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Task Force EPSAS

EPSAS WG 18/07

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EUROPEAN PUBLIC SECTOR ACCOUNTING STANDARDS

– CONCEPTUAL FRAMEWORK –

Reflection paper – for discussion

EPSAS Conceptual Framework

This reflection paper follows up the document 'EPSAS impact assessment considerations', presented at the EPSAS working group meeting in November 2017.

This draft of the Conceptual Framework forms a part of the envisaged technical proposal on EPSAS. The core elements of the technical proposal are:

- Conceptual Framework
- Process for developing standards (including governance)
- Considerations and bases for conclusions
- Summary and conclusions on key technical issues

This paper summarizes for the first time the work accomplished in the EPSAS Cell on Principles related to EPSAS standards concerning the approaches and definitions taken concerning the future EPSAS conceptual framework. It also outlines an approach to defining public sector reporting entities based on the EPSAS first time implementation guidance.

The paper also puts forward first reflections on the future standard-setting under the EPSAS conceptual framework. The formulations are open with regard to the four options[1] that will be assessed in the context of the EPSAS impact assessment and as to the nature of the standards to be set (binding or non-binding standards).

The EPSAS WG delegates are invited to discuss.

[1] EPSAS Impact assessment considerations - WG Nov'2017

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PREFACE

The specificity of public sector accounting mainly derives from the fact that public finance is about the use of the sovereign power for raising and spending tax payers´ money for delivering public goods, public services or public programmes to their beneficiaries. Fully disclosing the financial position and financial performance of public sector entities, on a comparable basis, is in the public interest and therefore a key concern for its protection.

Financial reporting under the accrual basis of accounting provides stakeholders with a complete and reliable picture of the financial position, of the financial performance and the cash flows of the reporting entity in the referenced period.

Whereas this information is key for the functioning of the economies of the Union and its markets, the Internal Market in particular, the Union is aimed at harmonizing the financial information presented by public sector entities in the EU Member States by developing and implementing a Conceptual Framework and a set of European Public Sector Accounting Standards (EPSAS).

The key objective of EPSAS is to achieve the necessary level of financial transparency and comparability of financial reporting, between and within EU Member States. This should be achieved by developing and implementing a set of European financial accounting and financial reporting standards. Together with the Conceptual Framework, they lay down the necessary concepts and operational measures derived thereof for the financial statements to provide a true and fair view of the financial position, financial performance and the cash-flows of public sector reporting entities under the accruals basis of accounting. This is subject to taking into account proportionality and subsidiarity requirements.

The EPSAS Conceptual Framework and the resulting standards should serve the overarching principle of public interest and be conducive to the European public good.

THE EPSAS CONCEPTUAL FRAMEWORK

This conceptual framework (the EPSAS CF) provides a set of concepts and definitions for the development, the adoption, and the publication of EPSAS and provides guidance for the preparation and the presentation of financial accounting information by public sector entities under the EPSAS basis of accounting. The Conceptual Framework may also help users to interpret the financial information presented by public sector entities.

The EPSAS CF is not focusing on individual standards but on ensuring consistency between the EPSAS derived thereof, in parts or as a whole. In addition, the framework also serves as a basis for providing guidance on the presentation of relevant events and transactions, where different interpretations are possible or where no specific standard exists yet.

The EPSAS CF is aimed at public sector reporting entities at national, regional, state and local government levels, and social security funds as well as other reporting entities that may adopt the EPSAS basis of accounting.

General Purpose Financial Reports under the EPSAS

General Purpose Financial Reports

General Purpose Financial Reports (GPFRs) comprise General Purpose Financial Statements (GPFSs) and other reports presenting—financial and non-financial information. GPFSs include statements such as the statement of financial position or balance sheet, the statement of financial performance or income statement, the statement of cash-flows, the statement of changes in net assets/ equity, *[the statement on comprehensive income]*, and the disclosure notes to those statements.

Objectives of General Purpose Financial Reports

GPFRs have the objective to provide financial information in support of accountability and decision making. GPFRs support the management of public finances.

Objectives of General Purpose Financial Statements

GPFSs under EPSAS should provide a true and fair view[2] of the financial position, financial performance and cash-flows of public sector reporting entities – governments or other public sector entities – for accountability and decision making purposes, and under the accrual basis of accounting, including in the context of sustainability and inter-generational equity. Non-financial information may be needed in order that the GPFSs provide a true and fair view.

Accrual basis of accounting

Under the accrual basis of accounting transactions and other events are recognized in financial statements when they occur and not when cash or its equivalent is received or paid. Therefore, the relevant events and transactions must be recorded following the rules of double entry book-keeping and recognized in the financial statements of the periods to which they relate.

True and fair view

In order to provide a true and fair view GPFRs should conform with the qualitative characteristics, the application principles and the resulting EPSAS deriving therefrom, subject to the constraints acknowledged in this Conceptual Framework. In exceptional cases preparers may consider it necessary to diverge from those standards in order that the GPFSs give a true and fair view of the financial position, financial performance and cash-flow of the reporting entity.

Users of General Purpose Financial Reports

The main users of GPFRs are resource providers and their representatives as well as service recipients and their representatives – ultimately the citizens as the key stakeholders of governments and other public sector entities. The legislature and members of parliament, and equivalent actors at sovereign or sub-sovereign levels, are

[2] It is to be noted that "true and fair view" does not a-priori imply the systematic use of current value measurement in accounting.

among the main users of GPFRs, and may make extensive and ongoing use of GPFRs, when acting in their capacity as representatives of the interests of service recipients and resource providers.

GPFRs provide a standardised set of reports meeting the information needs of users who are not empowered to require the disclosure of financial information tailored to their specific information needs. GPFSs represent the minimum level of necessary information to be provided to all users.

Qualitative Characteristics, Application Principles, Constraints

The qualitative characteristics (QCs) of information included in GPFRs and the application principles (APs) are the attributes that make that information useful to users and support the achievement of the objectives of EPSAS. QCs address the standard-setter and the preparers, while APs address mainly preparers. Both are aimed at providing the necessary concepts for operational measures in form of standards to ensure users about the quality of information included in GPFRs – bearing in mind that in certain circumstances they may be subjected to constraints. However, constraints may neither invalidate qualitative characteristics nor application principles.

Qualitative characteristics and application principles are all self-standing and mutually limiting each other. No hierarchy among them is herewith defined, also taking into consideration that a hierarchy might impact adversely on the ability of the standard-setter to cope with emerging cases in the future.

Qualitative characteristics

The following qualitative characteristics should apply:

- **Relevance** – Financial and non-financial information is relevant if it is capable of making a difference in achieving the objectives of GPFRs. Financial and non-financial information is capable of making a difference when it has confirmatory value, predictive value, or both.
- **Faithful representation/ Reliability** – To be reliable, financial and non-financial information must provide a faithful representation of the substance of economic and other phenomena that it purports to represent. Faithful representation is attained when the depiction of those phenomena is complete[1], prudent[2], neutral[3], verifiable[4] and free from material error. Information that faithfully represents economic or other phenomena depicts the substance over the form[5] of the underlying transactions, other events, activities or circumstances.
- **Completeness**[1] – The information which fulfils the recognition criteria should be complete within the bounds of materiality and cost-benefit considerations.
- **Prudence**[2] – 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 while liabilities or expenses are not understated.
- **Neutrality**[3] – Information is neutral if it is free from bias. GPFRs 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. The application of prudence under conditions of uncertainty does not constitute bias and does not affect neutrality.

- **Verifiability**[4] – Verifiability is the quality of information that helps assure users that GPFRs is based on supporting evidence in a way that it faithfully represents the substance of economic and other phenomena that it purports to represent.
- **Substance over form**[5] – Substance over form requires that the underlying transactions, other events, activities or circumstances are accounted for and presented in accordance with their substance and economic reality, and not merely their legal form.
- **Understandability** – Understandability is the quality of presenting information in a manner that facilitates expert and non-expert users to comprehend its meaning. Understandability is enhanced when information is classified, characterised and presented clearly and concisely.
- **Timeliness** – Timeliness means having information available for users before it loses its capacity to be useful for accountability and decision-making purposes. Having relevant information available sooner can enhance its usefulness as input to assessments of accountability and its capacity to inform and influence decisions that need to be made.
- **Comparability** – Comparability is the quality of information that enables users to identify similarities in, and differences between, two sets of phenomena in different reporting entities or in one reporting entity at different points in time.

Application principles

The following application principles should apply:

- **Going concern** – Financial statements shall 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. The rights and obligations specific to public action entrusted in public entities may only cease to exist, in full or in part, by law or decision of the government, even where public sector entities are merged, split or dissolved.
- **Consistency** – The accounting policies and the basis of preparation as well as the presentation and classification of items in the financial statements shall be retained from one period to the next unless, following a significant change in the nature of the entity's operations or a review of its financial statements, another accounting policy, basis of preparation, presentation or classification is more appropriate. In this case, the resulting changes shall be justified and disclosed. Consistency is a means of delivering comparability by making use of the same accounting principles or policies and basis of preparation, either from period to period within a reporting entity or in a single period across more than one reporting entity.
- **Offsetting/ Aggregation** – Assets and liabilities, and revenue and expenses shall not be offset unless so required or permitted by an EPSAS. It is important that assets and liabilities, and revenue and expenses be reported separately. Each material class of similar items shall be presented separately in the financial statements. Items of a dissimilar nature or function shall be presented separately, unless they are immaterial.

- **Presentational sensitivity** – There are areas where there may be some sensitivity when it comes to the level of detail at which information is presented in financial statements, e.g.: separate presentations or disclosures about individual military items, guarantees or legal cases. Presentational sensitivity however shall not have an impact on the recognition and measurement requirements related to the specific items in question.
- **Reporting period** – Financial statements shall be prepared and presented at least annually. When an entity's reporting date changes or the financial statements are presented for a period longer or shorter than one year, a reporting entity shall disclose, in addition to the period covered by the financial statements, the reason for using a longer or shorter period and the resulting limitation on comparability.
- **Compliance** – A reporting entity whose financial statements comply with EPSASs shall make an explicit and unreserved statement of such compliance in the notes. Financial statements shall not be described as complying with EPSASs unless they comply with all the requirements of EPSASs.

Constraints

The following may constrain information included in GPFRs:

- **Materiality** – Information is material if its omission or misstatement could influence the discharge of accountability by the entity, or the decisions that users make on the basis of the entity's GPFRs prepared for that reporting period. Materiality depends on both the nature and amount of the item.
- **Cost-benefit** – Financial reporting imposes costs. The benefits of financial reporting should justify those costs. Assessing whether the benefits of providing information justify the related costs is often a matter of judgment, because it is often not possible to identify and/or quantify all the costs and all the benefits of information included in GPFRs.
- **Balance between the individual qualitative characteristics and application principles** – The qualitative characteristics work together to contribute to the usefulness of information. In some cases, a balancing or trade-off between individual qualitative characteristics and application principles may be necessary to achieve the objectives of financial reporting. The aim is to achieve an appropriate balance among the individual qualitative characteristics and application principles in order to meet the objectives of financial reporting.

Definition of Elements

The elements are:

- Assets
- Liabilities
- Expenses
- Revenues
- Ownership contributions
- Ownership distributions

Assets

An asset is a resource presently controlled by the entity as a result of past events or transactions.

A resource is an item with service potential or the ability to generate economic benefits.

- Service potential is the capacity to provide services that contribute to achieving the entity's objectives.
- Economic benefits are cash inflows or a reduction in cash outflows.

Liabilities

A liability is a present obligation of the entity for an outflow of resources that results from past events or transactions.

A present obligation is a legally binding obligation (legal obligation) or non-legally binding obligation, which an entity has little or no realistic alternative to avoid.

- A legal obligation is enforceable in law.
- Non-legally binding obligations differ from legal obligations in that the party to whom the obligation exists cannot take legal (or equivalent) action to enforce settlement.

Expenses

An expense is a decrease in the net financial position of the entity, other than a decrease arising from ownership distribution.

Revenues

A revenue is an increase in the net financial position, other than an increase arising from ownership contribution.

Ownership contributions

Ownership contributions are inflows of resources to an entity, contributed by external parties in their capacity as owners, which establish or increase an interest in the net financial position of the entity.

Ownership distributions

Ownership distributions are outflows of resources from the entity, distributed to external parties in their capacity as owners, which return or reduce an interest in the net financial position of the entity.

Recognition and Derecognition of Elements

Recognition

Recognition is the process of incorporating and including, in amounts displayed on the face of the appropriate financial statement, an item that meets the definition of an element; and can be measured in a way that achieves the qualitative characteristics, and the application principles taking into account the constraints on information included in GPFRs.

Recognition criteria

The recognition criteria are that:

- An item satisfies the definition of an element; and
- Can be measured in a way that achieves the qualitative characteristics and takes account of constraints on information in GPFRs.

The items which fail to meet the definition of an element and the recognition criteria cannot be recognised. However, information about such items may be disclosed in the notes. Disclosure is appropriate when knowledge of the item is considered to be relevant to the evaluation of the financial position and financial performance of the entity and therefore meets the objectives of financial reporting.

In exceptional circumstances an individual EPSAS standard may also specify that, in order to deliver true and fair view, a resource or obligation (such as deferred inflows or outflows) that does not satisfy the recognition criteria may nevertheless need to be recognised in the financial statements.

Thereby it is important to distinguish flows (inflows and outflows) that relate to the current reporting period from those that relate to specified future reporting periods. A deferred inflow is an inflow of service potential or economic benefits provided to the entity for use in a specified future reporting period that results from a non-exchange transaction and increases net assets; and a deferred outflow is an outflow of service potential or economic benefits provided to another entity or party for use in a specified future reporting period that results from a non-exchange transaction and decreases net assets. These flows are restricted to non-exchange transactions and relate to a specified future period.

Derecognition

Derecognition is the process of evaluating whether changes have occurred since the previous reporting date that would warrant removing an element that had been previously recognized from the financial statements, and removing the item if such changes have occurred. In evaluating uncertainty about the existence of an element the same criteria are used for derecognition as at initial recognition.

Measurement

The selection of a measurement basis needs to reflect the objectives of financial reporting under the EPSAS basis of accounting, as well as comply with qualitative characteristics, application principles and constraints of information in financial reports. Two measurement concepts are distinguished: historical costs and current value.

Measurement concepts for assets

Historical cost for an asset is the consideration given to acquire or develop an asset, which is the cash or cash equivalent or the value of the other consideration given, at the time of its acquisition or development.

Under the historical cost model at the reporting date the amount of an asset may be reduced by recognizing depreciation and impairments.

Current value measurements for assets reflect the economic environment prevailing at the reporting date.

Measurement concepts for liabilities

Historical cost for a liability is the consideration received to assume an obligation, which is the cash or cash equivalents, or the value of the other consideration received at the time the liability is incurred.

Current value measurements for liabilities reflect the economic environment prevailing at the reporting date.

Measurement bases

Measurement should serve the objectives of general purpose financial reports in line with this framework. The selection of a measurement basis for assets and liabilities in order to meet the objectives of financial reporting should be provided at the level of EPSAS standards.

General Purpose Financial statements

General purpose financial statements should be prepared and presented to ensure comparability both with the entity's financial statements of previous periods and with those of other entities preparing and presenting financial statements under EPSAS.

General purpose financial statements should provide a structured representation of the financial position, financial performance and the cash-flows of an entity. They should provide information useful for decision making, and demonstrate the accountability of the entity for the resources entrusted to it.

General purpose financial statements prepared under EPSAS should be presented at least once a year. A complete set of general purpose financial statements should comprise:

- A statement of financial position, which consists in the presentation of the assets, the liabilities, including other resources and other obligations recognised, and the ownership contributions and ownership distributions of the reporting entity; the resulting balancing item provides the net worth (net assets/ liabilities) of that entity.
- A statement of financial performance, which consists in the presentation of the expenses and the revenue of the reporting entity; the resulting balancing item provides the surplus or deficit (net expenses/ revenue) of that entity.
- A statement of changes in net assets/ equity, which consists in the presentation of the increases or the decreases in the reporting entity`s net assets in the course of the reporting period.

- A cash flow statement, which consists in presentation of the sources of cash inflows and the items on which cash was expended in the course of the reporting period, and the cash balance as at the reporting date of the financial statements.
- Notes for the presentation of information in addition to that presented in the statement of financial position, the statement of financial performance, the statement of changes in net assets/ equity and the cash flow statement.
- *[Other comprehensive statements]*

For each financial year starting on or after 1 January public sector reporting entities as defined below should prepare and present general purpose financial statements in conformity with the present framework.

Decisions about the information and the level of detail at which it needs to be displayed and disclosed should take into account:

- The objectives of GPFRs,
- The qualitative characteristics, application principles and the constraints on information to be included in GPFRs, and
- The substance of the relevant economic or other phenomena about which information is considered necessary.

Public Sector Reporting Entity

General purpose financial statements under the EPSAS basis of accounting should serve the public interest and be conducive to the European public good. This implies that every entity which is held accountable for receiving resources, and for the use it makes of them for delivering public goods, public services or public programmes, is considered as a public sector entity.

A public sector entity or group of entities meeting one or more of the following criteria:

- ability to take economic decisions and engage in economic activities for which it is responsible and accountable in law or otherwise accountable to service recipients or resource providers,
- entitlement to own and transact assets in its own right,
- ability to incur liabilities on its own behalf, to take on other obligations or further commitments,

and which compiles accounts, or for which accounts can be compiled on its behalf, is considered as falling within the scope of public sector reporting entities, unless, upon entry into force of the present framework, it was already reporting on the basis of national or international generally accepted private sector accounting standards.

The determination of which public sector reporting entities should provide GPFRs under the EPSAS basis of accounting should be based on decision-making and accountability considerations, and be specified at the level of EPSAS standards with due regard to the circumstances of smaller and less risky entities.

The criteria and the requirements for the inclusion of an entity into a reporting group of entities should be provided at the level of EPSAS standards.

STANDARD-SETTING[3]

The Commission should adopt EPSAS on the condition that they are

- conducive to the European public good,
- conducive to objectives of GPFRs set out above, and
- conform to the qualitative characteristics and the application principles taking into consideration the constraints set out above.

The EPSAS should be aligned with internationally accepted accounting standards for the public sector where such standards exist. Thereby the Commission may also take into consideration:

- the accounting rules based on internationally accepted accounting standards for the public sector adopted by accounting officer of the Commission in line with Art 143 of Regulation (EU, Euratom) No 966/2012 of the European Parliament and of the Council, of 25 October 2012, on the financial rules applicable to the general budget of the Union.
- the accounting standards for the private sector adopted under Regulation (EC) 1606/2002 of the European Parliament and the Council, of 19 July 2002, on the application of international accounting standards, for short referred to as the IAS Regulation, the Directive 2013/34/EU, of 26 June 2013, of the European Parliament and the Council on the annual financial statements, consolidated financial statements and related reports of certain types of undertakings, referred to for short as the Accounting Directive.
- nationally developed and generally accepted accounting principles (GAAP) for the public sector developed by national standard setters which already invested into the modernisation of their public sector accounting and financial management systems and reached a high level of accounting maturity, and
- the rules of the statistical accounting framework adopted under the European System of Accounts (ESA).

The Commission should review the suitability of internationally accepted accounting standards for the public sector, in existence upon entry into force of the present framework, and decide on the alignment of EPSAS with those standards in accordance with the procedure laid down in - - -[3].

The considerations leading to any material amendment to or departure from internationally accepted accounting standards for the public sector should be documented in the process of the adoption of the European standard in question and be made public alongside the adopted standard.

[3] This chapter is meant to be part of the technical proposal but not part of the Conceptual Framework. The procedure for adopting EPSAS depends on the options as defined in draft impact assessment.

Adopted EPSAS should be published in full in each of the official languages of the Community in the Official Journal of the European Communities.

CONSIDERATIONS FOR THE FUTURE STANDARD-SETTING[4]

- *Public sector specificities*

  Considerations and bases for conclusions for the treatment of key public sector specific issues under the proposed EPSAS due-process, such as fair value, pensions/ social benefits, etc.

- *Summary and conclusions on key technical issues*

[4] This chapter is not meant to be part of the Conceptual Framework