Government Transfers — Basis for Conclusions

Section PS 3410

FOREWORD

CICA Public Sector Accounting Handbook Revisions Release No. 33, issued in March 2011, included GOVERNMENT TRANSFERS, Section PS 3410, which revises and replaces the existing standard.

The primary objective of a Basis for Conclusions document is to set out how the Public Sector Accounting Board (PSAB) reached its conclusions. As well, it sets out significant matters arising from comments received in response to the proposals exposed and indicates how PSAB has dealt with the issues raised.

These documents are intended to assist financial statement users, preparers, auditors and other parties interested in public sector financial reporting in understanding the rationale followed by PSAB when developing the standards.

This document has been prepared by staff of PSAB. This document does not form part of the CICA Public Sector Accounting (PSA) Handbook nor is it part of public sector generally accepted accounting principles (GAAP). Basis for Conclusions documents also do not include any guidance on the application of the relevant Section or Guideline.

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BACKGROUND

1 The existing standard, GOVERNMENT TRANSFERS, Section PS 3410, was issued in 1990 when governments were applying the modified accrual basis of accounting. With the subsequent change to full accrual accounting, the government community identified a need for additional guidance and clarification to ensure consistent interpretation of Section PS 3410. The major issues requiring clarification were as follows:

(a) How should multi-year funding provided by governments to outside organizations be recognized?

(b) What is the nature and level of authorization required for recognition of transfers by recipient and transferring governments?

(c) Do transfer terms and conditions affect the timing of recognition of transfers by recipient and transferring governments?

(d) Should the nature of a transfer (for example operating transfers, capital transfers or transfers of tangible capital assets), affect the accounting requirements for the transfer?

PURPOSE AND SCOPE

2 The new standard applies to all levels of government. It also applies to government organizations that apply the CICA Public Sector Accounting (PSA) Handbook. However, as the standard was written for governments, there may be additional application questions for government organizations. For example, when a government organization acts as a transferor, there may be additional considerations in applying the authorization requirements. When a government organization is a recipient of a government transfer from outside of its government reporting entity, the requirements for recipients would apply. However, if a government organization seeks to account for appropriations under the requirements of this standard, it may encounter issues that are not specifically addressed. PSAB has a project on its

current technical agenda dealing with appropriations and also has a project that will address more specifically the issues around the application of the PSA Handbook to government organizations.

3 The existing standard excluded transfers of tangible capital assets because under a modified accrual basis of accounting tangible capital assets were not recognized as assets; they were written off at acquisition. Consistent with the adoption of a full accrual basis of accounting, the new standard specifically includes transfers of tangible capital assets.

4 The existing standard also excluded transfers made through the tax system as they required special consideration given some unique issues with how these types of transfers differed from tax expenditures and how they were recognized and authorized. TAX REVENUE, Section PS 3510, issued in February 2010, distinguishes transfers made through a tax system that are authorized through tax legislation from those that are simply administered through the tax system but authorized like any other type of transfer. Transfers that are authorized through tax legislation are now addressed in Section PS 3510. PSAB concluded that all other transfers made through the tax system that are not authorized under tax legislation but are administered through that system should be recognized in accordance with Section PS 3410. Thus, the new government transfers standard includes them within the scope of Section PS 3410.

5 The existing standard and RESTRICTED ASSETS AND REVENUES, Section PS 3100, were somewhat confusing because Section PS 3100 included resources received from other governments, which are in essence government transfers. The new standard clarifies that resources from (non-government) third parties are addressed in Section PS 3100. The revisions to Section PS 3100 also clarify that government transfers should not be accounted for under Section PS 3100.

RECOGNITION

Transferring government

6 The existing standard used the terms "authorization" and "eligibility criteria" but did not provide definitions and guidance related to those terms. Because of the lack of definition and guidance, there was inconsistency in application of those terms. The new standard specifically defines the terms "authorization" and "eligibility criteria".

7 The existing standard allowed a transferring government to recognize advance payments ("prepayments" or "preflows") as financial assets. The new standard does not allow transferring governments to recognize any types of transfers as assets regardless of whether they are preflowed or not. This view is based on the fact that the transferring government does not receive economic value in return that can be recognized as an asset. A transfer is a non-exchange transaction and a redistribution of economic resources.

8 The existing standard did not need to address the issue of transfers of tangible capital assets as they were written off at acquisition under the modified accrual basis of accounting. The new standard requires that transfers of tangible capital assets be recognized as an expense at the net book value of the tangible capital asset transferred. Tangible capital assets are initially recognized at cost and are not written up to fair or some other value while they are held by a government, nor when they are sold or disposed of by a government. Thus, net book value was considered to be the appropriate measurement basis for transfers of tangible capital assets by a transferor.

9 The existing standard stated that contingent recoveries were not to be recognized as financial assets because the revenue might never be realized. However, disclosure of the existence of a contingent recovery that is likely to be realized was required. The new standard does not explicitly address contingencies. PSAB concluded that the government transfers standard was not the appropriate place to set out standards for contingent assets. The definition of an asset as well as new guidance defining and clarifying the interpretation and application of the terms "eligibility criteria" and "stipulations" can be used to assess when a transferor might have a receivable to recognize or a contingent asset to disclose. If it is certain that transfer terms will not be met by the recipient, then the transferring government would have an asset. If it is unlikely that a recipient will meet the transfer terms, then the transferring government may have a contingent asset to disclose.

Recipient government

10 The existing standard required transfers to be recognized in revenue once they were authorized and eligibility criteria, if any, had been met. It allowed for the possibility that a recipient government might have a liability if a transfer was paid before revenue recognition criteria had been met (i.e., before authorization was in place or before the recipient had met the eligibility criteria). However, the existing standard did not address the effect, if any, that transferor imposed stipulations may have on the timing of revenue recognition of a transfer. And, respondents indicated that the standard should also consider recipient actions and communications related to a transfer in considering when to recognize the transfer in revenue.

11 The new standard distinguishes between eligibility criteria and stipulations. Introducing the term stipulations was important as there may be ongoing liabilities for the recipient created from the terms and conditions set out by the transferor even though the recipient has met the eligibility criteria. The definition of a liability includes present obligations relating to the use of assets or the future provision of goods and services. The new standard acknowledges the effect stipulations may have on the timing of revenue recognition. It requires that transfers be recognized as revenue when the transfer is authorized and all eligibility criteria have been met by the recipient except when and to the extent that stipulations give rise to a liability in accordance with LIABILITIES, Section PS 3200.

12 The new standard also acknowledges that, in some cases, the stipulations set out in the transfer agreement may not be explicit enough to create a liability. In accordance with LIABILITIES, Section PS 3200, the new standard also notes that where the transferor stipulations are unclear, recipient actions and communications related to that transfer before the financial statement date would also need to be considered. In certain circumstances, those related actions and communications of the recipient could result in a constructive obligation that meets the definition of a liability. Because Section PS 3200 provides guidance for determining when actions and communication could result in a liability, PSAB referred to the guidance in paragraphs PS 3200.07-.17 to assist governments in making this determination. Thus, the stipulations of the transfer alone, or the stipulations of the transfer taken together with the actions and communications of the recipient government before the financial statement date, may create an obligation that meets the definition of a liability.

13 PSAB recognized that recipient actions and communications could be related to the terms of the existing transfer or be unrelated to the transfer. For those situations where recipient actions and communications are related to the terms of the existing transfer, the new standard permits the combination of the two events. In this case, the recipient government would initially recognize an asset and a liability as one event. Revenue would be subsequently recognized as the liability is settled.

14 However, when a recipient government receives a transfer with no stipulations and then creates an unrelated liability through its own actions and communications, the two events would be recognized separately. The (unconditional) transfer would be recognized as an asset and revenue when it is authorized and all eligibility criteria have been met. The obligation created by the recipient government would be recognized as a liability and an expense when it meets the criteria for liability recognition. This clarification ensures that unconditional transfers, such as Equalization payments, are not eligible for initial recognition as liabilities and subsequent recognition in revenue.

Revenue recognition

15 The existing standard applied the same recognition criteria to all types of transfers. The new standard does the same thing. However, in revising the government transfers standard, the biggest issue was the timing of the recognition of a capital transfer (in cash or in kind) in revenue. Under a modified accrual basis of accounting, capital assets were written off at acquisition and revenue was recognized when capital expenditures were incurred. Under a full accrual model, capital assets are amortized over their useful lives and questions were raised regarding the timing of revenue recognition of any related transfers.

16 Some respondents felt that immediate revenue recognition was appropriate once a transfer was authorized and eligibility criteria had been met because a transfer is in the nature of a gift. Others felt that revenue recognition over the period(s) the related asset was acquired or developed was appropriate because capital transfers are financing for the purchase or construction of a tangible capital asset. Still others felt that recognizing the transfer in revenue as the related asset is used to provide services was more reflective of the role of government in providing services to constituents. PSAB concluded that the most appropriate approach was to link the revenue recognition first to whether a liability is created as a result of a transfer received. If not, the transfer would be recognized in revenue as soon as all eligibility criteria have been met. If a liability is created, then the timing of revenue recognition would be as that liability is settled. The Board felt that the liability approach best reflected the substance of transfers received with terms and that the same approach should apply equally to all types of transfers. This approach would allow the terms of the liability to determine the pattern of revenue recognition.

17 Also, consistent with the approach in the new standard that requires revenue recognition unless a liability is created, PSAB was of the view that whether a recipient received funding for the acquisition of a tangible capital asset or the tangible capital asset itself, the accounting treatment should be the same. Thus, for a capital transfer, revenue recognition may occur over the periods when the asset is acquired or developed, over the related asset's useful life, or over a lesser period depending on the terms of the liability. Similarly, for a transfer of a tangible capital asset, revenue recognition may occur over the related asset's useful life or over a lesser period depending on the terms of the liability.

18 More specifically, PSAB clarified that a transfer of a non-depreciable asset such as land would be recognized as revenue when received or receivable. The transfer would not be recognized as a liability as the related asset is assumed to have an indefinite life and, thus, could be used indefinitely. The definition of a liability requires settlement at a specified or determinable date on occurrence of a specified event or on demand. Thus, an obligation to use a non-depreciable asset indefinitely would not meet the definition of a liability. Such obligations would never be "settled". Similarly, a capital transfer relating to a non-depreciable asset such as land would only meet the definition of a liability until the asset was acquired. At the date of asset acquisition the capital transfer would be recognized in revenue.

19 In setting out the requirements for the recipient, PSAB chose to balance competing points of view regarding the extent of guidance needed for determining when a liability existed. Because LIABILITIES, Section PS 3200, already provides that guidance, the Board agreed that directing recipients to Section PS 3200 was more practical than trying to replicate its guidance in the new standard.

20 In addition, in some circumstances, the new standard would resolve a conflict raised by respondents regarding the accounting for different sources of capital financing. The new standard would allow for consistency in the revenue recognition of various sources of financing for capital asset acquisition in cases where the liability for a capital transfer received is considered settled when the asset is bought or built. In such circumstances, the revenue recognition of

developer contributions accounted for in accordance with RESTRICTED ASSETS AND REVENUES, Section PS 3100, would be consistent with the revenue recognition of capital transfers received. However, the timing of revenue recognition of the two sources might be different if the capital transfer stipulations and/or the recipient actions and communications before the financial statement date specify the use of the tangible capital asset over its useful life. In such circumstances, the capital transfer liability may not be considered settled until the end of the asset's useful life and revenue recognition of the capital transfer may occur over that useful life. In contrast, developer contributions would be recognized in revenue as the related asset is bought or built.

21 Some respondents suggested that there is an implicit stipulation associated with all capital transfers to use the asset to provide services over the useful life of the related asset. Others felt that the liability related to a capital transfer is to buy or build the asset and that any expectation by the transferor that the asset will be used to provide services over its useful life is likely a valid one. However, it would not create the type of obligation that meets the definition of a liability and can be given recognition in financial statements. PSAB did not explicitly address the question of the existence of implicit stipulations related to capital transfers in the new standard. LIABILITIES, Section PS 3200, does note, however, that if a government has the ability to make individual choices, judgments or decisions relating to use, it retains some discretion and may not have a present obligation that meets the definition of a liability.

22 For a transfer received that is initially recognized as a liability, revenue recognition occurs as the terms of the liability are considered settled. Consistent with this requirement, transfers would normally be evaluated on a case-by-case basis. Thus, it is not expected that all capital transfers would be automatically recognized as liabilities and that related transfer revenue would be automatically recognized over the related asset's useful life. The intent of the new standard is that an application of professional judgment would occur on a case-by-case basis, giving consideration to the terms of each liability related to a capital transfer received.

Authorization

23 The existing standard did not specifically define what authorization meant for the purposes of the recognition criteria, although some guidance was provided regarding the authorization of discretionary grants. The new standard expands on this guidance and clarifies what authorization means for all types of transfers. It states that, in most cases, authorization means that an exercise of authority has occurred by the financial statement date under enabling legislation regulations or by-laws that have received final approval by the financial statement date.

24 The new standard recognizes, however, that the enabling legislation may not always be in place by the financial statement date. It allows an earlier point of recognition of a transfer liability / expense by a transferring government depending on the circumstances. This earlier point is called "demonstrable commitment". It requires a preponderance of evidence that the government is demonstrably committed to the transfer to exist at the financial statement date and final approval of the related legislation in the stub period. The stub period is the time between the financial statement date and the release of those statements, consistent with the period evaluated for subsequent events in SUBSEQUENT EVENTS, Section PS 2400. The requirement for final approval in the stub period recognizes the role of the legislature in finalizing such transactions and is consistent with the practices of some governments. PSAB again refers to the constructive obligation guidance in LIABILITIES, paragraphs PS 3200.07-.17, to indicate the evidence that a transferring government would evaluate to determine whether it is demonstrably committed to providing a transfer.

25 One concern raised regarding the introduction of the demonstrable commitment point of authorization for transferring governments was the potential that the concept might require the accrual of some budget promises. The introduction of demonstrable commitment as an authorization concept in the new government transfers standard does not add to the requirements of LIABILITIES, paragraphs PS 3200.07-.17, it just applies them in the context of transfers.

26 Similarly, an announcement on its own is insufficient evidence to support an assertion that a government is demonstrably committed to a transfer. Someone with the authority to bind the government must put the government in a position of having no discretion to avoid proceeding with the transfer. The guidance in LIABILITIES, paragraphs PS 3200.07-.17, describes the types of actions and communications that are required to meet this threshold of having no discretion to avoid the obligation. The creation of a valid expectation in others, perhaps through a public announcement, that the transfer will occur is, however, an important part of the evidence needed to support an assertion that the government has lost its discretion to avoid proceeding with a transfer.

27 Either point of authorization in the new standard includes a requirement for an exercise of authority by the financial statement date. The demonstrable commitment concept assumes an exercise of authority by the financial statement date as an exercise of authority is embedded in the requirements of LIABILITIES, paragraphs PS 3200.07-.17.

28 The new standard acknowledges that, in some cases, the authority to pay may be part of the authorization process and its absence at the financial statement date may indicate that the exercise of authority is not complete. In such cases, the government may retain its discretion to avoid proceeding with a transfer until the authority to pay is in place.

29 PSAB concluded that this earlier point of authorization is inappropriate for recipient governments as they would not have the evidence to support asset recognition until an exercise of the authority by the transferor under enabling legislation regulations or by-laws that has received final approval has occurred. Much of the evidence that a transferor would examine under the constructive obligation guidance in LIABILITIES, paragraphs PS 3200.07-.17 would be internal documentation unavailable to a recipient government.

TRANSITIONAL PROVISIONS

30 The new standard applies for fiscal periods beginning on or after April 1, 2012. Thus, the effective date for local governments with a December 31st fiscal year end would be for the fiscal period beginning January 1, 2013. The effective date of April 1, 2012 responds to feedback received from governments about the pace and volume of change in accounting standards. However, earlier adoption is encouraged.

31 ACCOUNTING CHANGES, paragraph PS 2120.13, allows a government adopting new PSA Handbook standards to apply them retroactively or prospectively. These provisions are the default position if a new standard simply provides an effective date and does not specify retroactive or prospective application. However, these provisions only apply when an entity is moving from a non-GAAP standard to a PSA Handbook standard. As the new government transfers standard replaces the government transfers standard issued in 1990, paragraph PS 2120.13 would not apply to most governments adopting the new government transfers standard. It was concluded, however, that the new government transfers standard should explicitly allow governments to adopt the new standard retroactively or prospectively. A description of retroactive and prospective application is provided in Section PS 2120.
