7



Term	Definition	Location
	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.	
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[4]	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
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

4 *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.

Term	Definition	Location
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-cash-generating assets	Assets other than cash-generating assets.	21.14
non-monetary items	Items that are not monetary items.	10.7
obligating event	An event that creates a legal or constructive obligation that results in an entity having no realistic alternative to settling that obligation.	19.18
onerous contract	A contract for the exchange of assets or services in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits or service potential expected to be received under it.	19.18



Term	Definition	Location
operating activities	The activities of the entity that are not investing or financing activities.	2.8, 3.6, 4.9, 18.8
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
oversight	The supervision of the activities of an entity, with the authority and responsibility to control, or exercise significant influence over, the financial and operating decisions of the entity.	20.4
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
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
provision	A liability of uncertain timing or amount.	19.18
qualifying asset	An asset that necessarily takes a substantial period of time to get ready for	1.6, 5.5

Term	Definition	Location
	its intended use or sale.	
recoverable service amount	The higher of a non-cash-generating asset's fair value less costs to sell and its value in use.	21.14
related party	Parties are considered to be related if one party has the ability to control the other party or exercise significant influence over the other party in making financial and operating decisions or if the related party entity and another entity are subject to common control. Related parties include: (a) entities that directly, or indirectly through one or more intermediaries, control, or are controlled by the reporting entity; (b) associates (see International Public Sector Accounting Standard IPSAS 7 *Accounting for Investments in Associates*); (c) individuals owning, directly or indirectly, an interest in the reporting entity that gives them significant influence over the entity, and close members of the family of any such individual; (d) key management personnel, and close members of the family of key management personnel; and (e) entities in which a substantial ownership interest is held, directly or indirectly, by any person described in (c) or (d), or over which such a person is able to exercise significant influence.	20.4
related party transaction	A transfer of resources or obligations between related parties, regardless of whether a price is charged. Related party transactions exclude transactions with any other entity that is a related party solely because of its economic dependence on the reporting entity or the government of	20.4

GLOSSARY

Term	Definition	Location
	which it forms part.	
remuneration of key management personnel	Any consideration or benefit derived directly or indirectly by key management personnel from the reporting entity for services provided in their capacity as members of the governing body or otherwise as employees of the reporting entity.	20.4
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
restructuring	A program that is planned and controlled by management, and materially changes either: (a) the scope of an entity's activities; or (b) the manner in which those activities are carried out.	19.18
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, 18.8
segment	Distinguishable activity or group of activities of an entity for which it is appropriate to separately report financial information for the purpose of evaluating the entity's past performance in achieving its objectives and for making decisions about the future allocation of resources.	18.9

Term	Definition	Location
segment accounting policies	Accounting policies adopted for preparing and presenting the financial statements of the consolidated group or entity as well as those accounting policies that relate specifically to segment reporting.	18.27
segment assets	Operating assets that are employed by a segment in its operating activities and that either are directly attributable to the segment or can be allocated to the segment on a reasonable basis. Segment assets include: ▪ receivables, loans, investments or other revenue-producing assets that relate to a segment's segment revenue which includes interest or dividend revenue; ▪ investments accounted for under the equity method only if the net surplus (deficit) from such investments is included in segment revenue; and ▪ joint venturer's share of the operating assets of a jointly controlled entity that is accounted for by proportionate consolidation in accordance with IPSAS 8 *Financial Reporting of Interests in Joint Ventures.* Segment assets do not include income tax or income tax equivalent assets that are recognised in accordance with accounting standards dealing with tax effect accounting.	18.27
segment expense	Expense resulting from the operating activities of a segment that is directly attributable to the segment and the relevant portion of an expense that can be allocated on a reasonable basis to the segment, including expenses relating to the provision of goods and services to external parties and expenses relating to transactions with other segments of the	18.27

GLOSSARY

same entity. Segment expense does not include:

(a) extraordinary items;

(b) interest, including interest incurred on advances or loans from other segments, unless the segment's operations are primarily of a financial nature;

(c) losses on sales of investments or losses on extinguishment of debt unless the segment's operations are primarily of a financial nature;

(d) an entity's share of net deficit or losses of associates, joint ventures, or other investments accounted for under the equity method;

(e) income tax or income-tax equivalent expense that is recognised in accordance with accounting standards dealing with tax effect accounting; or

(f) general administrative expenses, head office expenses, and other expenses that arise at the entity level and relate to the entity as a whole. However, costs are sometimes incurred at the entity level on behalf of a segment. Such costs are segment expenses if they relate to the segment's operating activities and they can be directly attributed or allocated to the segment on a reasonable basis.

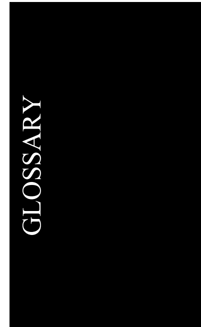
Segment expenses includes joint venturer's share of the expenses of a jointly controlled entity that is accounted for by proportionate consolidation in accordance with IPSAS 8 *Financial Reporting of Interests in Joint Ventures*.

Term	Definition	Location
segment liabilities	Operating liabilities that result from the operating activities of a segment and that either are directly attributable to the segment or can be allocated to the segment on a reasonable basis. Segment liabilities include: ▪ a joint venturer's share of the liabilities of a jointly controlled entity that is accounted for by proportionate consolidation in accordance with IPSAS 8 *Financial Reporting of Interests in Joint Ventures*; and ▪ related interest-bearing liabilities if a segment's segment expense includes interest expense. Segment liabilities do not include income tax or income tax equivalent liabilities that are recognised in accordance with accounting standards dealing with tax effect accounting.	18.27
segment revenue	Revenue reported in the entity's statement of financial performance that is directly attributable to a segment and the relevant portion of entity revenue that can be allocated on a reasonable basis to a segment, whether from budget appropriations or similar, grants, transfers, fines, fees or sales to external customers or from transactions with other segments of the same entity. Segment revenue does not include: (a) extraordinary items; (b) interest or dividend revenue, including interest earned on advances or loans to other segments, unless the segment's operations are primarily of a financial nature; or (c) gains on sales of investments or gains on extinguishment of debt unless the	18.27

GLOSSARY

Term	Definition	Location
	segment's operations are primarily of a financial nature.	
	Segment revenue includes: an entity's share of net surplus (deficit) of associates, joint ventures, or other investments accounted for under the equity method only if those items are included in consolidated or total entity revenue; and a joint venturer's share of the revenue of a jointly controlled entity that is accounted for by proportionate consolidation in accordance with IPSAS 8 *Financial Reporting of Interests in Joint Ventures.*	
significant influence	The power to participate in the financial and operating policy decisions of the investee, but is not control over those policies.	6.8, 7.6
	The power to participate in the financial and operating policy decisions of an activity but is not control or joint control over those policies.	8.5
	The power to participate in the financial and operating policy decisions of an entity, but not control those policies. Significant influence may be exercised in several ways, usually by representation on the board of directors or equivalent governing body but also by, for example, participation in the policy making process, material transactions between entities within an economic entity, interchange of managerial personnel or dependence on technical information. Significant influence may be gained by an ownership interest, statute or agreement. With regard to an ownership interest, significant influence is presumed in accordance with the definition contained in International Public Sector Accounting Standard IPSAS 7 *Accounting for Investments in Associates*.	20.4

Term	Definition	Location
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
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 (of a lease)	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
useful life (of property, plant and equipment)	Either: (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.	17.12, 21.14
value in use of a non-cash-generating asset	The present value of the asset's remaining service potential.	21.14
venturer	A party to a joint venture and has joint control over that joint venture.	8.5



Accrual IPSASs on Issue at December 2004

Accrual International Public Sector Accounting Standards on issue as at 31 December 2004 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)*
IPSAS 18	*Segment Reporting (June 2002)*
IPSAS 19	*Provisions, Contingent Liabilities and Contingent Assets (October 2002)*
IPSAS 20	*Related Party Disclosures (October 2002)*
IPSAS 21	*Impairment of Non-Cash-Generating Assets (December 2004)*

GUIDELINE 2—APPLICABILITY OF INTERNATIONAL STANDARDS ON AUDITING TO AUDITS OF FINANCIAL STATEMENTS OF GOVERNMENT BUSINESS ENTERPRISES

Introduction

1. The Introduction to the Public Sector Committee states that Public Sector Committee (PSC) pronouncements are aimed at developing and harmonizing public sector[1] financial reporting, accounting, and auditing practices. The PSC will consider and make use of pronouncements issued by the International Auditing and Assurance Board IAASB (formerly known as International Auditing Practices Committee) to the extent they are applicable to the public sector. International Standards on Auditing (ISAs) issued by the IAASB and International Public Sector Guidelines (IPSGs) are not intended to, and do not, override authoritative national standards issued by governments, regulatory or professional accounting bodies.

2. The purpose of this Guideline is to describe the applicability of ISAs to audits of financial statements[2] of government business enterprises.

Government Business Enterprises

3. This Guideline is applicable to such government business enterprises as national railroads, energy utilities, and communication services. Government business enterprises are normally required to operate commercially, that is, to make profits or to recoup, through user charges, a substantial proportion of their operating costs. In many countries, the public sector includes business enterprises that are owned or controlled by government. The principal activity of these government business enterprises is similar to that of private sector business enterprises, that is, to sell goods or services to individuals and nongovernment organizations as well as other public sector entities. Additional characteristics which government business enterprises usually possess are set out in IPSG 1, “Financial Reporting by Government Business Enterprises” (paragraphs 5 to 7).

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[1] As described in the Introduction to the PSC, “the term ‘public sector’ refers to national governments, regional (e.g., state, provincial, territorial) governments, local (e.g., city, town) governments and related governmental entities (e.g., agencies, boards, commissions and enterprises).”

[2] The term “financial statements,” as defined in the Preface to Statements of International Accounting Standards, covers balance sheets, income statements or profit and loss accounts, statements of changes in financial position, notes and other statements and explanatory material which are identified as being part of the financial statements.

Requirements for Audits of Financial Statements

4. Government business enterprises prepare financial statements for the use of legislators and government departments, outside investors, employees, lenders, the public and other users. Auditors are often required to express an opinion on such financial statements. IAASB has developed ISAs for auditors to use whenever an independent audit of financial statements is carried out.

5. The audit objectives for auditing and reporting on financial statements of government business enterprises are similar to those for private sector entities. As such, the same standards should apply regardless of the nature of the enterprise. Users of financial statements are entitled to a uniform quality of assurance and would not be well served by the application of differing standards. Therefore, audits of financial statements of government business enterprises should conform, in all material respects, with ISAs.

6. ISAs describe:
   - The basic principles which govern the auditor's professional responsibilities.
   - The qualifications or essential characteristics of auditors (e.g., adequate training, independence, and due care in performing audits of financial statements).
   - The standards and practices for performing audits of financial statements (e.g., adequate planning and supervision, the assessments of inherent and control risks and their impact on substantive procedures, and the process by which the auditor determines the procedures to be performed when carrying out the audit).
   - The form and content of audit reports.

7. Financial statements of government business enterprises may include information that is different from, or in addition to, that contained in the financial statements of business enterprises in the private sector (e.g., comparison of expenditures in the period with limits established by legislation). In such circumstances, appropriate modifications may be required to the nature, timing and extent of audit procedures, and the auditor's report.

8. Some government business enterprises employ resources to achieve a variety of nonfinancial or social objectives in addition to their commercial objectives. While their audited financial statements provide an accounting of their financial position, results of operations and changes in financial

position, these financial statements, by themselves, may not adequately report on the results of their non-commercial activities. Auditors may be required to audit and report on information relating to:

Compliance with legislation and regulatory requirements (including applicable local public sector pronouncements);

The adequacy of the enterprise's internal control structure; and

Economy, efficiency, and effectiveness of programs, projects and activities.

This information may either be included in, or may be in addition to, the enterprise's financial statements. The audit of such information may require auditors to perform work that is in addition to that required solely for the purpose of auditing and reporting on the financial statements.

9. Some government business enterprises may include in their annual reports information on performance in terms of achieving objectives as measured by specified financial or other indicators. Auditors may also be required to audit and report on this additional performance information.

10. This Guideline is not specifically designed to apply to the audit of the information set out in paragraphs 7 to 9; however, this Guideline and ISAs may be useful.

11. A Public Sector Perspective (PSP) on the applicability of ISAs to the audit of financial statements of public sector entities other than government business enterprises is included at the end of each ISA. Where no PSP is added the ISA is applicable in all material respects to the public sector.

The application of ISAs in the public sector was previously dealt with in International Public Sector Guideline 3.

SUMMARY OF OTHER DOCUMENTS

The Committee has issued studies, as summarized below. To obtain copies of these documents, please visit the IFAC website at www.ifac.org or contact the IFAC offices.

Study 1

Financial Reporting by National Governments

Issued March 1991

The scope of the Study is to consider:

- Financial reporting by national governments and their major governmental units;
- Financial reports that provide information on government plans, performance and compliance with relevant authorities;
- Information needs of the principal users of government financial reports, with primary emphasis on the needs of external users; and
- The forms of reporting best suited to meeting those information needs.

This Study is of particular interest to senior financial officers in government, politicians, legislative auditors and others who use government financial reports because it addresses the fundamental underpinnings of governmental financial reporting.

Comparative summaries of users, user needs and objectives were prepared. They illustrate that there is concurrence on who users are, what their needs are and, accordingly, the objectives of financial reporting.

The Study develops a logical progression from users and user needs to the objectives of government financial reporting. It provides further context for the discussion of objectives by exploring the governmental environment and the limits of financial reporting.

The Study then discusses financial reporting. Rather than recommending a single, preferred financial reporting model, the Study describes the spectrum of possible bases of accounting and different reporting models (types of reports). It then illustrates their strengths and weaknesses in meeting the objectives of financial reporting. The Study demonstrates that in moving from single displays of cash receipts and disbursements to summary financial reports that account for total economic resources, more of the objectives of financial reporting are met. Since

those objectives are derived from user needs, more complete and better information will better meet those needs.

The Study recognizes that financial reporting by national governments is influenced by government financial reporting policies and practices which are embedded in the provisions of legislation and legal prescription.

Study 2

Elements of the Financial Statements of National Governments

Issued July 1993

This Study considers the elements (types or classes of financial information) to be reported in financial statements prepared under the different bases of accounting that may be employed by national governments and their major units and the way in which those elements may be defined. It also considers the implications of reporting particular elements, or subsets thereof, for the messages communicated by financial statements and the achievement of the objectives identified in Study 1.

The Study aims to assist in developing the full potential of the accounting models currently employed in individual jurisdictions to communicate financial information to users. That is useful for accountability and decision making purposes.

This Study focuses on reporting the elements in the financial statements prepared for national governments. However, it is acknowledged that aspects of the delivery of goods and services and the achievement of government objectives will in some cases, be best achieved through the display of financial or non-financial information in notes, schedules or statements other than the statement of financial position or statement of financial performance in the financial report.

Study 3

Auditing for Compliance with Authorities—A Public Sector Perspective

Issued October 1994

This Study addresses aspects of the audit for compliance in the public sector which, in many countries, is subject to very different mandates and objectives than in the private sector. In a democratic system of government, accountability to the public and particularly, to its designated representatives, is an overriding aspect of the management of a public sector entity. Public sector entities are usually established by legislation and their operations governed by various authorities derived from legislation. Management of public sector entities is accountable for operating in accordance with the provisions of the relevant laws, regulations and other authorities governing them. Since legislation and other authorities are the primary means by which legislators control the raising and spending of money by the public sector,

auditing for compliance with relevant authorities is usually an important and integral part of the audit mandate, or terms of engagement, for most audits of public sector entities. Because of the variety of authorities, their provisions may be conflicting with one another and may be subject to differing interpretations. Also, subordinate authorities may not adhere to the directions or limits prescribed by the enabling legislation. As a result, an assessment of compliance with authority in the public sector requires considerable professional judgment and is of particular importance.

Study 4

Using the Work of Other Auditors—A Public Sector Perspective

Issued October 1994

This Study addresses using the work of other auditors, including both other external and internal auditors, in financial attest and compliance audits. It considers the matters an auditor has to take into consideration when using the work of another auditor and provides a public sector perspective to International Standard on Auditing (ISA) 600, "Using the Work of Another Auditor" and ISA 610, "Considering the Work of Internal Auditing."

The Study considers the principles stated in the ISAs noted above and describes their applicability to the public sector. It also discusses some of the particular issues arising in the public sector when a principal auditor considers using the work of another auditor. The areas discussed deserving special attention are the autonomy of different tiers of government, the differing mandates of Higher Audit Institutions (HAI), and the particular problems surrounding using the work of other auditors in an international context.

Study 5

Definition and Recognition of Assets

Issued August 1995

This Study identifies and describes the variety of views which exist about whether, when and how specific assets should be measured and reported in the public sector. It considers and explores:

- The definition and recognition of assets;
- The effect of different bases of accounting on the definition and recognition of assets; and
- The issues associated with certain types of assets.

The Study acknowledges that the demand for government services has increased. This growth in demand has meant increasing competition for government services, stimulated by education standards, communication and community interest in government actions. Consequently, governments are under pressure to manage their

assets efficiently and effectively. Accountability for efficiency and effectiveness of public sector asset management can be shown through better financial reporting. Better reporting provides a basis of understanding by the public, elected decision makers and by management. This, in turn, supports better decision making and asset allocation.

Study 6

Accounting for and Reporting Liabilities

Issued August 1995

This Study provides a public sector perspective on the definition and recognition of liabilities. It identifies, considers and explores views held on:

- The definition and classification of liabilities;
- The effect of different bases of accounting on accounting for and reporting liabilities; and
- The issues associated with certain types of liabilities.

The Study describes the variety of views which exist about whether, when and how certain liabilities should be measured and reported. Historically, governments have focused on their outstanding debt as a primary measure of the government's liabilities or indebtedness, particularly in formulating or assessing economic policy. However, governments assume a variety of commitments and obligations that give rise to other liabilities that are often unreported by governments. Yet information about all of a government's liabilities and exposure to potential liabilities is vital if governments are to manage their cash flow and make informed decisions about the financing of future services and resource allocation. While governments have liabilities similar to business enterprises, they also have other potential liabilities, such as recurring commitments under established social programs, guarantees and promises made by politicians. The study distinguishes liabilities, commitments and contingencies.

Study 7

Performance Reporting by Government Business Enterprises

Issued January 1996

This Study identifies principal users of performance information, considers the needs of those users, and outlines forms of reporting that could be available to meet those needs. The Study is thereby concerned primarily with the provision of information about an enterprise's performance (covering both financial and non-financial aspects of performance) supplementary to the information provided in financial statements, in the context of general purpose financial statements.

The need for this Study arises from the fact that financial standards on their own are not always sufficient to give an indication of the overall performance of a particular organization. Public sector bodies can differ from private sector enterprises in both their objectives and finance. Although government business enterprises are normally required to operate commercially and usually take the same legal form as private sector business enterprises, the combination of the fact that they often enjoy a monopoly position and the political context in which they operate means that the user of financial reports can rely less on measures of performance such as return on capital employed. As a result, groups with an interest in the performance such as return on capital employed. As a result, groups with an interest in the performance of government business enterprises—governments, legislators, taxpayers and consumers—may have difficulty in making informed judgments about the efficiency and effectiveness of government business enterprises.

Government business enterprises may not be delivering services in circumstances that are even close to being a competitive market. So the test of relative market efficiency and effectiveness cannot always be applied. The issue therefore is how to formulate performance measures that will enable judgments about efficiency and effectiveness to be made. This Study considers how such measures might be defined and how a government business enterprise's performance in relation to these measures might best be reported to those with an interest in its performance.

Study 8

The Government Financial Reporting Entity

Issued July 1996

This Study considers the implications of different approaches to the definition of the government financial reporting entity and different techniques for the construction of government financial reports to the achievement of objectives of financial reports.

This Study is a companion to Study 1, "Financial Reporting by National Governments," issued in March 1991, and Study 2, "Elements of the Financial Statement of National Governments," issued in July 1993. Study 8 builds on the discussions and definitions from Studies 1 and 2. Consistent with Studies 1 and 2, the primary focus of this Study is on financial reporting of national governments. However, the matters it addresses may be equally applicable for other levels of governments (state, provincial and local governments).

It is hoped that this Study will lead to improvements in financial reporting by governments and greater comparability of financial reports both within and between jurisdictions.

Study 9

Definition and Recognition of Revenues

Issued December 1996

This Study examines concepts, principles and issues related to the definitions and recognition of revenues in the general purpose financial statements of national governments and other non-business public sector entities. Specifically, this Study identifies and discusses the definition and classification of revenues, issues with certain types of revenue and the effect of different bases of accounting on the definition and recognition of revenues.

Information on revenues is important in assisting users to assess the financial condition and performance of governments. Comparing revenues with expenses helps users to assess interperiod equity (that is, whether current revenues are sufficient to cover the costs of programs and services provided in the current period).

This Study extends Study 1, "Financial Reporting by National Governments," issued in March 1991, and Study 2, "Elements of the Financial Statement of National Governments," issued in July 1993. It is also a companion to Study 5, "Definition and Recognition of Assets," Study 6, "Accounting for and Reporting Liabilities," and Study 10, "Definition and Recognition of Expenses/Expenditures."

The primary focus of this Study is on the financial statements prepared for national governments and for the entities and units they establish for the delivery of goods and services and the achievement of government objectives. However, the matters it addresses may be equally applicable for other levels of governments (state, provincial and local governments).

Study 10

Definition and Recognition of Expenses/Expenditures

Issued December 1996

This Study examines the concepts, principles and issues related to the treatment of expenses/expenditures in general purpose financial statements of governments and other non-business public sector entities.

Governments are under growing pressures not only to manage their funds effectively, but also to show their management has been effective. To achieve this, governments need complete information about their expenses/expenditures in order to assess their revenue requirements, the sustainability of their programs and their flexibility.

This Study extends Study 1, "Financial Reporting by National Governments," issued in March 1991, and Study 2, "Elements of the Financial Statement of National

Governments," issued in July 1993. It is also a companion to Study 5, "Definition and Recognition of Assets," Study 6, "Accounting for and Reporting Liabilities," and Study 9, "Definition and Recognition of Revenues."

The primary focus of this Study is on the financial statements prepared for national governments and for the entities and units they establish for the delivery of goods and services and the achievement of government objectives. However, the matters it addresses may be equally applicable for other levels of governments (state, provincial and local governments).

Study 11

Governmental Financial Reporting: Accounting Issues and Practices

Issued May 2000

This Study aims to assist governments at all levels in the identification of issues associated with financial reporting. Although some parts of the Study may relate to national governments only, other parts are applicable to all levels of government.

The Study contains a detailed description of both accrual and cash bases of accounting and provides examples of actual financial statements prepared under each basis. The document explains common practice within each basis of accounting, and provides examples of the variations within those bases. Governments wishing to change their basis of accounting or modify their accounting policies will be able to use this document as a source of information about a basis of accounting, including accounting policy issues associated with that basis and the format of financial statements prepared under that basis. This may assist governments in changing their basis of accounting and ultimately contribute to greater comparability within and between financial statements of governments.

Study 12

Perspectives on Cost Accounting for Governments

Issued September 2000

This Study intends to aid government financial officers and other government accountants in their efforts to develop and implement cost accounting. It provides government perspectives on cost accounting not available elsewhere, but it is not an in-depth exposition of the subject of cost accounting. The Study includes the following:

- Descriptions of the extent of governmental uses of cost accounting, recent growth, and prospects for future growth.
- Explanations of cost concepts that are relevant to various management objectives.

- Discussions of accounting standards issues where the resolution may affect the values used in the cost accounting exercise.
- Descriptions of how specific concepts and processes might be applied in designing and implementing a cost accounting system.
- Discusses major issues of importance to senior management.

It is designed to help fill the void by providing reference material for governments on this important topic.

Study 13

Governance in the Public Sector: A Governing Body Perspective

Issued July 2001

This Study outlines principles of governance and their application to public sector entities. Governance practices will need to be tailored according to the circumstances of individual public sector entities and the jurisdictions within which they operate. As entities develop and change over time, it will be necessary for the governing body, on an on-going basis, to review and amend governance practices. This Study aims to provide advice by defining common principles and recommendations concerning the governance of public sector entities in certain key areas. Its purpose is to consider an appropriate framework from the perspective of the governing body to assist in ensuring an appropriate balance between freedom to manage, accountability and the legitimate interests of different stakeholders. The Study defines common principles and recommendations concerning the governance of public sector entities with the objective of providing guidance to assist these entities in developing or reviewing their governance practices in such a way to enable them to operate in a more effective, efficient and transparent manner.

Study 14

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

Issued April 2002, Second Edition Issued December 2003

The Study provides guidance to help government entities intending to move to the accrual basis of accounting and present financial statements which comply with the accrual-based IPSASs.

It is separated into four parts:

Part I 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 notes the importance of the identification, design and delivery of training programs, and the involvement of the external auditor in the development process. The potential impact

of differing systems of government and the existing political environment on the transition process are also discussed.

Part II outlines the steps required to develop and approve accounting policies. It also identifies the types of issues that need to be addressed in identifying controlled entities for the purpose of preparing consolidated financial statements.

Part III considers the classes of assets, liabilities, revenues and expenses that occur in public sector entities. It outlines how these items should be defined, recognized, measured and disclosed in general purposes financial statements. The Study outlines the requirements of key IPSASs and other sources of relevant authoritative guidance, and the types of implementation tasks and issues that arise when complying with these requirements.

Part IV discusses implementation issues arising from a range of specific items, for example, cash, intangible assets, financial instruments, employee-related liabilities, liabilities arising from social policy obligations, non-exchange revenue and foreign currencies.

Summary of main changes to the previous edition of Study 14

IPSASs Published

Subsequent to the publication of the first edition of Study 14 (issued in April 2002), three accrual-based IPSASs and the Cash Basis IPSAS have been issued. Study 14 (2nd edition) has been updated to reflect:

- International Public Sector Accounting Standard (IPSAS) 18, "Segment Reporting;"
- International Public Sector Accounting Standard (IPSAS) 19, "Provisions, Contingent Liabilities and Contingent Assets;"
- International Public Sector Accounting Standard (IPSAS) 20, "Related Party Disclosures;" and
- Cash Basis IPSAS, "Financial Reporting Under The Cash Basis of Accounting."

References and Websites Updated

References and websites have been updated to link with the electronic address of the references used.

Others

The Study has also been updated to reflect other developments including:

- PSC has established two steering committees to prepare Invitation to Comment (ITCs) on revenue from non-exchange transactions (including taxes and transfers) and accounting for social policies of governments. Both these ITCs were issued in January 2004; and

- PSC has issued an exposure draft on impairment of assets.

Where the PSC has not addressed or developed guidance on particular issues, the Study has used examples from IASs. The Study has been updated to reflect recent Exposure Drafts and Standards published by the IASB.

Occasional Paper 1

Implementation of Accrual Accounting in Government: The New Zealand Experience

Issued October 1994

The New Zealand public sector experienced major reform in the late 1980s and early 1990s. This reform changed public sector management from a system based on compliance with detailed and restrictive rules and budget cash limits to a performance and accountability-based regime. The successful implementation of these reforms demanded considerable effort at both strategic and operational levels and led to fundamental and extensive changes in both the management of public sector operations and also in the financial results of those operations. The New Zealand experience demonstrates that such change is not only possible but can also be highly successful.

This paper focuses on the move (migration was the colloquialism) by New Zealand government departments from cash to accrual accounting, and the project to produce the first set of Financial Statements for the New Zealand Government. The paper also attempts to draw out the key management issues in the implementation of full accrual accounting in a national government. The paper is written from the viewpoint of the Treasury which played a central role in the change.

Occasional Paper 2

Auditing Whole of Government Financial Statements: The New Zealand Experience

Issued October 1994

This paper describes the role played by the Audit Office in the development of the Crown financial statements. Following an explanation of the role of the Audit Office in New Zealand, the role played by the Audit Office is analyzed in terms of fundamental audit characteristics such as independence, criteria (in particular, accounting practices to provide a true and fair view in the absence of relevant accounting standards) and evidence. The audit and management processes involved in auditing the Crown financial statements–including planning, setting of materiality levels, project control, training and reporting–are then described. The paper concludes with lessons for other countries.

Occasional Paper 3

Perspectives on Accrual Accounting

Issued 1996

This paper aims to inform readers about a range of perspectives on accrual accounting from a number of contributors who have experience in implementing this accounting reform or who have observed its progress.

The PSC believes that by sharing perspectives of those who have been involved in the use of accrual accounting information for decision making purposes, others may gain insights into the value of this form of financial reporting to their own governments and other public sector entities.

The PSC deliberately set out to obtain the views of a wide range of people with a range of occupational backgrounds. The PSC also set out to focus on people who have experience of changing information outputs. The contributors to this paper are politicians, economists, academics, administrators and accountants.

Occasional Paper 4

The Delegation of Public Services in France: An original Method of Public Administration: Delegated Public Service

Issued September 2001

Government services can be provided in various ways. Usually they are delivered directly by government agencies. In some cases they can be contracted to private sector entities for them to deliver the public service under agreed conditions.

The public service can be said to be "delegated," Such delegations occur, at the local authority level, in diverse fields such as water distribution, waste management and heating. Delegations are subject to special rules, and are contractual arrangements which balance the interests of the delegating authority and the private enterprise responsible for delivery of the service. Examples of collaborative arrangements of this type exist in other countries (Australia, Canada and New Zealand for example). This Occasional Paper describes the specific framework designed in France to manage the relationship between the parties and to ensure an adequate level of information and accountability.

Occasional Paper 5

Resource Accounting: Framework of Accounting Standard Setting in the UK Central Government Sector

Issued June 2002

The challenges for those moving to the accrual basis can be daunting. It can therefore be helpful for jurisdictions to know something of the issues, both anticipated and unanticipated, which have arisen in jurisdictions adopting the accrual basis and how those issues have been dealt with.

This paper considers the experiences of the United Kingdom, which decided to move to an accrual basis for both budgeting and financial reporting in 1995. It highlights some of the key arguments influencing the decision to adopt an accrual system, not just for financial reporting, but also for budgeting. It also locates accrual based budgeting and reporting in a wider performance management context. It particularly considers how the UK undertook the task of creating the infrastructure for accrual

accounting and budgeting in the form of a standard-setting framework and an authoritative manual of accounting policies, principles and treatments.

Occasional Paper 6

The Modernization of Government Accounting in France: The Current Situation, The Issues, The Outlook

Issued January 2003

This paper outlines the process of modernization of the French government accounting system that is currently underway. The paper is organized around three sections:

The current state of public sector accounting practices. This section outlines current practice. It explains that central government, national public establishments, local governments and social security funds do not follow the same accounting and budgetary practices. However, the present reform of central government accounting will lead to the adoption of uniform principles (including faithful representation, and the requirement to present a "true and fair view" of government accounts) and methods (accrual accounting), that French and foreign companies practice every day in their accounting systems.

The transition to accrual accounting: a goal for the near future. This section describes the consequences of the new Constitutional Bylaw 2001 on Budget Acts (known as the new Budgetary Constitution) on the government accounting system. The Budget Acts mandate the very clear distinction between accrual accounting and cash parliamentary appropriation. In France, a dual system will be applied: the national budget (appropriation) is and will continue to be expressed (and executed) on a modified cash basis, whereas the General Account of the Finance Administration (CGAF) (balance sheet and statement of revenue and expenditure) will be expressed on an accrual basis. The CGAFs (*Compte général de l'administration des Finances*) represent the financial statements of the central government.

Action: progress to date and future development. This section traces the progress made in the CGAF presentation since 1999. It outlines a description of the measures undertaken to develop and implement accrual accounting, including the evolution of the information system.

Occasional Paper 7

The Governmental Accounting System in Argentina

Issued January 2004

This Paper provides background to the development of the accounting profession in Argentina and its influence in the public sector. It also provides an overview of the

evolution of the public sector accounting system in Argentina from the onset of the Argentine Confederation.

The cash basis of accounting was adopted in the public sector in Argentina in 1859. In 1947, the financial statements were modified to include recognition of expenses on a commitment basis. The Paper outlines the weaknesses in the public sector accounting system which led to subsequent reform of the Governmental Financial Administration and, consequently, the adoption of accrual accounting in 1993.

The Paper outlines challenges and issues that arose in data collection, practice and culture as part of the reform process. It also notes that the reform has brought about a positive impact in Government Financial Administration, including an increase in efficiency and effectiveness in public administration, and delivered more accurate information to support political decision-making.

Finally, the Paper outlines anticipated future developments in the Governmental Accounting System. These include improving management accounting in the public sector to further enhance decision-making, consolidating all public sector entities, creating a continuous training program for public sector employees and harmonizing the Argentine public sector generally accepted accounting principles with International Public Sector Accounting Standards (IPSASs).

Selected Bibliography of Public Sector Accounting and Auditing Material

Issued January 1993

To help developing and coordinating programs to promote education and research and for encouraging and facilitating the exchange of information among member bodies and other interested parties, the PSC issued a Selected Bibliography of Public Sector Accounting and Auditing Material. The Bibliography has been designed to include all authoritative and non-authoritative public sector accounting and auditing material issued by standard-setting bodies and Supreme Audit Institutions.

The listings of publications included in the Bibliography have been provided by the organizations themselves and are currently updated as of June 30, 1992.

ETHICS

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For additional information on recent developments and to obtain final pronouncements issued subsequent to December 31, 2005 or outstanding exposure drafts visit the IESBA's page on the IFAC website at http://www.ifac.org/.

July 1996
Revised January 1998, November 2001 and June 2004

CODE OF ETHICS FOR PROFESSIONAL ACCOUNTANTS

(This Code is effective but will be withdrawn on June 30, 2006 when the Code issued in June 2005 becomes effective)[♦]

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Definitions

In this Code of Ethics for Professional Accountants the following expressions appear in **bold type** when they are first used and have the following meanings assigned to them:

Advertising	The communication to the public of information as to the services or skills provided by professional accountants in public practice with a view to procuring professional business.
Audit client	An entity in respect of which a firm conducts an audit engagement. When the audit client is a listed entity, audit client will always include its related entities.
Audit engagement	An assurance engagement to provide a high level of assurance that financial statements are free of material misstatement, such as an engagement in accordance with International Standards on Auditing. This includes a statutory audit which is an audit required by national legislation or other regulation.
Assurance client	An entity in respect of which a firm conducts an assurance engagement.
Assurance engagement	An engagement conducted to provide: (a) A high level of assurance that the subject matter conforms in all material respects with identified suitable criteria; or (b) A moderate level of assurance that the subject matter is plausible in the circumstances. This would include an engagement in accordance with the International Standard on Assurance Engagements issued by the International Auditing and Assurance Standards Board or in accordance with specific standards for assurance engagements issued by the International Auditing and Assurance Standards Board such as an audit or review of financial statements in accordance with International Standards on Auditing.
Assurance team	(a) All professionals participating in the assurance engagement; (b) All others within a firm who can directly influence the outcome of the assurance engagement, including:

- Those who recommend the compensation of, or who provide direct supervisory, management or other oversight of the assurance engagement partner in connection with the performance of the assurance engagement. For the purposes of an audit engagement this includes those at all successively senior levels above the lead engagement partner through the firm's chief executive;
- Those who provide consultation regarding technical or industry specific issues, transactions or events for the assurance engagement; and
- Those who provide quality control for the assurance engagement; and

(c) For the purposes of an audit client, all those within a network firm who can directly influence the outcome of the audit engagement.

Client account — Any bank account which is used solely for the banking of clients' monies.

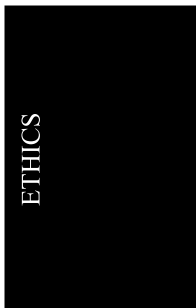
Clients' monies — Any monies – including documents of title to money e.g., bills of exchange, promissory notes, and documents of title which can be converted into money e.g., bearer bonds – received by a professional accountant in public practice to be held or paid out on the instruction of the person from whom or on whose behalf they are received.

Close family — A parent, non-dependent child or sibling.

Direct financial interest — A financial interest:

- Owned directly by and under the control of an individual or entity (including those managed on a discretionary basis by others); or
- Beneficially owned through a collective investment vehicle, estate, trust or other intermediary over which the individual or entity has control.

Directors and officers — Those charged with the governance of an entity, regardless of their title, which may vary from country to country.



Employed professional accountant	A professional accountant employed in industry, commerce, the public sector or education.
Existing accountant	A professional accountant in public practice currently holding an audit appointment or carrying out accounting, taxation, consulting or similar professional services for a client.
Financial interest	An interest in an equity or other security, debenture, loan or other debt instrument of an entity, including rights and obligations to acquire such an interest and derivatives directly related to such interest.
Firm	(a) A sole practitioner, partnership or corporation of professional accountants; (b) An entity that controls such parties; and (c) An entity controlled by such parties.
Immediate family	A spouse (or equivalent) or dependent.
Independence	Independence is: (a) Independence of mind – the state of mind that permits the provision of an opinion without being affected by influences that compromise professional judgment, allowing an individual to act with integrity, and exercise objectivity and professional skepticism; and (b) Independence in appearance – the avoidance of facts and circumstances that are so significant a reasonable and informed third party, having knowledge of all relevant information, including any safeguards applied, would reasonably conclude a firm's, or a member of the assurance team's, integrity, objectivity or professional skepticism had been compromised.
Indirect financial interest	A financial interest beneficially owned through a collective investment vehicle, estate, trust or other intermediary over which the individual or entity has no control.
Lead engagement partner	In connection with an audit, the partner responsible for signing the report on the consolidated financial statements of the audit client, and, where relevant, the partner responsible for signing the report in respect of any entity whose financial statements form part of the

	consolidated financial statements and on which a separate stand-alone report is issued. When no consolidated financial statements are prepared, the lead engagement partner would be the partner responsible for signing the report on the financial statements.
Listed entity	An entity whose shares, stock or debt are quoted or listed on a recognized stock exchange, or are marketed under the regulations of a recognized stock exchange or other equivalent body.
Network firm	An entity under common control, ownership or management with the firm or any entity that a reasonable and informed third party having knowledge of all relevant information would reasonably conclude as being part of the firm nationally or internationally.
Objectivity	A combination of impartiality, intellectual honesty and a freedom from conflicts of interest.
Office	A distinct sub-group, whether organized on geographical or practice lines.
Practice	A sole practitioner, a partnership or a corporation of professional accountants which offers professional services to the public.
Professional accountant	Those persons, whether they be in public practice, (including a sole practitioner, partnership or corporate body), industry, commerce, the public sector or education, who are members of an IFAC member body.
Professional accountant in public practice	Each partner or person occupying a position similar to that of a partner, and each employee in a practice providing professional services to a client irrespective of their functional classification (e.g., audit, tax or consulting) and professional accountants in a practice having managerial responsibilities. This term is also used to refer to a firm of professional accountants in public practice.
Professional services	Any service requiring accountancy or related skills performed by a professional accountant including accounting, auditing, taxation, management consulting and financial management services.
Publicity	The communication to the public of facts about a professional accountant which are not designed for the deliberate promotion of that professional accountant.

Receiving accountant A professional accountant in public practice to whom the existing accountant or client of the existing accountant has referred audit, accounting, taxation, consulting or similar appointments, or who is consulted in order to meet the needs of the client.

Related entity An entity that has any of the following relationships with the client:

(a) An entity that has direct or indirect control over the client provided the client is material to such entity;

(b) An entity with a direct financial interest in the client provided that such entity has significant influence over the client and the interest in the client is material to such entity;

(c) An entity over which the client has direct or indirect control;

(d) An entity in which the client, or an entity related to the client under (c) above, has a direct financial interest that gives it significant influence over such entity and the interest is material to the client and its related entity in (c); and

(e) An entity which is under common control with the client (hereinafter a "sister entity") provided the sister entity and the client are both material to the entity that controls both the client and sister entity.

Solicitation The approach to a potential client for the purpose of offering professional services.

Introduction

1. The International Federation of Accountants (IFAC) believes that due to national differences of culture, language, legal and social systems, the task of preparing detailed ethical requirements is primarily that of the member bodies in each country concerned and that they also have the responsibility to implement and enforce such requirements.

2. However, IFAC believes that the identity of the accountancy profession is characterized worldwide by its endeavor to achieve a number of common objectives and by its observance of certain fundamental principles for that purpose.

3. IFAC, therefore, recognizing the responsibilities of the accountancy profession as such, and considering its own role to be that of providing guidance, encouraging continuity of efforts, and promoting harmonization, has deemed it essential to establish an international Code of Ethics for Professional Accountants to be the basis on which the ethical requirements (code of ethics, detailed rules, guidelines, standards of conduct, etc.) for **professional accountants**[*] in each country should be founded.

4. This international Code is intended to serve as a model on which to base national ethical guidance. It sets standards of conduct for professional accountants and states the fundamental principles that should be observed by professional accountants in order to achieve common objectives. The accountancy profession throughout the world operates in an environment with different cultures and regulatory requirements. The basic intent of the Code, however, should always be respected. It is also acknowledged that, in those instances where a national requirement is in conflict with a provision in the Code, the national requirement would prevail. For those countries that wish to adopt the Code as their own national Code, IFAC has developed wording which may be used to indicate the authority and applicability in the country concerned. The wording is contained in the IFAC Statement of Policy of Council[**] *Preface to Ethical Requirements of (Name of Member Body).*

   Section 8 of this Code establishes a conceptual framework for **independence**[*] requirements for **assurance engagements**[*] that is the international standard on which national standards should be based. Accordingly, no member body or **firm**[*] is allowed to apply less stringent standards than those stated in that section. However, if member bodies or firms are prohibited from complying with certain parts of Section 8 by law or regulation, they should comply with all other parts of that section.

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[*] See Definitions.

[**] Effective May 2000, the IFAC Council was renamed the IFAC Board.

5. Further, the Code is established on the basis that unless a limitation is specifically stated, the objectives and fundamental principles are equally valid for all professional accountants, whether they be in public **practice**,* industry, commerce, the public sector or education.

6. A profession is distinguished by certain characteristics including:

   - Mastery of a particular intellectual skill, acquired by training and education;[1]

   - Adherence by its members to a common code of values and conduct established by its administrating body, including maintaining an outlook which is essentially objective; and

   - Acceptance of a duty to society as a whole (usually in return for restrictions in use of a title or in the granting of a qualification).

7. Members' duty to their profession and to society may at times seem to conflict with their immediate self interest or their duty of loyalty to their employer.

8. Against this background it is beholden on member bodies to lay down ethical requirements for their members to ensure the highest quality of performance and to maintain public confidence in the profession.

The Public Interest

9. A distinguishing mark of a profession is acceptance of its responsibility to the public. The accountancy profession's public consists of clients, credit grantors, governments, employers, employees, investors, the business and financial community, and others who rely on the **objectivity*** and integrity of professional accountants to maintain the orderly functioning of commerce. This reliance imposes a public interest responsibility on the accountancy profession. The public interest is defined as the collective well-being of the community of people and institutions the professional accountant serves.

10. A professional accountant's responsibility is not exclusively to satisfy the needs of an individual client or employer. The standards of the accountancy profession are heavily determined by the public interest, for example:

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[1] For details of the education requirements recommended and prescribed by IFAC, reference should be made to the statements developed by the Accounting Education Standards Board, including International Education Standards, International Education Guidelines and International Education Papers.

* See Definitions.

- Independent auditors help to maintain the integrity and efficiency of the financial statements presented to financial institutions in partial support for loans and to stockholders for obtaining capital;
- Financial executives serve in various financial management capacities in organizations and contribute to the efficient and effective use of the organization's resources;
- Internal auditors provide assurance about a sound internal control system which enhances the reliability of the external financial information of the employer;
- Tax experts help to establish confidence and efficiency in, and the fair application of, the tax system; and
- Management consultants have a responsibility toward the public interest in advocating sound management decision making.

11. Professional accountants have an important role in society. Investors, creditors, employers and other sectors of the business community, as well as the government and the public at large rely on professional accountants for sound financial accounting and reporting, effective financial management and competent advice on a variety of business and taxation matters. The attitude and behavior of professional accountants in providing such services have an impact on the economic well-being of their community and country.

12. Professional accountants can remain in this advantageous position only by continuing to provide the public with these unique services at a level which demonstrates that the public confidence is firmly founded. It is in the best interest of the worldwide accountancy profession to make known to users of the services provided by professional accountants that they are executed at the highest level of performance and in accordance with ethical requirements that strive to ensure such performance.

13. In formulating their national code of ethics, member bodies should therefore consider the public service and user expectations of the ethical standards of professional accountants and take their views into account. By doing so, any existing "expectation gap" between the standards expected and those prescribed can be addressed or explained.

Objectives

14. The Code recognizes that the objectives of the accountancy profession are to work to the highest standards of professionalism, to attain the highest levels of performance and generally to meet the public interest requirement set out above. These objectives require four basic needs to be met:

- *Credibility*

  In the whole of society there is a need for credibility in information and information systems.

- *Professionalism*

  There is a need for individuals who can be clearly identified by clients, employers and other interested parties as professional persons in the accountancy field.

- *Quality of Services*

  There is a need for assurance that all services obtained from a professional accountant are carried out to the highest standards of performance.

- *Confidence*

  Users of the services of professional accountants should be able to feel confident that there exists a framework of professional ethics which governs the provision of those services.

Fundamental Principles

15. In order to achieve the objectives of the accountancy profession, professional accountants have to observe a number of prerequisites or fundamental principles.

16. The fundamental principles are:

- *Integrity*

  A professional accountant should be straightforward and honest in performing **professional services**.*

- *Objectivity*

  A professional accountant should be fair and should not allow prejudice or bias, conflict of interest or influence of others to override objectivity.

- *Professional Competence and Due Care*

  A professional accountant should perform professional services with due care, competence and diligence and has a continuing duty to maintain professional knowledge and skill at a level required to ensure that a client or employer receives the advantage of competent

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* See Definitions.

professional service based on up-to-date developments in practice, legislation and techniques.

- *Confidentiality*

  A professional accountant should respect the confidentiality of information acquired during the course of performing professional services and should not use or disclose any such information without proper and specific authority or unless there is a legal or professional right or duty to disclose.

- *Professional Behavior*

  A professional accountant should act in a manner consistent with the good reputation of the profession and refrain from any conduct which might bring discredit to the profession. The obligation to refrain from any conduct which might bring discredit to the profession requires IFAC member bodies to consider, when developing ethical requirements, the responsibilities of a professional accountant to clients, third parties, other members of the accountancy profession, staff, employers, and the general public.

- *Technical Standards*

  A professional accountant should carry out professional services in accordance with the relevant technical and professional standards. Professional accountants have a duty to carry out with care and skill, the instructions of the client or employer insofar as they are compatible with the requirements of integrity, objectivity and, in the case of **professional accountants in public practice,*** independence (see Section 8 below). In addition, they should conform with the technical and professional standards promulgated by:

  - IFAC (e.g., International Standards on Auditing);
  - International Accounting Standards Board;
  - The member's professional body or other regulatory body; and
  - Relevant legislation.

The Code

17. The objectives as well as the fundamental principles are of a general nature and are not intended to be used to solve a professional accountant's ethical problems in a specific case. However, the Code provides some guidance as to the application in practice of the objectives and the fundamental

* See Definitions.

principles with regard to a number of typical situations occurring in the accountancy profession.

18. The Code set out below is divided into three parts:

- Part A applies to all professional accountants unless otherwise specified.
- Part B applies only to those professional accountants in public practice.
- Part C applies to **employed professional accountants**,* and may also apply, in appropriate circumstances, to accountants employed in public practice.

* See Definitions.

PART A—APPLICABLE TO ALL PROFESSIONAL ACCOUNTANTS

SECTION 1

Integrity and Objectivity

1.1 Integrity implies not merely honesty but fair dealing and truthfulness. The principle of objectivity imposes the obligation on all professional accountants to be fair, intellectually honest and free of conflicts of interest.

1.2 Professional accountants serve in many different capacities and should demonstrate their objectivity in varying circumstances. Professional accountants in public practice undertake assurance engagements, and render tax and other management advisory services. Other professional accountants prepare financial statements as a subordinate of others, perform internal auditing services, and serve in financial management capacities in industry, commerce, the public sector and education. They also educate and train those who aspire to admission into the profession. Regardless of service or capacity, professional accountants should protect the integrity of their professional services, and maintain objectivity in their judgment.

1.3 In selecting the situations and practices to be specifically dealt within ethics requirements relating to objectivity, adequate consideration should be given to the following factors:

(a) Professional accountants are exposed to situations which involve the possibility of pressures being exerted on them. These pressures may impair their objectivity.

(b) It is impracticable to define and prescribe all such situations where these possible pressures exist. Reasonableness should prevail in establishing standards for identifying relationships that are likely to, or appear to, impair a professional accountant's objectivity.

(c) Relationships should be avoided which allow prejudice, bias or influences of others to override objectivity.

(d) Professional accountants have an obligation to ensure that personnel engaged on professional services adhere to the principle of objectivity.

(e) Professional accountants should neither accept nor offer gifts or entertainment which might reasonably be believed to have a significant and improper influence on their professional judgment or those with whom they deal. What constitutes an excessive gift or offer of entertainment varies from country to country but professional accountants should avoid circumstances which would bring their professional standing into disrepute.

SECTION 2

Resolution of Ethical Conflicts

2.1 From time to time professional accountants encounter situations which give rise to conflicts of interest. Such conflicts may arise in a wide variety of ways, ranging from the relatively trivial dilemma to the extreme case of fraud and similar illegal activities. It is not possible to attempt to itemize a comprehensive check list of potential cases where conflicts of interest might occur. The professional accountant should be constantly conscious of and be alert to factors which give rise to conflicts of interest. It should be noted that an honest difference of opinion between a professional accountant and another party is not in itself an ethical issue. However, the facts and circumstances of each case need investigation by the parties concerned.

2.2 It is recognized, however, that there can be particular factors which occur when the responsibilities of a professional accountant may conflict with internal or external demands of one type or another. Hence:

- There may be the danger of pressure from an overbearing supervisor, manager, **director**[*] or partner; or when there are family or personal relationships which can give rise to the possibility of pressures being exerted upon them. Indeed, relationships or interests which could adversely influence, impair or threaten a professional accountant's integrity should be discouraged.
- A professional accountant may be asked to act contrary to technical and/or professional standards.
- A question of divided loyalty as between the professional accountant's superior and the required professional standards of conduct could occur.
- Conflict could arise when misleading information is published which may be to the advantage of the employer or client and which may or may not benefit the professional accountant as a result of such publication.

2.3 In applying standards of ethical conduct professional accountants may encounter problems in identifying unethical behavior or in resolving an ethical conflict. When faced with significant ethical issues, professional accountants should follow the established policies of the employing organization to seek a resolution of such conflict. If those policies do not resolve the ethical conflict, the following should be considered:

[*] See Definitions.

(a) Review the conflict problem with the immediate superior. If the problem is not resolved with the immediate superior and the professional accountant determines to go to the next higher managerial level, the immediate superior should be notified of the decision. If it appears that the superior is involved in the conflict problem, the professional accountant should raise the issue with the next higher level of management. When the immediate superior is the Chief Executive Officer (or equivalent) the next higher reviewing level may be the Executive Committee, Board of Directors, Non-Executive Directors, Trustees, Partners' Management Committee or Shareholders.

(b) Seek counseling and advice on a confidential basis with an independent advisor or the applicable professional accountancy body to obtain an understanding of possible courses of action.

(c) If the ethical conflict still exists after fully exhausting all levels of internal review, the professional accountant as a last resort may have no other recourse on significant matters (e.g., fraud) than to resign and to submit an information memorandum to an appropriate representative of that organization.

2.4 Furthermore, in some countries local laws, regulations or professional standards may require certain serious matters to be reported to an external body such as an enforcement or supervisory authority.

2.5 Any professional accountant in a senior position should endeavor to ensure that policies are established within his or her employing organization to seek resolution of conflicts.

2.6 Member bodies are urged to ensure that confidential counseling and advice is available to members who experience ethical conflicts.

SECTION 3

Professional Competence

3.1 Professional accountants should not portray themselves as having expertise or experience they do not possess.

3.2 Professional competence may be divided into two separate phases:

(a) Attainment of professional competence

The attainment of professional competence requires initially a high standard of general education followed by specific education, training and examination in professionally relevant subjects, and whether prescribed or not, a period of work experience. This should be the normal pattern of development for a professional accountant.

(b) Maintenance of professional competence

(i) The maintenance of professional competence requires a continuing awareness of developments in the accountancy profession including relevant national and international pronouncements on accounting, auditing and other relevant regulations and statutory requirements.

(ii) A professional accountant should adopt a program designed to ensure quality control in the performance of professional services consistent with appropriate national and international pronouncements.

SECTION 4

Confidentiality

4.1 Professional accountants have an obligation to respect the confidentiality of information about a client's or employer's affairs acquired in the course of professional services. The duty of confidentiality continues even after the end of the relationship between the professional accountant and the client or employer.

4.2 Confidentiality should always be observed by a professional accountant unless specific authority has been given to disclose information or there is a legal or professional duty to disclose.

4.3 Professional accountants have an obligation to ensure that staff under their control and persons from whom advice and assistance is obtained respect the principle of confidentiality.

4.4 Confidentiality is not only a matter of disclosure of information. It also requires that a professional accountant acquiring information in the course of performing professional services does neither use nor appear to use that information for personal advantage or for the advantage of a third party.

4.5 A professional accountant has access to much confidential information about a client's or employer's affairs not otherwise disclosed to the public. Therefore, the professional accountant should be relied upon not to make unauthorized disclosures to other persons. This does not apply to disclosure of such information in order properly to discharge the professional accountant's responsibility according to the profession's standards.

4.6 It is in the interest of the public and the profession that the profession's standards relating to confidentiality be defined and guidance given on the nature and extent of the duty of confidentiality and the circumstances in which disclosure of information acquired during the course of providing professional services shall be permitted or required.

4.7 It should be recognized, however, that confidentiality of information is part of statute or common law and therefore detailed ethical requirements in respect thereof will depend on the law of the country of each member body.

4.8 The following are examples of the points which should be considered in determining whether confidential information may be disclosed:

(a) When disclosure is authorized. When authorization to disclose is given by the client or the employer the interests of all the parties including those third parties whose interests might be affected should be considered.

(b) When disclosure is required by law. Examples of when a professional accountant is required by law to disclose confidential information are:

(i) To produce documents or to give evidence in the course of legal proceedings; and

(ii) To disclose to the appropriate public authorities infringements of the law which come to light.

(c) When there is a professional duty or right to disclose:

(i) To comply with technical standards and ethics requirements; such disclosure is not contrary to this section;

(ii) To protect the professional interests of a professional accountant in legal proceedings;

(iii) To comply with the quality (or peer) review of a member body or professional body; and

(iv) To respond to an inquiry or investigation by a member body or regulatory body.

4.9 When the professional accountant has determined that confidential information can be disclosed, the following points should be considered:

(a) Whether or not all the relevant facts are known and substantiated, to the extent it is practicable to do so; when the situation involves unsubstantiated fact or opinion, professional judgment should be used in determining the type of disclosure to be made, if any;

(b) What type of communication is expected and the addressee; in particular, the professional accountant should be satisfied that the parties to whom the communication is addressed are appropriate recipients and have the responsibility to act on it; and

(c) Whether or not the professional accountant would incur any legal liability having made a communication and the consequences thereof.

In all such situations, the professional accountants should consider the need to consult legal counsel and/or the professional organization(s) concerned.

SECTION 5

Tax Practice

5.1 A professional accountant rendering professional tax services is entitled to put forward the best position in favor of a client, or an employer, provided the service is rendered with professional competence, does not in any way impair integrity and objectivity, and is in the opinion of the professional accountant consistent with the law. Doubt may be resolved in favor of the client or the employer if there is reasonable support for the position.

5.2 A professional accountant should not hold out to a client or an employer the assurance that the tax return prepared and the tax advice offered are beyond challenge. Instead, the professional accountant should ensure that the client or the employer are aware of the limitations attaching to tax advice and services so that they do not misinterpret an expression of opinion as an assertion of fact.

5.3 A professional accountant who undertakes or assists in the preparation of a tax return should advise the client or the employer that the responsibility for the content of the return rests primarily with the client or employer. The professional accountant should take the necessary steps to ensure that the tax return is properly prepared on the basis of the information received.

5.4 Tax advice or opinions of material consequence given to a client or an employer should be recorded, either in the form of a letter or in a memorandum for the files.

5.5 A professional accountant should not be associated with any return or communication in which there is reason to believe that it:

(a) Contains a false or misleading statement;

(b) Contains statements or information furnished recklessly or without any real knowledge of whether they are true or false; or

(c) Omits or obscures information required to be submitted and such omission or obscurity would mislead the revenue authorities.

5.6 A professional accountant may prepare tax returns involving the use of estimates if such use is generally acceptable or if it is impractical under the circumstances to obtain exact data. When estimates are used, they should be presented as such in a manner so as to avoid the implication of greater accuracy than exists. The professional accountant should be satisfied that estimated amounts are reasonable under the circumstances.

5.7 In preparing a tax return, a professional accountant ordinarily may rely on information furnished by the client or employer provided that the information appears reasonable. Although the examination or review of

documents or other evidence in support of the information is not required, the professional accountant should encourage, when appropriate, such supporting data to be provided.

In addition, the professional accountant:

(a) Should make use of the client's returns for prior years whenever feasible;

(b) Is required to make reasonable inquiries when the information presented appears to be incorrect or incomplete; and

(c) Is encouraged to make reference to the books and records of the business operations.

5.8 When a professional accountant learns of a material error or omission in a tax return of a prior year (with which the professional accountant may or may not have been associated), or of the failure to file a required tax return, the professional accountant has a responsibility to:

(a) Promptly advise the client or employer of the error or omission and recommend that disclosure be made to the revenue authorities. Normally, the professional accountant is not obligated to inform the revenue authorities, nor may this be done without permission.

(b) If the client or the employer does not correct the error the professional accountant:

(i) Should inform the client or the employer that it is not possible to act for them in connection with that return or other related information submitted to the authorities; and\

(ii) Should consider whether continued association with the client or employer in any capacity is consistent with professional responsibilities.

(c) If the professional accountant concludes that a professional relationship with the client or employer can be continued, all reasonable steps should be taken to ensure that the error is not repeated in subsequent tax returns.

(d) Professional or statutory requirements in some countries may also make it necessary for the professional accountant to inform the revenue authorities that there is no longer any association with the return or other information involved and that acting for the client or employer has ceased. In these circumstances, the professional accountant should advise the client or employer of the position before informing the authorities and should give no further information to the authorities without the consent of the client or employer unless required to do so by law.

SECTION 6

Cross Border Activities

6.1 When considering the application of ethical requirements in cross border activities a number of situations may arise. Whether a professional accountant is a member of the profession in one country only or is also a member of the profession in the country where the services are performed should not affect the manner of dealing with each situation.

6.2 A professional accountant qualifying in one country may reside in another country or may be temporarily visiting that country to perform professional services. In all circumstances, the professional accountant should carry out professional services in accordance with the relevant technical standards and ethical requirements. The particular technical standards which should be followed are not dealt within this section. In all other respects, however, the professional accountant should be guided by the ethical requirements set out below.

6.3 When a professional accountant performs services in a country other than the home country and differences on specific matters exist between ethical requirements of the two countries the following provisions should be applied:

(a) When the ethical requirements of the country in which the services are being performed are less strict than the IFAC Code of Ethics, then the IFAC Code of Ethics should be applied.

(b) When the ethical requirements of the country in which services are being performed are stricter than the IFAC Code of Ethics, then the ethical requirements in the country where services are being performed should be applied.

(c) When the ethical requirements of the home country are mandatory for services performed outside that country and are stricter than set out in (a) and (b) above, then the ethical requirements of the home country should be applied. (In the case of cross border advertising and solicitation see also Section 14 paragraph 14.4 and 14.5 below.)

SECTION 7

Publicity*

7.1 In the marketing and promotion of themselves and their work, professional accountants should:

(a) Not use means which brings the profession into disrepute;

(b) Not make exaggerated claims for the services they are able to offer, the qualifications they possess, or experience they have gained; and

(c) Not denigrate the work of other accountants.

* See Definitions.

PART B—APPLICABLE TO PROFESSIONAL ACCOUNTANTS IN PUBLIC PRACTICE

SECTION 8

Independence

8.1 It is in the public interest and, therefore, required by this Code of Ethics, that members of **assurance teams**,* firms and, when applicable, **network firms*** be independent of **assurance clients**.*

8.2 Assurance engagements are intended to enhance the credibility of information about a subject matter by evaluating whether the subject matter conforms in all material respects with suitable criteria. The International Standard on Assurance Engagements issued by the International Auditing and Assurance Standards Board describes the objectives and elements of assurance engagements to provide either a high or a moderate level of assurance. The International Auditing and Assurance Standards Board has also issued specific standards for certain assurance engagements. For example, International Standards on Auditing provide specific standards for audit (high level assurance) and review (moderate level assurance) of financial statements.

Paragraphs 8.3 through 8.6 are taken from the International Standard on Assurance Engagements and describe the nature of an assurance engagement. These paragraphs are presented here only to describe the nature of an assurance engagement. To obtain a full understanding of the objectives and elements of an assurance engagement it is necessary to refer to the full text contained in the International Standard on Assurance Engagements.

8.3 Whether a particular engagement is an assurance engagement will depend upon whether it exhibits all the following elements:

(a) A three party relationship involving:

(i) A professional accountant;

(ii) A responsible party; and

(iii) An intended user;

(b) A subject matter;

(c) Suitable criteria;

(d) An engagement process; and

(e) A conclusion.

* See Definitions.

The responsible party and the intended user will often be from separate organizations but need not be. A responsible party and an intended user may both be within the same organization. For example, a governing body may seek assurance about information provided by a component of that organization. The relationship between the responsible party and the intended user needs to be viewed within the context of a specific engagement.

8.4 There is a broad range of engagements to provide a high or moderate level of assurance. Such engagements may include:

- Engagements to report on a broad range of subject matters covering financial and non-financial information;
- Attest and direct reporting engagements;
- Engagements to report internally and externally; and
- Engagements in the private and public sector.

8.5 The subject matter of an assurance engagement may take many forms, such as the following:

- Data (for example, historical or prospective financial information, statistical information, performance indicators).
- Systems and processes (for example, internal controls).
- Behavior (for example, corporate governance, compliance with regulation, human resource practices).

8.6 Not all engagements performed by professional accountants are assurance engagements. Other engagements frequently performed by professional accountants that are not assurance engagements include:

- Agreed-upon procedures;
- Compilation of financial or other information;
- Preparation of tax returns when no conclusion is expressed, and tax consulting;
- Management consulting; and
- Other advisory services.

8.7 This section of the Code of Ethics (this section) provides a framework, built on principles, for identifying, evaluating and responding to threats to independence. The framework establishes principles that members of assurance teams, firms and network firms should use to identify threats to independence, evaluate the significance of those threats, and, if the threats are other than clearly insignificant, identify and apply safeguards to eliminate the threats or reduce them to an acceptable level. Judgment is

needed to determine which safeguards are to be applied. Some safeguards may eliminate the threat while others may reduce the threat to an acceptable level. This section requires members of assurance teams, firms and network firms to apply the principles to the particular circumstances under consideration. The examples presented are intended to illustrate the application of the principles in this section and are not intended to be, nor should they be interpreted as, an exhaustive list of all circumstances that may create threats to independence. Consequently, it is not sufficient for a member of an assurance team, a firm or a network firm merely to comply with the examples presented, rather they should apply the principles in this section to the particular circumstances they face.

A Conceptual Approach to Independence

8.8 Independence requires:

(a) *Independence of Mind*

The state of mind that permits the provision of an opinion without being affected by influences that compromise professional judgment, allowing an individual to act with integrity, and exercise objectivity and professional skepticism.

(b) *Independence in Appearance*

The avoidance of facts and circumstances that are so significant that a reasonable and informed third party, having knowledge of all relevant information, including safeguards applied, would reasonably conclude a firm's, or a member of the assurance team's, integrity, objectivity or professional skepticism had been compromised.

8.9 The use of the word "independence" on its own may create misunderstandings. Standing alone, the word may lead observers to suppose that a person exercising professional judgment ought to be free from all economic, financial and other relationships. This is impossible, as every member of society has relationships with others. Therefore, the significance of economic, financial and other relationships should also be evaluated in the light of what a reasonable and informed third party having knowledge of all relevant information would reasonably conclude to be unacceptable.

8.10 Many different circumstances, or combination of circumstances, may be relevant and accordingly it is impossible to define every situation that creates threats to independence and specify the appropriate mitigating action that should be taken. In addition, the nature of assurance engagements may differ and consequently different threats may exist, requiring the application of different safeguards. A conceptual framework that requires firms and members of assurance teams to identify, evaluate and address threats to independence, rather than merely comply with a set of specific rules which may be arbitrary, is, therefore, in the public interest.

8.11 This section is based on such a conceptual approach, one that takes into account threats to independence, accepted safeguards and the public interest. Under this approach, firms and members of assurance teams have an obligation to identify and evaluate circumstances and relationships that create threats to independence and to take appropriate action to eliminate these threats or to reduce them to an acceptable level by the application of safeguards. In addition to identifying and evaluating relationships between the firm, network firms, members of the assurance team and the assurance client, consideration should be given to whether relationships between individuals outside of the assurance team and the assurance client create threats to independence.

8.12 This section provides a framework of principles that members of assurance teams, firms and network firms should use to identify threats to independence, evaluate the significance of those threats, and, if the threats are other than clearly insignificant, identify and apply safeguards to eliminate the threats or reduce them to an acceptable level, such that independence of mind and independence in appearance are not compromised.

8.13 The principles in this section apply to all assurance engagements. The nature of the threats to independence and the applicable safeguards necessary to eliminate the threats or reduce them to an acceptable level differ depending on the characteristics of the individual engagement: whether the assurance engagement is an **audit engagement**[*] or another type of engagement; and in the case of an assurance engagement that is not an audit engagement, the purpose, subject matter and intended users of the report. A firm should, therefore, evaluate the relevant circumstances, the nature of the assurance engagement and the threats to independence in deciding whether it is appropriate to accept or continue an engagement, as well as the nature of the safeguards required and whether a particular individual should be a member of the assurance team.

8.14 Audit engagements provide assurance to a wide range of potential users; consequently, in addition to independence of mind, independence in appearance is of particular significance. Accordingly, for **audit clients**,[*] the members of the assurance team, the firm and network firms are required to be independent of the audit client. Similar considerations in the case of assurance engagements provided to non-audit assurance clients require the members of the assurance team and the firm to be independent of the non-audit assurance client. In the case of these engagements, consideration should be given to any threats that the firm has reason to believe may be created by network firm interests and relationships.

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[*] See Definitions.

8.15 In the case of an assurance report to a non-audit assurance client expressly restricted for use by identified users, the users of the report are considered to be knowledgeable as to the purpose, subject matter and limitations of the report through their participation in establishing the nature and scope of the firm's instructions to deliver the services, including the criteria by which the subject matter are to be evaluated. This knowledge and enhanced ability of the firm to communicate about safeguards with all users of the report increase the effectiveness of safeguards to independence in appearance. These circumstances may be taken into account by the firm in evaluating the threats to independence and considering the applicable safeguards necessary to eliminate the threats or reduce them to an acceptable level. At a minimum, it will be necessary to apply the provisions of this section in evaluating the independence of members of the assurance team and their **immediate** and **close family**.* Further, if the firm had a material **financial interest**,* whether direct or indirect, in the assurance client, the self-interest threat created would be so significant no safeguard could reduce the threat to an acceptable level. Limited consideration of any threats created by network firm interests and relationships may be sufficient.

8.16 Accordingly:

(a) For assurance engagements provided to an audit client, the members of the assurance team, the firm and network firms are required to be independent of the client;

(b) For assurance engagements provided to clients that are not audit clients, when the report is not expressly restricted for use by identified users, the members of the assurance team and the firm are required to be independent of the client; and

(c) For assurance engagements provided to clients that are not audit clients, when the assurance report is expressly restricted for use by identified users, the members of the assurance team are required to be independent of the client. In addition, the firm should not have a material **direct** or **indirect financial interest*** in the client.

* See Definitions.

These independence requirements for assurance engagements are illustrated as follows:

Client	Type of Assurance Engagement		
	Audit	Non-audit – not restricted use	Non-audit – restricted use
Audit client	Assurance team, firm and network firms		
Non-audit assurance client		Assurance team and firm	Assurance team and firm has no material financial interest

8.17 The threats and safeguards identified in this section are generally discussed in the context of interests or relationships between the firm, network firms, a member of the assurance team and the assurance client. In the case of a listed audit client, the firm and any network firms are required to consider the interests and relationships that involve that client's related entities. Ideally those entities and the interests and relationships should be identified in advance. For all other assurance clients, when the assurance team has reason to believe that a **related entity*** of such an assurance client is relevant to the evaluation of the firm's independence of the client, the assurance team should consider that related entity when evaluating independence and applying appropriate safeguards.

8.18 The evaluation of threats to independence and subsequent action should be supported by evidence obtained before accepting the engagement and while it is being performed. The obligation to make such an evaluation and take action arises when a firm, a network firm or a member of the assurance team knows, or could reasonably be expected to know, of circumstances or relationships that might compromise independence. There may be occasions when the firm, a network firm or an individual inadvertently violates this section. If such an inadvertent violation occurs, it would generally not compromise independence with respect to an assurance client provided the firm has appropriate quality control policies and procedures in place to promote independence and, once discovered, the violation is corrected promptly and any necessary safeguards are applied.

8.19 Throughout this section, reference is made to significant and clearly insignificant threats in the evaluation of independence. In considering the significance of any particular matter, qualitative as well as quantitative

* See Definitions.

factors should be taken into account. A matter should be considered clearly insignificant only if it is deemed to be both trivial and inconsequential.

Objective and Structure of this Section

8.20 The objective of this section is to assist firms and members of assurance teams in:

(a) Identifying threats to independence;

(b) Evaluating whether these threats are clearly insignificant; and

(c) In cases when the threats are not clearly insignificant, identifying and applying appropriate safeguards to eliminate or reduce the threats to an acceptable level.

In situations when no safeguards are available to reduce the threat to an acceptable level, the only possible actions are to eliminate the activities or interest creating the threat, or to refuse to accept or continue the assurance engagement.

8.21 This section outlines the threats to independence (paragraphs 8.28 through 8.33). It then analyzes safeguards capable of eliminating these threats or reducing them to an acceptable level (paragraphs 8.34 through 8.47). It concludes with some examples of how this conceptual approach to independence is to be applied to specific circumstances and relationships. The examples discuss threats to independence that may be created by specific circumstances and relationships (paragraphs 8.100 onwards). Professional judgment is used to determine the appropriate safeguards to eliminate threats to independence or to reduce them to an acceptable level. In certain examples, the threats to independence are so significant the only possible actions are to eliminate the activities or interest creating the threat, or to refuse to accept or continue the assurance engagement. In other examples, the threat can be eliminated or reduced to an acceptable level by the application of safeguards. The examples are not intended to be all-inclusive.

8.22 When threats to independence that are not clearly insignificant are identified, and the firm decides to accept or continue the assurance engagement, the decision should be documented. The documentation should include a description of the threats identified and the safeguards applied to eliminate or reduce the threats to an acceptable level.

8.23 The evaluation of the significance of any threats to independence and the safeguards necessary to reduce any threats to an acceptable level, takes into account the public interest. Certain entities may be of significant public interest because, as a result of their business, their size or their corporate status they have a wide range of stakeholders. Examples of such entities might include listed companies, credit institutions, insurance companies,

and pension funds. Because of the strong public interest in the financial statements of listed entities, certain paragraphs in this section deal with additional matters that are relevant to the audit of listed entities. Consideration should be given to the application of the principles set out in this section in relation to the audit of listed entities to other audit clients that may be of significant public interest.

National Perspectives

8.24 This section establishes a conceptual framework for independence requirements for assurance engagements that is the international standard on which national standards should be based. Accordingly, no member body or firm is allowed to apply less stringent standards than those stated in this section. When, however, member bodies or firms are prohibited from complying with certain parts of this section by law or regulation they should comply with all other parts of this section.

8.25 Certain examples in this section indicate how the principles are to be applied to **listed entity**[*] audit engagements. When a member body chooses not to differentiate between listed entity audit engagements and other audit engagements, the examples that relate to listed entity audit engagements should be considered to apply to all audit engagements.

8.26 When a firm conducts an assurance engagement in accordance with the International Standard on Assurance Engagements or with specific standards for assurance engagements issued by the International Auditing and Assurance Standards Board such as an audit or review of financial statements in accordance with International Standards on Auditing, the members of the assurance team and the firm should comply with this section unless they are prohibited from complying with certain parts of this section by law or regulation. In such cases, the members of the assurance team and the firm should comply with all other parts of this section.

8.27 Some countries and cultures may have set out, either by legislation or common practice, different definitions of relationships from those used in this section. For example, some national legislators or regulators may have prescribed lists of individuals who should be regarded as close family that differ from the definition contained in this section. Firms, network firms and members of assurance teams should be aware of those differences and comply with the more stringent requirements.

Threats to Independence

8.28 Independence is potentially affected by self-interest, self-review, advocacy, familiarity and intimidation threats.

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[*] See Definitions.

8.29 "Self-Interest Threat" occurs when a firm or a member of the assurance team could benefit from a financial interest in, or other self-interest conflict with, an assurance client.

Examples of circumstances that may create this threat include, but are not limited to:

- A direct financial interest or material indirect financial interest in an assurance client;
- A loan or guarantee to or from an assurance client or any of its **directors or officers**;*
- Undue dependence on total fees from an assurance client;
- Concern about the possibility of losing the engagement;
- Having a close business relationship with an assurance client;
- Potential employment with an assurance client; and
- Contingent fees relating to assurance engagements.

8.30 "Self-Review Threat" occurs when (1) any product or judgment of a previous assurance engagement or non-assurance engagement needs to be re-evaluated in reaching conclusions on the assurance engagement or (2) when a member of the assurance team was previously a director or officer of the assurance client, or was an employee in a position to exert direct and significant influence over the subject matter of the assurance engagement.

Examples of circumstances that may create this threat include, but are not limited to:

- A member of the assurance team being, or having recently been, a director or officer of the assurance client;
- A member of the assurance team being, or having recently been, an employee of the assurance client in a position to exert direct and significant influence over the subject matter of the assurance engagement;
- Performing services for an assurance client that directly affect the subject matter of the assurance engagement; and
- Preparation of original data used to generate financial statements or preparation of other records that are the subject matter of the assurance engagement.

* See Definitions.

8.31 "Advocacy Threat" occurs when a firm, or a member of the assurance team, promotes, or may be perceived to promote, an assurance client's position or opinion to the point that objectivity may, or may be perceived to be, compromised. Such may be the case if a firm or a member of the assurance team were to subordinate their judgment to that of the client.

Examples of circumstances that may create this threat include, but are not limited to:

- Dealing in, or being a promoter of, shares or other securities in an assurance client; and
- Acting as an advocate on behalf of an assurance client in litigation or in resolving disputes with third parties.

8.32 "Familiarity Threat" occurs when, by virtue of a close relationship with an assurance client, its directors, officers or employees, a firm or a member of the assurance team becomes too sympathetic to the client's interests.

Examples of circumstances that may create this threat include, but are not limited to:

- A member of the assurance team having an **immediate family**[*] member or close family member who is a director or officer of the assurance client;
- A member of the assurance team having an immediate family member or close family member who, as an employee of the assurance client, is in a position to exert direct and significant influence over the subject matter of the assurance engagement;
- A former partner of the firm being a director, officer of the assurance client or an employee in a position to exert direct and significant influence over the subject matter of the assurance engagement;
- Long association of a senior member of the assurance team with the assurance client; and
- Acceptance of gifts or hospitality, unless the value is clearly insignificant, from the assurance client, its directors, officers or employees.

8.33 "Intimidation Threat" occurs when a member of the assurance team may be deterred from acting objectively and exercising professional skepticism by threats, actual or perceived, from the directors, officers or employees of an assurance client.

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[*] See Definitions.

Examples of circumstances that may create this threat include, but are not limited to:

- Threat of replacement over a disagreement with the application of an accounting principle; and
- Pressure to reduce inappropriately the extent of work performed in order to reduce fees.

Safeguards

8.34 The firm and members of the assurance team have a responsibility to remain independent by taking into account the context in which they practice, the threats to independence and the safeguards available to eliminate the threats or reduce them to an acceptable level.

8.35 When threats are identified, other than those that are clearly insignificant, appropriate safeguards should be identified and applied to eliminate the threats or reduce them to an acceptable level. This decision should be documented. The nature of the safeguards to be applied will vary depending upon the circumstances. Consideration should always be given to what a reasonable and informed third party having knowledge of all relevant information, including safeguards applied, would reasonably conclude to be unacceptable. The consideration will be affected by matters such as the significance of the threat, the nature of the assurance engagement, the intended users of the assurance report and the structure of the firm.

8.36 Safeguards fall into three broad categories:

(a) Safeguards created by the profession, legislation or regulation;

(b) Safeguards within the assurance client; and

(c) Safeguards within the firm's own systems and procedures.

The firm and the members of the assurance team should select appropriate safeguards to eliminate or reduce threats to independence, other than those that are clearly insignificant, to an acceptable level.

8.37 Safeguards created by the profession, legislation or regulation, include:

- Educational, training and experience requirements for entry into the profession;
- Continuing education requirements;
- Professional standards and monitoring and disciplinary processes;
- External review of a firm's quality control system; and
- Legislation governing the independence requirements of the firm.

8.38 Safeguards within the assurance client, include:

- When the assurance client's management appoints the firm, persons other than management ratify or approve the appointment;
- The assurance client has competent employees to make managerial decisions;
- Policies and procedures that emphasize the assurance client's commitment to fair financial reporting;
- Internal procedures that ensure objective choices in commissioning non-assurance engagements; and
- A corporate governance structure, such as an audit committee, that provides appropriate oversight and communications regarding a firm's services.

8.39 Audit committees can have an important corporate governance role when they are independent of client management and can assist the Board of Directors in satisfying themselves that a firm is independent in carrying out its audit role. There should be regular communications between the firm and the audit committee (or other governance body if there is no audit committee) of listed entities regarding relationships and other matters that might, in the firm's opinion, reasonably be thought to bear on independence.

8.40 Firms should establish policies and procedures relating to independence communications with audit committees, or others charged with governance. In the case of the audit of listed entities, the firm should communicate orally and in writing at least annually, all relationships and other matters between the firm, network firms and the audit client that in the firm's professional judgment may reasonably be thought to bear on independence. Matters to be communicated will vary in each circumstance and should be decided by the firm, but should generally address the relevant matters set out in this section.

8.41 Safeguards within the firm's own systems and procedures may include firm-wide safeguards such as:

- Firm leadership that stresses the importance of independence and the expectation that members of assurance teams will act in the public interest;
- Policies and procedures to implement and monitor quality control of assurance engagements;
- Documented independence policies regarding the identification of threats to independence, the evaluation of the significance of these threats and the identification and application of safeguards to eliminate

or reduce the threats, other than those that are clearly insignificant, to an acceptable level;

- Internal policies and procedures to monitor compliance with firm policies and procedures as they relate to independence;
- Policies and procedures that will enable the identification of interests or relationships between the firm or members of the assurance team and assurance clients;
- Policies and procedures to monitor and, if necessary, manage the reliance on revenue received from a single assurance client;
- Using different partners and teams with separate reporting lines for the provision of non-assurance services to an assurance client;
- Policies and procedures to prohibit individuals who are not members of the assurance team from influencing the outcome of the assurance engagement;
- Timely communication of a firm's policies and procedures, and any changes thereto, to all partners and professional staff, including appropriate training and education thereon;
- Designating a member of senior management as responsible for overseeing the adequate functioning of the safeguarding system;
- Means of advising partners and professional staff of those assurance clients and related entities from which they must be independent;
- A disciplinary mechanism to promote compliance with policies and procedures; and
- Policies and procedures to empower staff to communicate to senior levels within the firm any issue of independence and objectivity that concerns them; this includes informing staff of the procedures open to them.

8.42 Safeguards within the firm's own systems and procedures may include engagement specific safeguards such as:

- Involving an additional professional accountant to review the work done or otherwise advise as necessary. This individual could be someone from outside the firm or network firm, or someone within the firm or network firm who was not otherwise associated with the assurance team;
- Consulting a third party, such as a committee of independent directors, a professional regulatory body or another professional accountant;
- Rotation of senior personnel;

- Discussing independence issues with the audit committee or others charged with governance;
- Disclosing to the audit committee, or others charged with governance, the nature of services provided and extent of fees charged;
- Policies and procedures to ensure members of the assurance team do not make, or assume responsibility for, management decisions for the assurance client;
- Involving another firm to perform or re-perform part of the assurance engagement;
- Involving another firm to re-perform the non-assurance service to the extent necessary to enable it to take responsibility for that service; and
- Removing an individual from the assurance team, when that individual's financial interests or relationships create a threat to independence.

8.43 When the safeguards available, such as those described above, are insufficient to eliminate the threats to independence or to reduce them to an acceptable level, or when a firm chooses not to eliminate the activities or interests creating the threat, the only course of action available will be the refusal to perform, or withdrawal from, the assurance engagement.

Engagement Period

8.44 The members of the assurance team and the firm should be independent of the assurance client during the period of the assurance engagement. The period of the engagement starts when the assurance team begins to perform assurance services and ends when the assurance report is issued, except when the assurance engagement is of a recurring nature. If the assurance engagement is expected to recur, the period of the assurance engagement ends with the notification by either party that the professional relationship has terminated or the issuance of the final assurance report, whichever is later.

8.45 In the case of an audit engagement, the engagement period includes the period covered by the financial statements reported on by the firm. When an entity becomes an audit client during or after the period covered by the financial statements that the firm will report on, the firm should consider whether any threats to independence may be created by:

- Financial or business relationships with the audit client during or after the period covered by the financial statements, but prior to the acceptance of the audit engagement; or
- Previous services provided to the audit client.

Similarly, in the case of an assurance engagement that is not an audit engagement, the firm should consider whether any financial or business relationships or previous services may create threats to independence.

8.46 If non-assurance services were provided to the audit client during or after the period covered by the financial statements but before the commencement of professional services in connection with the audit and those services would be prohibited during the period of the audit engagement, consideration should be given to the threats to independence, if any, arising from those services. If the threat is other than clearly insignificant, safeguards should be considered and applied as necessary to reduce the threat to an acceptable level. Such safeguards might include:

- Discussing independence issues related to the provision of the non-assurance services with those charged with governance of the client, such as the audit committee;
- Obtaining the audit client's acknowledgement of responsibility for the results of the non-assurance services;
- Precluding personnel who provided the non-assurance services from participating in the audit engagement; and
- Engaging another firm to review the results of the non-assurance services or having another firm re-perform the non-assurance services to the extent necessary to enable it to take responsibility for those services.

8.47 Non-assurance services provided to a non-listed audit client will not impair the firm's independence when the client becomes a listed entity provided:

(a) The previous non-assurance services were permissible under this section for non-listed audit clients;

(b) The services will be terminated within a reasonable period of time of the client becoming a listed entity, if they are impermissible under this section for listed audit clients; and

(c) The firm has implemented appropriate safeguards to eliminate any threats to independence arising from the previous services or reduce them to an acceptable level.

Effective Date

8.48 This section is applicable to assurance engagements when the assurance report is dated on or after December 31, 2004. Earlier application is encouraged.

Application of Principles to Specific Situations

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Introduction

8.100 The following examples describe specific circumstances and relationships that may create threats to independence. The examples describe the potential threats created and the safeguards that may be appropriate to eliminate the threats or reduce them to an acceptable level in each circumstance. The examples are not all-inclusive. In practice, the firm, network firms and the members of the assurance team will be required to assess the implications of similar, but different, circumstances and relationships and to determine whether safeguards, including the safeguards in paragraphs 8.37 through 8.42 can be applied to satisfactorily address the threats to independence. Paragraphs 8.1 through 8.48 of this section provide conceptual guidance to assist in this process.

8.101 Some of the examples deal with audit clients while others deal with assurance clients that are not audit clients. The examples illustrate how safeguards should be applied to fulfill the requirement for the members of the assurance team, the firm and network firms to be independent of an audit client, and for the members of the assurance team and the firm to be independent of an assurance client that is not an audit client. The examples do not include assurance reports to a non-audit assurance client expressly restricted for use by identified users. As stated in paragraph 8.15 for such engagements, members of the assurance team and their immediate and close family are required to be independent of the assurance client. Further, the firm should not have a material financial interest, direct or indirect, in the assurance client.

Financial Interests

8.102 A financial interest in an assurance client may create a self-interest threat. In evaluating the significance of the threat, and the appropriate safeguards to be applied to eliminate the threat or reduce it to an acceptable level, it is necessary to examine the nature of the financial interest. This includes an evaluation of the role of the person holding the financial interest, the materiality of the financial interest and the type of financial interest (direct or indirect).

8.103 When evaluating the type of financial interest, consideration should be given to the fact that financial interests range from those where the individual has no control over the investment vehicle or the financial interest held (e.g., a mutual fund, unit trust or similar intermediary vehicle) to those where the individual has control over the financial interest (e.g., as a trustee) or is able to influence investment decisions. In evaluating the significance of any threat to independence, it is important to consider the degree of control or influence that can be exercised over the intermediary, the financial interest held, or its investment strategy. When control exists, the financial interest should be considered direct. Conversely, when the

holder of the financial interest has no ability to exercise such control the financial interest should be considered indirect.

Provisions Applicable to All Assurance Clients

8.104 If a member of the assurance team, or their immediate family member, has a direct financial interest, or a material indirect financial interest, in the assurance client, the self-interest threat created would be so significant the only safeguards available to eliminate the threat or reduce it to an acceptable level would be to:

(a) Dispose of the direct financial interest prior to the individual becoming a member of the assurance team;

(b) Dispose of the indirect financial interest in total or dispose of a sufficient amount of it so that the remaining interest is no longer material prior to the individual becoming a member of the assurance team; or

(c) Remove the member of the assurance team from the assurance engagement.

8.105 If a member of the assurance team, or their immediate family member receives, by way of, for example, an inheritance, gift or, as a result of a merger, a direct financial interest or a material indirect financial interest in the assurance client, a self-interest threat would be created. The following safeguards should be applied to eliminate the threat or reduce it to an acceptable level:

(a) Disposing of the financial interest at the earliest practical date; or

(b) Removing the member of the assurance team from the assurance engagement.

During the period prior to disposal of the financial interest or the removal of the individual from the assurance team, consideration should be given to whether additional safeguards are necessary to reduce the threat to an acceptable level. Such safeguards might include:

- Discussing the matter with those charged with governance, such as the audit committee; or
- Involving an additional professional accountant to review the work done, or otherwise advise as necessary.

8.106 When a member of the assurance team knows that his or her close family member has a direct financial interest or a material indirect financial interest in the assurance client, a self-interest threat may be created. In evaluating the significance of any threat, consideration should be given to the nature of the relationship between the member of the assurance team and the close

family member and the materiality of the financial interest. Once the significance of the threat has been evaluated, safeguards should be considered and applied as necessary. Such safeguards might include:

- The close family member disposing of all or a sufficient portion of the financial interest at the earliest practical date;
- Discussing the matter with those charged with governance, such as the audit committee;
- Involving an additional professional accountant who did not take part in the assurance engagement to review the work done by the member of the assurance team with the close family relationship or otherwise advise as necessary; or
- Removing the individual from the assurance engagement.

8.107 When a firm or a member of the assurance team holds a direct financial interest or a material indirect financial interest in the assurance client as a trustee, a self-interest threat may be created by the possible influence of the trust over the assurance client. Accordingly, such an interest should only be held when:

(a) The member of the assurance team, an immediate family member of the member of the assurance team, and the firm are not beneficiaries of the trust;

(b) The interest held by the trust in the assurance client is not material to the trust;

(c) The trust is not able to exercise significant influence over the assurance client; and

(d) The member of the assurance team or the firm does not have significant influence over any investment decision involving a financial interest in the assurance client.

8.108 Consideration should be given to whether a self-interest threat may be created by the financial interests of individuals outside of the assurance team and their immediate and close family members. Such individuals would include:

- Partners, and their immediate family members, who are not members of the assurance team;
- Partners and managerial employees who provide non-assurance services to the assurance client; and
- Individuals who have a close personal relationship with a member of the assurance team.

Whether the interests held by such individuals may create a self-interest threat will depend upon factors such as:

- The firm's organizational, operating and reporting structure; and
- The nature of the relationship between the individual and the member of the assurance team.

The significance of the threat should be evaluated and, if the threat is other than clearly insignificant, safeguards should be considered and applied as necessary to reduce the threat to an acceptable level. Such safeguards might include:

- Where appropriate, policies to restrict people from holding such interests;
- Discussing the matter with those charged with governance, such as the audit committee; or
- Involving an additional professional accountant who did not take part in the assurance engagement to review the work done or otherwise advise as necessary.

8.109 An inadvertent violation of this section as it relates to a financial interest in an assurance client would not impair the independence of the firm, the network firm or a member of the assurance team when:

(a) The firm, and the network firm, have established policies and procedures that require all professionals to report promptly to the firm any breaches resulting from the purchase, inheritance or other acquisition of a financial interest in the assurance client;

(b) The firm, and the network firm, promptly notify the professional that the financial interest should be disposed of; and

(c) The disposal occurs at the earliest practical date after identification of the issue, or the professional is removed from the assurance team.

8.110 When an inadvertent violation of this section relating to a financial interest in an assurance client has occurred, the firm should consider whether any safeguards should be applied. Such safeguards might include:

- Involving an additional professional accountant who did not take part in the assurance engagement to review the work done by the member of the assurance team; or
- Excluding the individual from any substantive decision-making concerning the assurance engagement.

Provisions Applicable to Audit Clients

8.111 If a firm, or a network firm, has a direct financial interest in an audit client of the firm the self-interest threat created would be so significant no safeguard could reduce the threat to an acceptable level. Consequently, disposal of the financial interest would be the only action appropriate to permit the firm to perform the engagement.

8.112 If a firm, or a network firm, has a material indirect financial interest in an audit client of the firm a self-interest threat is also created. The only actions appropriate to permit the firm to perform the engagement would be for the firm, or the network firm, either to dispose of the indirect interest in total or to dispose of a sufficient amount of it so that the remaining interest is no longer material.

8.113 If a firm, or a network firm, has a material financial interest in an entity that has a controlling interest in an audit client, the self-interest threat created would be so significant no safeguard could reduce the threat to an acceptable level. The only actions appropriate to permit the firm to perform the engagement would be for the firm, or the network firm, either to dispose of the financial interest in total or to dispose of a sufficient amount of it so that the remaining interest is no longer material.

8.114 If the retirement benefit plan of a firm, or network firm, has a financial interest in an audit client a self-interest threat may be created. Accordingly, the significance of any such threat created should be evaluated and, if the threat is other than clearly insignificant, safeguards should be considered and applied as necessary to eliminate the threat or reduce it to an acceptable level.

8.115 If other partners, including partners who do not perform assurance engagements, or their immediate family, in the **office**[*] in which the **lead engagement partner**[*] practices in connection with the audit hold a direct financial interest or a material indirect financial interest in that audit client, the self-interest threat created would be so significant no safeguard could reduce the threat to an acceptable level. Accordingly, such partners or their immediate family should not hold any such financial interests in such an audit client.

8.116 The office in which the lead engagement partner practices in connection with the audit is not necessarily the office to which that partner is assigned. Accordingly, when the lead engagement partner is located in a different office from that of the other members of the assurance team, judgment should be used to determine in which office the partner practices in connection with that audit.

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[*] See Definitions.

8.117 If other partners and managerial employees who provide non-assurance services to the audit client, except those whose involvement is clearly insignificant, or their immediate family, hold a direct financial interest or a material indirect financial interest in the audit client, the self-interest threat created would be so significant no safeguard could reduce the threat to an acceptable level. Accordingly, such personnel or their immediate family should not hold any such financial interests in such an audit client.

8.118 A financial interest in an audit client that is held by an immediate family member of (a) a partner located in the office in which the lead engagement partner practices in connection with the audit, or (b) a partner or managerial employee who provides non-assurance services to the audit client is not considered to create an unacceptable threat provided it is received as a result of their employment rights (e.g., pension rights or share options) and, where necessary, appropriate safeguards are applied to reduce any threat to independence to an acceptable level.

8.119 A self-interest threat may be created if the firm, or the network firm, or a member of the assurance team has an interest in an entity and an audit client, or a director, officer or controlling owner thereof also has an investment in that entity. Independence is not compromised with respect to the audit client if the respective interests of the firm, the network firm, or member of the assurance team, and the audit client, or director, officer or controlling owner thereof are both immaterial and the audit client cannot exercise significant influence over the entity. If an interest is material, to either the firm, the network firm or the audit client, and the audit client can exercise significant influence over the entity, no safeguards are available to reduce the threat to an acceptable level and the firm, or the network firm, should either dispose of the interest or decline the audit engagement. Any member of the assurance team with such a material interest should either:

(a) Dispose of the interest;

(b) Dispose of a sufficient amount of the interest so that the remaining interest is no longer material; or

(c) Withdraw from the audit.

Provisions Applicable to Non-Audit Assurance Clients

8.120 If a firm has a direct financial interest in an assurance client that is not an audit client the self-interest threat created would be so significant no safeguard could reduce the threat to an acceptable level. Consequently, disposal of the financial interest would be the only action appropriate to permit the firm to perform the engagement.

8.121 If a firm has a material indirect financial interest in an assurance client that is not an audit client a self-interest threat is also created. The only action

appropriate to permit the firm to perform the engagement would be for the firm to either dispose of the indirect interest in total or to dispose of a sufficient amount of it so that the remaining interest is no longer material.

8.122 If a firm has a material financial interest in an entity that has a controlling interest in an assurance client that is not an audit client, the self-interest threat created would be so significant no safeguard could reduce the threat to an acceptable level. The only action appropriate to permit the firm to perform the engagement would be for the firm either to dispose of the financial interest in total or to dispose of a sufficient amount of it so that the remaining interest is no longer material.

8.123 When a restricted use report for an assurance engagement that is not an audit engagement is issued, exceptions to the provisions in paragraphs 8.104 through 8.108 and 8.120 through 8.122 are set out in 8.15.

Loans and Guarantees

8.124 A loan from, or a guarantee thereof by, an assurance client that is a bank or a similar institution, to the firm would not create a threat to independence provided the loan is made under normal lending procedures, terms and requirements and the loan is immaterial to both the firm and the assurance client. If the loan is material to the assurance client or the firm it may be possible, through the application of safeguards, to reduce the self-interest threat created to an acceptable level. Such safeguards might include involving an additional professional accountant from outside the firm, or network firm, to review the work performed.

8.125 A loan from, or a guarantee thereof by, an assurance client that is a bank or a similar institution, to a member of the assurance team or their immediate family would not create a threat to independence provided the loan is made under normal lending procedures, terms and requirements. Examples of such loans include home mortgages, bank overdrafts, car loans and credit card balances.

8.126 Similarly, deposits made by, or brokerage accounts of, a firm or a member of the assurance team with an assurance client that is a bank, broker or similar institution would not create a threat to independence provided the deposit or account is held under normal commercial terms.

8.127 If the firm, or a member of the assurance team, makes a loan to an assurance client, that is not a bank or similar institution, or guarantees such an assurance client's borrowing, the self-interest threat created would be so significant no safeguard could reduce the threat to an acceptable level, unless the loan or guarantee is immaterial to both the firm or the member of the assurance team and the assurance client.

8.128 Similarly, if the firm or a member of the assurance team accepts a loan from, or has borrowing guaranteed by, an assurance client that is not a bank or similar institution, the self-interest threat created would be so significant no safeguard could reduce the threat to an acceptable level, unless the loan or guarantee is immaterial to both the firm or the member of the assurance team and the assurance client.

8.129 The examples in paragraphs 8.124 through 8.128 relate to loans and guarantees between the firm and an assurance client. In the case of an audit engagement, the provisions should be applied to the firm, all network firms and the audit client.

Close Business Relationships with Assurance Clients

8.130 A close business relationship between a firm or a member of the assurance team and the assurance client or its management, or between the firm, a network firm and an audit client, will involve a commercial or common financial interest and may create self-interest and intimidation threats. The following are examples of such relationships:

- Having a material financial interest in a joint venture with the assurance client or a controlling owner, director, officer or other individual who performs senior managerial functions for that client.
- Arrangements to combine one or more services or products of the firm with one or more services or products of the assurance client and to market the package with reference to both parties.
- Distribution or marketing arrangements under which the firm acts as a distributor or marketer of the assurance client's products or services, or the assurance client acts as the distributor or marketer of the products or services of the firm.

In the case of an audit client, unless the financial interest is immaterial and the relationship is clearly insignificant to the firm, the network firm and the audit client, no safeguards could reduce the threat to an acceptable level. In the case of an assurance client that is not an audit client, unless the financial interest is immaterial and the relationship is clearly insignificant to the firm and the assurance client, no safeguards could reduce the threat to an acceptable level. Consequently, in both these circumstances the only possible courses of action are to:

(a) Terminate the business relationship;

(b) Reduce the magnitude of the relationship so that the financial interest is immaterial and the relationship is clearly insignificant; or

(c) Refuse to perform the assurance engagement.

Unless any such financial interest is immaterial and the relationship is clearly insignificant to the member of the assurance team, the only appropriate safeguard would be to remove the individual from the assurance team.

8.131 In the case of an audit client, business relationships involving an interest held by the firm, a network firm or a member of the assurance team or their immediate family in a closely held entity when the audit client or a director or officer of the audit client, or any group thereof, also has an interest in that entity, do not create threats to independence provided:

(a) The relationship is clearly insignificant to the firm, the network firm and the audit client;

(b) The interest held is immaterial to the investor, or group of investors; and

(c) The interest does not give the investor, or group of investors, the ability to control the closely held entity.

8.132 The purchase of goods and services from an assurance client by the firm (or from an audit client by a network firm) or a member of the assurance team would not generally create a threat to independence providing the transaction is in the normal course of business and on an arm's length basis. However, such transactions may be of a nature or magnitude so as to create a self-interest threat. If the threat created is other than clearly insignificant, safeguards should be considered and applied as necessary to reduce the threat to an acceptable level. Such safeguards might include:

- Eliminating or reducing the magnitude of the transaction;
- Removing the individual from the assurance team; or
- Discussing the issue with those charged with governance, such as the audit committee.

Family and Personal Relationships

8.133 Family and personal relationships between a member of the assurance team and a director, an officer or certain employees, depending on their role, of the assurance client, may create self-interest, familiarity or intimidation threats. It is impracticable to attempt to describe in detail the significance of the threats that such relationships may create. The significance will depend upon a number of factors including the individual's responsibilities on the assurance engagement, the closeness of the relationship and the role of the family member or other individual within the assurance client. Consequently, there is a wide spectrum of circumstances that will need to be evaluated and safeguards to be applied to reduce the threat to an acceptable level.

8.134 When an immediate family member of a member of the assurance team is a director, an officer or an employee of the assurance client in a position to exert direct and significant influence over the subject matter of the assurance engagement, or was in such a position during any period covered by the engagement, the threats to independence can only be reduced to an acceptable level by removing the individual from the assurance team. The closeness of the relationship is such that no other safeguard could reduce the threat to independence to an acceptable level. If application of this safeguard is not used, the only course of action is to withdraw from the assurance engagement. For example, in the case of an audit of financial statements, if the spouse of a member of the assurance team is an employee in a position to exert direct and significant influence on the preparation of the audit client's accounting records or financial statements, the threat to independence could only be reduced to an acceptable level by removing the individual from the assurance team.

8.135 When a close family member of a member of the assurance team is a director, an officer, or an employee of the assurance client in a position to exert direct and significant influence over the subject matter of the assurance engagement, threats to independence may be created. The significance of the threats will depend on factors such as:

- The position the close family member holds with the client; and
- The role of the professional on the assurance team.

The significance of the threat should be evaluated and, if the threat is other than clearly insignificant, safeguards should be considered and applied as necessary to reduce the threat to an acceptable level. Such safeguards might include:

- Removing the individual from the assurance team;
- Where possible, structuring the responsibilities of the assurance team so that the professional does not deal with matters that are within the responsibility of the close family member; or
- Policies and procedures to empower staff to communicate to senior levels within the firm any issue of independence and objectivity that concerns them.

8.136 In addition, self-interest, familiarity or intimidation threats may be created when a person who is other than an immediate or close family member of a member of the assurance team has a close relationship with the member of the assurance team and is a director, an officer or an employee of the assurance client in a position to exert direct and significant influence over the subject matter of the assurance engagement. Therefore, members of the assurance team are responsible for identifying any such persons and for consulting in accordance with firm procedures. The evaluation of the

significance of any threat created and the safeguards appropriate to eliminate the threat or reduce it to an acceptable level will include considering matters such as the closeness of the relationship and the role of the individual within the assurance client.

8.137 Consideration should be given to whether self-interest, familiarity or intimidation threats may be created by a personal or family relationship between a partner or employee of the firm who is not a member of the assurance team and a director, an officer or an employee of the assurance client in a position to exert direct and significant influence over the subject matter of the assurance engagement. Therefore partners and employees of the firm are responsible for identifying any such relationships and for consulting in accordance with firm procedures. The evaluation of the significance of any threat created and the safeguards appropriate to eliminate the threat or reduce it to an acceptable level will include considering matters such as the closeness of the relationship, the interaction of the firm professional with the assurance team, the position held within the firm, and the role of the individual within the assurance client.

8.138 An inadvertent violation of this section as it relates to family and personal relationships would not impair the independence of a firm or a member of the assurance team when:

(a) The firm has established policies and procedures that require all professionals to report promptly to the firm any breaches resulting from changes in the employment status of their immediate or close family members or other personal relationships that create threats to independence;

(b) Either the responsibilities of the assurance team are re-structured so that the professional does not deal with matters that are within the responsibility of the person with whom he or she is related or has a personal relationship, or, if this is not possible, the firm promptly removes the professional from the assurance engagement; and

(c) Additional care is given to reviewing the work of the professional.

8.139 When an inadvertent violation of this section relating to family and personal relationships has occurred, the firm should consider whether any safeguards should be applied. Such safeguards might include:

- Involving an additional professional accountant who did not take part in the assurance engagement to review the work done by the member of the assurance team; or
- Excluding the individual from any substantive decision-making concerning the assurance engagement.

Employment with Assurance Clients

8.140 A firm or a member of the assurance team's independence may be threatened if a director, an officer or an employee of the assurance client in a position to exert direct and significant influence over the subject matter of the assurance engagement has been a member of the assurance team or partner of the firm. Such circumstances may create self-interest, familiarity and intimidation threats particularly when significant connections remain between the individual and his or her former firm. Similarly, a member of the assurance team's independence may be threatened when an individual participates in the assurance engagement knowing, or having reason to believe, that he or she is to, or may, join the assurance client some time in the future.

8.141 If a member of the assurance team, partner or former partner of the firm has joined the assurance client, the significance of the self-interest, familiarity or intimidation threats created will depend upon the following factors:

(a) The position the individual has taken at the assurance client.

(b) The amount of any involvement the individual will have with the assurance team.

(c) The length of time that has passed since the individual was a member of the assurance team or firm.

(d) The former position of the individual within the assurance team or firm.

The significance of the threat should be evaluated and, if the threat is other than clearly insignificant, safeguards should be considered and applied as necessary to reduce the threat to an acceptable level. Such safeguards might include:

- Considering the appropriateness or necessity of modifying the assurance plan for the assurance engagement;
- Assigning an assurance team to the subsequent assurance engagement that is of sufficient experience in relation to the individual who has joined the assurance client;
- Involving an additional professional accountant who was not a member of the assurance team to review the work done or otherwise advise as necessary; or
- Quality control review of the assurance engagement.

In all cases, all of the following safeguards are necessary to reduce the threat to an acceptable level:

(a) The individual concerned is not entitled to any benefits or payments from the firm unless these are made in accordance with fixed pre-determined arrangements. In addition, any amount owed to the individual should not be of such significance to threaten the firm's independence.

(b) The individual does not continue to participate or appear to participate in the firm's business or professional activities.

8.142 A self-interest threat is created when a member of the assurance team participates in the assurance engagement while knowing, or having reason to believe, that he or she is to, or may, join the assurance client some time in the future. This threat can be reduced to an acceptable level by the application of all of the following safeguards:

(a) Policies and procedures to require the individual to notify the firm when entering serious employment negotiations with the assurance client.

(b) Removal of the individual from the assurance engagement.

In addition, consideration should be given to performing an independent review of any significant judgments made by that individual while on the engagement.

Recent Service with Assurance Clients

8.143 To have a former officer, director or employee of the assurance client serve as a member of the assurance team may create self-interest, self-review and familiarity threats. This would be particularly true when a member of the assurance team has to report on, for example, subject matter he or she had prepared or elements of the financial statements he or she had valued while with the assurance client.

8.144 If, during the period covered by the assurance report, a member of the assurance team had served as an officer or director of the assurance client, or had been an employee in a position to exert direct and significant influence over the subject matter of the assurance engagement, the threat created would be so significant no safeguard could reduce the threat to an acceptable level. Consequently, such individuals should not be assigned to the assurance team.

8.145 If, prior to the period covered by the assurance report, a member of the assurance team had served as an officer or director of the assurance client, or had been an employee in a position to exert direct and significant influence over the subject matter of the assurance engagement, this may create self-interest, self-review and familiarity threats. For example, such threats would be created if a decision made or work performed by the individual in the prior period, while employed by the assurance client, is to

be evaluated in the current period as part of the current assurance engagement. The significance of the threats will depend upon factors such as:

- The position the individual held with the assurance client;
- The length of time that has passed since the individual left the assurance client; and
- The role the individual plays on the assurance team.

The significance of the threat should be evaluated and, if the threat is other than clearly insignificant, safeguards should be considered and applied as necessary to reduce the threat to an acceptable level. Such safeguards might include:

- Involving an additional professional accountant to review the work done by the individual as part of the assurance team or otherwise advise as necessary; or
- Discussing the issue with those charged with governance, such as the audit committee.

Serving as an Officer or Director on the Board of Assurance Clients

8.146 If a partner or employee of the firm serves as an officer or as a director on the board of an assurance client the self-review and self-interest threats created would be so significant no safeguard could reduce the threats to an acceptable level. In the case of an audit engagement, if a partner or employee of a network firm were to serve as an officer or as a director on the board of an audit client the threats created would be so significant no safeguard could reduce the threats to an acceptable level. Consequently, if such an individual were to accept such a position the only course of action is to refuse to perform, or to withdraw from the assurance engagement.

8.147 The position of Company Secretary has different implications in different jurisdictions. The duties may range from administrative duties such as personnel management and the maintenance of company records and registers, to duties as diverse as ensuring that the company complies with regulations or providing advice on corporate governance matters. Generally this position is seen to imply a close degree of association with the entity and may create self-review and advocacy threats.

8.148 If a partner or employee of the firm or a network firm serves as Company Secretary for an audit client the self-review and advocacy threats created would generally be so significant, no safeguard could reduce the threat to an acceptable level. When the practice is specifically permitted under local law, professional rules or practice, the duties and functions undertaken

should be limited to those of a routine and formal administrative nature such as the preparation of minutes and maintenance of statutory returns.

8.149 Routine administrative services to support a company secretarial function or advisory work in relation to company secretarial administration matters is generally not perceived to impair independence, provided client management makes all relevant decisions.

Long Association of Senior Personnel with Assurance Clients

General Provisions

8.150 Using the same senior personnel on an assurance engagement over a long period of time may create a familiarity threat. The significance of the threat will depend upon factors such as:

- The length of time that the individual has been a member of the assurance team;
- The role of the individual on the assurance team;
- The structure of the firm; and
- The nature of the assurance engagement.

The significance of the threat should be evaluated and, if the threat is other than clearly insignificant, safeguards should be considered and applied to reduce the threat to an acceptable level. Such safeguards might include:

- Rotating the senior personnel off the assurance team;
- Involving an additional professional accountant who was not a member of the assurance team to review the work done by the senior personnel or otherwise advise as necessary; or
- Independent internal quality reviews.

Audit Clients that are Listed Entities[2]

8.151 Using the same lead engagement partner on an audit over a prolonged period may create a familiarity threat. This threat is particularly relevant in the context of the audit of listed entities and safeguards should be applied in such situations to reduce such threat to an acceptable level. Accordingly for the audit of listed entities:

(a) The lead engagement partner should be rotated after a pre-defined period, normally no more than seven years; and

[2] See also Interpretation 2003-02 on page 797.

(b) A partner rotating after a pre-defined period should not participate in the audit engagement until a further period of time, normally two years, has elapsed.

8.152 When an audit client becomes a listed entity the length of time the lead engagement partner has served the audit client in that capacity should be considered in determining when the partner should be rotated. However, the partner may continue to serve as the lead engagement partner for two additional years before rotating off the engagement.

8.153 While the lead engagement partner should be rotated after such a pre-defined period, some degree of flexibility over timing of rotation may be necessary in certain circumstances. Examples of such circumstances include:

- Situations when the lead engagement partner's continuity is especially important to the audit client, for example, when there will be major changes to the audit client's structure that would otherwise coincide with the rotation of the lead engagement partner; and
- Situations when, due to the size of the firm, rotation is not possible or does not constitute an appropriate safeguard.

In all such circumstances when the lead engagement partner is not rotated after such a pre-defined period equivalent safeguards should be applied to reduce any threats to an acceptable level.

8.154 When a firm has only a few audit partners with the necessary knowledge and experience to serve as lead engagement partner on an audit client that is a listed entity, rotation of the lead partner may not be an appropriate safeguard. In these circumstances the firm should apply other safeguards to reduce the threat to an acceptable level. Such safeguards would include involving an additional professional accountant who was not otherwise associated with the assurance team to review the work done or otherwise advise as necessary. This individual could be someone from outside the firm or someone within the firm who was not otherwise associated with the assurance team.

Provision of Non-Assurance Services to Assurance Clients[3]

8.155 Firms have traditionally provided to their assurance clients a range of non-assurance services that are consistent with their skills and expertise. Assurance clients value the benefits that derive from having these firms, who have a good understanding of the business, bring their knowledge and skill to bear in other areas. Furthermore, the provision of such non-assurance services will often result in the assurance team obtaining

[3] See also Interpretation 2003-01 on page 797.

information regarding the assurance client's business and operations that is helpful in relation to the assurance engagement. The greater the knowledge of the assurance client's business, the better the assurance team will understand the assurance client's procedures and controls, and the business and financial risks that it faces. The provision of non-assurance services may, however, create threats to the independence of the firm, a network firm or the members of the assurance team, particularly with respect to perceived threats to independence. Consequently, it is necessary to evaluate the significance of any threat created by the provision of such services. In some cases it may be possible to eliminate or reduce the threat created by application of safeguards. In other cases no safeguards are available to reduce the threat to an acceptable level.

8.156 The following activities would generally create self-interest or self-review threats that are so significant that only avoidance of the activity or refusal to perform the assurance engagement would reduce the threats to an acceptable level:

- Authorizing, executing or consummating a transaction, or otherwise exercising authority on behalf of the assurance client, or having the authority to do so.
- Determining which recommendation of the firm should be implemented.
- Reporting, in a management role, to those charged with governance.

8.157 The examples set out in paragraphs 8.163 through 8.202 are addressed in the context of the provision of non-assurance services to an assurance client. The potential threats to independence will most frequently arise when a non-assurance service is provided to an audit client. The financial statements of an entity provide financial information about a broad range of transactions and events that have affected the entity. The subject matter of other assurance services, however, may be limited in nature. Threats to independence, however, may also arise when a firm provides a non-assurance service related to the subject matter of a non-audit assurance engagement. In such cases, consideration should be given to the significance of the firm's involvement with the subject matter of the non-audit assurance engagement, whether any self-review threats are created and whether any threats to independence could be reduced to an acceptable level by application of safeguards, or whether the non-assurance engagement should be declined. When the non-assurance service is not related to the subject matter of the non-audit assurance engagement, the threats to independence will generally be clearly insignificant.

8.158 The following activities may also create self-review or self-interest threats:

- Having custody of an assurance client's assets.

- Supervising assurance client employees in the performance of their normal recurring activities.
- Preparing source documents or originating data, in electronic or other form, evidencing the occurrence of a transaction (for example, purchase orders, payroll time records, and customer orders).

The significance of any threat created should be evaluated and, if the threat is other than clearly insignificant, safeguards should be considered and applied as necessary to eliminate the threat or reduce it to an acceptable level. Such safeguards might include:

- Making arrangements so that personnel providing such services do not participate in the assurance engagement;
- Involving an additional professional accountant to advise on the potential impact of the activities on the independence of the firm and the assurance team; or
- Other relevant safeguards set out in national regulations.

8.159 New developments in business, the evolution of financial markets, rapid changes in information technology, and the consequences for management and control, make it impossible to draw up an all-inclusive list of all situations when providing non-assurance services to an assurance client might create threats to independence and of the different safeguards that might eliminate these threats or reduce them to an acceptable level. In general, however, a firm may provide services beyond the assurance engagement provided any threats to independence have been reduced to an acceptable level.

8.160 The following safeguards may be particularly relevant in reducing to an acceptable level threats created by the provision of non-assurance services to assurance clients:

- Policies and procedures to prohibit professional staff from making management decisions for the assurance client, or assuming responsibility for such decisions.
- Discussing independence issues related to the provision of non-assurance services with those charged with governance, such as the audit committee.
- Policies within the assurance client regarding the oversight responsibility for provision of non-assurance services by the firm.
- Involving an additional professional accountant to advise on the potential impact of the non-assurance engagement on the independence of the member of the assurance team and the firm.

- Involving an additional professional accountant outside of the firm to provide assurance on a discrete aspect of the assurance engagement.
- Obtaining the assurance client's acknowledgement of responsibility for the results of the work performed by the firm.
- Disclosing to those charged with governance, such as the audit committee, the nature and extent of fees charged.
- Making arrangements so that personnel providing non-assurance services do not participate in the assurance engagement.

8.161 Before the firm accepts an engagement to provide a non-assurance service to an assurance client, consideration should be given to whether the provision of such a service would create a threat to independence. In situations when a threat created is other than clearly insignificant, the non-assurance engagement should be declined unless appropriate safeguards can be applied to eliminate the threat or reduce it to an acceptable level.

8.162 The provision of certain non-assurance services to audit clients may create threats to independence so significant that no safeguard could eliminate the threat or reduce it to an acceptable level. However, the provision of such services to a related entity, division or discrete financial statement item of such clients may be permissible when any threats to the firm's independence have been reduced to an acceptable level by arrangements for that related entity, division or discrete financial statement item to be audited by another firm or when another firm re-performs the non-assurance service to the extent necessary to enable it to take responsibility for that service.

Preparing Accounting Records and Financial Statements

8.163 Assisting an audit client in matters such as preparing accounting records or financial statements may create a self-review threat when the financial statements are subsequently audited by the firm.

8.164 It is the responsibility of client management to ensure that accounting records are kept and financial statements are prepared, although they may request the firm to provide assistance. If firm, or network firm, personnel providing such assistance make management decisions, the self-review threat created could not be reduced to an acceptable level by any safeguards. Consequently, personnel should not make such decisions. Examples of such managerial decisions include:

- Determining or changing journal entries, or the classifications for accounts or transaction or other accounting records without obtaining the approval of the audit client;
- Authorizing or approving transactions; and

- Preparing source documents or originating data (including decisions on valuation assumptions), or making changes to such documents or data.

8.165 The audit process involves extensive dialogue between the firm and management of the audit client. During this process, management requests and receives significant input regarding such matters as accounting principles and financial statement disclosure, the appropriateness of controls and the methods used in determining the stated amounts of assets and liabilities. Technical assistance of this nature and advice on accounting principles for audit clients are an appropriate means to promote the fair presentation of the financial statements. The provision of such advice does not generally threaten the firm's independence. Similarly, the audit process may involve assisting an audit client in resolving account reconciliation problems, analyzing and accumulating information for regulatory reporting, assisting in the preparation of consolidated financial statements (including the translation of local statutory accounts to comply with group accounting policies and the transition to a different reporting framework such as International Financial Reporting Standards), drafting disclosure items, proposing adjusting journal entries and providing assistance and advice in the preparation of local statutory accounts of subsidiary entities. These services are considered to be a normal part of the audit process and do not, under normal circumstances, threaten independence.

General Provisions

8.166 The examples in paragraphs 8.167 through 8.170 indicate that self-review threats may be created if the firm is involved in the preparation of accounting records or financial statements and those financial statements are subsequently the subject matter of an audit engagement of the firm. This notion may be equally applicable in situations when the subject matter of the assurance engagement is not financial statements. For example, a self-review threat would be created if the firm developed and prepared prospective financial information and subsequently provided assurance on this prospective financial information. Consequently, the firm should evaluate the significance of any self-review threat created by the provision of such services. If the self-review threat is other than clearly insignificant safeguards should be considered and applied as necessary to reduce the threat to an acceptable level.

Audit Clients that are Not Listed Entities

8.167 The firm, or a network firm, may provide an audit client that is not a listed entity with accounting and bookkeeping services, including payroll services, of a routine or mechanical nature, provided any self-review threat created is reduced to an acceptable level. Examples of such services include:

- Recording transactions for which the audit client has determined or approved the appropriate account classification;
- Posting coded transactions to the audit client's general ledger;
- Preparing financial statements based on information in the trial balance; and
- Posting audit client approved entries to the trial balance.

The significance of any threat created should be evaluated and, if the threat is other than clearly insignificant, safeguards should be considered and applied as necessary to reduce the threat to an acceptable level. Such safeguards might include:

- Making arrangements so such services are not performed by a member of the assurance team;
- Implementing policies and procedures to prohibit the individual providing such services from making any managerial decisions on behalf of the audit client;
- Requiring the source data for the accounting entries to be originated by the audit client;
- Requiring the underlying assumptions to be originated and approved by the audit client; or
- Obtaining audit client approval for any proposed journal entries or other changes affecting the financial statements.

Audit Clients that are Listed Entities

8.168 The provision of accounting and bookkeeping services, including payroll services and the preparation of financial statements or financial information which forms the basis of the financial statements on which the audit report is provided, on behalf of an audit client that is a listed entity, may impair the independence of the firm or network firm, or at least give the appearance of impairing independence. Accordingly, no safeguard other than the prohibition of such services, except in emergency situations and when the services fall within the statutory audit mandate, could reduce the threat created to an acceptable level. Therefore, a firm or a network firm should not, with the limited exceptions below, provide such services to listed entities which are audit clients.

8.169 The provision of accounting and bookkeeping services of a routine or mechanical nature to divisions or subsidiaries of listed audit clients would not be seen as impairing independence with respect to the audit client provided that the following conditions are met:

(a) The services do not involve the exercise of judgment.

(b) The divisions or subsidiaries for which the service is provided are collectively immaterial to the audit client, or the services provided are collectively immaterial to the division or subsidiary.

(c) The fees to the firm, or network firm, from such services are collectively clearly insignificant.

If such services are provided, all of the following safeguards should be applied:

(a) The firm, or network firm, should not assume any managerial role nor make any managerial decisions.

(b) The listed audit client should accept responsibility for the results of the work.

(c) Personnel providing the services should not participate in the audit.

Emergency Situations

8.170 The provision of accounting and bookkeeping services to audit clients in emergency or other unusual situations, when it is impractical for the audit client to make other arrangements, would not be considered to pose an unacceptable threat to independence provided:

(a) The firm, or network firm, does not assume any managerial role or make any managerial decisions;

(b) The audit client accepts responsibility for the results of the work; and

(c) Personnel providing the services are not members of the assurance team.

Valuation Services

8.171 A valuation comprises the making of assumptions with regard to future developments, the application of certain methodologies and techniques, and the combination of both in order to compute a certain value, or range of values, for an asset, a liability or for a business as a whole.

8.172 A self-review threat may be created when a firm or network firms performs a valuation for an audit client that is to be incorporated into the client's financial statements.

8.173 If the valuation service involves the valuation of matters material to the financial statements and the valuation involves a significant degree of subjectivity, the self-review threat created could not be reduced to an acceptable level by the application of any safeguard. Accordingly, such valuation services should not be provided or, alternatively, the only course of action would be to withdraw from the audit engagement.

8.174 Performing valuation services that are neither separately, nor in the aggregate, material to the financial statements, or that do not involve a significant degree of subjectivity, may create a self-review threat that could be reduced to an acceptable level by the application of safeguards. Such safeguards might include:

- Involving an additional professional accountant who was not a member of the assurance team to review the work done or otherwise advise as necessary;
- Confirming with the audit client their understanding of the underlying assumptions of the valuation and the methodology to be used and obtaining approval for their use;
- Obtaining the audit client's acknowledgement of responsibility for the results of the work performed by the firm; and
- Making arrangements so that personnel providing such services do not participate in the audit engagement.

In determining whether the above safeguards would be effective, consideration should be given to the following matters:

(a) The extent of the audit client's knowledge, experience and ability to evaluate the issues concerned, and the extent of their involvement in determining and approving significant matters of judgment.

(b) The degree to which established methodologies and professional guidelines are applied when performing a particular valuation service.

(c) For valuations involving standard or established methodologies, the degree of subjectivity inherent in the item concerned.

(d) The reliability and extent of the underlying data.

(e) The degree of dependence on future events of a nature which could create significant volatility inherent in the amounts involved.

(f) The extent and clarity of the disclosures in the financial statements.

8.175 When a firm, or a network firm, performs a valuation service for an audit client for the purposes of making a filing or return to a tax authority, computing an amount of tax due by the assurance client, or for the purpose of tax planning, this would not create a significant threat to independence because such valuations are generally subject to external review, for example by a tax authority.

8.176 When the firm performs a valuation that forms part of the subject matter of an assurance engagement that is not an audit engagement, the firm should consider any self-review threats. If the threat is other than clearly

insignificant, safeguards should be considered and applied as necessary to eliminate the threat or reduce it to an acceptable level.

Provision of Taxation Services to Audit Clients

8.177 In many jurisdictions, the firm may be asked to provide taxation services to an audit client. Taxation services comprise a broad range of services, including compliance, planning, provision of formal taxation opinions and assistance in the resolution of tax disputes. Such assignments are generally not seen to create threats to independence.

Provision of Internal Audit Services to Audit Clients

8.178 A self-review threat may be created when a firm, or network firm, provides internal audit services to an audit client. Internal audit services may comprise an extension of the firm's audit service beyond requirements of generally accepted auditing standards, assistance in the performance of a client's internal audit activities or outsourcing of the activities. In evaluating any threats to independence, the nature of the service will need to be considered. For this purpose, internal audit services do not include operational internal audit services unrelated to the internal accounting controls, financial systems or financial statements.

8.179 Services involving an extension of the procedures required to conduct an audit in accordance with International Standards on Auditing would not be considered to impair independence with respect to an audit client provided that the firm's or network firm's personnel do not act or appear to act in a capacity equivalent to a member of audit client management.

8.180 When the firm, or a network firm, provides assistance in the performance of a client's internal audit activities or undertakes the outsourcing of some of the activities, any self-review threat created may be reduced to an acceptable level by ensuring that there is a clear separation between the management and control of the internal audit by audit client management and the internal audit activities themselves.

8.181 Performing a significant portion of the audit client's internal audit activities may create a self-review threat and a firm, or network firm, should consider the threats and proceed with caution before taking on such activities. Appropriate safeguards should be put in place and the firm, or network firm, should, in particular, ensure that the audit client acknowledges its responsibilities for establishing, maintaining and monitoring the system of internal controls.

8.182 Safeguards that should be applied in all circumstances to reduce any threats created to an acceptable level include ensuring that:

(a) The audit client is responsible for internal audit activities and acknowledges its responsibility for establishing, maintaining and monitoring the system of internal controls;

(b) The audit client designates a competent employee, preferably within senior management, to be responsible for internal audit activities;

(c) The audit client, the audit committee or supervisory body approves the scope, risk and frequency of internal audit work;

(d) The audit client is responsible for evaluating and determining which recommendations of the firm should be implemented;

(e) The audit client evaluates the adequacy of the internal audit procedures performed and the findings resulting from the performance of those procedures by, among other things, obtaining and acting on reports from the firm; and

(f) The findings and recommendations resulting from the internal audit activities are reported appropriately to the audit committee or supervisory body.

8.183 Consideration should also be given to whether such non-assurance services should be provided only by personnel not involved in the audit engagement and with different reporting lines within the firm.

Provision of IT Systems Services to Audit Clients

8.184 The provision of services by a firm or network firm to an audit client that involve the design and implementation of financial information technology systems that are used to generate information forming part of a client's financial statements may create a self-review threat.

8.185 The self-review threat is likely to be too significant to allow the provision of such services to an audit client unless appropriate safeguards are put in place ensuring that:

(a) The audit client acknowledges its responsibility for establishing and monitoring a system of internal controls;

(b) The audit client designates a competent employee, preferably within senior management, with the responsibility to make all management decisions with respect to the design and implementation of the hardware or software system;

(c) The audit client makes all management decisions with respect to the design and implementation process;

(d) The audit client evaluates the adequacy and results of the design and implementation of the system; and

(e) The audit client is responsible for the operation of the system (hardware or software) and the data used or generated by the system.

8.186 Consideration should also be given to whether such non-assurance services should be provided only by personnel not involved in the audit engagement and with different reporting lines within the firm.

8.187 The provision of services by a firm, or network firm, to an audit client which involve either the design or the implementation of financial information technology systems that are used to generate information forming part of a client's financial statements may also create a self-review threat. The significance of the threat, if any, should be evaluated and, if the threat is other than clearly insignificant, safeguards should be considered and applied as necessary to eliminate the threat or reduce it to an acceptable level.

8.188 The provision of services in connection with the assessment, design and implementation of internal accounting controls and risk management controls are not considered to create a threat to independence provided that firm or network firm personnel do not perform management functions.

Temporary Staff Assignments to Audit Clients

8.189 The lending of staff by a firm, or network firm, to an audit client may create a self-review threat when the individual is in a position to influence the preparation of a client's accounts or financial statements. In practice, such assistance may be given (particularly in emergency situations) but only on the understanding that the firm's or network firm's personnel will not be involved in:

(a) Making management decisions;

(b) Approving or signing agreements or other similar documents; or

(c) Exercising discretionary authority to commit the client.

Each situation should be carefully analyzed to identify whether any threats are created and whether appropriate safeguards should be implemented. Safeguards that should be applied in all circumstances to reduce any threats to an acceptable level include:

- The staff providing the assistance should not be given audit responsibility for any function or activity that they performed or supervised during their temporary staff assignment; and
- The audit client should acknowledge its responsibility for directing and supervising the activities of firm, or network firm, personnel.

Provision of Litigation Support Services to Audit Clients

8.190 Litigation support services may include such activities as acting as an expert witness, calculating estimated damages or other amounts that might become receivable or payable as the result of litigation or other legal dispute, and assistance with document management and retrieval in relation to a dispute or litigation.

8.191 A self-review threat may be created when the litigation support services provided to an audit client include the estimation of the possible outcome and thereby affects the amounts or disclosures to be reflected in the financial statements. The significance of any threat created will depend upon factors such as:

- The materiality of the amounts involved;
- The degree of subjectivity inherent in the matter concerned; and
- The nature of the engagement.

The firm, or network firm, should evaluate the significance of any threat created and, if the threat is other than clearly insignificant, safeguards should be considered and applied as necessary to eliminate the threat or reduce it to an acceptable level. Such safeguards might include:

- Policies and procedures to prohibit individuals assisting the audit client from making managerial decisions on behalf of the client;
- Using professionals who are not members of the assurance team to perform the service; or
- The involvement of others, such as independent experts.

8.192 If the role undertaken by the firm or network firm involved making managerial decisions on behalf of the audit client, the threats created could not be reduced to an acceptable level by the application of any safeguard. Therefore, the firm or network firm should not perform this type of service for an audit client.

Provision of Legal Services to Audit Clients

8.193 Legal services are defined as any services for which the person providing the services must either be admitted to practice before the Courts of the jurisdiction in which such services are to be provided, or have the required legal training to practice law. Legal services encompass a wide and diversified range of areas including both corporate and commercial services to clients, such as contract support, litigation, mergers and acquisition advice and support and the provision of assistance to clients' internal legal departments. The provision of legal services by a firm, or network firm, to

an entity that is an audit client may create both self-review and advocacy threats.

8.194 Threats to independence need to be considered depending on the nature of the service to be provided, whether the service provider is separate from the assurance team and the materiality of any matter in relation to the entities' financial statements. The safeguards set out in paragraph 8.160 may be appropriate in reducing any threats to independence to an acceptable level. In circumstances when the threat to independence cannot be reduced to an acceptable level the only available action is to decline to provide such services or withdraw from the audit engagement.

8.195 The provision of legal services to an audit client which involve matters that would not be expected to have a material effect on the financial statements are not considered to create an unacceptable threat to independence.

8.196 There is a distinction between advocacy and advice. Legal services to support an audit client in the execution of a transaction (e.g., contract support, legal advice, legal due diligence and restructuring) may create self-review threats; however, safeguards may be available to reduce these threats to an acceptable level. Such a service would not generally impair independence, provided that:

(a) Members of the assurance team are not involved in providing the service; and

(b) In relation to the advice provided, the audit client makes the ultimate decision or, in relation to the transactions, the service involves the execution of what has been decided by the audit client.

8.197 Acting for an audit client in the resolution of a dispute or litigation in such circumstances when the amounts involved are material in relation to the financial statements of the audit client would create advocacy and self-review threats so significant no safeguard could reduce the threat to an acceptable level. Therefore, the firm should not perform this type of service for an audit client.

8.198 When a firm is asked to act in an advocacy role for an audit client in the resolution of a dispute or litigation in circumstances when the amounts involved are not material to the financial statements of the audit client, the firm should evaluate the significance of any advocacy and self-review threats created and, if the threat is other than clearly insignificant, safeguards should be considered and applied as necessary to eliminate the threat or reduce it to an acceptable level. Such safeguards might include:

- Policies and procedures to prohibit individuals assisting the audit client from making managerial decisions on behalf of the client; or

- Using professionals who are not members of the assurance team to perform the service.

8.199 The appointment of a partner or an employee of the firm or network firm as General Counsel for legal affairs to an audit client would create self-review and advocacy threats that are so significant no safeguards could reduce the threats to an acceptable level. The position of General Counsel is generally a senior management position with broad responsibility for the legal affairs of a company and consequently, no member of the firm or network firm should accept such an appointment for an audit client.

Recruiting Senior Management

8.200 The recruitment of senior management for an assurance client, such as those in a position to affect the subject of the assurance engagement, may create current or future self-interest, familiarity and intimidation threats. The significance of the threat will depend upon factors such as:

- The role of the person to be recruited; and
- The nature of the assistance sought.

The firm could generally provide such services as reviewing the professional qualifications of a number of applicants and provide advice on their suitability for the post. In addition, the firm could generally produce a short-list of candidates for interview, provided it has been drawn up using criteria specified by the assurance client.

The significance of the threat created should be evaluated and, if the threat is other than clearly insignificant, safeguards should be considered and applied as necessary to reduce the threat to an acceptable level. In all cases, the firm should not make management decisions and the decision as to whom to hire should be left to the client.

Corporate Finance and Similar Activities

8.201 The provision of corporate finance services, advice or assistance to an assurance client may create advocacy and self-review threats. In the case of certain corporate finance services, the independence threats created would be so significant no safeguards could be applied to reduce the threats to an acceptable level. For example, promoting, dealing in, or underwriting of an assurance client's shares is not compatible with providing assurance services. Moreover, committing the assurance client to the terms of a transaction or consummating a transaction on behalf of the client would create a threat to independence so significant no safeguard could reduce the threat to an acceptable level. In the case of an audit client the provision of those corporate finance services referred to above by a firm or a network firm would create a threat to independence so significant no safeguard could reduce the threat to an acceptable level.

8.202 Other corporate finance services may create advocacy or self-review threats; however, safeguards may be available to reduce these threats to an acceptable level. Examples of such services include assisting a client in developing corporate strategies, assisting in identifying or introducing a client to possible sources of capital that meet the client specifications or criteria, and providing structuring advice and assisting a client in analyzing the accounting effects of proposed transactions. Safeguards that should be considered include:

- Policies and procedures to prohibit individuals assisting the assurance client from making managerial decisions on behalf of the client;
- Using professionals who are not members of the assurance team to provide the services; and
- Ensuring the firm does not commit the assurance client to the terms of any transaction or consummate a transaction on behalf of the client.

Fees and Pricing

Fees—Relative Size

8.203 When the total fees generated by an assurance client represent a large proportion of a firm's total fees, the dependence on that client or client group and concern about the possibility of losing the client may create a self-interest threat. The significance of the threat will depend upon factors such as:

- The structure of the firm; and
- Whether the firm is well established or newly created.

The significance of the threat should be evaluated and, if the threat is other than clearly insignificant, safeguards should be considered and applied as necessary to reduce the threat to an acceptable level. Such safeguards might include:

- Discussing the extent and nature of fees charged with the audit committee, or others charged with governance;
- Taking steps to reduce dependency on the client;
- External quality control reviews; and
- Consulting a third party, such as a professional regulatory body or another professional accountant.

8.204 A self-interest threat may also be created when the fees generated by the assurance client represent a large proportion of the revenue of an individual partner. The significance of the threat should be evaluated and, if the threat is other than clearly insignificant, safeguards should be considered and

applied as necessary to reduce the threat to an acceptable level. Such safeguards might include:

- Policies and procedures to monitor and implement quality control of assurance engagements; and
- Involving an additional professional accountant who was not a member of the assurance team to review the work done or otherwise advise as necessary.

Fees—Overdue

8.205 A self-interest threat may be created if fees due from an assurance client for professional services remain unpaid for a long time, especially if a significant part is not paid before the issue of the assurance report for the following year. Generally the payment of such fees should be required before the report is issued. The following safeguards may be applicable:

- Discussing the level of outstanding fees with the audit committee, or others charged with governance.
- Involving an additional professional accountant who did not take part in the assurance engagement to provide advice or review the work performed.

The firm should also consider whether the overdue fees might be regarded as being equivalent to a loan to the client and whether, because of the significance of the overdue fees, it is appropriate for the firm to be re-appointed.

Pricing

8.206 When a firm obtains an assurance engagement at a significantly lower fee level than that charged by the predecessor firm, or quoted by other firms, the self-interest threat created will not be reduced to an acceptable level unless:

(a) The firm is able to demonstrate that appropriate time and qualified staff are assigned to the task; and

(b) All applicable assurance standards, guidelines and quality control procedures are being complied with.

Contingent Fees

8.207 Contingent fees are fees calculated on a predetermined basis relating to the outcome or result of a transaction or the result of the work performed. For the purposes of this section, fees are not regarded as being contingent if a court or other public authority has established them.

8.208 A contingent fee charged by a firm in respect of an assurance engagement creates self-interest and advocacy threats that cannot be reduced to an acceptable level by the application of any safeguard. Accordingly, a firm should not enter into any fee arrangement for an assurance engagement under which the amount of the fee is contingent on the result of the assurance work or on items that are the subject matter of the assurance engagement.

8.209 A contingent fee charged by a firm in respect of a non-assurance service provided to an assurance client may also create self-interest and advocacy threats. If the amount of the fee for a non-assurance engagement was agreed to, or contemplated, during an assurance engagement and was contingent on the result of that assurance engagement, the threats could not be reduced to an acceptable level by the application of any safeguard. Accordingly, the only acceptable action is not to accept such arrangements. For other types of contingent fee arrangements, the significance of the threats created will depend on factors such as:

- The range of possible fee amounts;
- The degree of variability;
- The basis on which the fee is to be determined;
- Whether the outcome or result of the transaction is to be reviewed by an independent third party; and
- The effect of the event or transaction on the assurance engagement.

The significance of the threats should be evaluated and, if the threats are other than clearly insignificant, safeguards should be considered and applied as necessary to reduce the threats to an acceptable level. Such safeguards might include:

- Disclosing to the audit committee, or others charged with governance, the extent and nature of fees charged;
- Review or determination of the final fee by an unrelated third party; or
- Quality and control policies and procedures.

Gifts and Hospitality

8.210 Accepting gifts or hospitality from an assurance client may create self-interest and familiarity threats. When a firm or a member of the assurance team accepts gifts or hospitality, unless the value is clearly insignificant, the threats to independence cannot be reduced to an acceptable level by the application of any safeguard. Consequently, a firm or a member of the assurance team should not accept such gifts or hospitality.

Actual or Threatened Litigation

8.211 When litigation takes place, or appears likely, between the firm or a member of the assurance team and the assurance client, a self-interest or intimidation threat may be created. The relationship between client management and the members of the assurance team must be characterized by complete candor and full disclosure regarding all aspects of a client's business operations. The firm and the client's management may be placed in adversarial positions by litigation, affecting management's willingness to make complete disclosures and the firm may face a self-interest threat. The significance of the threat created will depend upon such factors as:

- The materiality of the litigation;
- The nature of the assurance engagement; and
- Whether the litigation relates to a prior assurance engagement.

Once the significance of the threat has been evaluated the following safeguards should be applied, if necessary, to reduce the threats to an acceptable level:

(a) Disclosing to the audit committee, or others charged with governance, the extent and nature of the litigation;

(b) If the litigation involves a member of the assurance team, removing that individual from the assurance team; or

(c) Involving an additional professional accountant in the firm who was not a member of the assurance team to review the work done or otherwise advise as necessary.

If such safeguards do not reduce the threat to an appropriate level, the only appropriate action is to withdraw from, or refuse to accept, the assurance engagement.

Section 8 Interpretations

These interpretations are directed towards the application of the IFAC *Code of Ethics for Professional Accountants* to the topics of the specific queries received. Those subject to the regulations of other authoritative bodies, such as the US Securities and Exchange Commission, may wish to consult with them for their positions on these matters.

Interpretation 2003-01

The Provision of Non-Assurance Services to Assurance Clients

The *Code of Ethics for Professional Accountants* addresses the issue of the provision of non assurance services to assurance clients in paragraphs 8.155-8.202 inclusive. The Code does not currently include any transitional provisions relating to the requirements set out in these paragraphs however the Ethics Committee[4] has concluded that it is appropriate to allow a transitional period of one year, during which existing contracts to provide non assurance services for assurance clients may be completed if additional safeguards are put in place to reduce any threat to independence to an insignificant level. This transitional period commences on December 31, 2004 (or from the date of implementation of the Code for members of those IFAC member bodies which have adopted an earlier implementation date).

Interpretation 2003-02

Lead Engagement Partner Rotation for Audit Clients that are Listed Entities

The *Code of Ethics for Professional Accountants* addresses the issue of engagement partner rotation for financial statement audit clients that are listed entities in paragraphs 8.151-8.154.

The paragraphs state that in the financial statement audit of a listed entity the engagement partner should be rotated after serving in that capacity for a pre-defined period, normally no more than seven years. They also state that some degree of flexibility in timing of rotation may be necessary in certain circumstances. The Ethics Committee[5] believes that the implementation (or early adoption) of the Code constitutes an example of a circumstance in which some degree of flexibility over timing of rotation may be necessary.

The Code does not currently include any transitional provisions relating to these requirements. However, the Ethics Committee[6] has concluded that it is appropriate to allow a transitional period of two years. Consequently, on

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[4] Now referred to as the International Ethics Standards Board for Accountants.

[5] See footnote 4.

[6] See footnote 4.

implementation or early adoption of the Code, while the length of time the engagement partner has served the financial statement audit client in that capacity should be considered in determining when rotation should occur, the partner may continue to serve as the engagement partner for two additional years from the date of implementation (or early adoption) before rotating off the engagement. In such circumstances, the additional requirements of paragraph 8.153 to apply equivalent safeguards in order to reduce any threats to an acceptable level should be followed.

SECTION 9

Professional Competence and Responsibilities Regarding the Use of Non-Accountants

9.1 Professional accountants in public practice should refrain from agreeing to perform professional services which they are not competent to carry out unless competent advice and assistance is obtained so as to enable them to satisfactorily perform such services. If a professional accountant does not have the competence to perform a specific part of the professional service, technical advice may be sought from experts such as other professional accountants, lawyers, actuaries, engineers, geologists, valuers.

9.2 In such situations, although the professional accountant is relying on the technical competence of the expert, the knowledge of the ethical requirements cannot be automatically assumed. Since the ultimate responsibility for the professional service rests with the professional accountant, the professional accountant should see that the requirements of ethical behavior are followed.

9.3 When using the services of experts who are not professional accountants, the professional accountant must take steps to see that such experts are aware of ethical requirements. Primary attention should be paid to the fundamental principles in paragraph 16 of the Introduction to this Code. These principles would extend to any assignment in which such experts would participate.

9.4 The degree of supervision and the amount of guidance that will be needed will depend upon the individuals involved and the nature of the engagement. Examples of such guidance and supervision might include:

- Asking individuals to read the appropriate ethical codes;
- Requiring written confirmation of understanding of the ethical requirements; and
- Providing consultation when potential conflicts arise.

9.5 The professional accountant should also be alert to specific independence requirements or other risks unique to the engagement. Such situations will require special attention and guidance/supervision to see that ethical requirements are met. For example, Section 8 of this Code requires all professionals participating in the assurance engagement to be independent of the assurance client.

9.6 If at any time the professional accountant is not satisfied that proper ethical behavior can be respected or assured, the engagement should not be accepted; or, if the engagement has commenced, it should be terminated.

SECTION 10

Fees and Commissions

10.1 Professional accountants in public practice who undertake professional services for a client, assume the responsibility to perform such services with integrity and objectivity and in accordance with the appropriate technical standards. That responsibility is discharged by applying the professional skill and knowledge which professional accountants in public practice have acquired through training and experience. For the services rendered, the **professional accountant in public practice*** is entitled to remuneration.

Professional Fees

10.2 Professional fees should be a fair reflection of the value of the professional services performed for the client, taking into account:

(a) The skill and knowledge required for the type of professional services involved;

(b) The level of training and experience of the persons necessarily engaged in performing the professional services;

(c) The time necessarily occupied by each person engaged in performing the professional services; and

(d) The degree of responsibility that performing those services entails.

10.3 Professional fees should normally be computed on the basis of appropriate rates per hour or per day for the time of each person engaged in performing professional services. These rates should be based on the fundamental premise that the organization and conduct of the professional accountant in public practice and the services provided to clients are well planned, controlled and managed. They should take into account the factors set out in paragraph 10.2 and are influenced by the legal, social and economic conditions of each country. It is for each professional accountant in public practice to determine the appropriate rates.

10.4 A professional accountant in public practice should not make a representation that specific professional services in current or future periods will be performed for either a stated fee, estimated fee, or fee range if it is likely at the time of the representation that such fees will be substantially increased and the prospective client is not advised of that likelihood.

10.5 When performing professional services for a client it may be necessary or expedient to charge a pre-arranged fee, in which event the professional

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* See Definitions.

accountant in public practice should estimate a fee taking into account the matters referred to in paragraphs 10.2 through 10.4.

10.6 It is not improper for a professional accountant in public practice to charge a client a lower fee than has previously been charged for similar services, provided the fee has been calculated in accordance with the factors referred to in paragraphs 10.2 through 10.4.

Commentary

The fact that a professional accountant in public practice secures work by quoting a fee lower than another is not improper. However, professional accountants in public practice who obtain work at fees significantly lower than those charged by an **existing accountant,*** or quoted by others, should be aware that there is a risk of a perception that the quality of work could be impaired.

Accordingly, when deciding on a fee to be quoted to a client for the performance of professional services, a professional accountant should be satisfied that, as a result of the fee quoted:

- The quality of work will not be impaired and that due care will be applied to comply with all professional standards and quality control procedures in the performance of those services, and
- The client will not be misled as to the precise scope of services that a quoted fee is intended to cover and the basis on which future fees will be charged.

10.7 As stated in paragraph 8.208:

An assurance engagement should not be performed for a fee that is contingent on the result of the assurance work or on items that are the subject matter of the assurance engagement. Paragraph 8.209 provides guidance on threats that may be created if a non-assurance engagement is provide to an assurance client for a contingent fee, and the safeguards that may reduce the threats to an acceptable level.

Commentary

Fees should not be regarded as being contingent if fixed by a court or other public authority. Fees charged on a percentage or similar basis, except when authorized by statute or approved by a member body as generally accepted practice for certain professional services, should be regarded as contingent fees.

* See Definitions.

10.8 The foregoing paragraphs relate to fees as distinct from reimbursement of expenses. Out-of-pocket expenses, in particular traveling expenses, attributable directly to the professional services performed for a particular client would normally be charged to that client in addition to the professional fees.

10.9 It is in the best interests of both the client and the professional accountant in public practice that the basis on which fees are computed and any billing arrangements are clearly defined, preferably in writing, before the commencement of the engagement to help in avoiding misunderstandings with respect to fees. (For further guidance, refer to International Standard on Auditing 210, "Terms of Audit Engagements.")

Commissions

10.10 In those countries where payment and receipt of commissions are permitted, either by statute or by a member body, and the professional accountant in public practice accepts such a commission this fact should be disclosed to the client.

10.11 Subject to paragraph 10.10, a professional accountant in public practice should not pay a commission to obtain a client nor should a commission be accepted for referral of a client to a third party. A professional accountant in public practice should not accept a commission for the referral of the products or services of others.

10.12 Payment and receipt of referral fees between professional accountants in public practice when no services are performed by the referring accountant are regarded as commissions for the purpose of paragraph 10.11.

10.13 A professional accountant in public practice may enter into an arrangement for the purchase of the whole or part of an accounting practice requiring payments to individuals formerly engaged in the practice or payments to their heirs or estates. Such payments are not regarded as commissions for the purpose of paragraph 10.10.

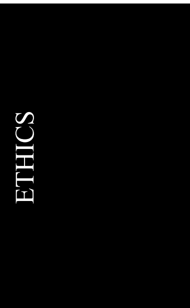
SECTION 11

Activities Incompatible with the Practice of Public Accountancy

11.1 A professional accountant in public practice should not concurrently engage in any business, occupation or activity which impairs or might impair integrity, objectivity or independence, or the good reputation of the profession and therefore would be incompatible with the rendering of professional services.

11.2 The rendering of two or more types of professional services concurrently does not by itself impair integrity, objectivity or independence.

11.3 The simultaneous engagement in another business, occupation or activity unrelated to professional services which has the effect of not allowing the professional accountant in public practice properly to conduct a professional practice in accordance with the fundamental ethical principles of the accountancy profession should be regarded as inconsistent with the practice of public accountancy.



SECTION 12

Clients' Monies

12.1 It is recognized that in some countries the law does not permit a professional accountant in public practice to hold **clients' monies**;* in other countries there are legal duties imposed on professional accountants in public practice who do hold such monies. The professional accountant in public practice should not hold clients' monies if there is reason to believe that they were obtained from, or are to be used for, illegal activities.

12.2 A professional accountant in public practice entrusted with monies belonging to others should:

(a) Keep such monies separately from personal or firm monies;

(b) Use such monies only for the purpose for which they are intended; and

(c) At all times, be ready to account for those monies to any persons entitled to such accounting.

12.3 A professional accountant in public practice should maintain one or more bank accounts for clients' monies. Such bank accounts may include a general **client account*** into which the monies of a number of clients may be paid.

12.4 Clients' monies received by a professional accountant in public practice should be deposited without delay to the credit of a client account, or – if in the form of documents of title to money and documents of title which can be converted into money – be safeguarded against unauthorized use.

12.5 Monies may only be drawn from the client account on the instructions of the client.

12.6 Fees due from a client may be drawn from client's monies provided the client, after being notified of the amount of such fees, has agreed to such withdrawal.

12.7 Payments from a client account shall not exceed the balance standing to the credit of the client.

12.8 When it seems likely that the client's monies remain on client account for a significant period of time, the professional accountant in public practice should, with the concurrence of the client, place such monies in an interest bearing account within a reasonable time.

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* See Definitions.

12.9 All interest earned on clients' monies should be credited to the client account.

12.10 Professional accountants in public practice should keep such books of account as will enable them, at any time, to establish clearly their dealings with clients' monies in general and the monies of each individual client in particular. A statement of account should be provided to the client at least once a year.

SECTION 13

Relations with Other Professional Accountants in Public Practice

Accepting New Assignments

13.1 The extension of the operations of a business undertaking frequently results in the formation of branches or subsidiary companies at locations where an **existing accountant*** does not practice. In these circumstances, the client or the existing accountant in consultation with the client may request a **receiving accountant*** practicing at those locations to perform such professional services as necessary to complete the assignment.

13.2 Referral of business may also arise in the area of special services or special tasks. The scope of the services offered by professional accountants in public practice continues to expand and the depth of knowledge which is needed to serve the public often calls for special skills. Since it is impracticable for any one professional accountant in public practice to acquire special expertise or experience in all fields of accountancy, some professional accountants in public practice have decided that it is neither appropriate nor desirable to develop within their firms the complete range of special skills which may be required.

13.3 Professional accountants in public practice should only undertake such services which they can expect to complete with professional competence. It is essential therefore for the profession in general and in the interests of their clients that professional accountants in public practice be encouraged to obtain advice when appropriate from those who are competent to provide it.

13.4 An existing accountant without a particular skill may however be reluctant to refer a client to another professional accountant in public practice who may possess that skill, because of the fear of losing existing business to the other professional accountant in public practice. As a result, clients may be deprived of the benefit of advice which they are entitled to receive.

13.5 The wishes of the client should be paramount in the choice of professional advisers, whether or not special skills are involved. Accordingly, a professional accountant in public practice should not attempt to restrict in any way the client's freedom of choice in obtaining special advice, and when appropriate should encourage a client to do so.

13.6 The services or advice of a professional accountant in public practice having special skills may be sought in one or other of the following ways:

(a) By the client:

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* See Definitions.

(i) After prior discussion and consultation with the existing accountant;

(ii) On the specific request or recommendation of the existing accountant; and

(iii) Without reference to the existing accountant; or

(b) By the existing accountant with due observance of the duty of confidentiality.

13.7 When a professional accountant in public practice is asked to provide services or advice, inquiries should be made as to whether the prospective client has an existing accountant. In cases where there is an existing accountant who will continue to provide professional services, the procedures set out in paragraphs 13.8 through 13.14 should be observed. If the appointment will result in another professional accountant in public practice being superseded, the procedures set out in paragraphs 13.15 through13.26 should be followed.

13.8 The receiving accountant should limit the services provided to the specific assignment received by referral from the existing accountant or the client unless otherwise requested by the client. The receiving accountant also has the duty to take reasonable steps to support the existing accountant's current relationship with the client and should not express any criticism of the professional services of the existing accountant without giving the latter an opportunity to provide all relevant information.

13.9 A receiving accountant who is asked by the client to undertake an assignment of a type which is clearly distinct from that being carried out by the existing accountant or from that initially received by referral from the existing accountant or from the client, should regard this as a separate request to provide services or advice. Before accepting any appointments of this nature, the receiving accountant should advise the client of the professional obligation to communicate with the existing accountant and should immediately do so preferably in writing, advising of the approach made by the client and the general nature of the request as well as seeking all relevant information, if any, necessary to perform the assignment.

13.10 Circumstances sometimes arise when the client insists that the existing accountant should not be informed. In this case, the receiving accountant should decide whether the client's reasons are valid. In the absence of special circumstances a mere disinclination by the client for communication with the existing accountant would not be a satisfactory reason.

13.11 The receiving accountant should:

(a) Comply with the instructions received from the existing accountant or the client to the extent that they do not conflict with relevant legal or other requirements; and

(b) Ensure, insofar as it is practicable to do so, that the existing accountant is kept informed of the general nature of the professional services being performed.

13.12 When there are two or more other professional accountants in public practice performing professional services for the client concerned it may be appropriate to notify only the relevant professional accountant in public practice depending on the specific services being performed.

13.13 When appropriate the existing accountant, in addition to issuing instructions concerning referred business, should maintain contact with the receiving accountants and cooperate with them in all reasonable requests for assistance.

13.14 When the opinion of a professional accountant, other than the existing accountant, is sought on the application of accounting, auditing, reporting or other standards or principles to specific circumstances or transactions, the professional accountant should be alert to the possibility of the opinion creating undue pressure on the judgment and objectivity of the accountant. An opinion given without full and proper facts can cause difficulty to the receiving accountant if the opinion is challenged or the receiving accountant is subsequently appointed by the company. Accordingly, the professional accountant should seek to minimize the risk of giving inappropriate guidance by ensuring that he or she has access to all relevant information. When there is a request for an opinion in the above circumstances there is a requirement for communication with the existing accountant. It is important that the existing accountant, with the permission of the client, provide the receiving accountant with all requested relevant information about the client. With the permission of the client, the receiving accountant should also provide a copy of the final report to the existing accountant. If the client does not agree to these communications, then the engagement should ordinarily not be performed.

Superseding Another Professional Accountant in Public Practice

13.15 The proprietors of a business have an indisputable right to choose their professional advisers and to change to others should they so desire. While it is essential that the legitimate interests of the proprietors are protected, it is also important that a professional accountant in public practice who is asked to replace another professional accountant in public practice has the opportunity to ascertain if there are any professional reasons why the appointment should not be accepted. This cannot effectively be done

without direct communication with the existing accountant. In the absence of a specific request, the existing accountant should not volunteer information about the client's affairs.

13.16 Communication enables a professional accountant in public practice to ascertain whether the circumstances in which a change in appointment is proposed are such that the appointment can properly be accepted and also whether there is a wish to undertake the engagement. In addition, such communication helps to preserve the harmonious relationships which should exist between all professional accountants in public practice on whom clients rely for professional advice and assistance.

13.17 The extent to which an existing accountant can discuss the affairs of the client with the proposed professional accountant in public practice depends on:

(a) Whether the client's permission to do so has been obtained; and/or

(b) The legal or ethical requirements relating to such disclosure which may vary by country.

13.18 The proposed professional accountant in public practice should treat in the strictest confidence and give due weight to any information provided by the existing accountant.

13.19 The information provided by the existing accountant may indicate, for example, that the ostensible reasons given by the client for the change are not in accordance with the facts. It may disclose that the proposal to make a change in professional accountants in public practice was made because the existing accountants stood their ground and properly carried out the duties as professional accountants in public practice despite opposition or evasion on an occasion on which important differences of principles or practice have arisen with the client.

13.20 Communication between the parties therefore serves:

(a) To protect a professional accountant in public practice from accepting an appointment in circumstances where all the pertinent facts are not known;

(b) To protect the minority proprietors of a business who may not be fully informed of the circumstances in which the change is proposed; and

(c) To protect the interests of the existing accountant when the proposed change arises from, or is an attempt to interfere with, the conscientious exercise of the existing accountant's duty to act as an independent professional.

13.21 Before accepting an appointment involving recurring professional services hitherto carried out by another professional accountant in public practice, the proposed professional accountant in public practice should:

(a) Ascertain if the prospective client has advised the existing accountant of the proposed change and has given permission, preferably in writing, to discuss the client's affairs fully and freely with the proposed professional accountant in public practice;

(b) When satisfied with the reply received from the prospective client, request permission to communicate with the existing accountant. If such permission is refused or the permission referred to in (a) above is not given, the proposed professional accountant in public practice should, in the absence of exceptional circumstances of which there is full knowledge, and unless there is satisfaction as to necessary facts by other means, decline the appointment; and

(c) On receipt of permission, ask the existing accountant, preferably in writing:

(i) To provide information on any professional reasons which should be known before deciding whether or not to accept the appointment and, if there are such matters; and

(ii) To provide all the necessary details to be able to come to a decision.

13.22 The existing accountant, on receipt of the communication referred to in paragraph 13.21(c) should forthwith:

(a) Reply, preferably in writing, advising whether there are any professional reasons why the proposed professional accountant in public practice should not accept the appointment;

(b) If there are any such reasons or other matters which should be disclosed, ensure that the client has given permission to give details of this information to the proposed professional accountant in public practice. If permission is not granted, the existing accountant should report that fact to the proposed professional accountant in public practice; and

(c) On receipt of permission from the client, disclose all information needed by the proposed professional accountant in public practice to be able to decide whether or not to accept the appointment, and discuss freely with the proposed professional accountant in public practice all matters relevant to the appointment of which the latter should be aware.

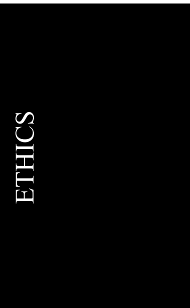
13.23 If the proposed professional accountant in public practice does not receive, within a reasonable time, a reply from the existing accountant and there is

no reason to believe that there are any exceptional circumstances surrounding the proposed change, the proposed professional accountant in public practice should endeavor to communicate with the existing accountant by some other means. If unable to obtain a satisfactory outcome in this way, the proposed professional accountant in public practice should send a further letter, stating that there is an assumption that there is no professional reason why the appointment should not be accepted and that there is an intention to do so.

13.24 The fact that there may be fees owing to the existing accountant is not a professional reason why another professional accountant in public practice should not accept the appointment.

13.25 The existing accountant should promptly transfer to the new professional accountant in public practice all books and papers of the client which are or may be held after the change in appointment has been effected and should advise the client accordingly, unless the professional accountant in public practice has a legal right to withhold them.

13.26 Certain organizations, either because of legislative requirements or otherwise, call for submissions or tenders, e.g., competitive bids, in relation to professional services offered by accountants in public practice. In reply to a public advertisement or an unsolicited request to make a submission or submit a tender, a professional accountant in public practice should, if the appointment may result in the replacement of another professional accountant in public practice, state in the submission or tender that before acceptance the opportunity to contact the other professional accountant in public practice is required so that inquiries may be made as to whether there are any professional reasons why the appointment should not be accepted. If the submission or tender is successful, the existing accountant should then be contacted.



SECTION 14

Advertising and Solicitation

14.1 Whether or not **advertising*** and **solicitation*** by individual professional accountants in public practice are permitted is a matter for member bodies to determine based upon the legal, social and economic conditions in each country.

14.2 When permitted, such advertising and solicitation should be aimed at informing the public in an objective manner and should be decent, honest, truthful and in good taste. Solicitation by the use of coercion or harassment should be prohibited.

14.3 Examples of activities which may be considered not to meet the above criteria include those that:

- Create false, deceptive or unjustified expectations of favorable results;
- Imply the ability to influence any court, tribunal, regulatory agency or similar body or official;
- Consist of self-laudatory statements that are not based on verifiable facts;
- Make comparisons with other professional accountants in public practice;
- Contain testimonials or endorsements;
- Contain any other representations that would be likely to cause a reasonable person to misunderstand or be deceived; and
- Make unjustified claims to be an expert or specialist in a particular field of accountancy.

14.4 A professional accountant in public practice in a country where advertising is permitted should not seek to obtain an advantage by advertising in newspapers or magazines published or distributed in a country where advertising is prohibited. Similarly, a professional accountant in public practice in a country where advertising is prohibited should not advertise in a newspaper or magazine published in a country where advertising is permitted.

14.5 In situations where professional accountants in public practice in their international cross border activities violate the provisions of paragraph 14.4, contact should take place between the member body in the country in which the violation takes place and the member body of the home country of the

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* See Definitions.

professional accountant in public practice to ensure that the member body in the home country is made aware of such violation.

14.6 It is clearly desirable that the public should be aware of the range of services available from a professional accountant. Accordingly there is no objection to a member body communicating such information to the public on an institutional basis, i.e., in the name of the member body.

Publicity by Professional Accountants in Public Practice in a Non-Advertising Environment

14.7 When advertising is not permitted, publicity by individual professional accountants in public practice is acceptable provided:

(a) It has as its object the notification to the public or such sectors of the public as are concerned, of matters of fact in a manner that is not false, misleading or deceptive;

(b) It is in good taste;

(c) It is professionally dignified; and

(d) It avoids frequent repetition of, and any undue prominence being given to the name of the professional accountant in public practice.

14.8 The examples which follow are illustrative of circumstances in which publicity is acceptable and the matters to be considered in connection therewith subject always to the overriding requirements mentioned in the preceding paragraph.

Appointments and Awards

It is in the interests of the public and the accountancy profession that any appointment or other activity of a professional accountant in a matter of national or local importance, or the award of any distinction to a professional accountant, should receive publicity and that membership of the professional body should be mentioned. However, the professional accountant should not make use of any of the aforementioned appointments or activities for personal professional advantage.

Professional Accountants Seeking Employment or Professional Business

A professional accountant may inform interested parties through any medium that a partnership or salaried employment of an accountancy nature is being sought. The professional accountant should not, however, publicize for subcontract work in a manner which could be interpreted as seeking to procure professional business. Publicity seeking subcontract work may be acceptable if placed only in the professional press and provided that neither the professional accountant's name, address or telephone number appears in the publicity. A professional accountant may write a letter or make a direct

approach to another professional accountant when seeking employment or professional business.

Directories

A professional accountant may be listed in a directory provided neither the directory itself nor the entry could reasonably be regarded as a promotional advertisement for those listed therein. Entries should be limited to name, address, telephone number, professional description and any other information necessary to enable the user of the directory to make contact with the person or organization to which the entry relates.

Books, Articles, Interviews, Lectures, Radio and Television Appearances

Professional accountants who author books or articles on professional subjects, may state their name and professional qualifications and give the name of their organization but shall not give any information as to the services that firm provides.

Similar provisions are applicable to participation by a professional accountant in a lecture, interview or a radio or television program on a professional subject. What professional accountants write or say, however, should not be promotional of themselves or their firm but should be an objective professional view of the topic under consideration. Professional accountants are responsible for using their best endeavors to ensure that what ultimately goes before the public complies with these requirements.

Training Courses, Seminars, Etc.

A professional accountant may invite clients, staff or other professional accountants to attend training courses or seminars conducted for the assistance of staff. Other persons should not be invited to attend such training courses or seminars except in response to an unsolicited request. The requirement should in no way prevent professional accountants from providing training services to other professional bodies, associations or educational institutions which run courses for their members or the public. However, undue prominence should not be given to the name of a professional accountant in any booklets or documents issued in connection therewith.

Booklets and Documents Containing Technical Information

Booklets and other documents bearing the name of a professional accountant and giving technical information for the assistance of staff or clients may be issued to such persons or to other professional accountants.

Other persons should not be issued with such booklets or documents except in response to an unsolicited request.

Staff Recruitment

Genuine vacancies for staff may be communicated to the public through any medium in which comparable staff vacancies normally appear. The fact that a job specification necessarily gives some detail as to one or more of the services provided to clients by the professional accountant in public practice is acceptable but it should not contain any promotional element. There should not be any suggestion that the services offered are superior to those offered by other professional accountants in public practice as a consequence of size, associations, or for any other reason.

In publications such as those specifically directed to schools and other places of education to inform students and graduates of career opportunities in the profession, services offered to the public may be described in a businesslike way.

More latitude may also be permissible in a section of a newspaper devoted to staff vacancies than would be allowed if the vacancy appeared in a prominent position elsewhere in a newspaper on the grounds that it would be most unlikely that a potential client would use such media to select a professional adviser.

Publicity on Behalf of Clients

A professional accountant in public practice may publicize on behalf of clients, primarily for staff. However, the professional accountant in public practice should ensure that the emphasis in the publicity is directed towards the objectives to be achieved for the client.

Brochures and Firm Directories

A professional accountant in public practice may issue to clients or, in response to an unsolicited request, to a non-client:

(a) A factual and objectively worded account of the services provided; and

(b) A directory setting out names of partners, office addresses and names and addresses of associated firms and correspondents.

Stationery and Nameplates

Stationery of professional accountants in public practice should be of an acceptable professional standard and comply with the requirements of the law and of the member body concerned as to names of partners, principals and others who participate in the practice, use of professional descriptions and designatory letters, cities or countries where the practice is represented, logotypes, etc. The designation of any services provided by the practice as being of specialist nature should not be permitted. Similar provisions, where applicable, should apply to nameplates.

Newspaper Announcements

Appropriate newspapers or magazines may be used to inform the public of the establishment of a new practice, of changes in the composition of a partnership of professional accountants in public practice, or of any alteration in the address of a practice.

Such announcements should be limited to a bare statement of facts and consideration given to the appropriateness of the area of distribution of the newspaper or magazine and number of insertions.

Inclusion of the Name of a Professional Accountant in Public Practice in a Document Issued by a Client

When a client proposes to publish a report by a professional accountant in public practice dealing with the client's existing business affairs or in connection with the establishment of a new business venture, the professional accountant in public practice should take steps to ensure that the context in which the report is published is not such as might result in the public being misled as to the nature and meaning of the report. In these circumstances, the professional accountant in public practice should advise the client that permission should first be obtained before publication of the document.

Similar consideration should be given to other documents proposed to be issued by a client containing the name of a professional accountant in public practice acting in an independent professional capacity. This does not preclude the inclusion of the name of a professional accountant in public practice in the annual report of a client.

When professional accountants in their private capacity are associated with, or hold office in, an organization, the organization may use their name and professional status on stationery and other documents. The professional accountant in public practice should ensure that this information is not used in such a way as might lead the public to believe that there is a connection with the organization in an independent professional capacity.

PART C—APPLICABLE TO EMPLOYED PROFESSIONAL ACCOUNTANTS

The following sections contain guidance which is particularly relevant to professional accountants working in industry, commerce, the public sector or education. Professional accountants employed in public practice should be aware they may find that the principles set out below are also of application to their particular circumstances. If professional accountants employed in practice are in doubt as to the applicability of any particular guidance, they should seek assistance from their professional body.

SECTION 15

Conflict of Loyalties

15.1 Employed professional accountants owe a duty of loyalty to their employer as well as to their profession and there may be times when the two are in conflict. An employee's normal priority should be to support his or her organization's legitimate and ethical objectives and the rules and procedures drawn up in support of them. However, an employee cannot legitimately be required to:

(a) Break the law;

(b) Breach the rules and standards of their profession;

(c) Lie to or mislead (including misleading by keeping silent) those acting as auditors to the employer; or

(d) Put their name to or otherwise be associated with a statement which materially misrepresents the facts.

15.2 Differences in view about the correct judgment on accounting or ethical matters should normally be raised and resolved within the employee's organization, initially with the employee's immediate superior and possibly thereafter, where disagreement about a significant ethical issue remains, with higher levels of management or non executive directors.

15.3 If employed accountants cannot resolve any material issue involving a conflict between their employers and their professional requirements they may, after exhausting all other relevant possibilities, have no other recourse but to consider resignation. Employees should state their reasons for doing so to the employer but their duty of confidentiality normally precludes them from communicating the issue to others (unless legally or professionally required to do so).

15.4 For further guidance as to the considerations involved see Section 2—Resolution of Ethical Conflicts.

SECTION 16

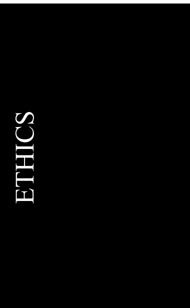
Support for Professional Colleagues

16.1 A professional accountant, particularly one having authority over others, should give due weight for the need for them to develop and hold their own judgment in accounting matters and should deal with differences of opinion in a professional way.

SECTION 17

Professional Competence

17.1 A professional accountant employed in industry, commerce, the public sector or education may be asked to undertake significant tasks for which he or she has not had sufficient specific training or experience. When undertaking such work the professional accountant should not mislead the employer as to the degree of expertise or experience he or she possesses, and where appropriate expert advice and assistance should be sought.



SECTION 18

Presentation of Information

18.1 A professional accountant is expected to present financial information fully, honestly and professionally and so that it will be understood in its context.

18.2 Financial and non-financial information should be maintained in a manner that describes clearly the true nature of business transactions, assets or liabilities and classifies and records entries in a timely and proper manner, and professional accountants should do everything that is within their powers to ensure that this is the case.

CODE OF ETHICS FOR PROFESSIONAL ACCOUNTANTS

(Effective June 30, 2006)

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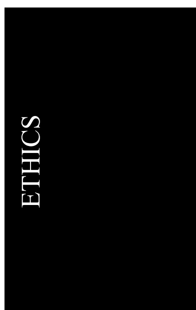

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PREFACE

The mission of the International Federation of Accountants (IFAC), as set out in its constitution, is "the worldwide development and enhancement of an accountancy profession with harmonized standards, able to provide services of consistently high quality in the public interest." In pursuing this mission, the IFAC Board has established the Ethics Standards Board for Accountants to develop and issue, under its own authority, high quality ethical standards and other pronouncements for professional accountants for use around the world.

This *Code of Ethics for Professional Accountants* establishes ethical requirements for professional accountants. A member body of IFAC or firm may not apply less stringent standards than those stated in this Code. However, if a member body or firm is prohibited from complying with certain parts of this Code by law or regulation, they should comply with all other parts of this Code.

Some jurisdictions may have requirements and guidance that differs from this Code. Professional accountants should be aware of those differences and comply with the more stringent requirements and guidance unless prohibited by law or regulation.

PART A—GENERAL APPLICATION OF THE CODE

Section 100 Introduction and Fundamental Principles 825
Section 110 Integrity.. 831
Section 120 Objectivity.. 832
Section 130 Professional Competence and Due Care 833
Section 140 Confidentiality 834
Section 150 Professional Behavior 836

SECTION 100

Introduction and Fundamental Principles

100.1 A distinguishing mark of the accountancy profession is its acceptance of the responsibility to act in the public interest. Therefore, a **professional accountant's**[*] responsibility is not exclusively to satisfy the needs of an individual client or employer. In acting in the public interest a professional accountant should observe and comply with the ethical requirements of this Code.

100.2 This Code is in three parts. Part A establishes the fundamental principles of professional ethics for professional accountants and provides a conceptual framework for applying those principles. The conceptual framework provides guidance on fundamental ethical principles. Professional accountants are required to apply this conceptual framework to identify threats to compliance with the fundamental principles, to evaluate their significance and, if such threats are other than **clearly insignificant**[*] to apply safeguards to eliminate them or reduce them to an acceptable level such that compliance with the fundamental principles is not compromised.

100.3 Parts B and C illustrate how the conceptual framework is to be applied in specific situations. It provides examples of safeguards that may be appropriate to address threats to compliance with the fundamental principles and also provides examples of situations where safeguards are not available to address the threats and consequently the activity or relationship creating the threats should be avoided. Part B applies to **professional accountants in public practice.**[*] Part C applies to **professional accountants in business.**[*] Professional accountants in public practice may also find the guidance in Part C relevant to their particular circumstances.

Fundamental Principles

100.4 A professional accountant is required to comply with the following fundamental principles:

(a) *Integrity*

A professional accountant should be straightforward and honest in all professional and business relationships.

ETHICS

* See Definitions.

(b) *Objectivity*

A professional accountant should not allow bias, conflict of interest or undue influence of others to override professional or business judgments.

(c) *Professional Competence and Due Care*

A professional accountant has a continuing duty to maintain professional knowledge and skill at the level required to ensure that a client or employer receives competent professional service based on current developments in practice, legislation and techniques. A professional accountant should act diligently and in accordance with applicable technical and professional standards when providing **professional services.**[*]

(d) *Confidentiality*

A professional accountant should respect the confidentiality of information acquired as a result of professional and business relationships and should not disclose any such information to third parties without proper and specific authority unless there is a legal or professional right or duty to disclose. Confidential information acquired as a result of professional and business relationships should not be used for the personal advantage of the professional accountant or third parties.

(e) *Professional Behavior*

A professional accountant should comply with relevant laws and regulations and should avoid any action that discredits the profession.

Each of these fundamental principles is discussed in more detail in Sections 110 – 150.

Conceptual Framework Approach

100.5 The circumstances in which professional accountants operate may give rise to specific threats to compliance with the fundamental principles. It is impossible to define every situation that creates such threats and specify the appropriate mitigating action. In addition, the nature of engagements and work assignments may differ and consequently different threats may exist, requiring the application of different safeguards. A conceptual framework that requires a professional accountant to identify, evaluate and address threats to compliance with the fundamental principles, rather than merely comply with a set of specific rules which may be arbitrary,

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* See Definitions.

is, therefore, in the public interest. This Code provides a framework to assist a professional accountant to identify, evaluate and respond to threats to compliance with the fundamental principles. If identified threats are other than clearly insignificant, a professional accountant should, where appropriate, apply safeguards to eliminate the threats or reduce them to an acceptable level, such that compliance with the fundamental principles is not compromised.

100.6 A professional accountant has an obligation to evaluate any threats to compliance with the fundamental principles when the professional accountant knows, or could reasonably be expected to know, of circumstances or relationships that may compromise compliance with the fundamental principles.

100.7 A professional accountant should take qualitative as well as quantitative factors into account when considering the significance of a threat. If a professional accountant cannot implement appropriate safeguards, the professional accountant should decline or discontinue the specific professional service involved, or where necessary resign from the client (in the case of a professional accountant in public practice) or the employing organization (in the case of a professional accountant in business).

100.8 A professional accountant may inadvertently violate a provision of this Code. Such an inadvertent violation, depending on the nature and significance of the matter, may not compromise compliance with the fundamental principles provided, once the violation is discovered, the violation is corrected promptly and any necessary safeguards are applied.

100.9 Parts B and C of this Code include examples that are intended to illustrate how the conceptual framework is to be applied. The examples are not intended to be, nor should they be interpreted as, an exhaustive list of all circumstances experienced by a professional accountant that may create threats to compliance with the fundamental principles. Consequently, it is not sufficient for a professional accountant merely to comply with the examples presented; rather, the framework should be applied to the particular circumstances encountered by the professional accountant.

Threats and Safeguards

100.10 Compliance with the fundamental principles may potentially be threatened by a broad range of circumstances. Many threats fall into the following categories:

(a) Self-interest threats, which may occur as a result of the financial or other interests of a professional accountant or of an immediate or **close family*** member;

(b) Self-review threats, which may occur when a previous judgment needs to be re-evaluated by the professional accountant responsible for that judgment;

(c) Advocacy threats, which may occur when a professional accountant promotes a position or opinion to the point that subsequent objectivity may be compromised;

(d) Familiarity threats, which may occur when, because of a close relationship, a professional accountant becomes too sympathetic to the interests of others; and

(e) Intimidation threats, which may occur when a professional accountant may be deterred from acting objectively by threats, actual or perceived.

Parts B and C of this Code, respectively, provide examples of circumstances that may create these categories of threats for professional accountants in public practice and professional accountants in business. Professional accountants in public practice may also find the guidance in Part C relevant to their particular circumstances.

100.11 Safeguards that may eliminate or reduce such threats to an acceptable level fall into two broad categories:

(a) Safeguards created by the profession, legislation or regulation; and

(b) Safeguards in the work environment.

100.12 Safeguards created by the profession, legislation or regulation include, but are not restricted to:

- Educational, training and experience requirements for entry into the profession.
- Continuing professional development requirements.
- Corporate governance regulations.
- Professional standards.
- Professional or regulatory monitoring and disciplinary procedures.

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* See Definitions.

- External review by a legally empowered third party of the reports, returns, communications or information produced by a professional accountant.

100.13 Parts B and C of this Code, respectively, discuss safeguards in the work environment for professional accountants in public practice and those in business.

100.14 Certain safeguards may increase the likelihood of identifying or deterring unethical behavior. Such safeguards, which may be created by the accounting profession, legislation, regulation or an employing organization, include, but are not restricted to:

- Effective, well publicized complaints systems operated by the employing organization, the profession or a regulator, which enable colleagues, employers and members of the public to draw attention to unprofessional or unethical behavior.
- An explicitly stated duty to report breaches of ethical requirements.

100.15 The nature of the safeguards to be applied will vary depending on the circumstances. In exercising professional judgment, a professional accountant should consider what a reasonable and informed third party, having knowledge of all relevant information, including the significance of the threat and the safeguards applied, would conclude to be unacceptable.

Ethical Conflict Resolution

100.16 In evaluating compliance with the fundamental principles, a professional accountant may be required to resolve a conflict in the application of fundamental principles.

100.17 When initiating either a formal or informal conflict resolution process, a professional accountant should consider the following, either individually or together with others, as part of the resolution process:

(a) Relevant facts;

(b) Ethical issues involved;

(c) Fundamental principles related to the matter in question;

(d) Established internal procedures; and

(e) Alternative courses of action.

Having considered these issues, a professional accountant should determine the appropriate course of action that is consistent with the fundamental principles identified. The professional accountant should also weigh the consequences of each possible course of action. If the matter remains unresolved, the professional accountant should consult

with other appropriate persons within the **firm*** or employing organization for help in obtaining resolution.

100.18 Where a matter involves a conflict with, or within, an organization, a professional accountant should also consider consulting with those charged with governance of the organization, such as the board of directors or the audit committee.

100.19 It may be in the best interests of the professional accountant to document the substance of the issue and details of any discussions held or decisions taken, concerning that issue.

100.20 If a significant conflict cannot be resolved, a professional accountant may wish to obtain professional advice from the relevant professional body or legal advisors, and thereby obtain guidance on ethical issues without breaching confidentiality. For example, a professional accountant may have encountered a fraud, the reporting of which could breach the professional accountant's responsibility to respect confidentiality. The professional accountant should consider obtaining legal advice to determine whether there is a requirement to report.

100.21 If, after exhausting all relevant possibilities, the ethical conflict remains unresolved, a professional accountant should, where possible, refuse to remain associated with the matter creating the conflict. The professional accountant may determine that, in the circumstances, it is appropriate to withdraw from the **engagement team*** or specific assignment, or to resign altogether from the engagement, the firm or the employing organization.

* See Definitions.

SECTION 110

Integrity

110.1 The principle of integrity imposes an obligation on all professional accountants to be straightforward and honest in professional and business relationships. Integrity also implies fair dealing and truthfulness.

110.2 A professional accountant should not be associated with reports, returns, communications or other information where they believe that the information:

(a) Contains a materially false or misleading statement;

(b) Contains statements or information furnished recklessly; or

(c) Omits or obscures information required to be included where such omission or obscurity would be misleading.

110.3 A professional accountant will not be considered to be in breach of paragraph 110.2 if the professional accountant provides a modified report in respect of a matter contained in paragraph 110.2.

SECTION 120

Objectivity

120.1 The principle of objectivity imposes an obligation on all professional accountants not to compromise their professional or business judgment because of bias, conflict of interest or the undue influence of others.

120.2 A professional accountant may be exposed to situations that may impair objectivity. It is impracticable to define and prescribe all such situations. Relationships that bias or unduly influence the professional judgment of the professional accountant should be avoided.

SECTION 130

Professional Competence and Due Care

130.1 The principle of professional competence and due care imposes the following obligations on professional accountants:

(a) To maintain professional knowledge and skill at the level required to ensure that clients or employers receive competent professional service; and

(b) To act diligently in accordance with applicable technical and professional standards when providing professional services.

130.2 Competent professional service requires the exercise of sound judgment in applying professional knowledge and skill in the performance of such service. Professional competence may be divided into two separate phases:

(a) Attainment of professional competence; and

(b) Maintenance of professional competence.

130.3 The maintenance of professional competence requires a continuing awareness and an understanding of relevant technical professional and business developments. Continuing professional development develops and maintains the capabilities that enable a professional accountant to perform competently within the professional environments.

130.4 Diligence encompasses the responsibility to act in accordance with the requirements of an assignment, carefully, thoroughly and on a timely basis.

130.5 A professional accountant should take steps to ensure that those working under the professional accountant's authority in a professional capacity have appropriate training and supervision.

130.6 Where appropriate, a professional accountant should make clients, employers or other users of the professional services aware of limitations inherent in the services to avoid the misinterpretation of an expression of opinion as an assertion of fact.

SECTION 140

Confidentiality

140.1 The principle of confidentiality imposes an obligation on professional accountants to refrain from:

(a) Disclosing outside the firm or employing organization confidential information acquired as a result of professional and business relationships without proper and specific authority or unless there is a legal or professional right or duty to disclose; and

(b) Using confidential information acquired as a result of professional and business relationships to their personal advantage or the advantage of third parties.

140.2 A professional accountant should maintain confidentiality even in a social environment. The professional accountant should be alert to the possibility of inadvertent disclosure, particularly in circumstances involving long association with a business associate or a close or **immediate family**[*] member.

140.3 A professional accountant should also maintain confidentiality of information disclosed by a prospective client or employer.

140.4 A professional accountant should also consider the need to maintain confidentiality of information within the firm or employing organization.

140.5 A professional accountant should take all reasonable steps to ensure that staff under the professional accountant's control and persons from whom advice and assistance is obtained respect the professional accountant's duty of confidentiality.

140.6 The need to comply with the principle of confidentiality continues even after the end of relationships between a professional accountant and a client or employer. When a professional accountant changes employment or acquires a new client, the professional accountant is entitled to use prior experience. The professional accountant should not, however, use or disclose any confidential information either acquired or received as a result of a professional or business relationship.

140.7 The following are circumstances where professional accountants are or may be required to disclose confidential information or when such disclosure may be appropriate:

(a) Disclosure is permitted by law and is authorized by the client or the employer;

[*] See Definitions.

(b) Disclosure is required by law, for example:

(i) Production of documents or other provision of evidence in the course of legal proceedings; or

(ii) Disclosure to the appropriate public authorities of infringements of the law that come to light; and

(c) There is a professional duty or right to disclose, when not prohibited by law:

(i) To comply with the quality review of a member body or professional body;

(ii) To respond to an inquiry or investigation by a member body or regulatory body;

(iii) To protect the professional interests of a professional accountant in legal proceedings; or

(iv) To comply with technical standards and ethics requirements.

140.8 In deciding whether to disclose confidential information, professional accountants should consider the following points:

(a) Whether the interests of all parties, including third parties whose interests may be affected, could be harmed if the client or employer consents to the disclosure of information by the professional accountant;

(b) Whether all the relevant information is known and substantiated, to the extent it is practicable; when the situation involves unsubstantiated facts, incomplete information or unsubstantiated conclusions, professional judgment should be used in determining the type of disclosure to be made, if any; and

(c) The type of communication that is expected and to whom it is addressed; in particular, professional accountants should be satisfied that the parties to whom the communication is addressed are appropriate recipients.

SECTION 150

Professional Behavior

150.1 The principle of professional behavior imposes an obligation on professional accountants to comply with relevant laws and regulations and avoid any action that may bring discredit to the profession. This includes actions which a reasonable and informed third party, having knowledge of all relevant information, would conclude negatively affects the good reputation of the profession.

150.2 In marketing and promoting themselves and their work, professional accountants should not bring the profession into disrepute. Professional accountants should be honest and truthful and should not:

(a) Make exaggerated claims for the services they are able to offer, the qualifications they possess, or experience they have gained; or

(b) Make disparaging references or unsubstantiated comparisons to the work of others.

PART B—PROFESSIONAL ACCOUNTANTS IN PUBLIC PRACTICE

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SECTION 200

Introduction

200.1 This Part of the Code illustrates how the conceptual framework contained in Part A is to be applied by professional accountants in public practice. The examples in the following sections are not intended to be, nor should they be interpreted as, an exhaustive list of all circumstances experienced by a professional accountant in public practice that may create threats to compliance with the principles. Consequently, it is not sufficient for a professional accountant in public practice merely to comply with the examples presented; rather, the framework should be applied to the particular circumstances faced.

200.2 A professional accountant in public practice should not engage in any business, occupation or activity that impairs or might impair integrity, objectivity or the good reputation of the profession and as a result would be incompatible with the rendering of professional services.

Threats and Safeguards

200.3 Compliance with the fundamental principles may potentially be threatened by a broad range of circumstances. Many threats fall into the following categories:

(a) Self-interest;

(b) Self-review;

(c) Advocacy;

(d) Familiarity; and

(e) Intimidation.

These threats are discussed further in Part A of this Code.

The nature and significance of the threats may differ depending on whether they arise in relation to the provision of services to a **financial statement audit client**,* a non-financial statement audit **assurance client*** or a non-assurance client.

200.4 Examples of circumstances that may create self-interest threats for a professional accountant in public practice include, but are not limited to:

- A **financial interest*** in a client or jointly holding a financial interest with a client.
- Undue dependence on total fees from a client.

* See Definitions.

- Having a close business relationship with a client.
- Concern about the possibility of losing a client.
- Potential employment with a client.
- **Contingent fees*** relating to an **assurance engagement**.*
- A loan to or from an assurance client or any of its directors or officers.

200.5 Examples of circumstances that may create self-review threats include, but are not limited to:

- The discovery of a significant error during a re-evaluation of the work of the professional accountant in public practice.
- Reporting on the operation of financial systems after being involved in their design or implementation.
- Having prepared the original data used to generate records that are the subject matter of the engagement.
- A member of the **assurance team*** being, or having recently been, a **director or officer*** of that client.
- A member of the assurance team being, or having recently been, employed by the client in a position to exert direct and significant influence over the subject matter of the engagement.
- Performing a service for a client that directly affects the subject matter of the assurance engagement.

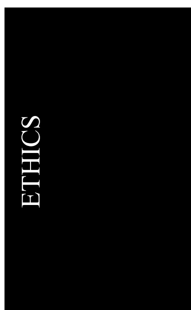
200.6 Examples of circumstances that may create advocacy threats include, but are not limited to:

- Promoting shares in a **listed entity*** when that entity is a financial statement audit client.
- Acting as an advocate on behalf of an assurance client in litigation or disputes with third parties.

200.7 Examples of circumstances that may create familiarity threats include, but are not limited to:

- A member of the engagement team having a close or immediate family relationship with a director or officer of the client.
- A member of the engagement team having a close or immediate family relationship with an employee of the client who is in a

* See Definitions.



position to exert direct and significant influence over the subject matter of the engagement.

- A former partner of the firm being a director or officer of the client or an employee in a position to exert direct and significant influence over the subject matter of the engagement.
- Accepting gifts or preferential treatment from a client, unless the value is clearly insignificant.
- Long association of senior personnel with the assurance client.

200.8 Examples of circumstances that may create intimidation threats include, but are not limited to:

- Being threatened with dismissal or replacement in relation to a client engagement.
- Being threatened with litigation.
- Being pressured to reduce inappropriately the extent of work performed in order to reduce fees.

200.9 A professional accountant in public practice may also find that specific circumstances give rise to unique threats to compliance with one or more of the fundamental principles. Such unique threats obviously cannot be categorized. In either professional or business relationships, a professional accountant in public practice should always be on the alert for such circumstances and threats.

200.10 Safeguards that may eliminate or reduce threats to an acceptable level fall into two broad categories:

(a) Safeguards created by the profession, legislation or regulation; and

(b) Safeguards in the work environment.

Examples of safeguards created by the profession, legislation or regulation are described in paragraph 100.12 of Part A of this Code.

200.11 In the work environment, the relevant safeguards will vary depending on the circumstances. Work environment safeguards comprise firm-wide safeguards and engagement specific safeguards. A professional accountant in public practice should exercise judgment to determine how to best deal with an identified threat. In exercising this judgment a professional accountant in public practice should consider what a reasonable and informed third party, having knowledge of all relevant information, including the significance of the threat and the safeguards applied, would reasonably conclude to be acceptable. This consideration will be affected by matters such as the significance of the threat, the nature of the engagement and the structure of the firm.

200.12 Firm-wide safeguards in the work environment may include:

- Leadership of the firm that stresses the importance of compliance with the fundamental principles.
- Leadership of the firm that establishes the expectation that members of an assurance team will act in the public interest.
- Policies and procedures to implement and monitor quality control of engagements.
- Documented policies regarding the identification of threats to compliance with the fundamental principles, the evaluation of the significance of these threats and the identification and the application of safeguards to eliminate or reduce the threats, other than those that are clearly insignificant, to an acceptable level.
- For firms that perform assurance engagements, documented **independence**[*] policies regarding the identification of threats to independence, the evaluation of the significance of these threats and the evaluation and application of safeguards to eliminate or reduce the threats, other than those that are clearly insignificant, to an acceptable level.
- Documented internal policies and procedures requiring compliance with the fundamental principles.
- Policies and procedures that will enable the identification of interests or relationships between the firm or members of engagement teams and clients.
- Policies and procedures to monitor and, if necessary, manage the reliance on revenue received from a single client.
- Using different partners and engagement teams with separate reporting lines for the provision of non-assurance services to an assurance client.
- Policies and procedures to prohibit individuals who are not members of an engagement team from inappropriately influencing the outcome of the engagement.
- Timely communication of a firm's policies and procedures, including any changes to them, to all partners and professional staff, and appropriate training and education on such policies and procedures.

[*] See Definitions.

- Designating a member of senior management to be responsible for overseeing the adequate functioning of the firm's quality control system.
- Advising partners and professional staff of those assurance clients and related entities from which they must be independent.
- A disciplinary mechanism to promote compliance with policies and procedures.
- Published policies and procedures to encourage and empower staff to communicate to senior levels within the firm any issue relating to compliance with the fundamental principles that concerns them.

200.13 Engagement-specific safeguards in the work environment may include:

- Involving an additional professional accountant to review the work done or otherwise advise as necessary.
- Consulting an independent third party, such as a committee of independent directors, a professional regulatory body or another professional accountant.
- Discussing ethical issues with those charged with governance of the client.
- Disclosing to those charged with governance of the client the nature of services provided and extent of fees charged.
- Involving another firm to perform or re-perform part of the engagement.
- Rotating senior assurance team personnel.

200.14 Depending on the nature of the engagement, a professional accountant in public practice may also be able to rely on safeguards that the client has implemented. However it is not possible to rely solely on such safeguards to reduce threats to an acceptable level.

200.15 Safeguards within the client's systems and procedures may include:

- When a client appoints a firm in public practice to perform an engagement, persons other than management ratify or approve the appointment.
- The client has competent employees with experience and seniority to make managerial decisions.
- The client has implemented internal procedures that ensure objective choices in commissioning non-assurance engagements.

- The client has a corporate governance structure that provides appropriate oversight and communications regarding the firm's services.

SECTION 210

Professional Appointment

Client Acceptance

210.1 Before accepting a new client relationship, a professional accountant in public practice should consider whether acceptance would create any threats to compliance with the fundamental principles. Potential threats to integrity or professional behavior may be created from, for example, questionable issues associated with the client (its owners, management and activities).

210.2 Client issues that, if known, could threaten compliance with the fundamental principles include, for example, client involvement in illegal activities (such as money laundering), dishonesty or questionable financial reporting practices.

210.3 The significance of any threats should be evaluated. If identified threats are other than clearly insignificant, safeguards should be considered and applied as necessary to eliminate them or reduce them to an acceptable level.

210.4 Appropriate safeguards may include obtaining knowledge and understanding of the client, its owners, managers and those responsible for its governance and business activities, or securing the client's commitment to improve corporate governance practices or internal controls.

210.5 Where it is not possible to reduce the threats to an acceptable level, a professional accountant in public practice should decline to enter into the client relationship.

210.6 Acceptance decisions should be periodically reviewed for recurring client engagements.

Engagement Acceptance

210.7 A professional accountant in public practice should agree to provide only those services that the professional accountant in public practice is competent to perform. Before accepting a specific client engagement, a professional accountant in public practice should consider whether acceptance would create any threats to compliance with the fundamental principles. For example, a self-interest threat to professional competence and due care is created if the engagement team does not possess, or cannot acquire, the competencies necessary to properly carry out the engagement.

210.8 A professional accountant in public practice should evaluate the significance of identified threats and, if they are other than clearly

insignificant, safeguards should be applied as necessary to eliminate them or reduce them to an acceptable level. Such safeguards may include:

- Acquiring an appropriate understanding of the nature of the client's business, the complexity of its operations, the specific requirements of the engagement and the purpose, nature and scope of the work to be performed.
- Acquiring knowledge of relevant industries or subject matters.
- Possessing or obtaining experience with relevant regulatory or reporting requirements.
- Assigning sufficient staff with the necessary competencies.
- Using experts where necessary.
- Agreeing on a realistic time frame for the performance of the engagement.
- Complying with quality control policies and procedures designed to provide reasonable assurance that specific engagements are accepted only when they can be performed competently.

210.9 When a professional accountant in public practice intends to rely on the advice or work of an expert, the professional accountant in public practice should evaluate whether such reliance is warranted. The professional accountant in public practice should consider factors such as reputation, expertise, resources available and applicable professional and ethical standards. Such information may be gained from prior association with the expert or from consulting others.

Changes in a Professional Appointment

210.10 A professional accountant in public practice who is asked to replace another professional accountant in public practice, or who is considering tendering for an engagement currently held by another professional accountant in public practice, should determine whether there are any reasons, professional or other, for not accepting the engagement, such as circumstances that threaten compliance with the fundamental principles. For example, there may be a threat to professional competence and due care if a professional accountant in public practice accepts the engagement before knowing all the pertinent facts.

210.11 The significance of the threats should be evaluated. Depending on the nature of the engagement, this may require direct communication with the **existing accountant**[*] to establish the facts and circumstances behind the

[*] See Definitions.

proposed change so that the professional accountant in public practice can decide whether it would be appropriate to accept the engagement. For example, the apparent reasons for the change in appointment may not fully reflect the facts and may indicate disagreements with the existing accountant that may influence the decision as to whether to accept the appointment.

210.12 An existing accountant is bound by confidentiality. The extent to which the professional accountant in public practice can and should discuss the affairs of a client with a proposed accountant will depend on the nature of the engagement and on:

(a) Whether the client's permission to do so has been obtained; or

(b) The legal or ethical requirements relating to such communications and disclosure, which may vary by jurisdiction.

210.13 In the absence of specific instructions by the client, an existing accountant should not ordinarily volunteer information about the client's affairs. Circumstances where it may be appropriate to disclose confidential information are set out in Section 140 of Part A of this Code.

210.14 If identified threats are other than clearly insignificant, safeguards should be considered and applied as necessary to eliminate them or reduce them to an acceptable level.

210.15 Such safeguards may include:

- Discussing the client's affairs fully and freely with the existing accountant.
- Asking the existing accountant to provide known information on any facts or circumstances, that, in the existing accountant's opinion, the proposed accountant should be aware of before deciding whether to accept the engagement.
- When replying to requests to submit tenders, stating in the tender that, before accepting the engagement, contact with the existing accountant will be requested so that inquiries may be made as to whether there are any professional or other reasons why the appointment should not be accepted.

210.16 A professional accountant in public practice will ordinarily need to obtain the client's permission, preferably in writing, to initiate discussion with an existing accountant. Once that permission is obtained, the existing accountant should comply with relevant legal and other regulations governing such requests. Where the existing accountant provides information, it should be provided honestly and unambiguously. If the proposed accountant is unable to communicate with the existing accountant, the proposed accountant should try to obtain information

about any possible threats by other means such as through inquiries of third parties or background investigations on senior management or those charged with governance of the client.

210.17 Where the threats cannot be eliminated or reduced to an acceptable level through the application of safeguards, a professional accountant in public practice should, unless there is satisfaction as to necessary facts by other means, decline the engagement.

210.18 A professional accountant in public practice may be asked to undertake work that is complementary or additional to the work of the existing accountant. Such circumstances may give rise to potential threats to professional competence and due care resulting from, for example, a lack of or incomplete information. Safeguards against such threats include notifying the existing accountant of the proposed work, which would give the existing accountant the opportunity to provide any relevant information needed for the proper conduct of the work.

SECTION 220

Conflicts of Interest

220.1 A professional accountant in public practice should take reasonable steps to identify circumstances that could pose a conflict of interest. Such circumstances may give rise to threats to compliance with the fundamental principles. For example, a threat to objectivity may be created when a professional accountant in public practice competes directly with a client or has a joint venture or similar arrangement with a major competitor of a client. A threat to objectivity or confidentiality may also be created when a professional accountant in public practice performs services for clients whose interests are in conflict or the clients are in dispute with each other in relation to the matter or transaction in question.

220.2 A professional accountant in public practice should evaluate the significance of any threats. Evaluation includes considering, before accepting or continuing a client relationship or specific engagement, whether the professional accountant in public practice has any business interests, or relationships with the client or a third party that could give rise to threats. If threats are other than clearly insignificant, safeguards should be considered and applied as necessary to eliminate them or reduce them to an acceptable level.

220.3 Depending upon the circumstances giving rise to the conflict, safeguards should ordinarily include the professional accountant in public practice:

(a) Notifying the client of the firm's business interest or activities that may represent a conflict of interest, and obtaining their consent to act in such circumstances; or

(b) Notifying all known relevant parties that the professional accountant in public practice is acting for two or more parties in respect of a matter where their respective interests are in conflict, and obtaining their consent to so act; or

(c) Notifying the client that the professional accountant in public practice does not act exclusively for any one client in the provision of proposed services (for example, in a particular market sector or with respect to a specific service) and obtaining their consent to so act.

220.4 The following additional safeguards should also be considered:

(a) The use of separate engagement teams; and

(b) Procedures to prevent access to information (e.g., strict physical separation of such teams, confidential and secure data filing); and

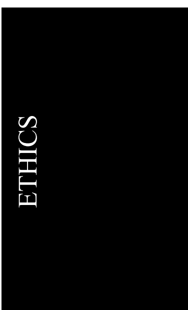
(c) Clear guidelines for members of the engagement team on issues of security and confidentiality; and

(d) The use of confidentiality agreements signed by employees and partners of the firm; and

(e) Regular review of the application of safeguards by a senior individual not involved with relevant client engagements.

220.5 Where a conflict of interest poses a threat to one or more of the fundamental principles, including objectivity, confidentiality or professional behavior, that cannot be eliminated or reduced to an acceptable level through the application of safeguards, the professional accountant in public practice should conclude that it is not appropriate to accept a specific engagement or that resignation from one or more conflicting engagements is required.

220.6 Where a professional accountant in public practice has requested consent from a client to act for another party (which may or may not be an existing client) in respect of a matter where the respective interests are in conflict and that consent has been refused by the client, then the professional accountant in public practice must not continue to act for one of the parties in the matter giving rise to the conflict of interest.



SECTION 230

Second Opinions

230.1 Situations where a professional accountant in public practice is asked to provide a second opinion on the application of accounting, auditing, reporting or other standards or principles to specific circumstances or transactions by or on behalf of a company or an entity that is not an existing client may give rise to threats to compliance with the fundamental principles. For example, there may be a threat to professional competence and due care in circumstances where the second opinion is not based on the same set of facts that were made available to the existing accountant, or is based on inadequate evidence. The significance of the threat will depend on the circumstances of the request and all the other available facts and assumptions relevant to the expression of a professional judgment.

230.2 When asked to provide such an opinion, a professional accountant in public practice should evaluate the significance of the threats and, if they are other than clearly insignificant, safeguards should be considered and applied as necessary to eliminate them or reduce them to an acceptable level. Such safeguards may include seeking client permission to contact the existing accountant, describing the limitations surrounding any opinion in communications with the client and providing the existing accountant with a copy of the opinion.

230.3 If the company or entity seeking the opinion will not permit communication with the existing accountant, a professional accountant in public practice should consider whether, taking all the circumstances into account, it is appropriate to provide the opinion sought.

SECTION 240

Fees and Other Types of Remuneration

240.1 When entering into negotiations regarding professional services, a professional accountant in public practice may quote whatever fee deemed to be appropriate. The fact that one professional accountant in public practice may quote a fee lower than another is not in itself unethical. Nevertheless, there may be threats to compliance with the fundamental principles arising from the level of fees quoted. For example, a self-interest threat to professional competence and due care is created if the fee quoted is so low that it may be difficult to perform the engagement in accordance with applicable technical and professional standards for that price.

240.2 The significance of such threats will depend on factors such as the level of fee quoted and the services to which it applies. In view of these potential threats, safeguards should be considered and applied as necessary to eliminate them or reduce them to an acceptable level. Safeguards which may be adopted include:

- Making the client aware of the terms of the engagement and, in particular, the basis on which fees are charged and which services are covered by the quoted fee.
- Assigning appropriate time and qualified staff to the task.

240.3 Contingent fees are widely used for certain types of non-assurance engagements.[1] They may, however, give rise to threats to compliance with the fundamental principles in certain circumstances. They may give rise to a self-interest threat to objectivity. The significance of such threats will depend on factors including:

- The nature of the engagement.
- The range of possible fee amounts.
- The basis for determining the fee.
- Whether the outcome or result of the transaction is to be reviewed by an independent third party.

240.4 The significance of such threats should be evaluated and, if they are other than clearly insignificant, safeguards should be considered and applied as necessary to eliminate or reduce them to an acceptable level. Such safeguards may include:

[1] Contingent fees for non-assurance services provided to assurance clients are discussed in Section 290 of this part of the Code.

- An advance written agreement with the client as to the basis of remuneration.
- Disclosure to intended users of the work performed by the professional accountant in public practice and the basis of remuneration.
- Quality control policies and procedures.
- Review by an objective third party of the work performed by the professional accountant in public practice.

240.5 In certain circumstances, a professional accountant in public practice may receive a referral fee or commission relating to a client. For example, where the professional accountant in public practice does not provide the specific service required, a fee may be received for referring a continuing client to another professional accountant in public practice or other expert. A professional accountant in public practice may receive a commission from a third party (e.g., a software vendor) in connection with the sale of goods or services to a client. Accepting such a referral fee or commission may give rise to self-interest threats to objectivity and professional competence and due care.

240.6 A professional accountant in public practice may also pay a referral fee to obtain a client, for example, where the client continues as a client of another professional accountant in public practice but requires specialist services not offered by the existing accountant. The payment of such a referral fee may also create a self-interest threat to objectivity and professional competence and due care.

240.7 A professional accountant in public practice should not pay or receive a referral fee or commission, unless the professional accountant in public practice has established safeguards to eliminate the threats or reduce them to an acceptable level. Such safeguards may include:

- Disclosing to the client any arrangements to pay a referral fee to another professional accountant for the work referred.
- Disclosing to the client any arrangements to receive a referral fee for referring the client to another professional accountant in public practice.
- Obtaining advance agreement from the client for commission arrangements in connection with the sale by a third party of goods or services to the client.

240.8 A professional accountant in public practice may purchase all or part of another firm on the basis that payments will be made to individuals formerly owning the firm or to their heirs or estates. Such payments are not regarded as commissions or referral fees for the purpose of paragraph 240.5-240.7 above.

SECTION 250

Marketing Professional Services

250.1 When a professional accountant in public practice solicits new work through **advertising*** or other forms of marketing, there may be potential threats to compliance with the fundamental principles. For example, a self-interest threat to compliance with the principle of professional behavior is created if services, achievements or products are marketed in a way that is inconsistent with that principle.

250.2 A professional accountant in public practice should not bring the profession into disrepute when marketing professional services. The professional accountant in public practice should be honest and truthful and should not:

- Make exaggerated claims for services offered, qualifications possessed or experience gained; or
- Make disparaging references to unsubstantiated comparisons to the work of another.

If the professional accountant in public practice is in doubt whether a proposed form of advertising or marketing is appropriate, the professional accountant in public practice should consult with the relevant professional body.

* See Definitions.

SECTION 260

Gifts and Hospitality

260.1 A professional accountant in public practice, or an immediate or close family member, may be offered gifts and hospitality from a client. Such an offer ordinarily gives rise to threats to compliance with the fundamental principles. For example, self-interest threats to objectivity may be created if a gift from a client is accepted; intimidation threats to objectivity may result from the possibility of such offers being made public.

260.2 The significance of such threats will depend on the nature, value and intent behind the offer. Where gifts or hospitality which a reasonable and informed third party, having knowledge of all relevant information, would consider clearly insignificant are made a professional accountant in public practice may conclude that the offer is made in the normal course of business without the specific intent to influence decision making or to obtain information. In such cases, the professional accountant in public practice may generally conclude that there is no significant threat to compliance with the fundamental principles.

260.3 If evaluated threats are other than clearly insignificant, safeguards should be considered and applied as necessary to eliminate them or reduce them to an acceptable level. When the threats cannot be eliminated or reduced to an acceptable level through the application of safeguards, a professional accountant in public practice should not accept such an offer.

SECTION 270

Custody of Client Assets

270.1 A professional accountant in public practice should not assume custody of client monies or other assets unless permitted to do so by law and, if so, in compliance with any additional legal duties imposed on a professional accountant in public practice holding such assets.

270.2 The holding of client assets creates threats to compliance with the fundamental principles; for example, there is a self-interest threat to professional behavior and may be a self interest threat to objectivity arising from holding client assets. To safeguard against such threats, a professional accountant in public practice entrusted with money (or other assets) belonging to others should:

(a) Keep such assets separately from personal or firm assets; and

(b) Use such assets only for the purpose for which they are intended; and

(c) At all times, be ready to account for those assets, and any income, dividends or gains generated, to any persons entitled to such accounting; and

(d) Comply with all relevant laws and regulations relevant to the holding of and accounting for such assets.

270.3 In addition, professional accountants in public practice should be aware of threats to compliance with the fundamental principles through association with such assets, for example, if the assets were found to derive from illegal activities, such as money laundering. As part of client and engagement acceptance procedures for such services, professional accountants in public practice should make appropriate inquiries about the source of such assets and should consider their legal and regulatory obligations. They may also consider seeking legal advice.

SECTION 280

Objectivity—All Services

280.1 A professional accountant in public practice should consider when providing any professional service whether there are threats to compliance with the fundamental principle of objectivity resulting from having interests in, or relationships with, a client or directors, officers or employees. For example, a familiarity threat to objectivity may be created from a family or close personal or business relationship.

280.2 A professional accountant in public practice who provides an assurance service is required to be independent of the assurance client. Independence of mind and in appearance is necessary to enable the professional accountant in public practice to express a conclusion, and be seen to express a conclusion, without bias, conflict of interest or undue influence of others. Section 290 provides specific guidance on independence requirements for professional accountants in public practice when performing an assurance engagement.

280.3 The existence of threats to objectivity when providing any professional service will depend upon the particular circumstances of the engagement and the nature of the work that the professional accountant in public practice is performing.

280.4 A professional accountant in public practice should evaluate the significance of identified threats and, if they are other than clearly insignificant, safeguards should be considered and applied as necessary to eliminate them or reduce them to an acceptable level. Such safeguards may include:

- Withdrawing from the engagement team.
- Supervisory procedures.
- Terminating the financial or business relationship giving rise to the threat.
- Discussing the issue with higher levels of management within the firm.
- Discussing the issue with those charged with governance of the client.

SECTION 290

Independence—Assurance Engagements

290.1 In the case of an assurance engagement it is in the public interest and, therefore, required by this Code of Ethics, that members of **assurance teams**,* firms and, when applicable, **network firms*** be independent of assurance clients.

290.2 Assurance engagements are designed to enhance intended users' degree of confidence about the outcome of the evaluation or measurement of a subject matter against criteria. The International Framework for Assurance Engagements (the Assurance Framework) issued by the International Auditing and Assurance Standards Board describes the elements and objectives of an assurance engagement, and identifies engagements to which International Standards on Auditing (ISAs), International Standards on Review Engagements (ISREs) and International Standards on Assurance Engagements (ISAEs) apply. For a description of the elements and objectives of an assurance engagement reference should be made to the Assurance Framework.

290.3 As further explained in the Assurance Framework, in an assurance engagement the professional accountant in public practice expresses a conclusion designed to enhance the degree of confidence of the intended users other than the responsible party about the outcome of the evaluation or measurement of a subject matter against criteria.

290.4 The outcome of the evaluation or measurement of a subject matter is the information that results from applying the criteria to the subject matter. The term "subject matter information" is used to mean the outcome of the evaluation or measurement of subject matter. For example:

- The recognition, measurement, presentation and disclosure represented in the **financial statements*** (subject matter information) result from applying a financial reporting framework for recognition, measurement, presentation and disclosure, such as International Financial Reporting Standards, (criteria) to an entity's financial position, financial performance and cash flows (subject matter).
- An assertion about the effectiveness of internal control (subject matter information) results from applying a framework for evaluating the effectiveness of internal control, such as COSO or CoCo, (criteria) to internal control, a process (subject matter).

* See Definitions.

290.5 Assurance engagements may be assertion-based or direct reporting. In either case they involve three separate parties: a public accountant in public practice, a responsible party and intended users.

290.6 In an assertion-based assurance engagement, which includes a **financial statement audit engagement**,* the evaluation or measurement of the subject matter is performed by the responsible party, and the subject matter information is in the form of an assertion by the responsible party that is made available to the intended users.

290.7 In a direct reporting assurance engagement the professional accountant in public practice either directly performs the evaluation or measurement of the subject matter, or obtains a representation from the responsible party that has performed the evaluation or measurement that is not available to the intended users. The subject matter information is provided to the intended users in the assurance report.

290.8 Independence requires:

Independence of Mind

The state of mind that permits the expression of a conclusion without being affected by influences that compromise professional judgment, allowing an individual to act with integrity, and exercise objectivity and professional skepticism.

Independence in Appearance

The avoidance of facts and circumstances that are so significant that a reasonable and informed third party, having knowledge of all relevant information, including safeguards applied, would reasonably conclude a firm's, or a member of the assurance team's, integrity, objectivity or professional skepticism had been compromised.

290.9 The use of the word "independence" on its own may create misunderstandings. Standing alone, the word may lead observers to suppose that a person exercising professional judgment ought to be free from all economic, financial and other relationships. This is impossible, as every member of society has relationships with others. Therefore, the significance of economic, financial and other relationships should also be evaluated in the light of what a reasonable and informed third party having knowledge of all relevant information would reasonably conclude to be unacceptable.

290.10 Many different circumstances, or combination of circumstances, may be relevant and accordingly it is impossible to define every situation that creates threats to independence and specify the appropriate mitigating

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* See Definitions.

action that should be taken. In addition, the nature of assurance engagements may differ and consequently different threats may exist, requiring the application of different safeguards. A conceptual framework that requires firms and members of assurance teams to identify, evaluate and address threats to independence, rather than merely comply with a set of specific rules which may be arbitrary, is, therefore, in the public interest.

A Conceptual Approach to Independence

290.11 Members of assurance teams, firms and network firms are required to apply the conceptual framework contained in Section 100 to the particular circumstances under consideration. In addition to identifying relationships between the firm, network firms, members of the assurance team and the assurance client, consideration should be given to whether relationships between individuals outside of the assurance team and the assurance client create threats to independence.

290.12 The examples presented in this section are intended to illustrate the application of the conceptual framework and are not intended to be, nor should they be interpreted as, an exhaustive list of all circumstances that may create threats to independence. Consequently, it is not sufficient for a member of an assurance team, a firm or a network firm merely to comply with the examples presented, rather they should apply the framework to the particular circumstances they face.

290.13 The nature of the threats to independence and the applicable safeguards necessary to eliminate the threats or reduce them to an acceptable level differ depending on the characteristics of the individual assurance engagement: whether it is a financial statement audit engagement or another type of assurance engagement; and in the latter case, the purpose, subject matter information and intended users of the report. A firm should, therefore, evaluate the relevant circumstances, the nature of the assurance engagement and the threats to independence in deciding whether it is appropriate to accept or continue an engagement, as well as the nature of the safeguards required and whether a particular individual should be a member of the assurance team.

Assertion-Based Assurance Engagements

Financial Statement Audit Engagements

290.14 Financial statement audit engagements are relevant to a wide range of potential users; consequently, in addition to independence of mind, independence in appearance is of particular significance. Accordingly, for financial statement audit clients, the members of the assurance team, the firm and network firms are required to be independent of the financial statement audit client. Such independence requirements include

prohibitions regarding certain relationships between members of the assurance team and directors, officers and employees of the client in a position to exert direct and significant influence over the subject matter information (the financial statements). Also, consideration should be given to whether threats to independence are created by relationships with employees of the client in a position to exert direct and significant influence over the subject matter (the financial position, financial performance and cash flows).

Other Assertion-Based Assurance Engagements

290.15 In an assertion-based assurance engagement where the client is not a financial statement audit client, the members of the assurance team and the firm are required to be independent of the assurance client (the responsible party, which is responsible for the subject matter information and may be responsible for the subject matter). Such independence requirements include prohibitions regarding certain relationships between members of the assurance team and directors, officers and employees of the client in a position to exert direct and significant influence over the subject matter information. Also, consideration should be given to whether threats to independence are created by relationships with employees of the client in a position to exert direct and significant influence over the subject matter of the engagement. Consideration should also be given to any threats that the firm has reason to believe may be created by network firm interests and relationships.

290.16 In the majority of assertion-based assurance engagements, that are not financial statement audit engagements, the responsible party is responsible for the subject matter information and the subject matter. However, in some engagements the responsible party may not be responsible for the subject matter. For example, when a professional accountant in public practice is engaged to perform an assurance engagement regarding a report that an environmental consultant has prepared about a company's sustainability practices, for distribution to intended users, the environmental consultant is the responsible party for the subject matter information but the company is responsible for the subject matter (the sustainability practices).

290.17 In those assertion-based assurance engagements that are not financial statement audit engagements, where the responsible party is responsible for the subject matter information but not the subject matter the members of the assurance team and the firm are required to be independent of the party responsible for the subject matter information (the assurance client). In addition, consideration should be given to any threats the firm has reason to believe may be created by interests and relationships between a member of the assurance team, the firm, a network firm and the party responsible for the subject matter.

Direct Reporting Assurance Engagements

290.18 In a direct reporting assurance engagement the members of the assurance team and the firm are required to be independent of the assurance client (the party responsible for the subject matter).

Restricted Use Reports

290.19 In the case of an assurance report in respect of a non-financial statement audit client expressly restricted for use by identified users, the users of the report are considered to be knowledgeable as to the purpose, subject matter information and limitations of the report through their participation in establishing the nature and scope of the firm's instructions to deliver the services, including the criteria against which the subject matter are to be evaluated or measured. This knowledge and the enhanced ability of the firm to communicate about safeguards with all users of the report increase the effectiveness of safeguards to independence in appearance. These circumstances may be taken into account by the firm in evaluating the threats to independence and considering the applicable safeguards necessary to eliminate the threats or reduce them to an acceptable level. At a minimum, it will be necessary to apply the provisions of this section in evaluating the independence of members of the assurance team and their immediate and close family. Further, if the firm had a material financial interest, whether direct or indirect, in the assurance client, the self-interest threat created would be so significant no safeguard could reduce the threat to an acceptable level. Limited consideration of any threats created by network firm interests and relationships may be sufficient.

Multiple Responsible Parties

290.20 In some assurance engagements, whether assertion-based or direct reporting, that are not financial statement audit engagements, there might be several responsible parties. In such engagements, in determining whether it is necessary to apply the provisions in this section to each responsible party, the firm may take into account whether an interest or relationship between the firm, or a member of the assurance team, and a particular responsible party would create a threat to independence that is other than clearly insignificant in the context of the subject matter information. This will take into account factors such as:

- The materiality of the subject matter information (or the subject matter) for which the particular responsible party is responsible; and
- The degree of public interest associated with the engagement.

If the firm determines that the threat to independence created by any such interest or relationship with a particular responsible party would be

clearly insignificant it may not be necessary to apply all of the provisions of this section to that responsible party.

Other Considerations

290.21 The threats and safeguards identified in this section are generally discussed in the context of interests or relationships between the firm, network firms, members of the assurance team and the assurance client. In the case of a financial statement audit client that is a listed entity, the firm and any network firms are required to consider the interests and relationships that involve that client's related entities. Ideally those entities and the interests and relationships should be identified in advance. For all other assurance clients, when the assurance team has reason to believe that a **related entity*** of such an assurance client is relevant to the evaluation of the firm's independence of the client, the assurance team should consider that related entity when evaluating independence and applying appropriate safeguards.

290.22 The evaluation of threats to independence and subsequent action should be supported by evidence obtained before accepting the engagement and while it is being performed. The obligation to make such an evaluation and take action arises when a firm, a network firm or a member of the assurance team knows, or could reasonably be expected to know, of circumstances or relationships that might compromise independence. There may be occasions when the firm, a network firm or an individual inadvertently violates this section. If such an inadvertent violation occurs, it would generally not compromise independence with respect to an assurance client provided the firm has appropriate quality control policies and procedures in place to promote independence and, once discovered, the violation is corrected promptly and any necessary safeguards are applied.

290.23 Throughout this section, reference is made to significant and clearly insignificant threats in the evaluation of independence. In considering the significance of any particular matter, qualitative as well as quantitative factors should be taken into account. A matter should be considered clearly insignificant only if it is deemed to be both trivial and inconsequential.

Objective and Structure of this Section

290.24 The objective of this section is to assist firms and members of assurance teams in:

(a) Identifying threats to independence;

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* See Definitions.

(b) Evaluating whether these threats are clearly insignificant; and

(c) In cases when the threats are not clearly insignificant, identifying and applying appropriate safeguards to eliminate or reduce the threats to an acceptable level.

Consideration should always be given to what a reasonable and informed third party having knowledge of all relevant information, including safeguards applied, would reasonably conclude to be unacceptable. In situations when no safeguards are available to reduce the threat to an acceptable level, the only possible actions are to eliminate the activities or interest creating the threat, or to refuse to accept or continue the assurance engagement.

290.25 This section concludes with some examples of how this conceptual approach to independence is to be applied to specific circumstances and relationships. The examples discuss threats to independence that may be created by specific circumstances and relationships (paragraphs 290.100 onwards). Professional judgment is used to determine the appropriate safeguards to eliminate threats to independence or to reduce them to an acceptable level. In certain examples, the threats to independence are so significant the only possible actions are to eliminate the activities or interest creating the threat, or to refuse to accept or continue the assurance engagement. In other examples, the threat can be eliminated or reduced to an acceptable level by the application of safeguards. The examples are not intended to be all-inclusive.

290.26 Certain examples in this section indicate how the framework is to be applied to a financial statements audit engagement for a listed entity. When a member body chooses not to differentiate between listed entities and other entities, the examples that relate to financial statement audit engagements for listed entities should be considered to apply to all financial statement audit engagements.

290.27 When threats to independence that are not clearly insignificant are identified, and the firm decides to accept or continue the assurance engagement, the decision should be documented. The documentation should include a description of the threats identified and the safeguards applied to eliminate or reduce the threats to an acceptable level.

290.28 The evaluation of the significance of any threats to independence and the safeguards necessary to reduce any threats to an acceptable level, takes into account the public interest. Certain entities may be of significant public interest because, as a result of their business, their size or their corporate status they have a wide range of stakeholders. Examples of such entities may include listed companies, credit institutions, insurance companies, and pension funds. Because of the strong public interest in the financial statements of listed entities, certain paragraphs in this section

deal with additional matters that are relevant to the financial statement audit of listed entities. Consideration should be given to the application of the framework in relation to the financial statement audit of listed entities to other financial statement audit clients that may be of significant public interest.

290.29 Audit committees can have an important corporate governance role when they are independent of client management and can assist the Board of Directors in satisfying themselves that a firm is independent in carrying out its audit role. There should be regular communications between the firm and the audit committee (or other governance body if there is no audit committee) of listed entities regarding relationships and other matters that might, in the firm's opinion, reasonably be thought to bear on independence.

290.30 Firms should establish policies and procedures relating to independence communications with audit committees, or others charged with governance of the client. In the case of the financial statement audit of listed entities, the firm should communicate orally and in writing at least annually, all relationships and other matters between the firm, network firms and the financial statement audit client that in the firm's professional judgment may reasonably be thought to bear on independence. Matters to be communicated will vary in each circumstance and should be decided by the firm, but should generally address the relevant matters set out in this section.

Engagement Period

290.31 The members of the assurance team and the firm should be independent of the assurance client during the period of the assurance engagement. The period of the engagement starts when the assurance team begins to perform assurance services and ends when the assurance report is issued, except when the assurance engagement is of a recurring nature. If the assurance engagement is expected to recur, the period of the assurance engagement ends with the notification by either party that the professional relationship has terminated or the issuance of the final assurance report, whichever is later.

290.32 In the case of a financial statement audit engagement, the engagement period includes the period covered by the financial statements reported on by the firm. When an entity becomes a financial statement audit client during or after the period covered by the financial statements that the firm will report on, the firm should consider whether any threats to independence may be created by:

- Financial or business relationships with the audit client during or after the period covered by the financial statements, but prior to the acceptance of the financial statement audit engagement; or

- Previous services provided to the audit client.

Similarly, in the case of an assurance engagement that is not a financial statement audit engagement, the firm should consider whether any financial or business relationships or previous services may create threats to independence.

290.33 If a non-assurance service was provided to the financial statement audit client during or after the period covered by the financial statements but before the commencement of professional services in connection with the financial statement audit and the service would be prohibited during the period of the audit engagement, consideration should be given to the threats to independence, if any, arising from the service. If the threat is other than clearly insignificant, safeguards should be considered and applied as necessary to reduce the threat to an acceptable level. Such safeguards may include:

- Discussing independence issues related to the provision of the non-assurance service with those charged with governance of the client, such as the audit committee;
- Obtaining the client's acknowledgement of responsibility for the results of the non-assurance service;
- Precluding personnel who provided the non-assurance service from participating in the financial statement audit engagement; and
- Engaging another firm to review the results of the non-assurance service or having another firm re-perform the non-assurance service to the extent necessary to enable it to take responsibility for the service.

290.34 A non-assurance service provided to a non-listed financial statement audit client will not impair the firm's independence when the client becomes a listed entity provided:

(a) The previous non-assurance service was permissible under this section for non-listed financial statement audit clients;

(b) The service will be terminated within a reasonable period of time of the client becoming a listed entity, if they are impermissible under this section for financial statement audit clients that are listed entities; and

(c) The firm has implemented appropriate safeguards to eliminate any threats to independence arising from the previous service or reduce them to an acceptable level.

Application of Framework to Specific Situations

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Introduction

290.100 The following examples describe specific circumstances and relationships that may create threats to independence. The examples describe the potential threats created and the safeguards that may be appropriate to eliminate the threats or reduce them to an acceptable level in each circumstance. The examples are not all inclusive. In practice, the firm, network firms and the members of the assurance team will be required to assess the implications of similar, but different, circumstances and relationships and to determine whether safeguards, including the safeguards in paragraphs 200.12-200.15 can be applied to satisfactorily address the threats to independence.

290.101 Some of the examples deal with financial statement audit clients while others deal with assurance engagements for clients that are not financial statement audit clients. The examples illustrate how safeguards should be applied to fulfill the requirement for the members of the assurance team, the firm and network firms to be independent of a financial statement audit client, and for the members of the assurance team and the firm to be independent of an assurance client that is not a financial statement audit client. The examples do not include assurance reports to a non-financial statement audit client expressly restricted for use by identified users. As stated in paragraph 290.19 for such engagements, members of the assurance team and their immediate and close family are required to be independent of the assurance client. Further, the firm should not have a material financial interest, direct or indirect, in the assurance client.

290.102 The examples illustrate how the framework applies to financial statement audit clients and other assurance clients. The examples should be read in conjunction with paragraphs 290.20 which explain that, in the majority of assurance engagements, there is one responsible party and that responsible party comprises the assurance client. However, in some assurance engagements there are two responsible parties. In such circumstances, consideration should be given to any threats the firm has reason to believe may be created by interests and relationships between a member of the assurance team, the firm, a network firm and the party responsible for the subject matter.

290.103 Interpretation 2005-01 to this section provides further guidance on the application of the independence requirements contained in this section to assurance engagements that are not financial statement audit engagements.

Financial Interests

290.104 A financial interest in an assurance client may create a self-interest threat. In evaluating the significance of the threat, and the appropriate safeguards to be applied to eliminate the threat or reduce it to an acceptable level, it

is necessary to examine the nature of the financial interest. This includes an evaluation of the role of the person holding the financial interest, the materiality of the financial interest and the type of financial interest (direct or indirect).

290.105 When evaluating the type of financial interest, consideration should be given to the fact that financial interests range from those where the individual has no control over the investment vehicle or the financial interest held (e.g., a mutual fund, unit trust or similar intermediary vehicle) to those where the individual has control over the financial interest (e.g., as a trustee) or is able to influence investment decisions. In evaluating the significance of any threat to independence, it is important to consider the degree of control or influence that can be exercised over the intermediary, the financial interest held, or its investment strategy. When control exists, the financial interest should be considered direct. Conversely, when the holder of the financial interest has no ability to exercise such control the financial interest should be considered indirect.

Provisions Applicable to all Assurance Clients

290.106 If a member of the assurance team, or their immediate family member, has a **direct financial interest,*** or a material **indirect financial interest**,* in the assurance client, the self-interest threat created would be so significant the only safeguards available to eliminate the threat or reduce it to an acceptable level would be to:

(a) Dispose of the direct financial interest prior to the individual becoming a member of the assurance team;

(b) Dispose of the indirect financial interest in total or dispose of a sufficient amount of it so that the remaining interest is no longer material prior to the individual becoming a member of the assurance team; or

(c) Remove the member of the assurance team from the assurance engagement.

290.107 If a member of the assurance team, or their immediate family member receives, by way of, for example, an inheritance, gift or, as a result of a merger, a direct financial interest or a material indirect financial interest in the assurance client, a self-interest threat would be created. The following safeguards should be applied to eliminate the threat or reduce it to an acceptable level:

(a) Disposing of the financial interest at the earliest practical date; or

* See Definitions.

(b) Removing the member of the assurance team from the assurance engagement.

During the period prior to disposal of the financial interest or the removal of the individual from the assurance team, consideration should be given to whether additional safeguards are necessary to reduce the threat to an acceptable level. Such safeguards might include:

- Discussing the matter with those charged with governance, such as the audit committee; or
- Involving an additional professional accountant to review the work done, or otherwise advise as necessary.

290.108 When a member of the assurance team knows that his or her close family member has a direct financial interest or a material indirect financial interest in the assurance client, a self-interest threat may be created. In evaluating the significance of any threat, consideration should be given to the nature of the relationship between the member of the assurance team and the close family member and the materiality of the financial interest. Once the significance of the threat has been evaluated, safeguards should be considered and applied as necessary. Such safeguards might include:

- The close family member disposing of all or a sufficient portion of the financial interest at the earliest practical date;
- Discussing the matter with those charged with governance, such as the audit committee;
- Involving an additional professional accountant who did not take part in the assurance engagement to review the work done by the member of the assurance team with the close family relationship or otherwise advise as necessary; or
- Removing the individual from the assurance engagement.

290.109 When a firm or a member of the assurance team holds a direct financial interest or a material indirect financial interest in the assurance client as a trustee, a self-interest threat may be created by the possible influence of the trust over the assurance client. Accordingly, such an interest should only be held when:

(a) The member of the assurance team, an immediate family member of the member of the assurance team, and the firm are not beneficiaries of the trust;

(b) The interest held by the trust in the assurance client is not material to the trust;

(c) The trust is not able to exercise significant influence over the assurance client; and

(d) The member of the assurance team or the firm does not have significant influence over any investment decision involving a financial interest in the assurance client.

290.110 Consideration should be given to whether a self-interest threat may be created by the financial interests of individuals outside of the assurance team and their immediate and close family members. Such individuals would include:

- Partners, and their immediate family members, who are not members of the assurance team;
- Partners and managerial employees who provide non-assurance services to the assurance client; and
- Individuals who have a close personal relationship with a member of the assurance team.

Whether the interests held by such individuals may create a self-interest threat will depend upon factors such as:

- The firm's organizational, operating and reporting structure; and
- The nature of the relationship between the individual and the member of the assurance team.

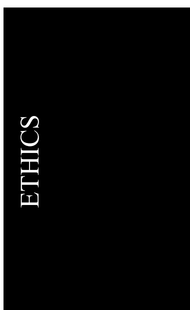
The significance of the threat should be evaluated and, if the threat is other than clearly insignificant, safeguards should be considered and applied as necessary to reduce the threat to an acceptable level. Such safeguards might include:

- Where appropriate, policies to restrict people from holding such interests;
- Discussing the matter with those charged with governance, such as the audit committee; or
- Involving an additional professional accountant who did not take part in the assurance engagement to review the work done or otherwise advise as necessary.

290.111 An inadvertent violation of this section as it relates to a financial interest in an assurance client would not impair the independence of the firm, the network firm or a member of the assurance team when:

(a) The firm, and the network firm, have established policies and procedures that require all professionals to report promptly to the firm any breaches resulting from the purchase, inheritance or other acquisition of a financial interest in the assurance client;

(b) The firm, and the network firm, promptly notify the professional that the financial interest should be disposed of; and



(c) The disposal occurs at the earliest practical date after identification of the issue, or the professional is removed from the assurance team.

290.112 When an inadvertent violation of this section relating to a financial interest in an assurance client has occurred, the firm should consider whether any safeguards should be applied. Such safeguards might include:

- Involving an additional professional accountant who did not take part in the assurance engagement to review the work done by the member of the assurance team; or
- Excluding the individual from any substantive decision-making concerning the assurance engagement.

Provisions Applicable to Financial Statement Audit Clients

290.113 If a firm, or a network firm, has a direct financial interest in a financial statement audit client of the firm the self-interest threat created would be so significant no safeguard could reduce the threat to an acceptable level. Consequently, disposal of the financial interest would be the only action appropriate to permit the firm to perform the engagement.

290.114 If a firm, or a network firm, has a material indirect financial interest in a financial statement audit client of the firm a self-interest threat is also created. The only actions appropriate to permit the firm to perform the engagement would be for the firm, or the network firm, either to dispose of the indirect interest in total or to dispose of a sufficient amount of it so that the remaining interest is no longer material.

290.115 If a firm, or a network firm, has a material financial interest in an entity that has a controlling interest in a financial statement audit client, the self-interest threat created would be so significant no safeguard could reduce the threat to an acceptable level. The only actions appropriate to permit the firm to perform the engagement would be for the firm, or the network firm, either to dispose of the financial interest in total or to dispose of a sufficient amount of it so that the remaining interest is no longer material.

290.116 If the retirement benefit plan of a firm, or network firm, has a financial interest in a financial statement audit client a self-interest threat may be created. Accordingly, the significance of any such threat created should be evaluated and, if the threat is other than clearly insignificant, safeguards should be considered and applied as necessary to eliminate the threat or reduce it to an acceptable level.

290.117 If other partners, including partners who do not perform assurance engagements, or their immediate family, in the **office*** in which the **engagement partner*** practices in connection with the financial statement audit hold a direct financial interest or a material indirect financial interest in that audit client, the self-interest threat created would be so significant no safeguard could reduce the threat to an acceptable level. Accordingly, such partners or their immediate family should not hold any such financial interests in such an audit client.

290.118 The office in which the engagement partner practices in connection with the financial statement audit is not necessarily the office to which that partner is assigned. Accordingly, when the engagement partner is located in a different office from that of the other members of the assurance team, judgment should be used to determine in which office the partner practices in connection with that audit.

290.119 If other partners and managerial employees who provide non-assurance services to the financial statement audit client, except those whose involvement is clearly insignificant, or their immediate family, hold a direct financial interest or a material indirect financial interest in the audit client, the self-interest threat created would be so significant no safeguard could reduce the threat to an acceptable level. Accordingly, such personnel or their immediate family should not hold any such financial interests in such an audit client.

290.120 A financial interest in a financial statement audit client that is held by an immediate family member of (a) a partner located in the office in which the engagement partner practices in connection with the audit, or (b) a partner or managerial employee who provides non-assurance services to the audit client is not considered to create an unacceptable threat provided it is received as a result of their employment rights (e.g., pension rights or share options) and, where necessary, appropriate safeguards are applied to reduce any threat to independence to an acceptable level.

290.121 A self-interest threat may be created if the firm, or the network firm, or a member of the assurance team has an interest in an entity and a financial statement audit client, or a director, officer or controlling owner thereof also has an investment in that entity. Independence is not compromised with respect to the audit client if the respective interests of the firm, the network firm, or member of the assurance team, and the audit client, or director, officer or controlling owner thereof are both immaterial and the audit client cannot exercise significant influence over the entity. If an interest is material, to either the firm, the network firm or the audit client, and the audit client can exercise significant influence over the entity, no

* See Definitions.

safeguards are available to reduce the threat to an acceptable level and the firm, or the network firm, should either dispose of the interest or decline the audit engagement. Any member of the assurance team with such a material interest should either:

(a) Dispose of the interest;

(b) Dispose of a sufficient amount of the interest so that the remaining interest is no longer material; or

(c) Withdraw from the audit.

Provisions Applicable to Non-Financial Statement Audit Assurance Clients

290.122 If a firm has a direct financial interest in an assurance client that is not a financial statement audit client the self-interest threat created would be so significant no safeguard could reduce the threat to an acceptable level. Consequently, disposal of the financial interest would be the only action appropriate to permit the firm to perform the engagement.

290.123 If a firm has a material indirect financial interest in an assurance client that is not a financial statement audit client a self-interest threat is also created. The only action appropriate to permit the firm to perform the engagement would be for the firm to either dispose of the indirect interest in total or to dispose of a sufficient amount of it so that the remaining interest is no longer material.

290.124 If a firm has a material financial interest in an entity that has a controlling interest in an assurance client that is not a financial statement audit client, the self-interest threat created would be so significant no safeguard could reduce the threat to an acceptable level. The only action appropriate to permit the firm to perform the engagement would be for the firm either to dispose of the financial interest in total or to dispose of a sufficient amount of it so that the remaining interest is no longer material.

290.125 When a restricted use report for an assurance engagement that is not a financial statement audit engagement is issued, exceptions to the provisions in paragraphs 290.106-290.110 and 290.122-290.124 are set out in 290.19.

Loans and Guarantees

290.126 A loan, or a guarantee of a loan, to the firm from an assurance client that is a bank or a similar institution, would not create a threat to independence provided the loan, or guarantee, is made under normal lending procedures, terms and requirements and the loan is immaterial to both the firm and the assurance client. If the loan is material to the assurance client or the firm it may be possible, through the application of safeguards, to reduce the self-interest threat created to an acceptable

level. Such safeguards might include involving an additional professional accountant from outside the firm, or network firm, to review the work performed.

290.127 A loan, or a guarantee of a loan, from an assurance client that is a bank or a similar institution, to a member of the assurance team or their immediate family would not create a threat to independence provided the loan, or guarantee, is made under normal lending procedures, terms and requirements. Examples of such loans include home mortgages, bank overdrafts, car loans and credit card balances.

290.128 Similarly, deposits made by, or brokerage accounts of, a firm or a member of the assurance team with an assurance client that is a bank, broker or similar institution would not create a threat to independence provided the deposit or account is held under normal commercial terms.

290.129 If the firm, or a member of the assurance team, makes a loan to an assurance client, that is not a bank or similar institution, or guarantees such an assurance client's borrowing, the self-interest threat created would be so significant no safeguard could reduce the threat to an acceptable level, unless the loan or guarantee is immaterial to both the firm or the member of the assurance team and the assurance client.

290.130 Similarly, if the firm or a member of the assurance team accepts a loan from, or has borrowing guaranteed by, an assurance client that is not a bank or similar institution, the self-interest threat created would be so significant no safeguard could reduce the threat to an acceptable level, unless the loan or guarantee is immaterial to both the firm or the member of the assurance team and the assurance client.

290.131 The examples in paragraphs 290.126-290.130 relate to loans and guarantees between the firm and an assurance client. In the case of a financial statement audit engagement, the provisions should be applied to the firm, all network firms and the audit client.

Close Business Relationships with Assurance Clients

290.132 A close business relationship between a firm or a member of the assurance team and the assurance client or its management, or between the firm, a network firm and a financial statement audit client, will involve a commercial or common financial interest and may create self-interest and intimidation threats. The following are examples of such relationships:

- Having a material financial interest in a joint venture with the assurance client or a controlling owner, director, officer or other individual who performs senior managerial functions for that client.

- Arrangements to combine one or more services or products of the firm with one or more services or products of the assurance client and to market the package with reference to both parties.
- Distribution or marketing arrangements under which the firm acts as a distributor or marketer of the assurance client's products or services, or the assurance client acts as the distributor or marketer of the products or services of the firm.

In the case of a financial statement audit client, unless the financial interest is immaterial and the relationship is clearly insignificant to the firm, the network firm and the audit client, no safeguards could reduce the threat to an acceptable level. In the case of an assurance client that is not a financial statement audit client, unless the financial interest is immaterial and the relationship is clearly insignificant to the firm and the assurance client, no safeguards could reduce the threat to an acceptable level. Consequently, in both these circumstances the only possible courses of action are to:

(a) Terminate the business relationship;

(b) Reduce the magnitude of the relationship so that the financial interest is immaterial and the relationship is clearly insignificant; or

(c) Refuse to perform the assurance engagement.

Unless any such financial interest is immaterial and the relationship is clearly insignificant to the member of the assurance team, the only appropriate safeguard would be to remove the individual from the assurance team.

290.133 In the case of a financial statement audit client, business relationships involving an interest held by the firm, a network firm or a member of the assurance team or their immediate family in a closely held entity when the audit client or a director or officer of the audit client, or any group thereof, also has an interest in that entity, do not create threats to independence provided:

(a) The relationship is clearly insignificant to the firm, the network firm and the audit client;

(b) The interest held is immaterial to the investor, or group of investors; and

(c) The interest does not give the investor, or group of investors, the ability to control the closely held entity.

290.134 The purchase of goods and services from an assurance client by the firm (or from a financial statement audit client by a network firm) or a

member of the assurance team would not generally create a threat to independence providing the transaction is in the normal course of business and on an arm's length basis. However, such transactions may be of a nature or magnitude so as to create a self-interest threat. If the threat created is other than clearly insignificant, safeguards should be considered and applied as necessary to reduce the threat to an acceptable level. Such safeguards might include:

- Eliminating or reducing the magnitude of the transaction;
- Removing the individual from the assurance team; or
- Discussing the issue with those charged with governance, such as the audit committee.

Family and Personal Relationships

290.135 Family and personal relationships between a member of the assurance team and a director, an officer or certain employees, depending on their role, of the assurance client, may create self-interest, familiarity or intimidation threats. It is impracticable to attempt to describe in detail the significance of the threats that such relationships may create. The significance will depend upon a number of factors including the individual's responsibilities on the assurance engagement, the closeness of the relationship and the role of the family member or other individual within the assurance client. Consequently, there is a wide spectrum of circumstances that will need to be evaluated and safeguards to be applied to reduce the threat to an acceptable level.

290.136 When an immediate family member of a member of the assurance team is a director, an officer or an employee of the assurance client in a position to exert direct and significant influence over the subject matter information of the assurance engagement, or was in such a position during any period covered by the engagement, the threats to independence can only be reduced to an acceptable level by removing the individual from the assurance team. The closeness of the relationship is such that no other safeguard could reduce the threat to independence to an acceptable level. If application of this safeguard is not used, the only course of action is to withdraw from the assurance engagement. For example, in the case of an audit of financial statements, if the spouse of a member of the assurance team is an employee in a position to exert direct and significant influence over the preparation of the audit client's accounting records or financial statements, the threat to independence could only be reduced to an acceptable level by removing the individual from the assurance team.

290.137 When an immediate family member of a member the assurance team is an employee in a position to exert direct and significant influence over the

subject matter of the engagement, threats to independence may be created. The significance of the threats will depend on factors such as:

- The position the immediate family member holds with the client; and
- The role of the professional on the assurance team.

The significance of the threat should be evaluated and, if the threat is other than clearly insignificant, safeguards should be considered and applied as necessary to reduce the threat to an acceptable level. Such safeguards might include:

- Removing the individual from the assurance team;
- Where possible, structuring the responsibilities of the assurance team so that the professional does not deal with matters that are within the responsibility of the immediate family member; or
- Policies and procedures to empower staff to communicate to senior levels within the firm any issue of independence and objectivity that concerns them.

290.138 When a close family member of a member of the assurance team is a director, an officer, or an employee of the assurance client in a position to exert direct and significant influence over the subject matter information of the assurance engagement, threats to independence may be created. The significance of the threats will depend on factors such as:

- The position the close family member holds with the client; and
- The role of the professional on the assurance team.

The significance of the threat should be evaluated and, if the threat is other than clearly insignificant, safeguards should be considered and applied as necessary to reduce the threat to an acceptable level. Such safeguards might include:

- Removing the individual from the assurance team;
- Where possible, structuring the responsibilities of the assurance team so that the professional does not deal with matters that are within the responsibility of the close family member; or
- Policies and procedures to empower staff to communicate to senior levels within the firm any issue of independence and objectivity that concerns them.

290.139 In addition, self-interest, familiarity or intimidation threats may be created when a person who is other than an immediate or close family member of a member of the assurance team has a close relationship with the member of the assurance team and is a director, an officer or an

employee of the assurance client in a position to exert direct and significant influence over the subject matter information of the assurance engagement. Therefore, members of the assurance team are responsible for identifying any such persons and for consulting in accordance with firm procedures. The evaluation of the significance of any threat created and the safeguards appropriate to eliminate the threat or reduce it to an acceptable level will include considering matters such as the closeness of the relationship and the role of the individual within the assurance client.

290.140 Consideration should be given to whether self-interest, familiarity or intimidation threats may be created by a personal or family relationship between a partner or employee of the firm who is not a member of the assurance team and a director, an officer or an employee of the assurance client in a position to exert direct and significant influence over the subject matter information of the assurance engagement. Therefore partners and employees of the firm are responsible for identifying any such relationships and for consulting in accordance with firm procedures. The evaluation of the significance of any threat created and the safeguards appropriate to eliminate the threat or reduce it to an acceptable level will include considering matters such as the closeness of the relationship, the interaction of the firm professional with the assurance team, the position held within the firm, and the role of the individual within the assurance client.

290.141 An inadvertent violation of this section as it relates to family and personal relationships would not impair the independence of a firm or a member of the assurance team when:

(a) The firm has established policies and procedures that require all professionals to report promptly to the firm any breaches resulting from changes in the employment status of their immediate or close family members or other personal relationships that create threats to independence;

(b) Either the responsibilities of the assurance team are re-structured so that the professional does not deal with matters that are within the responsibility of the person with whom he or she is related or has a personal relationship, or, if this is not possible, the firm promptly removes the professional from the assurance engagement; and

(c) Additional care is given to reviewing the work of the professional.

290.142 When an inadvertent violation of this section relating to family and personal relationships has occurred, the firm should consider whether any safeguards should be applied. Such safeguards might include:

- Involving an additional professional accountant who did not take part in the assurance engagement to review the work done by the member of the assurance team; or
- Excluding the individual from any substantive decision-making concerning the assurance engagement.

Employment with Assurance Clients

290.143 A firm or a member of the assurance team's independence may be threatened if a director, an officer or an employee of the assurance client in a position to exert direct and significant influence over the subject matter information of the assurance engagement has been a member of the assurance team or partner of the firm. Such circumstances may create self-interest, familiarity and intimidation threats particularly when significant connections remain between the individual and his or her former firm. Similarly, a member of the assurance team's independence may be threatened when an individual participates in the assurance engagement knowing, or having reason to believe, that he or she is to, or may, join the assurance client some time in the future.

290.144 If a member of the assurance team, partner or former partner of the firm has joined the assurance client, the significance of the self-interest, familiarity or intimidation threats created will depend upon the following factors:

(a) The position the individual has taken at the assurance client.

(b) The amount of any involvement the individual will have with the assurance team.

(c) The length of time that has passed since the individual was a member of the assurance team or firm.

(d) The former position of the individual within the assurance team or firm.

The significance of the threat should be evaluated and, if the threat is other than clearly insignificant, safeguards should be considered and applied as necessary to reduce the threat to an acceptable level. Such safeguards might include:

- Considering the appropriateness or necessity of modifying the assurance plan for the assurance engagement;
- Assigning an assurance team to the subsequent assurance engagement that is of sufficient experience in relation to the individual who has joined the assurance client;

- Involving an additional professional accountant who was not a member of the assurance team to review the work done or otherwise advise as necessary; or
- Quality control review of the assurance engagement.

In all cases, all of the following safeguards are necessary to reduce the threat to an acceptable level:

(a) The individual concerned is not entitled to any benefits or payments from the firm unless these are made in accordance with fixed pre-determined arrangements. In addition, any amount owed to the individual should not be of such significance to threaten the firm's independence.

(b) The individual does not continue to participate or appear to participate in the firm's business or professional activities.

290.145 A self-interest threat is created when a member of the assurance team participates in the assurance engagement while knowing, or having reason to believe, that he or she is to, or may, join the assurance client some time in the future. This threat can be reduced to an acceptable level by the application of all of the following safeguards:

(a) Policies and procedures to require the individual to notify the firm when entering serious employment negotiations with the assurance client.

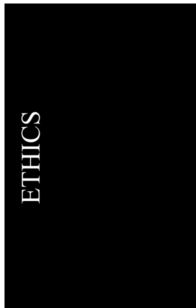
(b) Removal of the individual from the assurance engagement.

In addition, consideration should be given to performing an independent review of any significant judgments made by that individual while on the engagement.

Recent Service with Assurance Clients

290.146 To have a former officer, director or employee of the assurance client serve as a member of the assurance team may create self-interest, self-review and familiarity threats. This would be particularly true when a member of the assurance team has to report on, for example, subject matter information he or she had prepared or elements of the financial statements he or she had valued while with the assurance client.

290.147 If, during the period covered by the assurance report, a member of the assurance team had served as an officer or director of the assurance client, or had been an employee in a position to exert direct and significant influence over the subject matter information of the assurance engagement, the threat created would be so significant no safeguard could reduce the threat to an acceptable level. Consequently, such individuals should not be assigned to the assurance team.



290.148 If, prior to the period covered by the assurance report, a member of the assurance team had served as an officer or director of the assurance client, or had been an employee in a position to exert direct and significant influence over the subject matter information of the assurance engagement, this may create self-interest, self-review and familiarity threats. For example, such threats would be created if a decision made or work performed by the individual in the prior period, while employed by the assurance client, is to be evaluated in the current period as part of the current assurance engagement. The significance of the threats will depend upon factors such as:

- The position the individual held with the assurance client;
- The length of time that has passed since the individual left the assurance client; and
- The role the individual plays on the assurance team.

The significance of the threat should be evaluated and, if the threat is other than clearly insignificant, safeguards should be considered and applied as necessary to reduce the threat to an acceptable level. Such safeguards might include:

- Involving an additional professional accountant to review the work done by the individual as part of the assurance team or otherwise advise as necessary; or
- Discussing the issue with those charged with governance, such as the audit committee.

Serving as an Officer or Director on the Board of Assurance Clients

290.149 If a partner or employee of the firm serves as an officer or as a director on the board of an assurance client the self-review and self-interest threats created would be so significant no safeguard could reduce the threats to an acceptable level. In the case of a financial statement audit engagement, if a partner or employee of a network firm were to serve as an officer or as a director on the board of the audit client the threats created would be so significant no safeguard could reduce the threats to an acceptable level. Consequently, if such an individual were to accept such a position the only course of action is to refuse to perform, or to withdraw from the assurance engagement.

290.150 The position of Company Secretary has different implications in different jurisdictions. The duties may range from administrative duties such as personnel management and the maintenance of company records and registers, to duties as diverse as ensuring that the company complies with regulations or providing advice on corporate governance matters.

Generally this position is seen to imply a close degree of association with the entity and may create self-review and advocacy threats.

290.151 If a partner or employee of the firm or a network firm serves as Company Secretary for a financial statement audit client the self-review and advocacy threats created would generally be so significant, no safeguard could reduce the threat to an acceptable level. When the practice is specifically permitted under local law, professional rules or practice, the duties and functions undertaken should be limited to those of a routine and formal administrative nature such as the preparation of minutes and maintenance of statutory returns.

290.152 Routine administrative services to support a company secretarial function or advisory work in relation to company secretarial administration matters is generally not perceived to impair independence, provided client management makes all relevant decisions.

Long Association of Senior Personnel with Assurance Clients

General Provisions

290.153 Using the same senior personnel on an assurance engagement over a long period of time may create a familiarity threat. The significance of the threat will depend upon factors such as:

- The length of time that the individual has been a member of the assurance team;
- The role of the individual on the assurance team;
- The structure of the firm; and
- The nature of the assurance engagement.

The significance of the threat should be evaluated and, if the threat is other than clearly insignificant, safeguards should be considered and applied to reduce the threat to an acceptable level. Such safeguards might include:

- Rotating the senior personnel off the assurance team;
- Involving an additional professional accountant who was not a member of the assurance team to review the work done by the senior personnel or otherwise advise as necessary; or
- Independent internal quality reviews.

Financial Statement Audit Clients that are Listed Entities[2]

290.154 Using the same engagement partner or the same individual responsible for the **engagement quality control review*** on a financial statement audit over a prolonged period may create a familiarity threat. This threat is particularly relevant in the context of the financial statement audit of a listed entity and safeguards should be applied in such situations to reduce such threat to an acceptable level. Accordingly in respect of the financial statement audit of listed entities:

(a) The engagement partner and the individual responsible for the engagement quality control review should be rotated after serving in either capacity, or a combination thereof, for a pre-defined period, normally no more than seven years; and

(b) Such an individual rotating after a pre-defined period should not participate in the audit engagement until a further period of time, normally two years, has elapsed.

290.155 When a financial statement audit client becomes a listed entity the length of time the engagement partner or the individual responsible for the engagement quality control review has served the audit client in that capacity should be considered in determining when the individual should be rotated. However, the person may continue to serve as the engagement partner or as the individual responsible for the engagement quality control review for two additional years before rotating off the engagement.

290.156 While the engagement partner and the individual responsible for the engagement quality control review should be rotated after such a pre-defined period, some degree of flexibility over timing of rotation may be necessary in certain circumstances. Examples of such circumstances include:

- Situations when the person's continuity is especially important to the financial statement audit client, for example, when there will be major changes to the audit client's structure that would otherwise coincide with the rotation of the person's; and
- Situations when, due to the size of the firm, rotation is not possible or does not constitute an appropriate safeguard.

In all such circumstances when the person is not rotated after such a pre-defined period equivalent safeguards should be applied to reduce any threats to an acceptable level.

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2 See also Interpretation 2003-02 on page 903.

* See Definitions.

290.157 When a firm has only a few people with the necessary knowledge and experience to serve as engagement partner or individual responsible for the engagement quality control review on a financial statement audit client that is a listed entity, rotation may not be an appropriate safeguard. In these circumstances the firm should apply other safeguards to reduce the threat to an acceptable level. Such safeguards would include involving an additional professional accountant who was not otherwise associated with the assurance team to review the work done or otherwise advise as necessary. This individual could be someone from outside the firm or someone within the firm who was not otherwise associated with the assurance team.

Provision of Non-Assurance Services to Assurance Clients[3]

290.158 Firms have traditionally provided to their assurance clients a range of non-assurance services that are consistent with their skills and expertise. Assurance clients value the benefits that derive from having these firms, which have a good understanding of the business, bring their knowledge and skill to bear in other areas. Furthermore, the provision of such non-assurance services will often result in the assurance team obtaining information regarding the assurance client's business and operations that is helpful in relation to the assurance engagement. The greater the knowledge of the assurance client's business, the better the assurance team will understand the assurance client's procedures and controls, and the business and financial risks that it faces. The provision of non-assurance services may, however, create threats to the independence of the firm, a network firm or the members of the assurance team, particularly with respect to perceived threats to independence. Consequently, it is necessary to evaluate the significance of any threat created by the provision of such services. In some cases it may be possible to eliminate or reduce the threat created by application of safeguards. In other cases no safeguards are available to reduce the threat to an acceptable level.

290.159 The following activities would generally create self-interest or self-review threats that are so significant that only avoidance of the activity or refusal to perform the assurance engagement would reduce the threats to an acceptable level:

- Authorizing, executing or consummating a transaction, or otherwise exercising authority on behalf of the assurance client, or having the authority to do so.

[3] See also Interpretation 2003-01 on page 903.

- Determining which recommendation of the firm should be implemented.
- Reporting, in a management role, to those charged with governance.

290.160 The examples set out in paragraphs 290.166-290.205 are addressed in the context of the provision of non-assurance services to an assurance client. The potential threats to independence will most frequently arise when a non-assurance service is provided to a financial statement audit client. The financial statements of an entity provide financial information about a broad range of transactions and events that have affected the entity. The subject matter information of other assurance services, however, may be limited in nature. Threats to independence, however, may also arise when a firm provides a non-assurance service related to the subject matter information, of a non-financial statement audit assurance engagement. In such cases, consideration should be given to the significance of the firm's involvement with the subject matter information, of the engagement, whether any self-review threats are created and whether any threats to independence could be reduced to an acceptable level by application of safeguards, or whether the engagement should be declined. When the non-assurance service is not related to the subject matter information, of the non-financial statement audit assurance engagement, the threats to independence will generally be clearly insignificant.

290.161 The following activities may also create self-review or self-interest threats:

- Having custody of an assurance client's assets.
- Supervising assurance client employees in the performance of their normal recurring activities.
- Preparing source documents or originating data, in electronic or other form, evidencing the occurrence of a transaction (for example, purchase orders, payroll time records, and customer orders).

The significance of any threat created should be evaluated and, if the threat is other than clearly insignificant, safeguards should be considered and applied as necessary to eliminate the threat or reduce it to an acceptable level. Such safeguards might include:

- Making arrangements so that personnel providing such services do not participate in the assurance engagement;
- Involving an additional professional accountant to advise on the potential impact of the activities on the independence of the firm and the assurance team; or

- Other relevant safeguards set out in national regulations.

290.162 New developments in business, the evolution of financial markets, rapid changes in information technology, and the consequences for management and control, make it impossible to draw up an all-inclusive list of all situations when providing non-assurance services to an assurance client might create threats to independence and of the different safeguards that might eliminate these threats or reduce them to an acceptable level. In general, however, a firm may provide services beyond the assurance engagement provided any threats to independence have been reduced to an acceptable level.

290.163 The following safeguards may be particularly relevant in reducing to an acceptable level threats created by the provision of non-assurance services to assurance clients:

- Policies and procedures to prohibit professional staff from making management decisions for the assurance client, or assuming responsibility for such decisions.
- Discussing independence issues related to the provision of non-assurance services with those charged with governance, such as the audit committee.
- Policies within the assurance client regarding the oversight responsibility for provision of non-assurance services by the firm.
- Involving an additional professional accountant to advise on the potential impact of the non-assurance engagement on the independence of the member of the assurance team and the firm.
- Involving an additional professional accountant outside of the firm to provide assurance on a discrete aspect of the assurance engagement.
- Obtaining the assurance client's acknowledgement of responsibility for the results of the work performed by the firm.
- Disclosing to those charged with governance, such as the audit committee, the nature and extent of fees charged.
- Making arrangements so that personnel providing non-assurance services do not participate in the assurance engagement.

290.164 Before the firm accepts an engagement to provide a non-assurance service to an assurance client, consideration should be given to whether the provision of such a service would create a threat to independence. In situations when a threat created is other than clearly insignificant, the non-assurance engagement should be declined unless appropriate

safeguards can be applied to eliminate the threat or reduce it to an acceptable level.

290.165 The provision of certain non-assurance services to financial statement audit clients may create threats to independence so significant that no safeguard could eliminate the threat or reduce it to an acceptable level. However, the provision of such services to a related entity, division or discrete financial statement item of such clients may be permissible when any threats to the firm's independence have been reduced to an acceptable level by arrangements for that related entity, division or discrete financial statement item to be audited by another firm or when another firm re-performs the non-assurance service to the extent necessary to enable it to take responsibility for that service.

Preparing Accounting Records and Financial Statements

290.166 Assisting a financial statement audit client in matters such as preparing accounting records or financial statements may create a self-review threat when the financial statements are subsequently audited by the firm.

290.167 It is the responsibility of financial statement audit client management to ensure that accounting records are kept and financial statements are prepared, although they may request the firm to provide assistance. If firm, or network firm, personnel providing such assistance make management decisions, the self-review threat created could not be reduced to an acceptable level by any safeguards. Consequently, personnel should not make such decisions. Examples of such managerial decisions include:

- Determining or changing journal entries, or the classifications for accounts or transaction or other accounting records without obtaining the approval of the financial statement audit client;
- Authorizing or approving transactions; and
- Preparing source documents or originating data (including decisions on valuation assumptions), or making changes to such documents or data.

290.168 The audit process involves extensive dialogue between the firm and management of the financial statement audit client. During this process, management requests and receives significant input regarding such matters as accounting principles and financial statement disclosure, the appropriateness of controls and the methods used in determining the stated amounts of assets and liabilities. Technical assistance of this nature and advice on accounting principles for financial statement audit clients are an appropriate means to promote the fair presentation of the financial statements. The provision of such advice does not generally threaten the

firm's independence. Similarly, the financial statement audit process may involve assisting an audit client in resolving account reconciliation problems, analyzing and accumulating information for regulatory reporting, assisting in the preparation of consolidated financial statements (including the translation of local statutory accounts to comply with group accounting policies and the transition to a different reporting framework such as International Financial Reporting Standards), drafting disclosure items, proposing adjusting journal entries and providing assistance and advice in the preparation of local statutory accounts of subsidiary entities. These services are considered to be a normal part of the audit process and do not, under normal circumstances, threaten independence.

General Provisions

290.169 The examples in paragraphs 290.170-290.173 indicate that self-review threats may be created if the firm is involved in the preparation of accounting records or financial statements and those financial statements are subsequently the subject matter information of an audit engagement of the firm. This notion may be equally applicable in situations when the subject matter information of the assurance engagement is not financial statements. For example, a self-review threat would be created if the firm developed and prepared prospective financial information and subsequently provided assurance on this prospective financial information. Consequently, the firm should evaluate the significance of any self-review threat created by the provision of such services. If the self-review threat is other than clearly insignificant safeguards should be considered and applied as necessary to reduce the threat to an acceptable level.

Financial Statements Audit Clients that are Not Listed Entities

290.170 The firm, or a network firm, may provide a financial statement audit client that is not a listed entity with accounting and bookkeeping services, including payroll services, of a routine or mechanical nature, provided any self-review threat created is reduced to an acceptable level. Examples of such services include:

- Recording transactions for which the audit client has determined or approved the appropriate account classification;
- Posting coded transactions to the audit client's general ledger;
- Preparing financial statements based on information in the trial balance; and
- Posting the audit client approved entries to the trial balance.

ETHICS

The significance of any threat created should be evaluated and, if the threat is other than clearly insignificant, safeguards should be considered and applied as necessary to reduce the threat to an acceptable level. Such safeguards might include:

- Making arrangements so such services are not performed by a member of the assurance team;
- Implementing policies and procedures to prohibit the individual providing such services from making any managerial decisions on behalf of the audit client;
- Requiring the source data for the accounting entries to be originated by the audit client;
- Requiring the underlying assumptions to be originated and approved by the audit client; or
- Obtaining audit client approval for any proposed journal entries or other changes affecting the financial statements.

Financial Statement Audit Clients that are Listed Entities

290.171 The provision of accounting and bookkeeping services, including payroll services and the preparation of financial statements or financial information which forms the basis of the financial statements on which the audit report is provided, on behalf of a financial statement audit client that is a listed entity, may impair the independence of the firm or network firm, or at least give the appearance of impairing independence. Accordingly, no safeguard other than the prohibition of such services, except in emergency situations and when the services fall within the statutory audit mandate, could reduce the threat created to an acceptable level. Therefore, a firm or a network firm should not, with the limited exceptions below, provide such services to a listed entity that is a financial statement audit client.

290.172 The provision of accounting and bookkeeping services of a routine or mechanical nature to divisions or subsidiaries of a financial statement audit client that is a listed entity would not be seen as impairing independence with respect to the audit client provided that the following conditions are met:

(a) The services do not involve the exercise of judgment.

(b) The divisions or subsidiaries for which the service is provided are collectively immaterial to the audit client, or the services provided are collectively immaterial to the division or subsidiary.

(c) The fees to the firm, or network firm, from such services are collectively clearly insignificant.

If such services are provided, all of the following safeguards should be applied:

(a) The firm, or network firm, should not assume any managerial role nor make any managerial decisions.

(b) The audit client should accept responsibility for the results of the work.

(c) Personnel providing the services should not participate in the audit.

Emergency Situations

290.173 The provision of accounting and bookkeeping services to financial statement audit clients in emergency or other unusual situations, when it is impractical for the audit client to make other arrangements, would not be considered to pose an unacceptable threat to independence provided:

(a) The firm, or network firm, does not assume any managerial role or make any managerial decisions;

(b) The audit client accepts responsibility for the results of the work; and

(c) Personnel providing the services are not members of the assurance team.

Valuation Services

290.174 A valuation comprises the making of assumptions with regard to future developments, the application of certain methodologies and techniques, and the combination of both in order to compute a certain value, or range of values, for an asset, a liability or for a business as a whole.

290.175 A self-review threat may be created when a firm or network firm performs a valuation for a financial statement audit client that is to be incorporated into the client's financial statements.

290.176 If the valuation service involves the valuation of matters material to the financial statements and the valuation involves a significant degree of subjectivity, the self-review threat created could not be reduced to an acceptable level by the application of any safeguard. Accordingly, such valuation services should not be provided or, alternatively, the only course of action would be to withdraw from the financial statement audit engagement.

290.177 Performing valuation services for a financial statement audit client that are neither separately, nor in the aggregate, material to the financial statements, or that do not involve a significant degree of subjectivity, may create a self-review threat that could be reduced to an acceptable level by the application of safeguards. Such safeguards might include:

- Involving an additional professional accountant who was not a member of the assurance team to review the work done or otherwise advise as necessary;
- Confirming with the audit client their understanding of the underlying assumptions of the valuation and the methodology to be used and obtaining approval for their use;
- Obtaining the audit client's acknowledgement of responsibility for the results of the work performed by the firm; and
- Making arrangements so that personnel providing such services do not participate in the audit engagement.

In determining whether the above safeguards would be effective, consideration should be given to the following matters:

(a) The extent of the audit client's knowledge, experience and ability to evaluate the issues concerned, and the extent of their involvement in determining and approving significant matters of judgment.

(b) The degree to which established methodologies and professional guidelines are applied when performing a particular valuation service.

(c) For valuations involving standard or established methodologies, the degree of subjectivity inherent in the item concerned.

(d) The reliability and extent of the underlying data.

(e) The degree of dependence on future events of a nature which could create significant volatility inherent in the amounts involved.

(f) The extent and clarity of the disclosures in the financial statements.

290.178 When a firm, or a network firm, performs a valuation service for a financial statement audit client for the purposes of making a filing or return to a tax authority, computing an amount of tax due by the client, or for the purpose of tax planning, this would not create a significant threat to independence because such valuations are generally subject to external review, for example by a tax authority.

290.179 When the firm performs a valuation that forms part of the subject matter information of an assurance engagement that is not a financial statement audit engagement, the firm should consider any self-review threats. If the threat is other than clearly insignificant, safeguards should be considered and applied as necessary to eliminate the threat or reduce it to an acceptable level.

Provision of Taxation Services to Financial Statement Audit Clients

290.180 In many jurisdictions, the firm may be asked to provide taxation services to a financial statement audit client. Taxation services comprise a broad range of services, including compliance, planning, provision of formal taxation opinions and assistance in the resolution of tax disputes. Such assignments are generally not seen to create threats to independence.

Provision of Internal Audit Services to Financial Statement Audit Clients

290.181 A self-review threat may be created when a firm, or network firm, provides internal audit services to a financial statement audit client. Internal audit services may comprise an extension of the firm's audit service beyond requirements of generally accepted auditing standards, assistance in the performance of a client's internal audit activities or outsourcing of the activities. In evaluating any threats to independence, the nature of the service will need to be considered. For this purpose, internal audit services do not include operational internal audit services unrelated to the internal accounting controls, financial systems or financial statements.

290.182 Services involving an extension of the procedures required to conduct a financial statement audit in accordance with International Standards on Auditing would not be considered to impair independence with respect to the audit client provided that the firm's or network firm's personnel do not act or appear to act in a capacity equivalent to a member of audit client management.

290.183 When the firm, or a network firm, provides assistance in the performance of a financial statement audit client's internal audit activities or undertakes the outsourcing of some of the activities, any self-review threat created may be reduced to an acceptable level by ensuring that there is a clear separation between the management and control of the internal audit by client management and the internal audit activities themselves.

290.184 Performing a significant portion of the financial statement audit client's internal audit activities may create a self-review threat and a firm, or network firm, should consider the threats and proceed with caution before taking on such activities. Appropriate safeguards should be put in place and the firm, or network firm, should, in particular, ensure that the audit client acknowledges its responsibilities for establishing, maintaining and monitoring the system of internal controls.

290.185 Safeguards that should be applied in all circumstances to reduce any threats created to an acceptable level include ensuring that:

(a) The audit client is responsible for internal audit activities and acknowledges its responsibility for establishing, maintaining and monitoring the system of internal controls;

(b) The audit client designates a competent employee, preferably within senior management, to be responsible for internal audit activities;

(c) The audit client, the audit committee or supervisory body approves the scope, risk and frequency of internal audit work;

(d) The audit client is responsible for evaluating and determining which recommendations of the firm should be implemented;

(e) The audit client evaluates the adequacy of the internal audit procedures performed and the findings resulting from the performance of those procedures by, among other things, obtaining and acting on reports from the firm; and

(f) The findings and recommendations resulting from the internal audit activities are reported appropriately to the audit committee or supervisory body.

290.186 Consideration should also be given to whether such non-assurance services should be provided only by personnel not involved in the financial statement audit engagement and with different reporting lines within the firm.

Provision of IT Systems Services to Financial Statement Audit Clients

290.187 The provision of services by a firm or network firm to a financial statement audit client that involve the design and implementation of financial information technology systems that are used to generate information forming part of a client's financial statements may create a self-review threat.

290.188 The self-review threat is likely to be too significant to allow the provision of such services to a financial statement audit client unless appropriate safeguards are put in place ensuring that:

(a) The audit client acknowledges its responsibility for establishing and monitoring a system of internal controls;

(b) The audit client designates a competent employee, preferably within senior management, with the responsibility to make all management decisions with respect to the design and implementation of the hardware or software system;

(c) The audit client makes all management decisions with respect to the design and implementation process;

(d) The audit client evaluates the adequacy and results of the design and implementation of the system; and

(e) The audit client is responsible for the operation of the system (hardware or software) and the data used or generated by the system.

290.189 Consideration should also be given to whether such non-assurance services should be provided only by personnel not involved in the financial statement audit engagement and with different reporting lines within the firm.

290.190 The provision of services by a firm, or network firm, to a financial statement audit client which involve either the design or the implementation of financial information technology systems that are used to generate information forming part of a client's financial statements may also create a self-review threat. The significance of the threat, if any, should be evaluated and, if the threat is other than clearly insignificant, safeguards should be considered and applied as necessary to eliminate the threat or reduce it to an acceptable level.

290.191 The provision of services in connection with the assessment, design and implementation of internal accounting controls and risk management controls are not considered to create a threat to independence provided that firm or network firm personnel do not perform management functions.

Temporary Staff Assignments to Financial Statement Audit Clients

290.192 The lending of staff by a firm, or network firm, to a financial statement audit client may create a self-review threat when the individual is in a position to influence the preparation of a client's accounts or financial statements. In practice, such assistance may be given (particularly in emergency situations) but only on the understanding that the firm's or network firm's personnel will not be involved in:

(a) Making management decisions;

(b) Approving or signing agreements or other similar documents; or

(c) Exercising discretionary authority to commit the client.

Each situation should be carefully analyzed to identify whether any threats are created and whether appropriate safeguards should be implemented. Safeguards that should be applied in all circumstances to reduce any threats to an acceptable level include:

- The staff providing the assistance should not be given audit responsibility for any function or activity that they performed or supervised during their temporary staff assignment; and

- The audit client should acknowledge its responsibility for directing and supervising the activities of firm, or network firm, personnel.

Provision of Litigation Support Services to Financial Statement Audit Clients

290.193 Litigation support services may include activities such as acting as an expert witness, calculating estimated damages or other amounts that might become receivable or payable as the result of litigation or other legal dispute, and assistance with document management and retrieval in relation to a dispute or litigation.

290.194 A self-review threat may be created when the litigation support services provided to a financial statement audit client include the estimation of the possible outcome and thereby affects the amounts or disclosures to be reflected in the financial statements. The significance of any threat created will depend upon factors such as:

- The materiality of the amounts involved;
- The degree of subjectivity inherent in the matter concerned; and
- The nature of the engagement.

The firm, or network firm, should evaluate the significance of any threat created and, if the threat is other than clearly insignificant, safeguards should be considered and applied as necessary to eliminate the threat or reduce it to an acceptable level. Such safeguards might include:

- Policies and procedures to prohibit individuals assisting the audit client from making managerial decisions on behalf of the client;
- Using professionals who are not members of the assurance team to perform the service; or
- The involvement of others, such as independent experts.

290.195 If the role undertaken by the firm or network firm involved making managerial decisions on behalf of the financial statement audit client, the threats created could not be reduced to an acceptable level by the application of any safeguard. Therefore, the firm or network firm should not perform this type of service for an audit client.

Provision of Legal Services to Financial Statement Audit Clients

290.196 Legal services are defined as any services for which the person providing the services must either be admitted to practice before the Courts of the jurisdiction in which such services are to be provided, or have the required legal training to practice law. Legal services encompass a wide and diversified range of areas including both corporate and commercial services to clients, such as contract support, litigation, mergers and acquisition advice and support and the provision of assistance to clients'

internal legal departments. The provision of legal services by a firm, or network firm, to an entity that is a financial statement audit client may create both self-review and advocacy threats.

290.197 Threats to independence need to be considered depending on the nature of the service to be provided, whether the service provider is separate from the assurance team and the materiality of any matter in relation to the entities' financial statements. The safeguards set out in paragraph 290.162 may be appropriate in reducing any threats to independence to an acceptable level. In circumstances when the threat to independence cannot be reduced to an acceptable level the only available action is to decline to provide such services or withdraw from the financial statement audit engagement.

290.198 The provision of legal services to a financial statement audit client which involve matters that would not be expected to have a material effect on the financial statements are not considered to create an unacceptable threat to independence.

290.199 There is a distinction between advocacy and advice. Legal services to support a financial statement audit client in the execution of a transaction (e.g., contract support, legal advice, legal due diligence and restructuring) may create self-review threats; however, safeguards may be available to reduce these threats to an acceptable level. Such a service would not generally impair independence, provided that:

(a) Members of the assurance team are not involved in providing the service; and

(b) In relation to the advice provided, the audit client makes the ultimate decision or, in relation to the transactions, the service involves the execution of what has been decided by the audit client.

290.200 Acting for a financial statement audit client in the resolution of a dispute or litigation in such circumstances when the amounts involved are material in relation to the financial statements of the audit client would create advocacy and self-review threats so significant no safeguard could reduce the threat to an acceptable level. Therefore, the firm should not perform this type of service for a financial statement audit client.

290.201 When a firm is asked to act in an advocacy role for a financial statement audit client in the resolution of a dispute or litigation in circumstances when the amounts involved are not material to the financial statements of the audit client, the firm should evaluate the significance of any advocacy and self-review threats created and, if the threat is other than clearly insignificant, safeguards should be considered and applied as necessary to

eliminate the threat or reduce it to an acceptable level. Such safeguards might include:

- Policies and procedures to prohibit individuals assisting the audit client from making managerial decisions on behalf of the client; or
- Using professionals who are not members of the assurance team to perform the service.

290.202 The appointment of a partner or an employee of the firm or network firm as General Counsel for legal affairs to a financial statement audit client would create self-review and advocacy threats that are so significant no safeguards could reduce the threats to an acceptable level. The position of General Counsel is generally a senior management position with broad responsibility for the legal affairs of a company and consequently, no member of the firm or network firm should accept such an appointment for a financial statement audit client.

Recruiting Senior Management

290.203 The recruitment of senior management for an assurance client, such as those in a position to affect the subject matter information of the assurance engagement, may create current or future self-interest, familiarity and intimidation threats. The significance of the threat will depend upon factors such as:

- The role of the person to be recruited; and
- The nature of the assistance sought.

The firm could generally provide such services as reviewing the professional qualifications of a number of applicants and provide advice on their suitability for the post. In addition, the firm could generally produce a short-list of candidates for interview, provided it has been drawn up using criteria specified by the assurance client.

The significance of the threat created should be evaluated and, if the threat is other than clearly insignificant, safeguards should be considered and applied as necessary to reduce the threat to an acceptable level. In all cases, the firm should not make management decisions and the decision as to whom to hire should be left to the client.

Corporate Finance and Similar Activities

290.204 The provision of corporate finance services, advice or assistance to an assurance client may create advocacy and self-review threats. In the case of certain corporate finance services, the independence threats created would be so significant no safeguards could be applied to reduce the threats to an acceptable level. For example, promoting, dealing in, or underwriting of an assurance client's shares is not compatible with

providing assurance services. Moreover, committing the assurance client to the terms of a transaction or consummating a transaction on behalf of the client would create a threat to independence so significant no safeguard could reduce the threat to an acceptable level. In the case of a financial statement audit client the provision of those corporate finance services referred to above by a firm or a network firm would create a threat to independence so significant no safeguard could reduce the threat to an acceptable level.

290.205 Other corporate finance services may create advocacy or self-review threats; however, safeguards may be available to reduce these threats to an acceptable level. Examples of such services include assisting a client in developing corporate strategies, assisting in identifying or introducing a client to possible sources of capital that meet the client specifications or criteria, and providing structuring advice and assisting a client in analyzing the accounting effects of proposed transactions. Safeguards that should be considered include:

- Policies and procedures to prohibit individuals assisting the assurance client from making managerial decisions on behalf of the client;
- Using professionals who are not members of the assurance team to provide the services; and
- Ensuring the firm does not commit the assurance client to the terms of any transaction or consummate a transaction on behalf of the client.

Fees and Pricing

Fees—Relative Size

290.206 When the total fees generated by an assurance client represent a large proportion of a firm's total fees, the dependence on that client or client group and concern about the possibility of losing the client may create a self-interest threat. The significance of the threat will depend upon factors such as:

- The structure of the firm; and
- Whether the firm is well established or newly created.

The significance of the threat should be evaluated and, if the threat is other than clearly insignificant, safeguards should be considered and applied as necessary to reduce the threat to an acceptable level. Such safeguards might include:

- Discussing the extent and nature of fees charged with the audit committee, or others charged with governance;
- Taking steps to reduce dependency on the client;
- External quality control reviews; and
- Consulting a third party, such as a professional regulatory body or another professional accountant.

290.207 A self-interest threat may also be created when the fees generated by the assurance client represent a large proportion of the revenue of an individual partner. The significance of the threat should be evaluated and, if the threat is other than clearly insignificant, safeguards should be considered and applied as necessary to reduce the threat to an acceptable level. Such safeguards might include:

- Policies and procedures to monitor and implement quality control of assurance engagements; and
- Involving an additional professional accountant who was not a member of the assurance team to review the work done or otherwise advise as necessary.

Fees—Overdue

290.208 A self-interest threat may be created if fees due from an assurance client for professional services remain unpaid for a long time, especially if a significant part is not paid before the issue of the assurance report for the following year. Generally the payment of such fees should be required before the report is issued. The following safeguards may be applicable:

- Discussing the level of outstanding fees with the audit committee, or others charged with governance.
- Involving an additional professional accountant who did not take part in the assurance engagement to provide advice or review the work performed.

The firm should also consider whether the overdue fees might be regarded as being equivalent to a loan to the client and whether, because of the significance of the overdue fees, it is appropriate for the firm to be re-appointed.

Pricing

290.209 When a firm obtains an assurance engagement at a significantly lower fee level than that charged by the predecessor firm, or quoted by other firms, the self-interest threat created will not be reduced to an acceptable level unless:

(a) The firm is able to demonstrate that appropriate time and qualified staff are assigned to the task; and

(b) All applicable assurance standards, guidelines and quality control procedures are being complied with.

Contingent Fees

290.210 Contingent fees are fees calculated on a predetermined basis relating to the outcome or result of a transaction or the result of the work performed. For the purposes of this section, fees are not regarded as being contingent if a court or other public authority has established them.

290.211 A contingent fee charged by a firm in respect of an assurance engagement creates self-interest and advocacy threats that cannot be reduced to an acceptable level by the application of any safeguard. Accordingly, a firm should not enter into any fee arrangement for an assurance engagement under which the amount of the fee is contingent on the result of the assurance work or on items that are the subject matter information of the assurance engagement.

290.212 A contingent fee charged by a firm in respect of a non-assurance service provided to an assurance client may also create self-interest and advocacy threats. If the amount of the fee for a non-assurance engagement was agreed to, or contemplated, during an assurance engagement and was contingent on the result of that assurance engagement, the threats could not be reduced to an acceptable level by the application of any safeguard. Accordingly, the only acceptable action is not to accept such arrangements. For other types of contingent fee arrangements, the significance of the threats created will depend on factors such as:

- The range of possible fee amounts;
- The degree of variability;
- The basis on which the fee is to be determined;
- Whether the outcome or result of the transaction is to be reviewed by an independent third party; and
- The effect of the event or transaction on the assurance engagement.

The significance of the threats should be evaluated and, if the threats are other than clearly insignificant, safeguards should be considered and applied as necessary to reduce the threats to an acceptable level. Such safeguards might include:

- Disclosing to the audit committee, or others charged with governance, the extent and nature of fees charged;

- Review or determination of the final fee by an unrelated third party; or
- Quality and control policies and procedures.

Gifts and Hospitality

290.213 Accepting gifts or hospitality from an assurance client may create self-interest and familiarity threats. When a firm or a member of the assurance team accepts gifts or hospitality, unless the value is clearly insignificant, the threats to independence cannot be reduced to an acceptable level by the application of any safeguard. Consequently, a firm or a member of the assurance team should not accept such gifts or hospitality.

Actual or Threatened Litigation

290.214 When litigation takes place, or appears likely, between the firm or a member of the assurance team and the assurance client, a self-interest or intimidation threat may be created. The relationship between client management and the members of the assurance team must be characterized by complete candor and full disclosure regarding all aspects of a client's business operations. The firm and the client's management may be placed in adversarial positions by litigation, affecting management's willingness to make complete disclosures and the firm may face a self-interest threat. The significance of the threat created will depend upon such factors as:

- The materiality of the litigation;
- The nature of the assurance engagement; and
- Whether the litigation relates to a prior assurance engagement.

Once the significance of the threat has been evaluated the following safeguards should be applied, if necessary, to reduce the threats to an acceptable level:

(a) Disclosing to the audit committee, or others charged with governance, the extent and nature of the litigation;

(b) If the litigation involves a member of the assurance team, removing that individual from the assurance team; or

(c) Involving an additional professional accountant in the firm who was not a member of the assurance team to review the work done or otherwise advise as necessary.

If such safeguards do not reduce the threat to an appropriate level, the only appropriate action is to withdraw from, or refuse to accept, the assurance engagement.

Section 290 Interpretations

These interpretations are directed towards the application of the IFAC *Code of Ethics for Professional Accountants* to the topics of the specific queries received. Those subject to the regulations of other authoritative bodies, such as the US Securities and Exchange Commission, may wish to consult with them for their positions on these matters.

Interpretation 2003-01

The Provision of Non-Assurance Services to Assurance Clients

The *Code of Ethics for Professional Accountants* addresses the issue of the provision of non assurance services to assurance clients in paragraphs 290.158-290.205 inclusive. The Code does not currently include any transitional provisions relating to the requirements set out in these paragraphs however the Ethics Committee[4] has concluded that it is appropriate to allow a transitional period of one year, during which existing contracts to provide non assurance services for assurance clients may be completed if additional safeguards are put in place to reduce any threat to independence to an insignificant level. This transitional period commences on December 31, 2004 (or from the date of implementation of the Code for members of those IFAC member bodies which have adopted an earlier implementation date).

Interpretation 2003-02

Lead Engagement Partner Rotation for Audit Clients that are Listed Entities

The *Code of Ethics for Professional Accountants* addresses the issue of engagement partner rotation for financial statement audit clients that are listed entities in paragraphs 290.154-290.157.

The paragraphs state that in the financial statement audit of a listed entity the engagement partner should be rotated after serving in that capacity for a pre-defined period, normally no more than seven years. They also state that some degree of flexibility in timing of rotation may be necessary in certain circumstances. The Ethics Committee[5] believes that the implementation (or early adoption) of the Code constitutes an example of a circumstance in which some degree of flexibility over timing of rotation may be necessary.

The Code does not currently include any transitional provisions relating to these requirements. However, the Ethics Committee[6] has concluded that it is appropriate to allow a transitional period of two years. Consequently, on implementation or early adoption of the Code, while the length of time the engagement partner has served the

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[4] Now referrewd to as the International Ethics Standards Board for Accountants.

[5] See footnote 4.

[6] See footnote 4.

financial statement audit client in that capacity should be considered in determining when rotation should occur, the partner may continue to serve as the engagement partner for two additional years from the date of implementation (or early adoption) before rotating off the engagement. In such circumstances, the additional requirements of paragraph 290.157 to apply equivalent safeguards in order to reduce any threats to an acceptable level should be followed.

Interpretation 2005-01

Application of Section 290 to Assurance Engagements that are Not Financial Statement Audit Engagements

This interpretation provides guidance on the application of the independence requirements contained in Section 290 to assurance engagements that are not financial statement audit engagements.

This interpretation focuses on the application issues that are particular to assurance engagements that are not financial statement audit engagements. There are other matters noted in Section 290 that are relevant in the consideration of independence requirements for all assurance engagements. For example, paragraph 290.15 states that consideration should be given to any threats the firm has reason to believe may be created by network firms interests and relationships. Similarly, paragraph 290.21 states that for assurance clients, that are other than listed entity financial statement audit clients, when the assurance team has reason to believe that a related entity of such an assurance client is relevant to the evaluation of the firm's independence of the client, the assurance team should consider that related entity when evaluating independence and applying appropriate safeguards. These matters are not specifically addressed in this interpretation.

As explained in the International Framework for Assurance Engagements issued by the International Auditing and Assurance Standards Board, in an assurance engagement, the professional accountant in public practice expresses a conclusion designed to enhance the degree of confidence of the intended users other than the responsible party about the outcome of the evaluation or measurement of a subject matter against criteria.

Assertion-Based Assurance Engagements

In an assertion-based assurance engagement, the evaluation or measurement of the subject matter is performed by the responsible party, and the subject matter information is in the form of an assertion by the responsible party that is made available to the intended users.

In an assertion-based assurance engagement independence is required from the responsible party, which is responsible for the subject matter information and may be responsible for the subject matter.

In those assertion-based assurance engagements where the responsible party is responsible for the subject matter information but not the subject matter, independence is required from the responsible party. In addition, consideration should be given to any threats the firm has reason to believe may be created by interests and relationships between a member of the assurance team, the firm, a network firm and the party responsible for the subject matter.

Direct Reporting Assurance Engagements

In a direct reporting assurance engagement, the professional accountant in public practice either directly performs the evaluation or measurement of the subject matter, or obtains a representation from the responsible party that has performed the evaluation or measurement that is not available to the intended users. The subject matter information is provided to the intended users in the assurance report.

In a direct reporting assurance engagement independence is required from the responsible party, which is responsible for the subject matter.

Multiple Responsible Parties

In both assertion-based assurance engagements and direct reporting assurance engagements there may be several responsible parties. For example, a public accountant in public practice may be asked to provide assurance on the monthly circulation statistics of a number of independently owned newspapers. The assignment could be an assertion based assurance engagement where each newspaper measures its circulation and the statistics are presented in an assertion that is available to the intended users. Alternatively, the assignment could be a direct reporting assurance engagement, where there is no assertion and there may or may not be a written representation from the newspapers.

In such engagements, when determining whether it is necessary to apply the provisions in Section 290 to each responsible party, the firm may take into account whether an interest or relationship between the firm, or a member of the assurance team, and a particular responsible party would create a threat to independence that is other than clearly insignificant in the context of the subject matter information. This will take into account:

- The materiality of the subject matter information (or the subject matter) for which the particular responsible party is responsible; and
- The degree of public interest that is associated with the engagement.

If the firm determines that the threat to independence created by any such relationships with a particular responsible party would be clearly insignificant it may not be necessary to apply all of the provisions of this section to that responsible party.

Example

The following example has been developed to demonstrate the application of Section 290. It is assumed that the client is not also a financial statement audit client of the firm, or a network firm.

A firm is engaged to provide assurance on the total proven oil reserves of 10 independent companies. Each company has conducted geographical and engineering surveys to determine their reserves (subject matter). There are established criteria to determine when a reserve may be considered to be proven which the professional accountant in public practice determines to be suitable criteria for the engagement.

The proven reserves for each company as at December 31, 20X0 were as follows:

	Proven oil reserves thousands barrels
Company 1	5,200
Company 2	725
Company 3	3,260
Company 4	15,000
Company 5	6,700
Company 6	39,126
Company 7	345
Company 8	175
Company 9	24,135
Company 10	9,635
Total	**104,301**

The engagement could be structured in differing ways:

Assertion-Based Engagements

A1 Each company measures its reserves and provides an assertion to the firm and to intended users.

A2 An entity other than the companies measures the reserves and provides an assertion to the firm and to intended users.

Direct Reporting Engagements

D1 Each company measures the reserves and provides the firm with a written representation that measures its reserves against the established criteria for measuring proven reserves. The representation is not available to the intended users.

D2 The firm directly measures the reserves of some of the companies.

Application of Approach

A1 Each company measures its reserves and provides an assertion to the firm and to intended users.

There are several responsible parties in this engagement (companies 1-10). When determining whether it is necessary to apply the independence provisions to all of the companies, the firm may take into account whether an interest or relationship with a particular company would create a threat to independence that is other than clearly insignificant. This will take into account factors such as:

- The materiality of the company's proven reserves in relation to the total reserves to be reported on; and
- The degree of public interest associated with the engagement. (Paragraph 290.20.)

For example Company 8 accounts for 0.16% of the total reserves, therefore a business relationship or interest with Company 8 would create less of a threat than a similar relationship with Company 6, which accounts for approximately 37.5% of the reserves.

Having determined those companies to which the independence requirements apply, the assurance team and the firm are required to be independent of those responsible parties which would be considered to be the assurance client (paragraph 290.20).

A2 An entity other than the companies measures the reserves and provides an assertion to the firm and to intended users.

The firm would be required to be independent of the entity that measures the reserves and provides an assertion to the firm and to intended users (paragraph 290.17). That entity is not responsible for the subject matter and so consideration should be given to any threats the firm has reason to believe may be created by interests/relationships with the party responsible for the subject matter (paragraph 290.17). There are several parties responsible for subject matter in this engagement (Companies 1-10) As discussed in example A1 above, the firm may take into account whether an interest or relationship with a particular company would create a threat to independence that is other than clearly insignificant.

D1 Each company provides the firm with a representation that measures its reserves against the established criteria for measuring proven reserves. The representation is not available to the intended users.

There are several responsible parties in this engagement (Companies 1-10). When determining whether it is necessary to apply the independence provisions to all of the companies, the firm may take into account whether an interest or relationship with a particular company would create a threat to independence that is other than clearly insignificant. This will take into account factors such as:

- The materiality of the company's proven reserves in relation to the total reserves to be reported on; and
- The degree of public interest associated with the engagement. (paragraph 290.20).

For example Company 8 accounts for 0.16% of the reserves, therefore a business relationship or interest with Company 8 would create less of a threat than a similar relationship with Company 6 that accounts for approximately 37.5% of the reserves.

Having determined those companies to which the independence requirements apply, the assurance team and the firm are required to be independent of those responsible parties which would be considered to be the assurance client (paragraph 290.20).

D2 The firm directly measures the reserves of some of the companies

The application is the same as in example D1.

PART C—PROFESSIONAL ACCOUNTANTS IN BUSINESS

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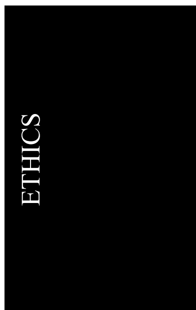


SECTION 300

Introduction

300.1 This Part of the Code illustrates how the conceptual framework contained in Part A is to be applied by professional accountants in business.

300.2 Investors, creditors, employers and other sectors of the business community, as well as governments and the public at large, all may rely on the work of professional accountants in business. Professional accountants in business may be solely or jointly responsible for the preparation and reporting of financial and other information, which both their employing organizations and third parties may rely on. They may also be responsible for providing effective financial management and competent advice on a variety of business-related matters.

300.3 A professional accountant in business may be a salaried employee, a partner, director (whether executive or non-executive), an owner manager, a volunteer or another working for one or more employing organization. The legal form of the relationship with the employing organization, if any, has no bearing on the ethical responsibilities incumbent on the professional accountant in business.

300.4 A professional accountant in business has a responsibility to further the legitimate aims of their employing organization. This Code does not seek to hinder a professional accountant in business from properly fulfilling that responsibility, but considers circumstances in which conflicts may be created with the absolute duty to comply with the fundamental principles.

300.5 A professional accountant in business often holds a senior position within an organization. The more senior the position, the greater will be the ability and opportunity to influence events, practices and attitudes. A professional accountant in business is expected, therefore, to encourage an ethics-based culture in an employing organization that emphasizes the importance that senior management places on ethical behavior.

300.6 The examples presented in the following sections are intended to illustrate how the conceptual framework is to be applied and are not intended to be, nor should they be interpreted as, an exhaustive list of all circumstances experienced by a professional accountant in business that may create threats to compliance with the principles. Consequently, it is not sufficient for a professional accountant in business merely to comply with the examples; rather, the framework should be applied to the particular circumstances faced.

Threats and Safeguards

300.7 Compliance with the fundamental principles may potentially be threatened by a broad range of circumstances. Many threats fall into the following categories:

(a) Self-interest;

(b) Self-review;

(c) Advocacy;

(d) Familiarity; and

(e) Intimidation.

These threats are discussed further in Part A of this Code.

300.8 Examples of circumstances that may create self-interest threats for a professional accountant in business include, but are not limited to:

- Financial interests, loans or guarantees.
- Incentive compensation arrangements.
- Inappropriate personal use of corporate assets.
- Concern over employment security.
- Commercial pressure from outside the employing organization.

300.9 Circumstances that may create self-review threats include, but are not limited to, business decisions or data being subject to review and justification by the same professional accountant in business responsible for making those decisions or preparing that data.

300.10 When furthering the legitimate goals and objectives of their employing organizations professional accountants in business may promote the organization's position, provided any statements made are neither false nor misleading. Such actions generally would not create an advocacy threat.

300.11 Examples of circumstances that may create familiarity threats include, but are not limited to:

- A professional accountant in business in a position to influence financial or non-financial reporting or business decisions having an immediate or close family member who is in a position to benefit from that influence.
- Long association with business contacts influencing business decisions.

- Acceptance of a gift or preferential treatment, unless the value is clearly insignificant.

300.12 Examples of circumstances that may create intimidation threats include, but are not limited to:

- Threat of dismissal or replacement of the professional accountant in business or a close or immediate family member over a disagreement about the application of an accounting principle or the way in which financial information is to be reported.
- A dominant personality attempting to influence the decision making process, for example with regard to the awarding of contracts or the application of an accounting principle.

300.13 Professional accountants in business may also find that specific circumstances give rise to unique threats to compliance with one or more of the fundamental principles. Such unique threats obviously cannot be categorized. In all professional and business relationships, professional accountants in business should always be on the alert for such circumstances and threats.

300.14 Safeguards that may eliminate or reduce to an acceptable level the threats faced by professional accountants in business fall into two broad categories:

(a) Safeguards created by the profession, legislation or regulation; and

(b) Safeguards in the work environment.

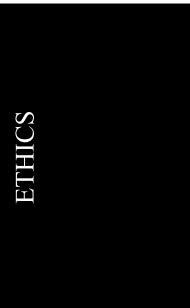
300.15 Examples of safeguards created by the profession, legislation or regulation are detailed in paragraph 100.12 of Part A of this Code.

300.16 Safeguards in the work environment include, but are not restricted to:

- The employing organization's systems of corporate oversight or other oversight structures.
- The employing organization's ethics and conduct programs.
- Recruitment procedures in the employing organization emphasizing the importance of employing high caliber competent staff.
- Strong internal controls.
- Appropriate disciplinary processes.
- Leadership that stresses the importance of ethical behavior and the expectation that employees will act in an ethical manner.
- Policies and procedures to implement and monitor the quality of employee performance.

- Timely communication of the employing organization's policies and procedures, including any changes to them, to all employees and appropriate training and education on such policies and procedures.
- Policies and procedures to empower and encourage employees to communicate to senior levels within the employing organization any ethical issues that concern them without fear of retribution.
- Consultation with another appropriate professional accountant.

300.17 In circumstances where a professional accountant in business believes that unethical behavior or actions by others will continue to occur within the employing organization, the professional accountant in business should consider seeking legal advice. In those extreme situations where all available safeguards have been exhausted and it is not possible to reduce the threat to an acceptable level, a professional accountant in business may conclude that it is appropriate to resign from the employing organization.



SECTION 310

Potential Conflicts

310.1 A professional accountant in business has a professional obligation to comply with the fundamental principles. There may be times, however, when their responsibilities to an employing organization and the professional obligations to comply with the fundamental principles are in conflict. Ordinarily, a professional accountant in business should support the legitimate and ethical objectives established by the employer and the rules and procedures drawn up in support of those objectives. Nevertheless, where compliance with the fundamental principles is threatened, a professional accountant in business must consider a response to the circumstances.

310.2 As a consequence of responsibilities to an employing organization, a professional accountant in business may be under pressure to act or behave in ways that could directly or indirectly threaten compliance with the fundamental principles. Such pressure may be explicit or implicit; it may come from a supervisor, manager, director or another individual within the employing organization. A professional accountant in business may face pressure to:

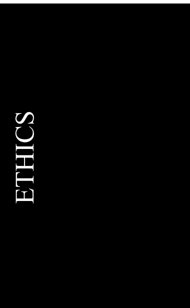
- Act contrary to law or regulation.
- Act contrary to technical or professional standards.
- Facilitate unethical or illegal earnings management strategies.
- Lie to, or otherwise intentionally mislead (including misleading by remaining silent) others, in particular:
    - The auditors of the employing organization; or
    - Regulators.
- Issue, or otherwise be associated with, a financial or non-financial report that materially misrepresents the facts, including statements in connection with, for example:
    - The financial statements;
    - Tax compliance;
    - Legal compliance; or
    - Reports required by securities regulators.

310.3. The significance of threats arising from such pressures, such as intimidation threats, should be evaluated and, if they are other than clearly insignificant, safeguards should be considered and applied as

necessary to eliminate them or reduce them to an acceptable level. Such safeguards may include:

- Obtaining advice where appropriate from within the employing organization, an independent professional advisor or a relevant professional body.
- The existence of a formal dispute resolution process within the employing organization.

- Seeking legal advice.



SECTION 320

Preparation and Reporting of Information

320.1 Professional accountants in business are often involved in the preparation and reporting of information that may either be made public or used by others inside or outside the employing organization. Such information may include financial or management information, for example, forecasts and budgets, financial statements, management discussion and analysis, and the management letter of representation provided to the auditors as part of an audit of financial statements. A professional accountant in business should prepare or present such information fairly, honestly and in accordance with relevant professional standards so that the information will be understood in its context.

320.2 A professional accountant in business who has responsibility for the preparation or approval of the general purpose financial statements of an employing organization should ensure that those financial statements are presented in accordance with the applicable financial reporting standards.

320.3 A professional accountant in business should maintain information for which the professional accountant in business is responsible in a manner that:

(a) Describes clearly the true nature of business transactions, assets or liabilities;

(b) Classifies and records information in a timely and proper manner; and

(c) Represents the facts accurately and completely in all material respects.

320.4 Threats to compliance with the fundamental principles, for example self-interest or intimidation threats to objectivity or professional competence and due care, may be created where a professional accountant in business may be pressured (either externally or by the possibility of personal gain) to become associated with misleading information or to become associated with misleading information through the actions of others.

320.5 The significance of such threats will depend on factors such as the source of the pressure and the degree to which the information is, or may be, misleading. The significance of the threats should be evaluated and, if they are other than clearly insignificant, safeguards should be considered and applied as necessary to eliminate them or reduce them to an acceptable level. Such safeguards may include consultation with superiors within the employing organization, for example, the audit committee or other body responsible for governance, or with a relevant professional body.

320.6 Where it is not possible to reduce the threat to an acceptable level, a professional accountant in business should refuse to remain associated with information they consider is or may be misleading. Should the professional accountant in business be aware that the issuance of misleading information is either significant or persistent, the professional accountant in business should consider informing appropriate authorities in line with the guidance in Section 140. The professional accountant in business may also wish to seek legal advice or resign.

SECTION 330

Acting with Sufficient Expertise

330.1 The fundamental principle of professional competence and due care requires that a professional accountant in business should only undertake significant tasks for which the professional accountant in business has, or can obtain, sufficient specific training or experience. A professional accountant in business should not intentionally mislead an employer as to the level of expertise or experience possessed, nor should a professional accountant in business fail to seek appropriate expert advice and assistance when required.

330.2 Circumstances that threaten the ability of a professional accountant in business to perform duties with the appropriate degree of professional competence and due care include:

- Insufficient time for properly performing or completing the relevant duties.
- Incomplete, restricted or otherwise inadequate information for performing the duties properly.
- Insufficient experience, training and/or education.
- Inadequate resources for the proper performance of the duties.

330.3 The significance of such threats will depend on factors such as the extent to which the professional accountant in business is working with others, relative seniority in the business and the level of supervision and review applied to the work. The significance of the threats should be evaluated and, if they are other than clearly insignificant, safeguards should be considered and applied as necessary to eliminate them or reduce them to an acceptable level. Safeguards that may be considered include:

- Obtaining additional advice or training.
- Ensuring that there is adequate time available for performing the relevant duties.
- Obtaining assistance from someone with the necessary expertise.
- Consulting, where appropriate, with:
    - Superiors within the employing organization;
    - Independent experts; or
    - A relevant professional body.

330.4 Where threats cannot be eliminated or reduced to an acceptable level, professional accountants in business should consider whether to refuse to perform the duties in question. If the professional accountant in business

determines that refusal is appropriate the reasons for doing so should be clearly communicated.

SECTION 340

Financial Interests

340.1 Professional accountants in business may have financial interests, or may know of financial interests of immediate or close family members, that could, in certain circumstances, give rise to threats to compliance with the fundamental principles. For example, self-interest threats to objectivity or confidentiality may be created through the existence of the motive and opportunity to manipulate price sensitive information in order to gain financially. Examples of circumstances that may create self-interest threats include, but are not limited to situations where the professional accountant in business or an immediate or close family member:

- Holds a direct or indirect financial interest in the employing organization and the value of that financial interest could be directly affected by decisions made by the professional accountant in business;
- Is eligible for a profit related bonus and the value of that bonus could be directly affected by decisions made by the professional accountant in business;
- Holds, directly or indirectly, share options in the employing organization, the value of which could be directly affected by decisions made by the professional accountant in business;
- Holds, directly or indirectly, share options in the employing organization which are, or will soon be, eligible for conversion; or
- May qualify for share options in the employing organization or performance related bonuses if certain targets are achieved.

340.2 In evaluating the significance of such a threat, and the appropriate safeguards to be applied to eliminate the threat or reduce it to an acceptable level, professional accountants in business must examine the nature of the financial interest. This includes an evaluation of the significance of the financial interest and whether it is direct or indirect. Clearly, what constitutes a significant or valuable stake in an organization will vary from individual to individual, depending on personal circumstances.

340.3 If threats are other than clearly insignificant, safeguards should be considered and applied as necessary to eliminate or reduce them to an acceptable level. Such safeguards may include:

- Policies and procedures for a committee independent of management to determine the level of form of remuneration of senior management.

- Disclosure of all relevant interests, and of any plans to trade in relevant shares to those charged with the governance of the employing organization, in accordance with any internal policies.
- Consultation, where appropriate, with superiors within the employing organization.
- Consultation, where appropriate, with those charged with the governance of the employing organization or relevant professional bodies.
- Internal and external audit procedures.
- Up-to-date education on ethical issues and the legal restrictions and other regulations around potential insider trading.

340.4 A professional accountant in business should neither manipulate information nor use confidential information for personal gain.

SECTION 350

Inducements

Receiving Offers

350.1 A professional accountant in business or an immediate or close family member may be offered an inducement. Inducements may take various forms, including gifts, hospitality, preferential treatment and inappropriate appeals to friendship or loyalty.

350.2 Offers of inducements may create threats to compliance with the fundamental principles. When a professional accountant in business or an immediate or close family member is offered an inducement, the situation should be carefully considered. Self-interest threats to objectivity or confidentiality are created where an inducement is made in an attempt to unduly influence actions or decisions, encourage illegal or dishonest behavior or obtain confidential information. Intimidation threats to objectivity or confidentiality are created if such an inducement is accepted and it is followed by threats to make that offer public and damage the reputation of either the professional accountant in business or an immediate or close family member.

350.3 The significance of such threats will depend on the nature, value and intent behind the offer. If a reasonable and informed third party, having knowledge of all relevant information, would consider the inducement insignificant and not intended to encourage unethical behavior, then a professional accountant in business may conclude that the offer is made in the normal course of business and may generally conclude that there is no significant threat to compliance with the fundamental principles.

350.4 If evaluated threats are other than clearly insignificant, safeguards should be considered and applied as necessary to eliminate them or reduce them to an acceptable level. When the threats cannot be eliminated or reduced to an acceptable level through the application of safeguards, a professional accountant in business should not accept the inducement. As the real or apparent threats to compliance with the fundamental principles do not merely arise from acceptance of an inducement but, sometimes, merely from the fact of the offer having been made, additional safeguards should be adopted. A professional accountant in business should assess the risk associated with all such offers and consider whether the following actions should be taken:

(a) Where such offers have been made, immediately inform higher levels of management or those charged with governance of the employing organization;

(b) Inform third parties of the offer – for example, a professional body or the employer of the individual who made the offer; a

professional accountant in business should, however, consider seeking legal advice before taking such a step; and

(c) Advise immediate or close family members of relevant threats and safeguards where they are potentially in positions that might result in offers of inducements, for example as a result of their employment situation; and

(d) Inform higher levels of management or those charged with governance of the employing organization where immediate or close family members are employed by competitors or potential suppliers of that organization.

Making Offers

350.5 A professional accountant in business may be in a situation where the professional accountant in business is expected to, or is under other pressure to, offer inducements to subordinate the judgment of another individual or organization, influence a decision-making process or obtain confidential information.

350.6 Such pressure may come from within the employing organization, for example, from a colleague or superior. It may also come from an external individual or organization suggesting actions or business decisions that would be advantageous to the employing organization possibly influencing the professional accountant in business improperly.

350.7 A professional accountant in business should not offer an inducement to improperly influence professional judgment of a third party.

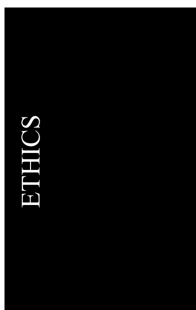
350.8 Where the pressure to offer an unethical inducement comes from within the employing organization, the professional accountant should follow the principles and guidance regarding ethical conflict resolution set out in Part A of this Code.

DEFINITIONS

In this *Code of Ethics for Professional Accountants* the following expressions have the following meanings assigned to them:

Term	Meaning
Advertising	The communication to the public of information as to the services or skills provided by professional accountants in public practice with a view to procuring professional business.
Assurance client	The responsible party that is the person (or persons) who: (a) In a direct reporting engagement, is responsible for the subject matter; or (b) In an assertion-based engagement, is responsible for the subject matter information and may be responsible for the subject matter. (For an assurance client that is a financial statement audit client see the definition of financial statement audit client.)
Assurance engagement	An engagement in which a professional accountant in public practice expresses a conclusion designed to enhance the degree of confidence of the intended users other than the responsible party about the outcome of the evaluation or measurement of a subject matter against criteria. (For guidance on assurance engagements see the International Framework for Assurance Engagements issued by the International Auditing and Assurance Standards Board which describes the elements and objectives of an assurance engagement and identifies engagements to which International Standards on Auditing (ISAs), International Standards on Review Engagements (ISREs) and International Standards on Assurance Engagements (ISAEs) apply.)
Assurance team	(a) All members of the engagement team for the assurance engagement; (b) All others within a firm who can directly influence the outcome of the assurance engagement, including:

	(i) those who recommend the compensation of, or who provide direct supervisory, management or other oversight of the assurance engagement partner in connection with the performance of the assurance engagement. For the purposes of a financial statement audit engagement this includes those at all successively senior levels above the engagement partner through the firm's chief executive; (ii) those who provide consultation regarding technical or industry specific issues, transactions or events for the assurance engagement; and (iii) those who provide quality control for the assurance engagement, including those who perform the engagement quality control review for the assurance engagement; and
	(c) For the purposes of a financial statement audit client, all those within a network firm who can directly influence the outcome of the financial statement audit engagement.
Clearly insignificant	A matter that is deemed to be both trivial and inconsequential.
Close family	A parent, child or sibling, who is not an immediate family member.
Contingent fee	A fee calculated on a predetermined basis relating to the outcome or result of a transaction or the result of the work performed. A fee that is established by a court or other public authority is not a contingent fee.
Direct financial interest	A financial interest: • Owned directly by and under the control of an individual or entity (including those managed on a discretionary basis by others); or • Beneficially owned through a collective investment vehicle, estate, trust or other



	intermediary over which the individual or entity has control
Director or officer	Those charged with the governance of an entity, regardless of their title, which may vary from country to country.
Engagement partner	The partner or other person in the firm who is responsible for the engagement and its performance, and for the report that is issued on behalf of the firm, and who, where required, has the appropriate authority from a professional, legal or regulatory body.
Engagement quality control review	A process designed to provide an objective evaluation, before the report is issued, of the significant judgments the engagement team made and the conclusions they reached in formulating the report.
Engagement team	All personnel performing an engagement, including any experts contracted by the firm in connection with that engagement.
Existing accountant	A professional accountant in public practice currently holding an audit appointment or carrying out accounting, taxation, consulting or similar professional services for a client.
Financial interest	An interest in an equity or other security, debenture, loan or other debt instrument of an entity, including rights and obligations to acquire such an interest and derivatives directly related to such interest.
Financial statements	The balance sheets, income statements or profit and loss accounts, statements of changes in financial position (which may be presented in a variety of ways, for example, as a statement of cash flows or a statement of fund flows), notes and other statements and explanatory material which are identified as being part of the financial statements.

Financial statement audit client	An entity in respect of which a firm conducts a financial statement audit engagement. When the client is a listed entity, financial statement audit client will always include its related entities.
Financial statement audit engagement	A reasonable assurance engagement in which a professional accountant in public practice expresses an opinion whether financial statements are prepared in all material respects in accordance with an identified financial reporting framework, such as an engagement conducted in accordance with International Standards on Auditing. This includes a Statutory Audit, which is a financial statement audit required by legislation or other regulation.
	(a) An entity that controls such parties; and
	(b) An entity controlled by such parties.
Immediate family	A spouse (or equivalent) or dependant.
Independence	Independence is:
	(a) Independence of mind – the state of mind that permits the provision of an opinion without being affected by influences that compromise professional judgment, allowing an individual to act with integrity, and exercise objectivity and professional skepticism
	(b) Independence in appearance – the avoidance of facts and circumstances that are so significant a reasonable and informed third party, having knowledge of all relevant information, including any safeguards applied, would reasonably conclude a firm's, or a member of the assurance team's, integrity, objectivity or professional skepticism had been compromised.
Indirect financial interest	A financial interest beneficially owned through a collective investment vehicle, estate, trust or other intermediary over which the individual or entity has no control.
Listed entity	An entity whose shares, stock or debt are quoted or listed on a recognized stock exchange, or are

	marketed under the regulations of a recognized stock exchange or other equivalent body.
Network firm	An entity under common control, ownership or management with the firm or any entity that a reasonable and informed third party having knowledge of all relevant information would reasonably conclude as being part of the firm nationally or internationally.
Office	A distinct sub-group, whether organized on geographical or practice lines.
Professional accountant	An individual who is a member of an IFAC member body.
Professional accountant in business	A professional accountant employed or engaged in an executive or non-executive capacity in such areas as commerce, industry, service, the public sector, education, the not for profit sector, regulatory bodies or professional bodies, or a professional accountant contracted by such entities.
Professional accountant in public practice	A professional accountant, irrespective of functional classification (e.g., audit, tax or consulting) in a firm that provides professional services. This term is also used to refer to a firm of professional accountants in public practice.
Professional services	Services requiring accountancy or related skills performed by a professional accountant including accounting, auditing, taxation, management consulting and financial management services.
Related entity	An entity that has any of the following relationships with the client:
	(a) An entity that has direct or indirect control over the client provided the client is material to such entity;
	(b) An entity with a direct financial interest in the client provided that such entity has significant influence over the client and the interest in the client is material to such entity;
	(c) An entity over which the client has direct or indirect control;

(d) An entity in which the client, or an entity related to the client under (c) above, has a direct financial interest that gives it significant influence over such entity and the interest is material to the client and its related entity in (c); and

(e) An entity which is under common control with the client (hereinafter a "sister entity") provided the sister entity and the client are both material to the entity that controls both the client and sister entity.

EFFECTIVE DATE

The Code is effective on June 30, 2006. Section 290 is applicable to assurance engagements when the assurance report is dated on or after June 30, 2006. Earlier application is encouraged.