Background and Purpose

One of the main ways that governments meet their objectives and carry out programs is through transfers to individuals, organizations or other governments. For example, each year the provincial government and its organizations receive considerable funds from the federal government which are used to deliver programs and services to British Columbians. In turn, the provincial government also transfers funds to individuals and government organizations which constitute a significant portion of the government's annual spending. These are major sources of funds for services provided to British Columbians in areas such as health care and education.

Government transfers payments are described as non-exchange transactions that do not fit neatly into accrual accounting. In a non-exchange transaction, a government gives (or receives) value without directly receiving (or giving) equal value in return. They are in essence a redistribution of economic resources. Government transfers are not exchange transactions such as a purchase or sale in that the recipient is not required to provide any goods or services directly in return. Transfers are also not loans in that the recipient is not required to repay the transfer in the future, nor are they investments as the recipient is not required to provide a direct financial return to the transferring government.

The absence of an equal exchange (the underpinning of accrual accounting) can sometimes make it difficult to decide when a transaction has occurred that should be recognized in the financial statements. The most difficult accounting issue for government transfers is determining when a transfer transaction should be recognized by a recipient organization as revenue, particularly when there are stipulations imposed on the transfers by the transferring government.

This Guideline focuses on the Office's approach for assessing the appropriate accounting treatment of government transfers from a recipient entity's perspective under the new PS 3410 "*Government Transfers*" standard when there are stipulations imposed by the transferor.

References

- Section PS 3410 "*Government Transfers*" (new)
- Section PS 3200 "*Liabilities*"
- PSAB *Basis for Conclusions*—Government Transfers Section PS 3410 (April 2011)
- Issues Analysis: Government Transfers (April 2010)
- IPSAS 23 "*Revenue from Non-Exchange Transactions*"

Understanding the New PS 3410 Section

The new Section PS 3410 "*Government Transfers*" is expected to impact recipient accounting for funds received from governments (in particular capital funding) primarily because of the introduction of the concept of stipulations. Stipulations describe how a recipient must use the transferred resources or the actions it must perform in order to keep the transfer. The new standard acknowledges that transferor

imposed stipulations may effect the timing of revenue recognition of a transfer by a recipient organization.

The general recognition criteria in the new standard requires that transfers be recognized as revenue by a recipient organization 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 an obligation that meets the definition of a liability in accordance with Section PS3200 "*Liabilities*".

The new standard also acknowledges that in some cases, the stipulations set out in a transfer agreement may not be explicit enough to create a liability. In this respect, the new standard notes that where the stipulations are unclear, recipient actions and communications related to the transfer before the financial statement date would also need to be considered. In certain circumstances, those related actions and communications of the recipient, combined with the terms of the stipulations, could result in a constructive obligation that meets the definition of a liability.

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 the liability is settled. The Board felt that the liability approach best reflected the substance of transfers received with terms and that the terms of the liability would determine the pattern of revenue recognition.

Office Approach to Applying Sections PS 3410 and PS 3200

In setting out the requirements for the recipient, PSAB chose to direct recipients/users to Section PS 3200 for determining when a liability existed. This is unfortunate because PS 3200 is a broad principles-based standard that does not provide the specificity of guidance required for ensuring consistent application, particularly given the unique circumstances of government transfer transactions. In this respect, PS 3200 clearly states that the Section does not include standards for recognition of specific types of liabilities which are dealt with in individual PSA Handbook Sections. In our view, this has resulted in a circular arrangement that bounces recipients/users back and forth between PS Section 3200 and PS 3410.

This apparent absence of guidance has created a situation where there are many differing interpretations of how PS 3200 should be applied to the unique circumstances of government transfers. In our consultations to date, we have found a wide range of views between preparers, audit firms, legislative auditors, and others. This is not surprising as PS 3200 was not designed to provide the level of guidance necessary for ensuring consistent application for specific types of liabilities.

For situations where there is a lack of guidance in the PSA Handbook necessary to ensure a consistent application or interpretation of a standard, Section PS 1150 "*Generally accepted accounting principles*" notes that other sources can be consulted to apply a PSA Handbook standard to specific circumstances. It is our view that to ensure the consistent application of PS 3200 to the unique circumstances of government transfer transactions, other sources need to be consulted. We further believe that the

IPSAS 23 standard is the most relevant source to consult as the IPSAS liability definition is consistent with the PS 3200 definition and IPSAS 23 provides the level of guidance required to ensure more consistency in applying the concepts of PS 3200. Consequently, the guidance provided in this guideline has been informed by IPSAS 23.

Office Guidance

Determining whether specific circumstances create an obligation that meets the definition of a liability requires the application of professional judgment. Where a recipient entity has recorded or plans to record a liability, audit teams are encouraged to ask the entity to provide them with a detailed position paper documenting its position and underlying rationale. Receipt of the entity's position will facilitate the audit assessment and documentation of the appropriateness of management's related key judgments. If such a paper is not available, the audit team is encouraged to document the key circumstances (i.e., transfer stipulations along with the entity's actions and communications).

All three liability characteristics set out in the PS 3200 definition of a liability have to be met in order to qualify as a liability. Since the third characteristic (past transaction or event) is met when a transfer agreement is authorized and eligibility criteria, if any, have been met by the recipient, the guidance herein focuses on the conditions that would evidence the existence of the two other characteristics: 1) loss of discretion and 2) future economic settlement at a specified date.

The four conditions outlined in this section should be applied to the particular facts of each government transfer, and the preponderance of evidence for each condition must be considered in assessing whether transfer stipulations give rise to an obligation that meets the definition of a liability. Normally all four conditions would be present to support liability recognition; however this is not a rigid rule and, accordingly, professional judgment needs to be applied on a case-by-case basis.

Further, careful assessment of the circumstances and evidence used to support the initial recognition is crucial in that these circumstances and evidence are also used to determine when a liability is settled and revenue is recognized.

The Office's view is that the following conditions would need to be present in some form in order for the stipulations in a transfer agreement to meet the definition of a liability in accordance with PS 3200:

1. The performance obligation embedded in the stipulation is a consequence of the stipulation itself;
2. An assessment of performance against the stipulation is required and monitored to some extent;
3. There are substantive consequences in the event of non-compliance; and
4. Substantive consequences can be, and would be, enforced.

1. *Performance obligation is a consequence of the stipulation itself*

A stipulation that meets the definition of a liability imposes on a recipient entity a performance obligation as to how the recipient must use the transferred resources or the actions it must perform in order to keep the transfer. That is, the recipient is required to consume the future economic benefits embedded in the transferred asset as specified or to return future economic benefits to the transferor. To satisfy the definition of a liability, the performance obligation will be one of substance and not merely form in that the obligation is required as a consequence of the stipulation itself. For example, a term in a transfer agreement that requires the entity to perform an action that it has no alternative but to perform under its mandate may lead the audit team to conclude that the term is not in substance a stipulation that meets the definition of a liability. This is because, in these cases, the terms of the transfer itself do not impose on the recipient entity a performance obligation. This may be the case where the stipulations are stated so broadly that it suggests that the performance obligation is imposed by the operating mandate of the entity, not by the terms of the agreement.

2. *Assessment of performance is required and monitored*

To meet the definition of a liability, it is necessary that an outflow of resources is expected, leaving a recipient little or no discretion to avoid settlement of the obligation. To satisfy this characteristic of a liability, there would need to be a requirement that performance is assessed, and is able to be assessed, to determine compliance with the terms of the transfer. Therefore, a stipulation will need to specify such matters as the nature or quantity of the goods or services to be provided or the nature of the assets as appropriate (i.e., purpose stipulation) and, if relevant, the periods within which performance is to occur (i.e., time stipulation). In addition, performance will need to be monitored by, or on behalf of, the transferor on an ongoing basis. Otherwise, a recipient may be able to avoid an outflow of resources leaving a recipient with discretion to avoid settlement of the obligation.

3. *Substantive consequences in the event of non-compliance*

A recipient incurs a present obligation to transfer future economic benefits to third parties upon initially gaining control of a resource when there are substantive consequences in the event that the stipulations for how the recipient must use the transferred resource or the actions it must perform in order to keep the transfer is breached. This condition is required to evidence that the recipient has lost discretion to avoid future economic settlement at a future date. This is because the recipient is unable to avoid the outflow of resources as it is required to either consume the future economic benefits embodied in the transferred resource in the delivery of specific goods or services, or return the transferred resource to the transferror.

4. *Enforceability of the substantive consequences*

In determining whether a stipulation is a present obligation that meets the definition of a liability, the recipient considers whether a requirement to return the asset or other future economic benefits is enforceable, and would be enforced by the transferor. If the transferor could not enforce a requirement to return the asset or other future economic benefits, the stipulation would fail to meet the definition of a liability since the recipient could avoid the outflow of resources.

Further, if past experience with the transferor indicates that the transferor never enforces the requirement to return the transferred asset or other future economic benefit when breaches have occurred, then the audit team may conclude that the stipulation has the form but not the substance of a liability since the recipient can avoid the outflow of resources. As a practical consideration, if the recipient has no experience with the transferor, or has not previously breached stipulations that would prompt the transferor to decide whether to enforce a consequence, and it has no evidence to the contrary, the audit team would assume that the transferor would enforce the stipulation.

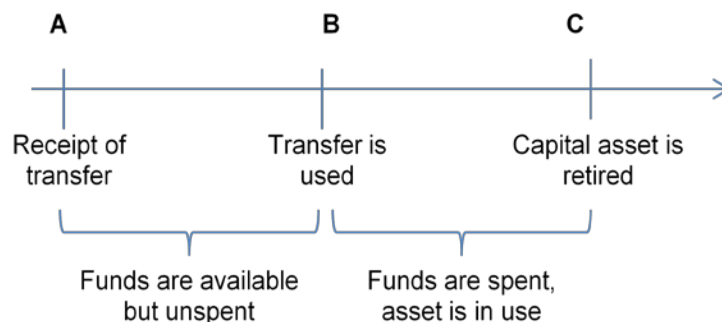
Application Examples

The following examples illustrate how the Office guidance would be applied. This typical government transfer scenario relates to funds transferred for the purpose of acquiring (or building) a tangible capital asset for use in providing services to the public for a defined number of years.

Capital Transfers Scenario 1

A government organization receives a government transfer of $150M to build a bridge. The agreement also contains an explicit stipulation to maintain and operate the bridge for a period of 25 years. The organization's mandate includes maintenance and the safe operation of bridges it controls. In addition, the agreement includes a stipulation requiring the organization to report back to the government on the use of funds and requires the organization to return the funds in the case of misused or unused funds. The organization has historically complied with stipulations of other government transfer agreements.

Under this scenario, a recipient's receipt and use of a capital transfer can be summarized by the following **timeline**:



Analysis: Timeline #1 – Funds are available but unspent

Under this scenario, there is a stipulation to build a tangible capital asset (a bridge). This period is prior to point B on the **timeline** diagram above.

The stipulation to build a bridge would likely meet the definition of a liability because:

- The performance obligation is specific (build a bridge) and is a consequence of the stipulation itself;
- An assessment of performance against the stipulation will occur (organization must report back on the use of funds)
- There are substantive consequences in the event of non-compliance (misused or unused funds must be returned); and
- The consequences are enforceable (organization has historically complied so no evidence to the contrary that the transferor would not enforce).

Under this scenario, the liability would be reduced and revenue recognized progressively over the construction period.

Timeline #2 – Funds are spent; tangible capital asset is in use

In addition to a stipulation to use transferred resources to acquire or build a tangible capital asset, there is a stipulation to operate the bridge over 25 years. This refers to the period subsequent to point B on the **timeline** diagram above.

The stipulation to operate the bridge would likely not meet the definition of a liability because the stipulation is too broad to enable an assessment of performance against the stipulation and the performance obligation is not a consequence of the stipulation itself but rather, imposed by the operating mandate of the entity.

Conclusion

To support a liability as defined by PS 3200, its settlement must result in a recipient's future sacrifice of economic benefits. In this typical government capital transfer scenario, once the recipient has spent the transferred funds to acquire or build a tangible capital asset and the asset is put in use, there will normally be no further sacrifice of economic benefits beyond that point. This is because the recipient's ongoing use of the asset in the delivery of services within the scope of its public policy mandate is not a sacrifice of economic benefits imposed by the transfer agreement itself, irrespective of the transfer including a stipulation requiring that the asset be used over a specified period of time.

Capital Transfers Scenario 2

The recipient entity receives a government transfer of $250M to build and operate a bridge for 25 years The transfer agreement specifies that $150M is to be used to construct the bridge and the balance of

$100M is to be used to maintain the bridge over the 25 year period. The agreement has no stipulation requiring the organization to report back to the government on the use of funds.

Analysis

While there is a stipulation to build a bridge ($150M) and to maintain the bridge ($100M), the requirements are not enforceable because there is no requirement to assess or monitor the performance obligation. Therefore, the stipulations in this scenario do not create an obligation that meets the definition of a liability. While the entity is constrained by its operating mandate to construct and operate/maintain the bridge, the loss of discretion comes from the entity's mandate, not from the stipulations of the transfer itself. As a result, the entire $250M should be recognized as revenue when received/receivable, irrespective of when the funds are spent.

Capital Transfers Scenario 3

The recipient entity receives a government transfer of $250M to build and operate a bridge for 25 years although the bridge has an estimated useful life of 40 years. The transfer agreement specifies that $150M is to be used to construct the bridge and the balance of $100M is to be used to maintain the bridge over the 25 year period to specific minimum standards. The stipulations in the agreement require the organization to report back to government on both the use of funds and the condition of the bridge on a periodic basis. The government has the right to invoke legal and contractual recourses in the case of non-compliance by the recipient. The recipient organization has historically complied with stipulations of other government transfer agreements.

Analysis

The stipulation to build the bridge ($150M) would likely meet the definition of a liability for the reasons given under scenario 1

The liability would be reduced and revenue recognized progressively over the construction period, similar to scenario 1.

The stipulation to maintain and operate the bridge over 25 years to a minimum standard of maintenance ($100M) would also likely meet the definition of a liability and the liability would be reduced and revenue recognized progressively over the 25-year period.

Capital Transfers Scenario 4

The facts are in this scenario are similar to the facts in scenario 3 except for the following:

- the recipient organization has historically not complied with the performance obligations of other transfer agreements; and
- the government has not previously invoked the legal and contractual recourses available in instances of non-compliance by the recipient

Analysis

The stipulations would likely not meet the definition of a liability even though a specific performance obligation exists and the performance obligation is legally or contractually enforceable. This is because the entity has historically not complied with the performance obligation of other transfer agreements and the transferring government has not historically initiated recourse. As a result, past experience demonstrates that in substance, the performance obligations are not enforced, and therefore the entity has not lost its discretion to avoid settlement.

Prepared by: Office of the Auditor General of British Columbia (OAG)

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