



Tasmania

DEPARTMENT of  
TREASURY and FINANCE

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Ms Ruth Picker  
Acting Chairman  
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Dear Ms Picker

**CONVERGENCE OF GENERALLY ACCEPTED ACCOUNTING PRINCIPLES  
(GAAP) AND GOVERNMENT FINANCE STATISTICS (GFS)**

As you will be aware, a Joint Working Group comprising representatives from the Heads of Treasuries Accounting and Reporting Advisory Committee (HoTARAC), the Australian Accounting Standards Board (AASB), Australasian Council of Auditors-General (ACAG) and the Australian Bureau of Statistics, has been considering conceptual and technical aspects to assist in progressing the convergence of GAAP and GFS.

Specifically, the Working Group's project included:

- the consideration of fundamental differences in approach and identification of conceptual differences between GFS and GAAP – in particular those impacting on net operating result and net assets/net worth;
- the development of detailed Issues Papers around these conceptual differences;
- the identification of a reasonable course for convergence through the specification of recommended changes to one or both reporting frameworks in relation to each of the key differences;
- the recommendation of transitional arrangements; and
- the preparation of a report that provides recommendations on areas of convergence and any other transitional strategies, and describes the implications of any remaining differences.

The Working Group has finalised a series of conceptual and technical Issues Papers in respect of the convergence of GAAP and GFS. These Papers were considered and endorsed by Heads of Treasuries at its July 2003 meeting.

I am pleased to forward these Papers for the Board's consideration. Should you require assistance or clarification in respect of any of these Papers, please contact the convenor of the Working Group, Mr Brett Kaufmann on (02) 6215 3158.

Yours sincerely



Philip Mussared

**ACTING SECRETARY**

6 August 2003

cc: Dr Ken Henry, Chair, Heads of Treasuries  
Mr Brett Kaufmann, Chair, HoTARAC Working Group

**HOTARAC REPORT**  
**GFS/GAAP CONVERGENCE**  
**FEBRUARY TO JUNE 2003**

**HoTARAC WORKING GROUP**  
**GFS/GAAP CONVERGENCE**  
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**NOTE:** The technical papers in the grey box have not been circulated but are available from your respective HoTARAC representative

# **HoTARAC Report to HoTs**

## **HARMONISATION OF GENERALLY ACCEPTED ACCOUNTING PRINCIPLES AND GOVERNMENT FINANCE STATISTICS**

### ***Introduction***

This paper provides a progress report against the Terms of Reference for the HoTARAC Working Group on Government Finance Statistics (GFS)/Generally Accepted Accounting Principles (GAAP) Harmonisation and makes a range of recommendations. HoTARAC agreed the Terms of Reference for its Working Group at its February meeting. Since that time, the Working Group met on 4 occasions.

The views expressed in the attached documents are solely those of the Working Group. In no way do the views expressed represent those of their employers or the organisations that they represent.

### ***Recommendations***

- HoTARAC recommends endorsement of the attached set of papers for submission by the Chairman to the AASB.
- Timely endorsement is a critical input to the AASB's workplan for GAAP/GFS harmonisation.

It should be noted, given the AASB's intended timetable, that jurisdictions will need to consider the timing of application of a converged framework for their budgets, budget updates, budget outcomes and AAS 31 reports.

Technical papers: The papers developed by HoTARAC on the technical differences between GFS and GAAP have not been circulated. These papers are available from your respective HoTARAC representative.

Further, it is proposed that the papers concerning logistical issues are for the information of Heads of Treasuries and are not for distribution to the AASB.

## HOTARAC Report Attachment

### HOTARAC WORKING GROUP GFS/GAAP CONVERGENCE SUMMARY OF CONCLUSIONS

Issue	Conclusion
<b>Conceptual</b>	
Objectives of the two frameworks	<ul style="list-style-type: none"> <li>– there is a substantial conceptual overlap between GFS and GAAP</li> <li>– both frameworks rely on a single set of underlying financial data - GAAP</li> <li>– practitioners already use the strengths of both frameworks to ensure that data is appropriately classified, measured and disclosed</li> <li>– convergence is possible.</li> </ul>
Role and scope of budget reporting	<ul style="list-style-type: none"> <li>– Budget reporting is being investigated by IFAC PSC but other accounting standard setters are not currently considering it.</li> <li>– The convergence solution must continue to cater for Budget reporting practices of all jurisdictions.</li> </ul>
Identification of the Users and Their Uses of Public Sector Financial Statements	<ul style="list-style-type: none"> <li>– Government financial reports have a diverse group of users, who have a wide range of uses of the reports.</li> </ul>
<b>Technical</b>	
Pro-forma financial statements	While some options may be preferred by some over others, it is possible to construct converged financial statements that comply with both frameworks.
Consolidations	<p>The Working Group recommends that the AASB re-consider the issue of reporting by the general government sector (GGS). There is evidence that users use GGS reports for specific purposes that differ from the uses of consolidated financial statements. The converged standards need to allow the GGS to be treated as a reporting entity. In order to facilitate this, the accounting standards would need to be prescriptive as to what constitutes a reporting entity within government (eg adopting the ABS definition of the general government sector).</p> <p>In addition, GAAP may need to provide for sector financial statements to be presented within consolidated statements rather than through note disclosure.</p> <p>The accounting standards should be amended to clarify the measurement of the General Government equity investment in the PNFC and PFC sectors, to align with the GFS treatment.</p>

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### HOTARAC WORKING GROUP GFS/GAAP CONVERGENCE SUMMARY OF CONCLUSIONS, PAGE 2

Issue	Conclusion
<p>Issue 1.1 Revisions relating to prior periods</p>	<p>Australian accounting standards currently treat prior period revisions as revenues/(expenses) of the period in which they were first identified. International accounting standards take prior period revisions against retained results in the equity section of the balance sheet.</p> <p>GFS would take prior period revisions directly against the period(s) in which the related economic activity occurred and are reflected in current period's net worth (eg equity).</p> <ul style="list-style-type: none"> <li>– <i>short term</i>: adopt the GFS principle of taking prior period adjustments against net results (a component of equity)</li> <li>– <i>long term</i>: adoption of IAS 8 will substantially resolve this difference.</li> <li>– <i>watch list</i>: the two frameworks may perceive the timing of a change in estimate differently (eg. accounting might view a change in estimate as arising currently, but GFS could back-cast). Consequently, IAS developments should be monitored to ensure convergence is achieved.</li> </ul>
<p>Issue 1.2 Borrowing costs on qualifying assets</p>	<p>Australian accounting standards currently require capitalisation of borrowing costs during the construction phase for some assets. GFS expenses borrowing costs in the period during which they are incurred.</p> <ul style="list-style-type: none"> <li>– <i>short term</i>: adopt GFS practice of expensing rather than capitalising borrowing costs</li> <li>– <i>long term</i>: AASB ED 111 (adopting IAS 23) will provide a choice between capitalising and expensing of borrowing costs. Jurisdictions will then need to choose the expensing option to achieve convergence.</li> </ul>
<p>Issue 2.1 Actuarial adjustments for government defined benefit superannuation schemes</p>	<p>Accounting treats actuarial adjustments as revenues/(expenses) of the period during which the actuary's opinion was provided. GFS treats most actuarial adjustments as other economic flows (eg re-measurements).</p> <ul style="list-style-type: none"> <li>– <i>short term</i>: (a) adopt the GFS treatment of these adjustments as re-measurements; along with (b) a revised operating statement format based on comprehensive income reporting principles.</li> <li>– <i>long term</i>: adoption of the IASB's performance reporting standard is likely to result in these adjustments being treated as re-measurements.</li> <li>– <i>watch list</i>: monitor the development of: (a) accounting standard on post employment benefits; and (b) performance reporting.</li> </ul>

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### HOTARAC WORKING GROUP GFS/GAAP CONVERGENCE SUMMARY OF CONCLUSIONS, PAGE 3

Issue	Conclusion
<p>Issue 2.3 Non-current, non-financial assets: revaluations and profit/(loss) on disposal</p>	<p>Accounting generally takes revaluation increments and decrements to an asset revaluation reserve in equity except where an increment reverses a decrement expensed in a previous period or a decrement exceeds the balance of the asset revaluation reserve for that class of asset. In the latter cases, increments and decrements are recognised as revenues and expenses. Profits/(losses) on disposal are recognised in the Statement of Financial Performance.</p> <p>GFS classifies all revaluations as ‘other economic flows’ (eg re-measurements). Assets are revalued to market value immediately prior to disposal, so no difference arises on disposal.</p> <ul style="list-style-type: none"> <li>– <i>short term</i>: (a) adopt GFS treatment of all revaluations as re-measurements; along with (b) a revised operating statement format based on comprehensive income reporting principles.</li> <li>– <i>long term</i>: adopt IASB’s performance reporting standard which is likely to treat changes in asset values as re-measurements.</li> <li>– <i>watch list</i>: monitor developments regarding grouping of assets into classes versus tracking individual asset changes.</li> </ul>
<p>Issue 2.4 Self generating and regenerating assets (SGARAs)</p>	<p>Australian GAAP currently treats changes in net market value of SGARAs as revenues/(expenses) of the period during which they are recognised. International GAAP is likely to separate the change due to growth (treated as a “profit before re-measurement” item) from changes due to market value movements (likely to be classed as “re-measurements”).</p> <p>GFS separates movements in SGARAs into natural growth (affects operating statement through change in inventory) and price movements (an “other economic flow”).</p> <ul style="list-style-type: none"> <li>– <i>short term</i>: (a) adopt the GFS treatment of distinguishing movements in SGARAs (separation between growth and price changes); along with (b) a revised operating statement format based on comprehensive income reporting principles</li> <li>– <i>long term</i>: adoption of the IASB’s performance reporting standard is likely to result in these adjustments being treated as re-measurements.</li> <li>– <i>watch list</i>: monitor developments regarding performance reporting to ensure long term convergence is achieved.</li> </ul>

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### HOTARAC WORKING GROUP GFS/GAAP CONVERGENCE SUMMARY OF CONCLUSIONS, PAGE 4

Issue	Conclusion
<p>Issue 2.6 Initial Recognition of Assets</p>	<p>Accounting treats assets recognised for the first time as revenues of the period of recognition. GFS would classify such transactions as 'other economic flows'.</p> <p><i>Short term:</i> (a) adopt the GFS principle that classifies these as re-measurements; along with (b) a revised operating statement format based on comprehensive income reporting principles.</p> <p><i>Long term:</i> adoption of the IASB's performance reporting standard is likely to result in these adjustments being treated as re-measurements.</p> <p><i>Watch list:</i> monitor the development of the IASB's performance reporting standard.</p>
<p>Issue 3 Financial instruments (includes: – Issue 3.1 swaps and other derivatives – Issue 3.2 valuation of debt securities; and – Issue 3.4 premiums and discounts on repurchased debt)</p>	<p>Differences in treatment of financial instruments arise in 2 contexts:</p> <ol style="list-style-type: none"> <li>1) measurement: Australian GAAP permits either cost or market valuation methods. International standards will also permit a choice in certain circumstances. GFS requires market valuation.</li> <li>2) holding gains and losses: Australian GAAP treats the realised and—for market valued instruments—unrealised gains/(losses) as revenues/(expenses) of the period during which they arise. International GAAP is likely in the longer term to treat changes in value as re-measurements. GFS treats market value movements as "other economic flows"</li> </ol> <p>– <i>short term:</i> (a) adopt a revised operating statement format based on comprehensive income reporting principles; and (b) jurisdictions should elect a market valuation (fair value) basis as their own accounting policy.</p> <p>– <i>long term:</i> adoption of the IASB's financial instruments and performance reporting standards is likely to result in these adjustments being treated as re-measurements</p> <p>– <i>watch list:</i> monitor developments regarding both financial instruments and performance reporting to ensure long term convergence is achieved.</p>
<p>Issue 3.3 foreign exchange gains and losses</p>	<p>Accounting treats foreign exchange movements as revenues/(expenses) of the period in which they are recognised. GFS treats these movements as 'other economic flows'.</p> <p>– <i>short term:</i> adopt a revised operating statement format based on comprehensive income reporting principles</p> <p>– <i>long term:</i> adoption of the IASB's performance reporting standard would facilitate convergence on this issue.</p> <p>– <i>watch list:</i> monitor performance reporting developments to ensure convergence is achieved.</p>

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### HoTARAC WORKING GROUP GFS/GAAP CONVERGENCE SUMMARY OF CONCLUSIONS, PAGE 5

Issue	Conclusion
Issue 4.1 Defence weapons platforms	<p>Accounting would capitalise defence weapons platforms as they provide economic benefits over multiple periods. GFS currently treats defence weapons platforms as consumables, expensing them in the year of acquisition. This is based on the System of National Accounts (SNA) treatment.</p> <ul style="list-style-type: none"><li>– <i>short term</i>: the ABS has indicated that it is willing to early adopt probable changes resulting from the SNA Review</li><li>– <i>long term</i>: the SNA Review is likely to result in a change of treatment to capitalise defence weapons platforms.</li></ul>
Issue 4.2 Allowances for bad and doubtful debts	<p>Accounting considers that receivables should be ‘market valued’ by providing for any likely non-recoveries. The overall valuation of the receivables balance is considered more important than specific accuracy, so this is normally achieved by raising an allowance for doubtful debts as an expense and contra asset. Any bad debts written off are charged against the contra asset. GFS only permits expensing of bad debts where there is mutual agreement between the borrower and lender of the write-off. Any other changes, including unilateral write-downs, are ‘other economic flows’. GFS does not recognise provisions for doubtful debts.</p> <ul style="list-style-type: none"><li>– <i>short term</i>: adopt GAAP treatment with additional note disclosure to enable ABS to make adjustments for GFS presentation. The ABS has indicated that it would be willing to early adopt any outcomes from the SNA Review in this regard.</li><li>– <i>long term</i>: (a) encourage the ABS to support changes to debt valuation through the SNA Review; and (b) adopt a revised operating statement format based on comprehensive income reporting principles.</li><li>– <i>watch list</i>: monitor SNA Review progress and IASB’s performance reporting project to ensure convergence is achieved.</li></ul>

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### HOTARAC WORKING GROUP GFS/GAAP CONVERGENCE SUMMARY OF CONCLUSIONS, PAGE 6

Issue	Conclusion
<p>Issue 4.5 Capitalisation of research and development (R&amp;D) and other intangibles</p>	<p>Accounting expenses research and permits capitalisation of development costs that meet certain criteria. Capitalisation of other intangibles is permitted under certain conditions. Amortisation is an expense (like depreciation).</p> <p>GFS generally expenses both R&amp; D, but permits capitalisation of intangible assets under some circumstances. Amongst National Accountants there is some tendency to favour capitalising rather than expensing. Amortisation of intangibles is classed as an ‘other economic flow’.</p> <ul style="list-style-type: none"> <li>– <i>short term</i>: adopt GAAP treatment with additional note disclosure to enable ABS to make adjustments for GFS presentation.</li> <li>– <i>long term</i>: ABS should encourage IMF SNA Review to align with GAAP recognition principles and to classify amortisation as being similar to depreciation (expense).</li> <li>– <i>watch list</i>: monitor development in SNA Review and international standards to ensure convergence is achieved.</li> </ul>
<p>Issue 5.1 Distributions payable to owners <i>and</i> Issue 7.2 Distributions receivable from controlled entities</p>	<p>Accounting treatment differs depending on the designation of the type of transaction by the owners. Dividends are charged against retained results of the payee and reported as revenue by investor recipients. Returns of capital are charged against contributed capital and reduce the investor’s investment in the payee.</p> <p>GFS treats dividends as operating statement transactions—expenses of the payee and revenues to the recipient investor. Returns of capital are treated in the same way as accounting.</p> <ul style="list-style-type: none"> <li>– The difference in treatment of dividends by paying entities is unlikely to be resolved due to the conceptual differences in definition of an expense.</li> <li>– <i>short and long term</i>: (a) jurisdictions should formally designate that distributions to owners will be classified as dividend/return of equity in accordance with principles from UIG 38; and (b) adopt GAAP treatment with additional note disclosure to enable ABS to make adjustments for GFS presentation.</li> </ul>

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### HOTARAC WORKING GROUP GFS/GAAP CONVERGENCE SUMMARY OF CONCLUSIONS, PAGE 6

Issue	Conclusion
<p>Issue 5.2 Reduced net worth for commercial government operations</p>	<p>Accounting values interests in controlled entities on the basis of consolidated net assets (showing the minority interest as a part of equity).</p> <p>GFS starts with the proportion of net assets that corresponds to the proportion of ownership, but then compares with the market value of the investment. For unlisted entities this always results in a zero investment balance (as market value of investment interest equals net assets), but for listed entities this frequently results in negative value in the investor entity's balance sheet (as market value can be greater than net assets). National accountants explain the negative value as being due to either undervaluation of existing assets or failure to recognise/ capitalise assets such as intellectual property.</p> <ul style="list-style-type: none"> <li>– This difference is unlikely to be resolved due to the depth of the conceptual differences.</li> <li>– <i>short and long term</i>: adopt GAAP treatment with additional note disclosure to enable ABS to make adjustments for GFS presentation.</li> </ul>
<p>Issue 6.1 Investment property</p>	<p>While treatments are generally aligned at present, a proposed international accounting standard would, if adopted without specific public sector provisions, create divergence. IAS 40 offers a choice of accounting treatments: (1) if measured at cost, then depreciation is charged (fair value disclosed in notes); or (2) if measured at fair value then all valuation movements are revenues/(expenses) for the period.</p> <p><i>Short term</i>: frameworks are aligned.</p> <p><i>Long term</i>: (a) AASB should consider including the exclusions from IPSAS 16 as public sector specific provisions when adopting IAS 40. This will minimise the divergence. (b) encourage the AASB to comment to the IASB that, in the context of performance reporting, the change in fair value of investment properties should be split into components (eg. 'profit before re-measurement' and 're-measurement').</p> <p><i>Watch list</i>: monitor developments in IAS 40 and performance reporting to look for opportunities for convergence.</p>
<p>Issue 7.3 Depreciation/ Consumption of fixed capital</p>	<p>A difference relating to 'depreciation' arises between accounting and GFS where assets are valued at cost for accounting purposes, as GFS consistently requires market basis valuations.</p> <ul style="list-style-type: none"> <li>– <i>short and long term</i>: jurisdictions should nominate fair value (which is a 'market value' method) as the valuation basis for assets.</li> </ul>

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### HoTARAC WORKING GROUP GFS/GAAP CONVERGENCE SUMMARY OF CONCLUSIONS, PAGE 8

Issue	Conclusion
<b>Logistical – <i>not for distribution to the AASB</i></b>	
Practical issues relating to convergence	<ul style="list-style-type: none"><li>– In the long term convergence needs to extend across the government sector and its controlled entities. Incorporated subsidiaries may need exemption.</li><li>– The timeframe proposed by the AASB would result in an exposure draft standard by May 2004.</li><li>– Jurisdictions are likely to need to prepare separate GFS and GAAP reports for 03/04, 04/05, and possibly 05/06 to provide comparisons between budgets and actuals.</li></ul>
Work Plan	<ul style="list-style-type: none"><li>– Convergence issues may continue to emerge regularly over the next 2 to 3 years (given changes to SNA/GFS and adoption of IAS/IFRS) and then would only arise on changes to either GAAP or GFS</li></ul>



# HOTARAC GFS<sup>1</sup>/GAAP<sup>2</sup> Convergence Working Party--Overview of Technical Issues<sup>3</sup>

## Convergence vehicles—AAS 27, AAS 29 and AAS 31

Issue	Australian GAAP Treatment	GFS Treatment	Convergence Opportunities
<b>1.0 Measurement issues likely to be substantially resolved by adoption of international accounting standards<sup>4</sup></b>			
1.1 Revisions relating to prior periods	Prior period items are recorded in the current period (unless an entity restates prior period items and reissues the prior period financials).	Prior period items are taken directly to the period(s) in which the related economic activity is regarded as having taken place and are reflected in the current period's equity (net worth). For presentation purposes some jurisdictions have reported prior period adjustments in other economic flows for the period.	<p><i>Short term:</i> adopt the GFS principle of taking prior period adjustments against net results (a component of equity)</p> <p><i>Long term:</i> adoption of IAS 8 “Net Profit or Loss for the Period, Fundamental Errors and Changes in Accounting Policies” will result in an adjustment to opening retained earnings for some prior period adjustments.</p> <p><i>Watch list:</i> As the two frameworks may perceive the timing of a change in estimate differently (eg. accounting might view a change in estimate as arising currently, but GFS could back-cast). Consequently, IAS developments should be monitored to ensure convergence is achieved.</p>
1.2 Borrowing costs on qualifying assets	Borrowing costs on qualifying assets are capitalised with the asset. This increases the annual depreciation charged throughout its useful life. Note: borrowing costs not capitalised are expensed in the reporting period incurred.	All borrowing costs are expensed in the Operating Statement in the period incurred.	<p><i>Short term:</i> adopt GFS practice of expensing rather than capitalising borrowing costs</p> <p><i>Long term:</i> AASB ED 111 will permit reporting entities to choose between capitalising and expensing borrowing costs.</p>

<sup>1</sup> GFS is used throughout this document to refer to Government Finance Statistics.

<sup>2</sup> GAAP is used throughout this document to refer to generally accepted accounting principles.

<sup>3</sup> The issues listed include all convergence related technical issues identified by the participating jurisdictions. Other issues may exist that have not yet arisen and/or are not yet recognised or identified.

<sup>4</sup> IFRS 1 describes the circumstances under which an entity can first-time adopt international accounting standards (or domestic standards based on them).

Issue	Australian GAAP Treatment	GFS Treatment	Convergence opportunities
<b>2.0 Issues partially resolved by IASB's Performance Reporting Project, incorporating—</b>			
2.1 Government defined benefit superannuation schemes—actuarial adjustments	Treated as expense items in the Statement of Financial Performance.	Actuarial revaluations should be recorded in the period to which it relates (that is, may be recorded in prior period(s) figures) and are generally treated as a market value movement in the current period (other economic flows).	<p><i>Short term:</i> (a) adopt the GFS classification of these adjustments as re-measurements; and (b) adopt a revised operating statement format that is based on comprehensive income reporting principles.</p> <p><i>Long term:</i> adoption of performance reporting is likely to result in these adjustments being treated as re-measurements.</p> <p><i>Watch list:</i> monitor the development of: (a) accounting standard on post employment benefits; and (b) performance reporting.</p>
2.2 Government superannuation schemes—nominal interest	<p>Actual revenues and expenses resulting from transactions with employer-funded superannuation are reported as operating expenses in the period during which they accrue.</p> <p>International standards may unwind the interest expense and report it separately.</p>	Nominal interest is charged on the unfunded portion of the employer's liability to the superannuation scheme and reported as an expense in the employer's operating statement.	There is no real difference in GFS and GAAP treatment. All GFS does is to separately identify nominal superannuation interest, while GAAP records a single expense. A difference could arise under performance reporting, so developments should be monitored.
2.3 Non-current non-financial assets: revaluations and profit or loss on disposal	<p>Net revaluation increments relating to a class of non-current assets are taken to the asset revaluation reserve (in equity) except where reversing previous net revaluation decrements previously recognised as an expense. Reversals are first offset against the asset revaluation reserve with any residual expensed in the Statement of Financial Performance.</p> <p>Profit or losses on disposals are recognised in the Statement of Financial Performance. [Note: the gross proceeds are included in revenues for the period and the carrying amount of the non-current asset is included as an expense for the period.]</p>	Both asset revaluations and any market value movements arising immediately prior to the sale of assets are treated as price changes and recorded in the Statement of Other Economic Flows.	<p><i>Short term:</i> (a) adopt GFS treatment of all revaluations as re-measurements; along with (b) a revised operating statement format based on comprehensive income reporting principles.</p> <p><i>Long term:</i> adopt IASB's performance reporting standard which is likely to treat changes in asset values as re-measurements.</p> <p><i>Watch list:</i> monitor developments regarding group of assets into classes versus tracking individual asset changes.</p>

Issue	Australian GAAP Treatment	GFS Treatment	Convergence opportunities
2.4 Self generating and regenerating assets (SGARAs)	Changes in net market value of these assets are revenues/expenses of the period during which they are recognised.	Changes in stocks of SGARAs and natural resources (including oil, minerals, water, spectrum, and non-cultivated biological resources) are separated into first time recognition (usually an other economic flow), natural growth (which effectively increases inventory) and price movements (also an other economic flow).	<p><i>Short term:</i> (a) adopt the GFS treatment of distinguishing movements in SGARAs (separate growth from price changes); along with (b) adoption of a revised operating statement format based on comprehensive income reporting principles.</p> <p><i>Long term:</i> adoption of the IASB's performance reporting standard is likely to result in these adjustments being treated as re-measurements.</p> <p><i>Watch list:</i> monitor developments regarding performance reporting to ensure long term convergence is achieved.</p>
2.5 Extractive industries	Extractive industries recognise assets/inventories when severed from the ground. Inventory is recognised at cost and subject to normal net realisable value test.	Changes in stocks of natural resources (including oil, minerals, water, spectrum, and non-cultivated biological resources) are separated into first time recognition (usually an other economic flow) and price movements (also an other economic flow).	Difficult to measure and unlikely to be material for public sector in practice.
2.6 Assets recognised for the first time (eg through stocktake or initial recognition of pre-existing asset)	Initial recognitions of existing assets would result in revenue recognition during the period.	Initial recognitions of existing assets is a re-measurement, and hence is an Other Economic Flow.	<p><i>Short term:</i> (a) adopt the GFS principle that classifies these as re-measurements; along with (b) a revised operating statement format based on comprehensive income reporting principles.</p> <p><i>Long term:</i> adoption of the IASB's performance reporting standard is likely to result in these adjustments being treated as re-measurements.</p> <p><i>Watch list:</i> monitor development of the IASB's performance reporting standard.</p>

Issue	Australian GAAP Treatment	GFS Treatment	Convergence opportunities
<b>3.0 Issues affected by adoption of the international financial instruments standard—[Note: 3 of the following 4 issues have been consolidated into a single “Financial Instruments” paper (Issue 3.3 has a separate paper).]</b>			
3.1 Swaps and other derivatives	<p>The realised and unrealised movements are recorded as revenues or expenses in the Statement of Financial Performance.</p> <p>Swap interest is treated as an expense of the period, like the interest costs to which it is limiting exposure.</p>	<p>Treated as a price change. Therefore it is not included in operating revenues and expenses, but in the Statement of Other Economic Flows (which impacts directly on equity).</p> <p>Swap interest is treated as a market value movement due to there being no underlying principle balance.</p>	<p><i>Short term:</i> (a) adopt a revised operating statement format based on comprehensive income reporting principles; and (b) jurisdictions should elect fair value basis as their own accounting policy.</p> <p>Swap interest—follow GAAP with disclosure to permit ABS to adjust as required.</p>
3.2 Valuation of debt securities (eg value by issuer)	<p>Australian GAAP currently permits statement preparers to choose the method by which issued securities are valued, so long as it is ‘reliable’. In practice, most issuers would use issue price adjusted for any amortisation of discounts/ premia as distinct from market value.</p>	<p>At a macroeconomic level there is a need for both parties (the issuer and the holder) to value debt on the same basis. Consequently, GFS requires issuers of debt securities to revalue using market value.</p>	<p><i>Long term:</i> adoption of the IASB’s financial instruments and performance reporting standards is likely to result in these adjustments being treated as re-measurements.</p> <p>ABS to encourage re-consideration of the classification treatment of swap interest by the IMF.</p> <p><i>Watch list:</i> monitor development of financial instruments and performance reporting standards to ensure long term convergence is achieved.</p>
3.3 Foreign exchange gains and losses	<p>Both realised and unrealised gains and losses are recorded as revenue or expenses in the Statement of Financial Performance in the reporting period during which the exchange rates change.</p>	<p>The operating result excludes both realised and unrealised foreign exchange gains and losses as they are regarded as price changes and would be reported in the Statement of Other Economic Flows.</p>	<p><i>Short term:</i> adopt a revised operating statement format based on comprehensive income reporting principles</p> <p><i>Long term:</i> adoption of the IASB’s performance reporting standard would facilitate convergence on this issue.</p> <p><i>Watch list:</i> monitor performance reporting developments to ensure convergence is achieved.</p>

Issue	Australian GAAP Treatment	GFS Treatment	Convergence opportunities
3.4 Premiums and discounts on repurchased debt	Australian accounting standards provide specific disclosure requirements for financial instruments. Recognition and measurement presently occur under general concepts and principles (eg SAC 4).	Repurchase premiums and discounts are treated as market value movements at the time the debt is repurchased and recorded in the Statement of Other Economic Flows.	See entry in this column for issues 3.1 and 3.2 above.
<b>4.0 Measurement issues needing changes in the IMF GFS or Australian GFS frameworks</b>			
4.1 Defence weapons (Commonwealth only)	Treated as capital expenditure. Defence weapons systems are included in assets on the Statement of Financial Position. Depreciation expense on assets is recorded in the Statement of Financial Performance.	Treated as an expense. Defence weapons systems are expensed directly to the Operating Statement in the period acquired.	<p><i>Short term:</i> the ABS has indicated that it is willing to early adopt probable changes resulting from the SNA Review</p> <p><i>Long term:</i> the SNA Review is likely to result in a change of treatment to capitalise defence weapons platforms.</p>
4.2 Allowances for bad and doubtful debts	Both allowances and write-off of specific debts are treated as part of operating expenses in the current period. Where an allowance is raised, when bad debts are written off they are charged directly against the allowance. At the end of a reporting period, the entity would review the reasonableness of the allowance balance and adjust as required.	Mutually agreed debts are write-off are only recorded in the Operating Statement. Other write-downs, are treated as volume changes and recorded in the Statement of Other Economic Flows. However, provisions for write-downs are not recognised in GFS.	<p><i>Short term:</i> (a) adopt GAAP treatment with additional note disclosure to enable ABS to make adjustments for GFS presentation. The ABS has indicated that it would be willing to early adopt any outcomes from the SNA Review in this regard.</p> <p><i>Long term:</i> (a) encourage the ABS to support changes to debt valuation through the SNA Review; and (b) adopt a revised operating statement format based on comprehensive income reporting principles.</p> <p><i>Watch list:</i> monitor SNA Review progress and IASB's performance reporting project to ensure convergence is achieved.</p>

Issue	Australian GAAP Treatment	GFS Treatment	Convergence opportunities
4.3 International Development Association (IDA) /Asian Development Fund(ADF) subscriptions	Accounting considers the likelihood and measurement, treats these items as expenses. If an asset, these could only be contingent.	IMF provided advice that some countries treat these as an asset.	Interpretation issue to be internally resolved by the Commonwealth.
4.4 Amortisation of intangible assets	Accounting treats amortisation as the conceptual equivalent of depreciation and expenses it during the period. It is possible that future standards may include impairment as the only basis for expensing of an intangible (eg goodwill may no longer be amortised).	GFS may treat the amortisation of non-produced, intangible assets as an other economic flow.	<p><i>Short and long term:</i> adopt GAAP treatment with additional note disclosure to enable ABS to make adjustments for GFS presentation.</p> <p><i>Watch list:</i> monitor development in SNA Review and international standards to ensure convergence is achieved.</p>
4.5 Capitalisation of research and development (R&D) costs (and intangible assets)	<p>R&amp;D costs generally expensed. However, R&amp;D costs are required to be deferred to the extent that they are expected, beyond any reasonable doubt, to be recoverable.</p> <p>Under IAS 38, research costs are expensed when incurred and development costs should be capitalised if specific criteria are met.</p>	R&D costs generally expensed. However, intellectual property and software can be capitalised.	As per Issue 4.4.

Issue	Australian GAAP Treatment	GFS Treatment	Convergence opportunities
4.6 Constructive obligation	Recognition of liabilities is prescribed under certain circumstances, such as when an entity has made a public announcement that it will act in a particular way or admitted responsibility for a particular situation.	Due to reliance on the concept of transactions, only actual liabilities to another party or parties are recognised. However, a variety of sources of information may be consulted to determine if a liability exists. In practice, the ABS staff expects that in most cases there would be no difference from GAAP.	Treatment is currently aligned. However, in practice, the ABS prefers to have the option of a case-by-case examination.
4.7 Share based payments	Executives (and others) often have remuneration packages that include share-based payments (eg share ownership plans, options, etc). It is proposed that the expenses of these share-based payments be measured when the right/payment is granted and expensed over the period between grant and vesting.	Any non-cash remuneration should form part of the “compensation of employees” for the period granted.	There potentially exists a timing difference if GFS recognises in the period of the grant and GAAP recognises over a longer time period. However, this is unlikely to arise for GGS entities.
<b>5.0 Measurement issues unlikely to be resolved by changes to either framework</b>			
5.1 Distributions payable to owners (dividends, etc)	The paying entity reflects distributions to owners as reductions in retained surpluses or returns of capital, depending on the type of distribution.	The paying entity reflects distributions to owners as ‘GFS expenses’ or returns of capital, depending on the type of distribution.	This difference is unlikely to be resolved due to the conceptual differences in the definition of “expense”. <i>Short and long term:</i> (a) jurisdictions should formally designate that distributions to owners will be classified as dividends or returns of equity in accordance with principles from UIG 38; and (b) adopt GAAP treatment with additional note disclosure to enable ABS to make adjustments for GFS presentation.

Issue	Australian GAAP Treatment	GFS Treatment	Convergence opportunities
5.2 Reduced net worth for commercial government operations	Equity/net worth is the residual of assets less liabilities of an entity. It is not affected by the market value of the entity's equities.	Net worth is measured as assets less liabilities less shares and contributed capital [which is the market value of the shares]. Where the market values the shares at a higher value a negative net worth figure is recorded for the entity in the investments line of the parent sector.	This difference is unlikely to be resolved due to the depth of the conceptual differences.  <i>Short and long term:</i> adopt GAAP treatment with additional note disclosure to enable ABS to make adjustments for GFS presentation.
5.3 Changes in the carrying amount of an investment in an associate	Investments in entities over which a reporting entity exerts significant influence are accounted for using equity accounting.  The amount of an investor's share of the post-acquisition profit or loss of the associate is recognised in the statement of financial performance. Any dividends received or receivable are recognised as a reduction in the carrying amount of the investment in the associate. The amount of the investor's share of the post-acquisition increments and decrements in the associate's reserves is recognised in the investor's reserves.	Where associate's shares are traded, then market value changes are measured using the market price (changes are other economic flows). Where not traded, the investor's share of changes in net worth of the investee is recognised as an other economic flow.	This difference is unlikely to be resolved due to the depth of the conceptual differences.  <i>Short and long term:</i> adopt GAAP treatment with additional note disclosure to enable ABS to make adjustments for GFS presentation.
5.4 Minority interests	Net operating results are apportioned on a proportionate basis and the split between the parent entity and outside equity interests is disclosed on the face of the statement. Outside equity interests are a separate component of equity.	Treated as a liability, with any valuation differences treated as a revaluation and taken to equity via statement of other economic flows.	This difference is unlikely to be resolved due to the depth of the conceptual differences.  <i>Short and long term:</i> adopt GAAP treatment with additional note disclosure to enable ABS to make adjustments for GFS presentation.

Issue	Australian GAAP Treatment	GFS Treatment	Convergence opportunities
<b>6.0 Measurement issues likely to require specific provisions for the public sector in general standards</b>			
6.1 Investment properties (property held for rental income or capital appreciation)	<p>No existing Australian accounting standard.</p> <p>IAS 40: allows two alternative treatments (a) cost based treatment allows for depreciation; and (b) fair value basis doesn't depreciate investment properties and any changes in fair value are revenues/expenses of the period</p> <p>IPSAS 13 excludes social service property from the definition of investment property</p>	Investment properties treated as any other property—consumption of capital is expensed and changes in fair value are other economic flows.	<p><i>Short term:</i> frameworks are aligned.</p> <p><i>Long term:</i> (a) AASB should consider including the exclusions from IPSAS 16 as public sector specific provisions when adopting IAS 40. This will minimise the divergence. (b) encourage the AASB to comment to the IASB that, in the context of performance reporting, the change in fair value of investment properties should be split into components (eg. 'profit before re-measurement' and 're-measurement').</p> <p><i>Watch list:</i> monitor developments in IAS 40 and performance reporting to look for opportunities for convergence.</p>
6.2 Valuation of inventory (including Defence inventory)	Accounting standards require inventory to be carried at the lower of cost or net realisable value.	GFS expects inventory to be valued at its current replacement cost (eg. market value to acquire).	This issue is considered to be immaterial in the public sector.
6.3 Treatment of transaction costs	In many situations accounting nets off costs incidental to sale when reporting disposals.	Service charges are classified and reported separately to provide a better measure of inter-sector (eg private non-financial to general government) services.	Jurisdictions should adopt a policy of separately recording all relevant expenses to eliminate this difference (eg. no netting of transaction costs or service charges).

Issue	Australian GAAP Treatment	GFS Treatment	Convergence opportunities
<b>7.0 Measurement issues likely to be resolved by jurisdictions' selection of appropriate accounting treatments</b>			
7.1 IMF Special Drawing Rights	On receiving an SDR (on the basis of a legal opinion dating back to the mid-1990s), Treasury debits an asset and credits a liability. The legal advice was based on the fact that Australia could be required to repay the SDRs if the IMF were wound up or if Australia were to exit from the IMF.	The IMF describes SDRs as financial assets for which there are no corresponding liabilities. They have been described as being “almost like a line of credit to the country to be drawn upon as they need it.” The IMF policy on accounting for SDRs would result in the credit entry being to “other revenues”, as the possibility of repayment being called is remote. The ABS considers that the right is a notional asset and on receipt would DR asset/CR other economic flow.	Treatment difference to be resolved by the Commonwealth internally.
7.2 Distributions receivable from controlled entities (dividends)	The treatment of dividends received does not change depending on their funding source. That is, there is consistent treatment regardless of whether the dividend is from within the general government sector or paid as a result of the sale of non-financial assets.	GFS considers the underlying source of the “dividend” received—surpluses, retained surpluses, or capital restructuring. Proceeds from the sale of non-financial assets would be treated as returns of equity and not dividend revenue.	Refer to discussion against issue 5.1 above.
7.3 Depreciation/ Consumption of Fixed Capital	Depreciation systematic allocates an asset's depreciable value over its useful life. The depreciable amount of an asset is the historical cost or revalued amount less any expected recoveries from disposal at the end of its useful life. Depreciation, mirroring the consumption of the asset's future economic benefits, is an expense of the period during which the future economic benefits are consumed.	Consumption of fixed capital, an expense of the period, is measured as the decline in the value of fixed assets during the period as a result of physical deterioration, normal obsolescence or normal accidental damage (using average market prices during the period). In Australian practice, the consumption of fixed capital is aligned with GAAP depreciation expense.	In practice there is no difference so long as assets are measured at market (eg fair) value.  Some jurisdictions have indicated that they are carrying some portion of their assets at cost. These jurisdictions need to consider the implications of this decision.

## POSSIBLE CONVERGENCE ISSUES CONSIDERED AND DISCARDED

Issue	Australian GAAP Treatment	GFS Treatment	Reason for discarding
The Probable Recognition Criterion: Recognition of expenses versus assets	Recognition based on SAC 4 requirements. Transaction would give rise to a recognised asset if it is <i>probable</i> that the future economic benefits embodied in the asset will eventuate. SACs 2, 3, and 4 are to be replaced by the IAS framework, which has a different definition of expense.	Recognition based on GFSM guidance which does not include a probability test. Transaction would create an assets if ownership rights are established and enforced and it is capable of providing economic benefits (para 10.30 GFSM).	After discussion, the Working Group determined that there was general alignment in practice between the two frameworks in Australia.
Land under roads	Recognised as an asset, but exemption provided from valuation until 2006.	As an asset land under roads would be expected to be valued at market value. In practice, due to the difficulty with valuation, GFS accepts accounting data.	No conceptual or practical difference between the two frameworks.
Negative goodwill	<p>Where the fair values of the identifiable net assets acquired exceed the cost of acquisition, the difference represents a discount on acquisition (eg negative goodwill). The discount on acquisition is allocated pro rata across the non-monetary assets acquired until the discount is eliminated (any remaining discount is recognised as revenue).</p> <p>If the controlling entity uses a fair value asset valuation basis, then it may subsequently re-value the individual assets up to their fair value.</p>	While the concept of negative goodwill is not covered in the GFS manual, the treatment would rely on first principles. Where negative goodwill arises on acquisition, GFS would book the initial acquisition of the relevant suite of assets at the transacted value (eg. the value agreed between buyer and seller). Immediately thereafter, a revaluation is undertaken to bring the valuation up to reflect appropriate market values.	Negative goodwill rarely arises in practice and, if it did, there is likely to be no difference in practice.



## OBJECTIVES OF GAAP AND GFS

This paper provides an overview of the objectives and uses of the Generally Accepted Accounting Principles (GAAP) and Government Finance Statistics (GFS) frameworks. Both frameworks exist to provide financial information to interested parties and decision makers. There is substantial overlap between the principles, practices and measurement methods adopted by both frameworks. The reasons for adopting those principles, practices and measurement method sometimes differ between these frameworks.

The Australian Accounting Standards Board (AASB) oversees the development of Australian Accounting Standards. These standards are Australian GAAP, as expressed in the Statements of Accounting Concepts, accounting standards and other authoritative pronouncements.

The Uniform Presentation Framework (UPF) is based on the concepts and classifications used by the Australian Bureau of Statistics (ABS) in the preparation of public finance reports. These in turn, are based on international standards set out in the International Monetary Fund's (IMF) *A Manual of Government Finance Statistics* and the United Nations' *A System of National Accounts*. The GFS classification adopts an internationally consistent format for presenting the financial transactions of governments and government trading enterprises (including public corporations). Changes to the IMF's framework only occur following extensive consultation with financial experts and economic statisticians from member countries.

In Australia, public sector reporting entities prepare audited general purpose financial reports in accordance with accounting standards issued by the AASB, including outcomes reports, and for some jurisdictions, budgets and forward estimates. In addition, the Australian Loan Council requires all Australian governments to present budgets and forward estimates and to prepare outcomes reports in accordance with the UPF, to allow comparison between jurisdictions and the formation of national aggregates.

Consequently some jurisdictions in Australia have been producing two sets of budget and actual financial statements, one under each framework. This dual reporting regime causes considerable confusion for financial report users and may encourage Governments to indulge in presentation shopping. It also means that the headline presentation of budgets are not comparable across jurisdictions. Also, users have expressed concerns that GFS basis data has not been uniformly subject to audit clearance. Auditors-General are required under the rules of the professional accounting bodies to certify that general purpose financial reports are presented in accordance with Australia accounting standards.

### *Government Finance Statistics*

#### Background

GFS is an accounting framework developed for two specific purposes:

- Measuring the impact of public policy on the economy; and

- Uniformly measuring and reporting financial information about the government sector in the national accounts of each country and governments of a type or level (eg. local, state, national).<sup>1 and 2</sup>

GFS was developed to accommodate differences in the activities of governments compared to activities in the private sector. For decision-making purposes, the IMF requires international consistency in its economic data. In summary, government transactions:

- (a) impact on other sectors of the economy;
- (b) include many unilateral transactions (sometimes referred to as non-exchange transactions) such as the collection of taxes and the payment of benefits; and
- (c) incorporate a number of activities that are non-market in nature, such as road-building, national defence, policing and so forth.

#### Key Objective

The stated purpose of the IMF's *Government Finance Statistics Manual 2001* "is to provide a comprehensive conceptual and accounting framework suitable for analysing and evaluating fiscal policy, especially the performance of the general government sector and the broader public sector of any country."<sup>3</sup> The GFS framework includes many of the same basic elements as GAAP basis accounting—assets, liabilities, revenues and expenses.

GFS specifically relates to the public sector, it does not refer to equity, which is a private sector concept. GFS provides a single measure of net worth, which is generally equivalent to the accounting concept of net assets, although there is a technical difference in the calculation of these two measures. GFS also provides some standard measures of government financial position such as net debt, net worth and net lending.

#### Link to SNA93

The broad definitional and conceptual elements of GFS are derived from the System of National Accounts embodied in *A System of National Accounts 1993 (SNA93)*<sup>4</sup>.

SNA93 has been described as "a coherent, consistent and integrated set of macroeconomic accounts, balance sheets and tables, based on a set of internationally agreed concepts, definitions, classifications and accounting rules. It provides a comprehensive accounting framework within which economic data can be compiled and presented in a form that is designed for economic analysis, decision-taking, and

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<sup>1</sup> *Government Finance Statistics Manual 2001*: International Monetary Fund, Washington, DC; 2001: paragraphs 1.2 to 1.4.

<sup>2</sup> As a consequence the meaning of the term "government" must be taken from the context in which it is used – whether for the sector as a whole, whole-of-government reporting by a jurisdiction, or otherwise. In this paper the term will primarily pertain to a jurisdiction's whole of government reporting.

<sup>3</sup> *Government Finance Statistics Manual 2001*: International Monetary Fund, Washington DC; 2001: paragraph 1.2.

<sup>4</sup> Issued jointly by the United Nations (UN), the IMF, the Commission of the European Communities, the Organisation for Economic Co-operation and Development (OECD) and the World Bank.

policy-making.”<sup>5</sup> SNA93 provides a comprehensive chart of accounts, which standardises classification and reporting and facilitates international comparability.

GFS attends to the special nature and role of governments and their economic impact on the economy as a whole, whilst also meeting statistical requirements. The ABS provides GFS data to the IMF for publication with similar statistics for all IMF member countries. Because these statistics are prepared in accordance with the IMF standard, they can be used for international comparisons between member countries and international consolidations.

GFS and SNA share the same set of core statistical and economic concepts, which are broadly similar to the concepts used by accounting standard setters. GFS is designed to provide data that can be used for compiling national accounts. Therefore, the use of similar concepts SNA system of national accounts. Examples of these concepts include:

- Use of double entries to capture movements in stocks and flows of economic resources on an accrual basis<sup>6</sup>
- Principles based definitions for the primary elements (assets, liabilities, revenue, and expenses) focussing on the impact of that element on the entity<sup>1</sup> at current market prices<sup>2</sup> considering probability and reliable measurement.<sup>3</sup>
- Valuation of all stocks and flows<sup>10</sup> using current market prices or values
- Maintenance of a comparable time series by allocating transactions to multiple prior periods where appropriate.
- Stocks and many categories of flows are presented at gross value (netting is only permitted for particular types of transactions)<sup>11</sup>; and
- Consolidations to the sectoral level, eliminating transactions and other inter-sector relationships to come to a composite set of financial information for the sector<sup>12</sup>.

Alignment of GFS and SNA framework ensures that users of government finance statistics can relate the statistics to national accounts data for the whole economy and other sectors. This enables the ABS to use GFS data as an input into the Australian national accounts, so that the contribution of governments to the Australian economy can be seen against that of other sectors such as companies and households.

In GFS, an important distinction is drawn between transaction flows and other economic flows, both of which impact on net worth.

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<sup>5</sup> *System of National Accounts 1993*: Issued jointly by the: Commission of European Communities, International Monetary Fund, Organisation for Economic Co-operation and Development, United Nations, and World Bank; Brussels/Luxembourg, New York, Paris, Washington DC; 1993: paragraph 1.1.

<sup>6</sup> An accrual is described as occurring at the time “economic value is created, transformed, exchanged, transferred or extinguished”. *GFS Manual 2001* paragraph 3.41.

<sup>71</sup> *GFS manual 2001* paragraphs 4.20, 4.25, 7.4 and 7.14

<sup>82</sup> *GFS manual 2001* paragraphs 3.73 to 3.79

<sup>93</sup> *GFS manual 2001* paragraphs 3.54

<sup>10</sup> “Flows...are economic events and other occurrences that cause changes in the value of stocks through the creation, transformation, exchange, transfer or extinction of value, recorded in the relevant period on an accrual basis.” *Accruals-based Government Finance Statistics 2000*, Australian Bureau of Statistics, paragraph 3.5

<sup>11</sup> *GFS Manual 2001* paragraph 3.83 to 3.90.

<sup>12</sup> *GFS Manual 2001* paragraph 3.92.

Transaction flows result directly from economic activities (e.g. production, income generation, and consumption) and contribute directly to important economic measures such as GDP, saving, GFS Net Operating Balance (NOB) and net lending or borrowing<sup>13</sup>; whereas other economic flows (revaluations and other changes in the volume of assets) do not. Transactions are perceived as reflecting policy and managerial decisions while other economic flows arise move passively—often without active decision-making.

In essence, transactions represent changes to stocks<sup>14</sup> that come about as a result of mutually agreed interactions between institutional units, for example, the sale of a good or service by one unit and its purchase by another. Transactions also include items such as depreciation that do not involve interaction with another institutional unit. The recording of such 'internal' transactions recognises that an institutional unit can act in two capacities of economic interest. For example, by recording depreciation, there is recognition that the unit is both the owner of a fixed asset and the consumer of the services provided by that asset. As an aside, it is also worth noting that despite their compulsory nature, taxes are considered to be transactions as they are deemed to occur by mutual agreement between the government and the taxpayer.

'Other flows' represent changes to stocks that do not result from a transaction<sup>15</sup>. For example, revaluations (which are also sometimes referred to as holding gains and losses) represent changes to stocks that arise from price movements, including exchange rate movements. Other changes in the volume of assets relate to changes to stocks arising from events such as discoveries of new assets (e.g. mineral deposits) and depletion or destruction of existing assets.

The GFS Manual provides a format for publication of a fourth financial statement, titled the Statement of Other Economic Flows, to summarise and report other economic flows. Currently, the UPF does not require publication of this statement. Where this statement is not published, these other flows are taken directly against the entity's net worth in the GFS Balance Sheet. The Commonwealth has published this Statement.

Consistent publication of this statement would be an important first step toward assisting with harmonisation. The Working Party notes that the ABS has advised that presentation of this statement alongside the operating statement (as in a "comprehensive reporting" format) would be acceptable practice.

All changes in stocks result from flows. As a consequence, if the GFS Opening Balance Sheet is combined with the GFS Operating Statements and the Statement of Other Economic Flows for an entity for a financial period, the outcome would be the

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<sup>13</sup> *Accruals-based Government Finance Statistics 2000* paragraph 3.9.

<sup>14</sup> "Stocks refer to a unit's holdings of assets and liabilities at a specific time, valued at market prices at the time." *Accruals-based Government Finance Statistics 2000* paragraph 3.5 and *GFS Manual 2001* paragraph 3.1.

<sup>15</sup> *GFS Manual 2001* paragraph 3.25 and *Accruals-based Government Finance Statistics 2000* paragraph 3.11.

GFS Closing Balance Sheet.<sup>16</sup> Attachment 1 provides a simplified schematic of the GFS reporting framework. For full detail, refer to Figure 4.1 from the *GFS Manual*.

## *Accounting Standards*

### Key objective

Accounting standards are based on GAAP that seek to identify, measure, recognise and disclose economic transactions of a reporting entity. These principles have been developed over centuries to meet the changing needs of the business community. In particular, these principles are intended to enable external stakeholders to assess stewardship, performance, financial position, and financing and investing decisions. Such assessment is normally to assist or evaluate the allocation of scarce resources<sup>17</sup>.

The Public Sector Accounting Standards Board (PSASB) was formed in the mid 1980s to address particular public sector reporting needs. One of the major achievements of the PSASB was the introduction of accrual reporting to the government sector through AAS 31 “Financial Reporting by Governments”, AAS 29 “Financial Reporting by Government Departments” and AAS 27 “Financial Reporting by Local Governments”. As with accounting standards generally, the three government standards focus on the effects of transactions and other events on the financial position, investment decisions and performance of individual entities rather than economic transactions with other entities in the economy. The PSASB was disbanded when the Commonwealth took responsibility for regulating accounting standard setting in July 2000. The Commonwealth delegated responsibility for accounting standard setting for all sectors with the AASB.

With the rise of globalisation and companies being listed on more than one stock exchange, the importance of adopting a singular international accounting framework has emerged. In 2002, Australia and the European Commission decided to converge with International Accounting Standards (IAS and IFRS), issued by the International Accounting Standards Board (IASB), for the private sector, from 1 January 2005.

### Uses of Australian Accounting Standards

All Australian governments have adopted accrual accounting and reporting. Most have also implemented accrual budgeting.

Because of their focus on entity performance (including financial position and investing and financing decisions), accounting standards do not make the GFS distinction between transactions and other economic flows. Accounting standards consider that entity management is responsible for the effective management of all resources, including transactions and movements in market values. Accounting standards do not therefore specifically isolate market value movements in financial reports. (Attachment 2 provides a graphical summary of the relationships between the current, primary Australian GAAP financial statements.) It should also be noted that because of the “modified historical cost” valuation basis underlying accounting standards, not all market value movements are recorded in the period during which they occur. The IASB’s performance reporting project has started to consider these

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<sup>16</sup> *GFS Manual 2001* paragraph 4.8.

<sup>17</sup> Statement of Accounting Concepts SAC 2 “Objective of General Purpose Financial Reporting” paragraphs 11 to 15.

issues and is scheduled to issue a draft standard in 2004, but the standard will not be mandatory until after 2005. (Attachment 3 provides a schematic illustration of the possible structure of the new comprehensive reporting framework. It is likely the new framework will facilitate GFS/GAAP convergence. Attachment 4 provides a schematic summary of the relationships between the primary Australian GAAP financial statements post performance reporting.)

The accounting framework also relies on a number of basic principles including:

- Use of double entry accounting to capture both transactions and some changes in market value on an accrual basis.<sup>18</sup>
- Principles based definitions for the primary elements (assets, liabilities, revenue and expenses), focussing on the nature of that element in the hands of the entity (eg. control and economic impact), the existence and measurability of an individual item<sup>19</sup>;
- Current market values used for reporting of some but not all assets and liabilities (eg. market value basis is required for hedges and other derivatives; market value may be used by election for measuring physical assets). Market valuations are only used where reliable and consistent;
- Financial reports reflect the current period activities of the reporting entity, with the immediate prior period alongside for comparison. Adjustments arising in current period that relate to the comparative or other prior periods must be adjusted in the currently published data.
- Categories of financial elements are presented at gross value (netting is only permitted when specifically required by the standards<sup>20</sup>); and
- Consolidates on an entity basis, with a focus on control<sup>21</sup>.

### *Financial Statement Presentation Summary*

The format of the two frameworks' Statement of Financial Position (Balance Sheet), Statement of Financial Performance (Operating Statement and Statement of Other Economic Flows), and Statement of Cash Flows are substantially similar. The overlap will increase with the likely changes arising from the IASB performance reporting project.

Some conceptual differences will continue to exist (such as the GFS emphasis on time series maintenance). In addition, the International Accounting Standards Board includes more reporting options in its pronouncements—for example, current value accounting and treatment of borrowing expenses. With a few exceptions, if an entity adopts the options that align with the GFS, IFRS are substantially aligned with GFS.

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<sup>18</sup> Accounting Standards do not currently distinguish between transactions and market value movements. However, the IASB's performance reporting project may result in a distinction similar to that in GFS.

<sup>19</sup> Statement of Accounting Concepts SAC 4 "Definition and Recognition of the Elements of Financial Statements" paragraphs 14, 38, 48, 65, 111, and 117.

<sup>20</sup> Examples of situations where netting is permitted include Australian Accounting Standards Board AASB 1033 "Presentation and Disclosure of Financial Instruments" paragraph 4.5, AASB 1044 "Provisions, Contingent Liabilities and Contingent Assets" paragraphs 6.3 and 6.4, Urgent Issues Group Abstract 50 "Evaluating the Substance of Transactions Involving Leases" Appendix A paragraph 2, and Australian Accounting Standard AAS 23 "Set-off and Extinguishment of Debt" paragraph 9.1.

<sup>21</sup> AAS 24 "Consolidated Financial Reports" paragraphs 3 and 4.

Attachment 3 contains a schematic that compares the two reporting frameworks and highlights the scope for convergence.

Presentation issues remain an important consideration, for example the need to include an equivalent of the GFS Fiscal Balance/Net Lending and a sub total equivalent to the GFS Net Operating Result.

Once convergence is achieved and given that the two frameworks have separate overseers, both oversight bodies and preparers will need to continue to include harmonisation in the standard setting process. This issue will need to be addressed at the international level. However, HOTARAC and AASB may also wish to formally task a specific sub-committee with this responsibility.

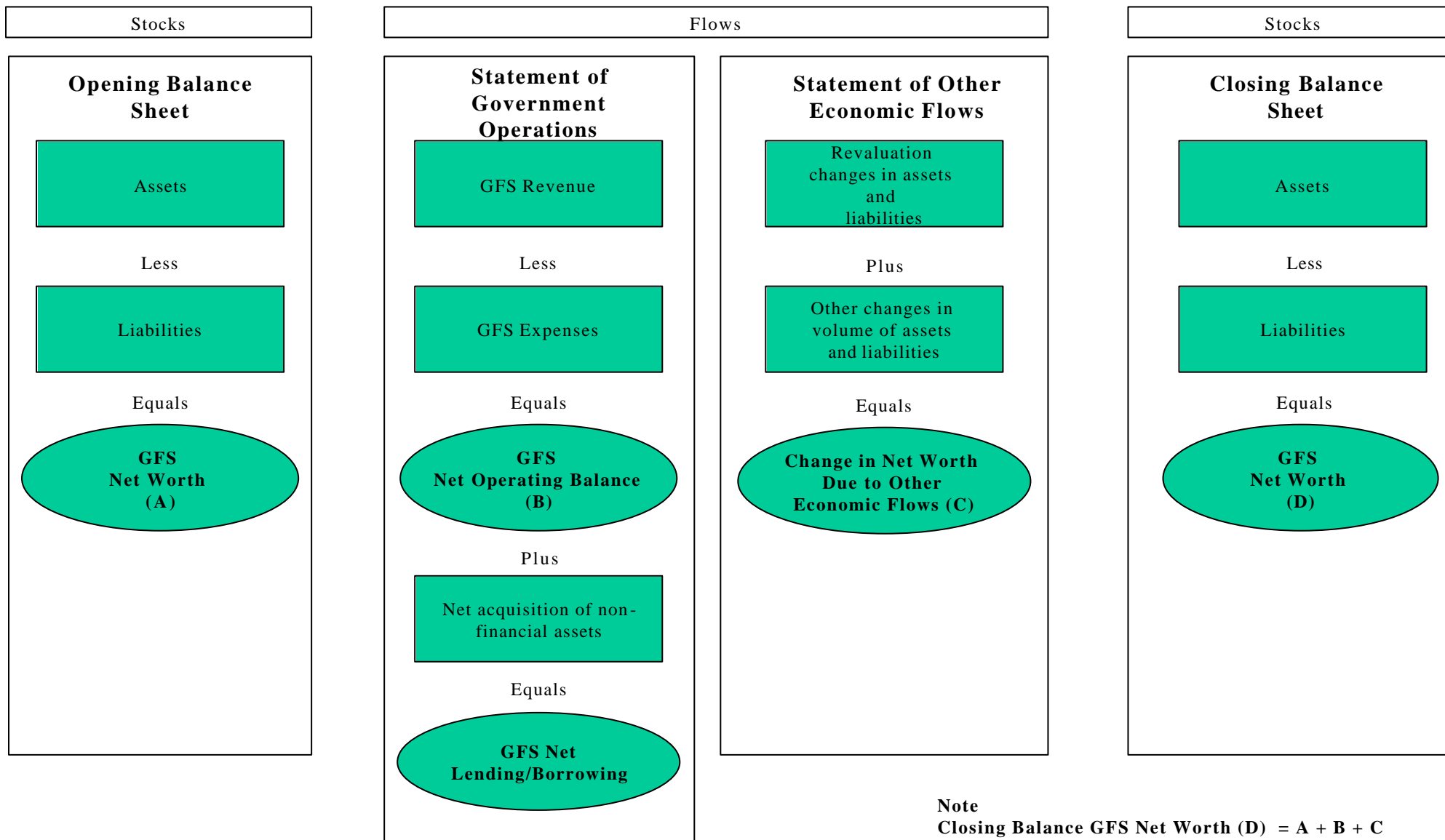
### *Conclusion*

While the GAAP and GFS frameworks emerged from different sources, there is a substantial conceptual overlap between them. In fact, both frameworks rely on a single set of underlying financial data. Practitioners can currently use the strengths of both frameworks to ensure that data is appropriately classified, measured and disclosed.<sup>22</sup> A converged framework should build on existing strengths and eliminate uncertainties caused by presentation of two similar, but different, sets of financial statements.

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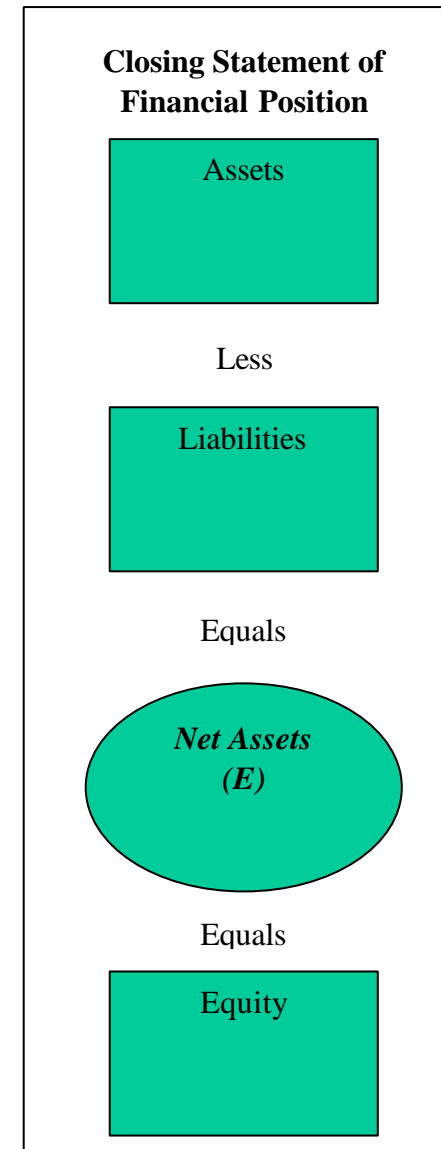
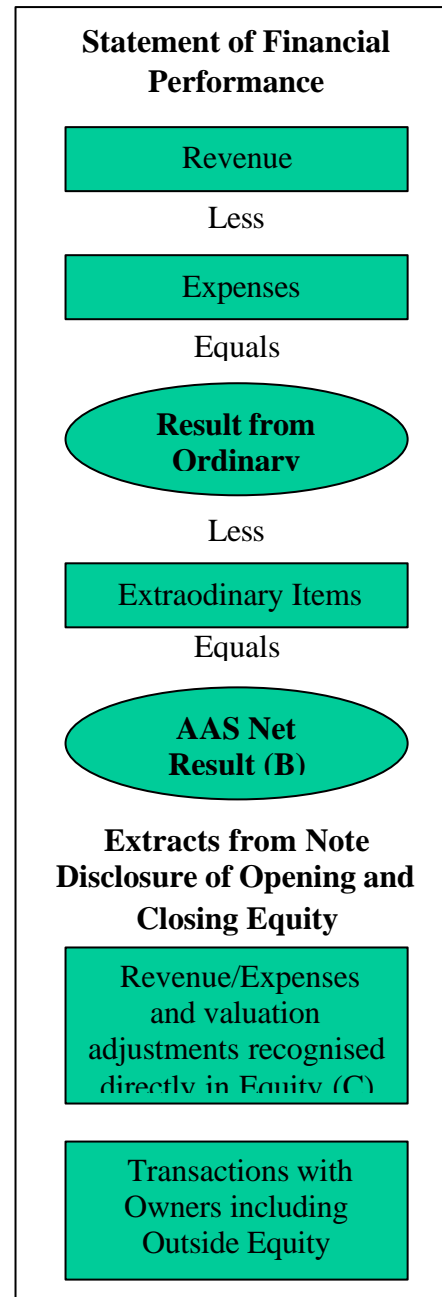
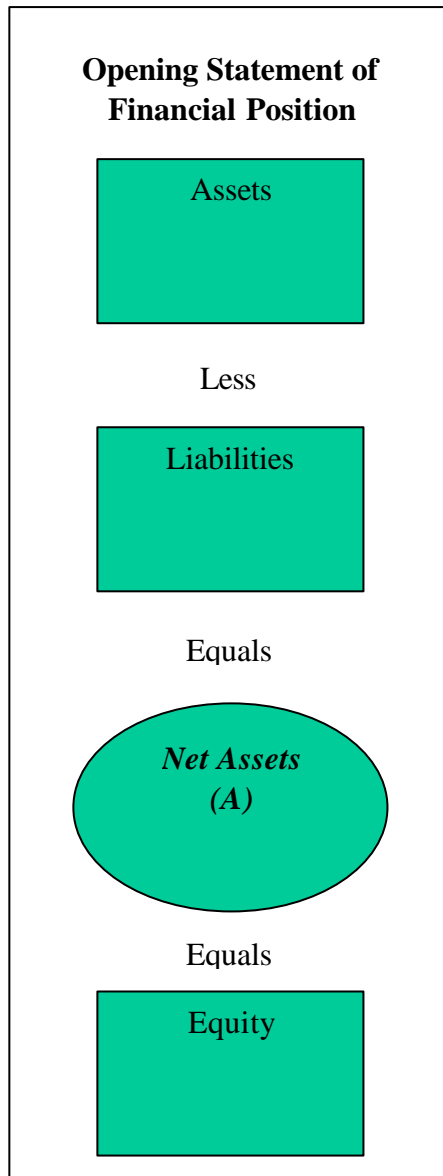
<sup>22</sup> For example, accounting standards are specifically prescriptive about the classification of leases while GFS more clearly distinguishes between grants and loans

# GFS Reporting Framework



# GAAP – Current Australian GAAP Reporting Framework

Attachment 2

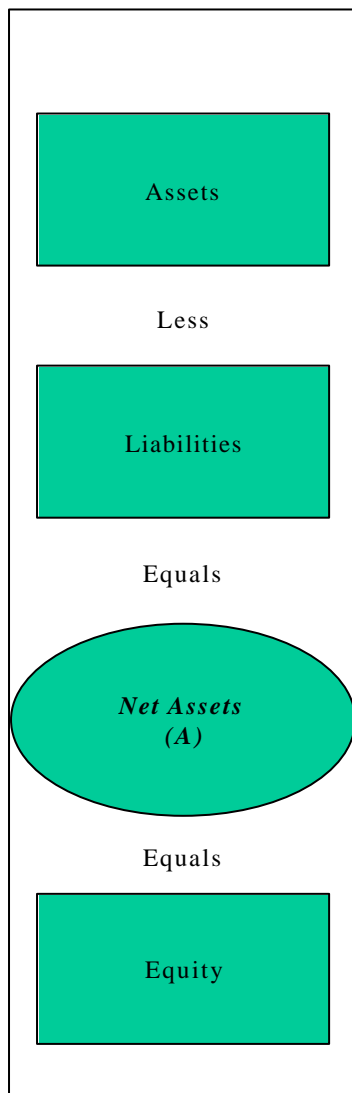


**Note**

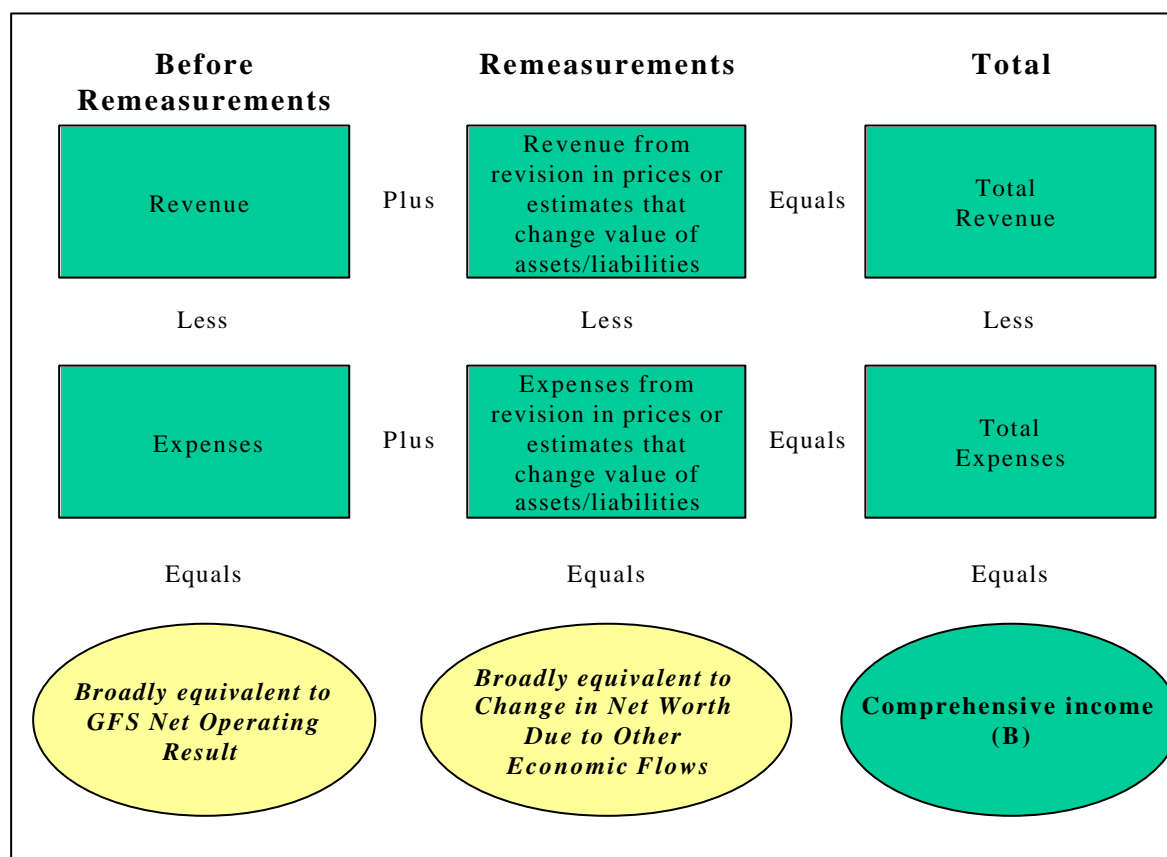
**Closing Balance Net Assets (E) = A + B + C**

# GAAP – Proposed Comprehensive Reporting Framework

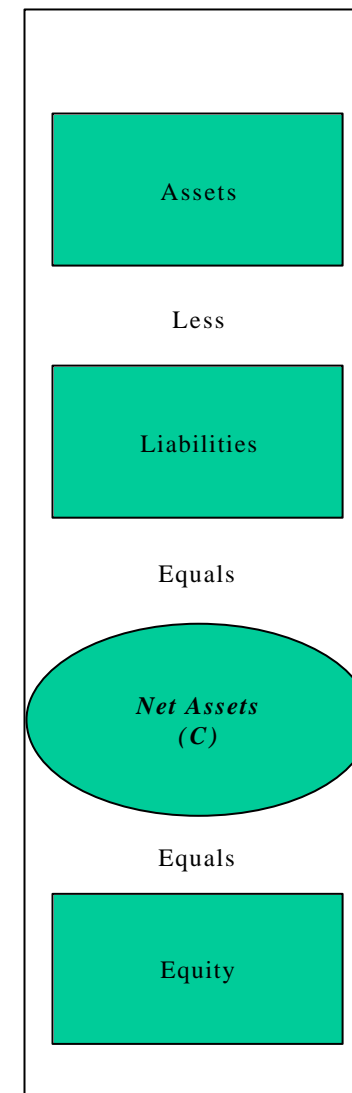
## Opening Statement of Financial Position



## Comprehensive Income Statement



## Closing Statement of Financial Position

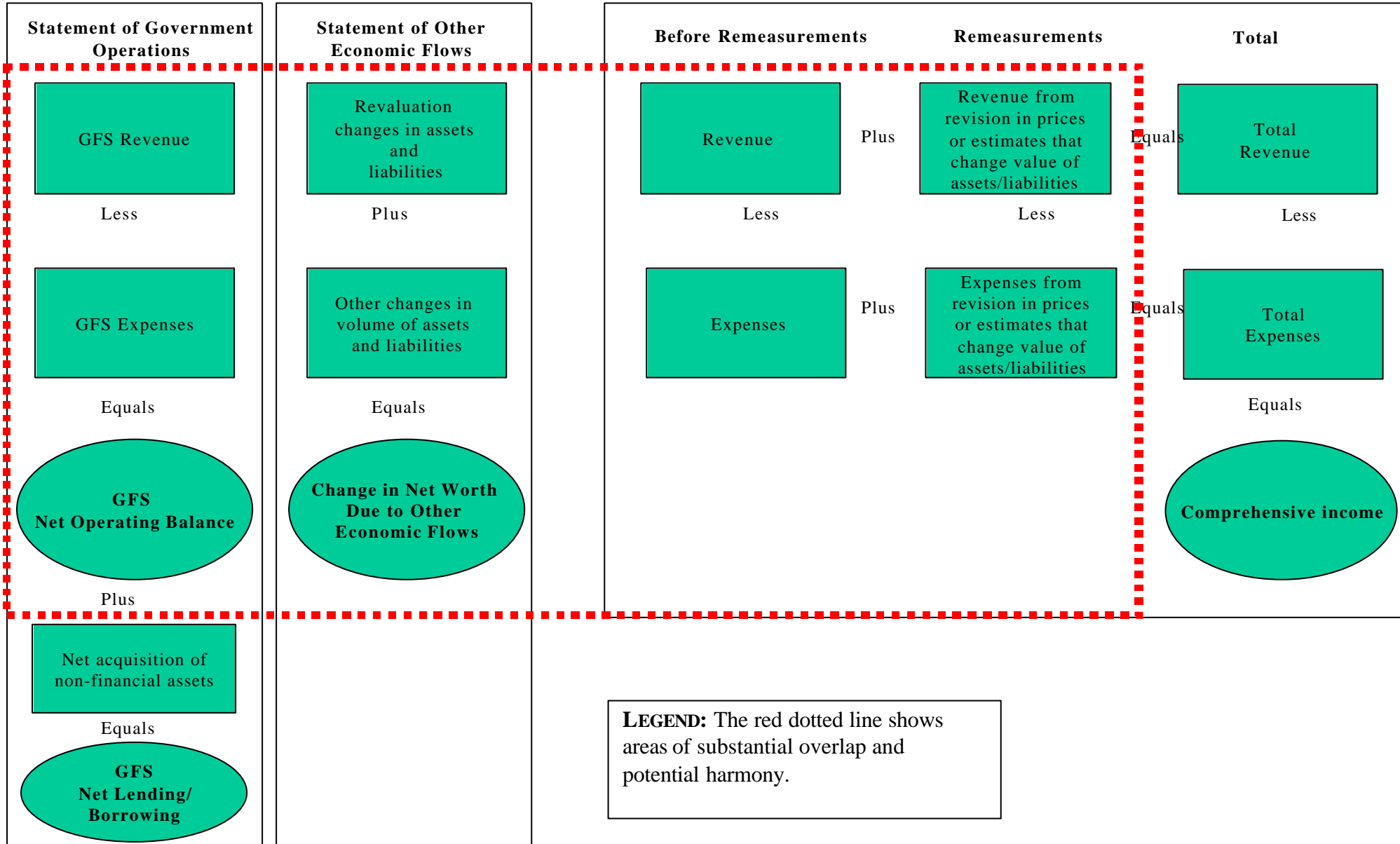


**Note**  
**Closing Balance Net Assets (C) = A + B + transactions with owners**  
*(not depicted)*

- Required disclosure on extremely simplified level
- Sub totals not presented under the IASB standard

**GFS Reporting Framework**

**GAAP - Proposed Comprehensive Reporting Framework**





## **BUDGET (EX-ANTE) REPORTING FRAMEWORK**

### *Background*

The objective for harmonisation of Government Finance Statistics (GFS) and Generally Accepted Accounting Principles (GAAP) reporting is to achieve a standard which provides a single set of reports for Government which are auditable, comparable between jurisdictions (within Australia and internationally), and in which the outcome statements are directly comparable with the budget statements published by that Government for the year in question.

Governments produce budgets to show proposed expenditure on policy and programs for the budget period. For many years, budgets have been presented on a cash basis. However, in recent years, with the implementation of GAAP reporting and the accrual based GFS framework, the presentation of budget information has shifted to an accrual basis.

Government budgets form the basis for planning and resource allocation of public sector resources. Accordingly, the public sector budget statement is of fundamental importance to Government as it:

- reports the Government's spending intentions; and
- seeks authority from Parliament for spending.

A basic principle of the Westminster system of democracy is that it is Parliament which approves Government spending. Parliament's role in exercising control over public finances and holding the Government of the day accountable for the use of the powers bestowed upon it by law, is pivotal to the proper functioning of the democratic system of government.

The key means by which parliamentary approval is given to government spending is through the annual appropriation process. This process involves having Members of Parliament annually debate and vote on the Government's funding requests, which are specified in annual Appropriation Acts and supported by supplementary information provided in the Government's Budget Papers. The annual Appropriation Act provides the legal authority for the Government to make payments in accordance with the purposes specified in the Act. Additional appropriation acts are required to support additional spending.

Each jurisdiction has discretion in developing its own budget and appropriation frameworks. As a result, there is some diversity in the budget presentation across jurisdictions. The Uniform Presentation Framework (UPF) was introduced in recognition of the need for the Commonwealth, state and territory governments to provide a common core of financial information in their budgets. A common budget framework allows for interjurisdictional comparisons, formation of national aggregates and encourages the understanding of the budget information. The UPF focuses on budget reporting and is based on the Government Finance Statistics (GFS) reporting framework.

Victoria and the ACT use Australian Accounting Standards (AAS) as the basis for their primary budget.<sup>1</sup> All other jurisdictions use GFS as the primary basis for their budget, although the Commonwealth presents budget information in both formats. The UPF reporting requirements are usually appended to the budget documents within each jurisdiction.

There is some flexibility in the budget presentations whether they are based on either the GFS or GAAP reporting frameworks. For example, some jurisdictions choose to depart from strict GFS principles with regard to the treatment of premium/discount on loans, or make other adjustments to present an underlying budget result. Jurisdictions also have flexibility regarding selection of the headline Budget measures, some focus on Net Operating Result, whilst others focus on Net Lending/Borrowing<sup>2</sup>. The headline measure used by each jurisdiction is shown below in Table 1. The headline fiscal measures are incorporated into each Government’s fiscal strategy and, depending on the public policy objectives of the Government, may influence the selected fiscal measures to headline the Budget presentation.

**Table 1 Headline Budget Measures Used by Jurisdictions<sup>1</sup>**

<b>Jurisdiction</b>	<b>Headline Measure</b>
Australian Capital Territory	Net operating balance (AAS)
Commonwealth	Underlying cash balance (GFS)
New South Wales	Net lending/borrowing (GFS)
Northern Territory	Net operating balance (GFS)
South Australia	Net lending/borrowing (GFS)
Tasmania	Net lending/borrowing (GFS)
Victoria	Net operating balance (AAS)
Western Australia	Net operating balance (GFS)

Notes:

1. Table extracted from Western Australia 2003-04 Budget Papers, Budget Paper No 3 Economic and Fiscal Outlook, page 43.

Most jurisdictions will also publish a “budget outcome” document in the same format as the budget documentation, as an acquittal or accountability document. Where this document is on a GFS basis, it may be based on audited numbers, but will not usually be subject to external audit verification. Victoria is the only jurisdiction where the budgeted financial statements are also subject to audit.

### *Scope of Budget Reporting*

The scope of the Headline Budget is at the discretion of each jurisdiction. However, generally all jurisdictions focus on reporting for the General Government Sector, as defined by the Australian Bureau of Statistics. This sector includes all agencies that receive parliamentary appropriations and some additional statutory authorities that are regulatory or provide services that are non-market in nature.

<sup>1</sup> The budget statements are prepared for the General Government Sector only and so do not fully comply with AAS 24 which requires a full consolidation of controlled entities for the Government.

<sup>2</sup> The HoTARAC GAAP/GFS Convergence Working Group is focussing on convergence of Net Operating Results and the issue of presentation of Net Lending/Borrowing measure is yet to be resolved.

The Headline Budget focus on the General Government Sector has arisen because this sector is closely aligned with the entities covered by the parliamentary appropriations bills. The Government, through the appropriation process, has the greatest level of direct control over expenditure in the General Government sector.

*UPF Budget:* The UPF requires production of Budget estimates for the General Government, PNFC and Total Non-Financial Public Sector. The UPF does not require the production of Budget estimates for the Public Financial Corporations Sector. As a consequence, budget estimates for the Total Public Sector are also not required under the UPF. Information on the PFC is only required, under the UPF, for reporting of outcomes information. However, Western Australia present PFC and Total Public Sector estimates in their Budget documents.

*GAAP:* In contrast, GAAP reporting currently focuses on the Total Public Sector which is considered to be a single reporting entity. Under GAAP, reporting for the General Government Sector is a sector reporting issue and occurs by way of note in the GAAP financial statements.

### *International Standards*

The International Federation of Accountants (IFAC) Public Sector Committee (PSC) is examining budget reporting and has formed a Steering Committee to review this issue. The PSC has noted that budget reporting links to the work of GFS/IPSAS harmonisation.

The PSC has engaged a consultant to prepare a paper which outlines best practice in budget formulation presentation and reporting; considers whether budget reporting falls within the PSC's mandate; and make recommendations on what, if any, budget reporting matters should be addressed in IPSAS. A Steering Committee is to be established to provide input on the project.

The AASB plan for implementing the GFS/GAAP convergence strategy does not include development of standards for budget reporting, including specification of a budgeting entity. The AASB has identified prospective financial reporting as a long-term project and is awaiting on international developments prior completing this project.

### *Conclusion*

The issue of Budget reporting is being pursued at the international level, and will not be considered by the AASB as part of the GFS/GAAP harmonisation process. Any reporting standard will need to provide Governments with a capacity to prepare financial statements with a focus on both the General Government Sector (to satisfy Budget outcomes) and the Total Public Sector (in accordance with the reporting entity). This can be addressed as a sector/segment reporting issue.

The budget is based on the General Government Sector, which is not currently deemed to be a reporting entity, and so the budget statements cannot be audited as a general purpose financial statement.

In the absence of an accounting standard for budget reporting, budget presentation will continue to be at the discretion of each jurisdiction. Parliaments expect Government to present their budgets in the same form as the outcomes statements. HoTARAC believes that the standards should require that budgets be presented in the same form as the outcome statements. Beyond that there is no need for a standard on budgets or prospective statements.

*GFS/GAAP Technical Issues requiring consideration of Budget Reporting*

- Consolidation (Sector/Segment reporting)
- Ownership relationships within the Public Sector
- Extent of harmonisation within operating statement (ie net operating result or GFS Net Lending/Borrowing); and
- Victorian Budget presentation, where the budget is subject to audit. The budget is based on the General Government Sector, which is not a reporting entity, and so the budget statements cannot be audited as a general purpose financial statement.

# IDENTIFICATION OF THE USERS AND THEIR USES OF PUBLIC SECTOR FINANCIAL STATEMENTS<sup>1</sup>

## *Introduction*

The purpose of this paper is to provide information on the uses and needs of the users of public sector financial information. This paper identifies the users and uses of GFS and GAAP reports, based on interviews with user group representatives.

Public sector financial information is used domestically by a broad range of users, including:

- Parliaments, especially:
  - Joint Public Accounts Committees;
  - Governments and their central agencies
  
- Broader finance sector of the economy
  - trading banks;
  - investment banks; and
  - other financial institutions
  
- Economists
  - analysts
  - advisors

A key use of the financial information is public sector resource allocation and the facilitation of accountability processes. Closely aligned to resource allocation is the evaluation of the impact of a government's policies on the economy. That is, public and private sector economic analysts use the financial information to assess the impact of individual policies on local and national economies. Other corporate analysts will factor in the information when establishing pricing policies for both financial markets products and other corporate goods and services.

International users, such as credit rating agencies, International Monetary Fund and the World Bank, use the public sector financial statements to assess the financial risk of the Australian economy, which in turn determines the cost to access funds from the international capital markets.

The majority of users have indicated that the current reporting framework is not meeting their needs. Much of the information produced, specifically the dual accrual data, is not easily understood. As a consequence, there is a tendency to rely on GFS cash measures because they are more easily understood, and have a long-standing, consistent time series.

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<sup>1</sup> The IAS framework refers to "Statements" and SAC 2 refers to "Reports". In this paper both terms are used interchangeably and should be taken to mean both financial statements and the associated notes.

## *Summary of Responses*

The interviews conducted included the following users:

- Chief Economist – Commonwealth Bank
- Chief Economist – ABN Amro Australia Ltd
- Access Economics
- Loans Council
- Commonwealth Grants Commission
- International Credit Rating Agencies (Moody's and Standard & Poor's)
- Joint Committee of Public Accounts and Audit (JCPAA)

A number of key users of public sector financial statements have identified significant problems with the current framework. The key problems identified included:

- *Confusion* – almost all users found the current public sector reporting framework difficult to interpret.
- *Lack of understanding* – given the current framework has nine different measurement indices many users were not sure which measure should be used in assessing the public sector.
- *Complexity* - many users expressed a desire to simplify the information and present one set of financial statements.
- *Lack of clarity* – information presented under the two different frameworks and the resultant reconciliation information between the two is unclear and disjointed. As a result the users generally will “cherry pick” their preferred measurements that they see as the reliable measures and base their decisions on that measure only and essentially disregard the rest.
- *Reliability, consistency and comparability* – Users require reliable, consistent and comparable time series of financial data. These characteristics were critical to the majority of users.

The user groups interviewed were generally aware that there were two distinct frameworks that the public sector reported under ie: GFS and AAS. However, it was the general feeling of the users of the current framework that too much information causes confusion. As a result, most of the reported information is not used in decision making processes. Attachment 1 provides more detailed information concerning the individual users' specific responses.

## *Uses of financial information*

The discussion with key users also identified some specific uses of the financial information. These uses give a clear indication of the importance of producing simple, reliable and understandable public sector financial reports.

The discussion found that public sector financial information is used by:

- *Economists* - use the financial information as base data for the economic modelling of the public sector and assess fiscal discipline of jurisdictions. In addition, economists use the information to understand the macro-economic implications of the fiscal behaviour of the public sector.
- *Credit rating agencies* - use the information to determine the credit rating for the public sector jurisdictions
- *Financial markets* (merchant banks etc) – use the financial information to price various products offered in the financial markets
- *Statutory Bodies* – to determine the distribution of financial resources between various public sector jurisdictions
- *Parliament* – to discharge statutory accountability requirements as defined in legislation

The above uses are testament to the value of the public sector financial information in general. The current financial reporting framework is not meeting the needs of the users interviewed. Whilst the users identified specific uses of financial information, there is also a generic set of uses for financial information.

## *Generic Uses of financial information*

### Australian Accounting standard setter's perspective

Existing Australian Accounting Concepts SAC 2 *Objectives of General Purpose Financial Reporting* states that financial statements are “a means of communicating relevant and reliable information about a reporting entity to users”<sup>2</sup>.

The particular information that users require to make decisions concerning the allocation of scarce resources will overlap with the information required to evaluate whether that entity is operating economically and efficiently<sup>3</sup>. SAC 2 describes several uses of information as follows:

#### **Performance (Financial and Non-Financial):**<sup>4</sup>

- determining the cost of providing goods and services
- change in the entity's control over resources during the reporting period; and
- assessing the resources necessary to enable the entity to continue to provide services in the future and the likely cost of those services.

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<sup>2</sup> SAC 2 *Objectives of General Purpose Financial Reporting* – paragraph 11

<sup>3</sup> SAC 2 *Objectives of General Purpose Financial Reporting* – paragraph 28

<sup>4</sup> SAC 2 *Objectives of General Purpose Financial Reporting* – paragraph 29 & 30

**Financial Position:**<sup>5</sup>

- information about the entity's control over resources, financial structure, capacity for adaptation and solvency
- information about the availability of assets to meet financial commitments as they fall due; and
- the ability of an entity to continue to provide goods and services in the future will be influenced by government policy objectives.

**Financing and investing (source and use of resources):**<sup>6</sup>

- disclosure of the sources and applications of funds during the reporting period
- this information indicates the way in which the reporting entity has financed its operations and invested its resources during the reporting period
- confirming that resources have been used for the purposes intended; and
- useful in assessing the ability of the reporting entity to continue to provide goods and services in the future and in assessing whether the reporting entity is achieving its objectives.

**Compliance:**<sup>7</sup>

- compliance with externally-imposed requirements governing the reporting entity's operations may affect users' assessments of the reporting entity's performance, financial position, or financing and investing.

International accounting perspective:

The IAS identifies the following objectives of financial statements<sup>8</sup>:

- to provide information about an enterprise that is useful to a wide range of users in making economic decisions
- show the results of stewardship of management over the resources entrusted to it

These general principles are directly comparable to the objectives outlined in SAC 2.

In addition to generic information some other reasons for use are:

- Some jurisdictions are legally required to produce financial reports using accounting standards;
- Members of professional bodies are required to comply with accounting standards when producing general purpose financial reports;
- Accountants, financial analysts and general users may be more familiar with conventional accounting treatments; and
- Note disclosures add extensively to the information presented in the primary financial statements.

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<sup>5</sup> SAC 2 *Objective of General Purpose Financial Reporting* – paragraph 32,36 & 37

<sup>6</sup> SAC 2 *Objective of General Purpose Financial Reporting* – paragraph 38

<sup>7</sup> SAC 2 *Objective of General Purpose Financial Reporting* – paragraph 39 & 40

<sup>8</sup> IAS Standards Framework – paragraph 14

### GFS perspective

The GFS Manual also recognises a number of generic uses for financial information including<sup>9</sup>:

- measure the impacts of public policy on the economy as a whole;
- provide information about actual outcomes against a government's intentions (budget);
- "provide statistics that will enable policymakers and analysts to study developments in the financial operations, financial position, and liquidity situation of the general government sector or the public sector in a consistent and systematic manner";
- analyse the operations of a specific level of government or the public sector as a whole;
- examine transactions between levels of government;
- provide systematic, integrated and comprehensive comparison points that are calculated using a uniform set of rules, such as net operating balance, net lending/borrowing or changes in net worth;
- provide a uniform framework for analysis of government financial information through an agreed accounts structure (eg users might be seeking information about particular forms of taxation, government debt securities, social program expenditures, or foreign exchange transactions); and
- analysis of government activities in the context of the economy as a whole.

In addition, other recognised uses for GFS information include:

- International bodies prefer to look at standardised data that can be compared to similar units or sectors from other countries;
- Financial analysts prefer information that eliminates local variations in measurement or presentation;
- National statisticians use GFS basis data as a key input into compilation of national accounts; and
- Economists are more comfortable with the terminology and definitions adopted by GFS and SNA.

### *Users of Financial Information*

The stakeholders of whole-of-government financial reporting are representative of the broader community. This is the case as the information relied upon is for a wide variety of purposes, with the actual need for the information dependent on the end-user. Users range from Parliaments and their oversight Committees, Governments and their agencies, external monitoring parties such as credit rating agencies, to the general public and their representative groups.

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<sup>9</sup> GFS Manual 2001 paragraphs 1.3 and 1.7 to 1.10.

Whilst the scope of this paper has been limited to users of reports within the scope of the AASB Harmonisation Project stage 1 papers (Total State Sector, General Government Sector and entities within the General Government sector) it is acknowledged that the AASB harmonisation project will extend to a broader audience, including government business enterprises and local government users.

International perspective:

The IASB has a development framework that identifies users and their information needs.<sup>10</sup> The IAS identifies the following as users of financial statements:

- Investors
- Employees
- Lenders
- Suppliers and other trade creditors
- Customers
- Governments and their agencies
- Public

This list breaks down users into more detailed classes than Australian Statement of Accounting Concepts 2 (SAC 2), however, the IAS and SAC 2 user list is conceptually similar.

*Users and Uses Table*

The table on the following page identifies the users of financial information and their specific uses.

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<sup>10</sup> IAS Standards Framework – paragraph 9

<b>Users</b>	<b>Uses</b>
<p><i>Parliament:</i></p> <ul style="list-style-type: none"> <li>• Parliamentarians as “electoral representatives”; and</li> <li>• Parliamentary oversight committees (eg. Public Accounts Committees).</li> </ul>	<ul style="list-style-type: none"> <li>• Approval of funding</li> <li>• Stewardship</li> <li>• Government accountability</li> </ul>
<p><i>Regulatory, reporting and rating agencies:</i></p> <ul style="list-style-type: none"> <li>• the Australian Loan Council*;</li> <li>• the Australian Bureau of Statistics;</li> <li>• Commonwealth Grants Commission*;</li> <li>• Productivity Commission;</li> <li>• Credit Rating Agencies; and</li> <li>• Other governments as regulators (eg State over Local Government)</li> </ul> <p>And internationally:</p> <ul style="list-style-type: none"> <li>• the International Monetary Fund;</li> <li>• the Organisation for Economic Coordination and Development;</li> <li>• the World Bank; and</li> <li>• International Credit Rating Agencies.</li> </ul>	<ul style="list-style-type: none"> <li>• Comparability of government financial performance with other jurisdictions</li> <li>• Credit risk assessment</li> <li>• Track key financial performance indicators (example: Net worth)</li> <li>• Projection of economic impacts</li> </ul>
<p><i>Government:</i></p> <ul style="list-style-type: none"> <li>• The Executive (Cabinet) of Commonwealth, State and Territory Governments.</li> </ul>	<ul style="list-style-type: none"> <li>• Comparability of government financial performance with other jurisdictions</li> <li>• Track key financial performance indicators (example: net worth, underlying cash)</li> <li>• Budget and forward estimates—sustainability</li> <li>• Financial management</li> <li>• Track policy delivery (especially where \$ value spend was promised)</li> </ul>
<p><i>Government agencies:</i></p> <ul style="list-style-type: none"> <li>• Agencies and Departments (service provision agencies, Treasury and Finance, Auditors, Others); and Government Authorities and Boards.</li> </ul>	<ul style="list-style-type: none"> <li>• fiduciary and</li> <li>• managerial accountability responsibilities of individual agencies and,</li> <li>• in more limited cases in a monitoring role.</li> </ul>

<b>Users</b>	<b>Uses</b>
<p><i>Service providers:</i></p> <ul style="list-style-type: none"> <li>• Suppliers;</li> <li>• Financial Institutions;</li> <li>• Finance Providers under Private Financing of Public Infrastructure; and</li> <li>• Employees and their representatives (eg. unions).</li> </ul>	<ul style="list-style-type: none"> <li>• Credit risk assessment</li> <li>• Viability of their service market/opportunities for additional work</li> <li>• Comparability of government financial performance with other jurisdictions</li> </ul>
<p><i>Public:</i></p> <ul style="list-style-type: none"> <li>• Taxpayers, ratepayers, and other citizens;</li> <li>• Media (financial and other commentators);</li> <li>• Industry groups (eg. Business Council of Australia, Chamber of Commerce, Australian Council of Trade Unions); and</li> <li>• Tertiary bodies and academics</li> </ul>	<ul style="list-style-type: none"> <li>• Comparability of government financial performance with other jurisdictions</li> <li>• General background information source</li> <li>• Research data</li> <li>• Personal impact of public policy</li> </ul>

\* Refer to Attachment 1 for details

## User Group meetings

User Group	Comments
<p>Access Economics Alan Tregilgas - Consultant</p> <p>Contact details: (08) 8338 3600 0401 114 665</p>	<p>Issues raised:</p> <ul style="list-style-type: none"> <li>• Highly value uniform reporting based on strong and transparent conceptual framework.</li> <li>• Support the initiative to converge GFS and GAAP because achieves above objective.</li> <li>• Important that transactions and revaluations are clearly distinguished.</li> <li>• Important that fiscal balance presented free from revaluation effect.</li> </ul>
<p>Commonwealth Bank Michael Blyth – Chief Economist</p> <p>Contact details: (02) 9378 2000</p>	<p>Issues Raised:</p> <ul style="list-style-type: none"> <li>• Different measures cause confusion.</li> <li>• Financial markets want simple numbers.</li> <li>• Time series is important for international and domestic comparison.</li> <li>• Underlying cash seen as the more relevant measure and has reliable time series. Accrual financial data is too confusing and takes too much time to analyse.</li> <li>• Accrual information not as important because time series not as reliable as underlying cash.</li> <li>• Unable to interpret information in timely manner due to current framework structure ie: 9 different reported measures.</li> </ul>

<b>User Group</b>	<b>Comments</b>
<p>ABN Amro Australia Ltd Kieran Davies – Chief Economist</p> <p>Contact details: (02) 9239 9100</p>	<p>Issues Raised:</p> <ul style="list-style-type: none"> <li>• Multiple measures creates confusion as to what number should be used to assess performance.</li> <li>• Less time spent on analysis of Commonwealth budget due to the problems associated with the current financial framework.</li> <li>• Analysis of States has almost disappeared.</li> <li>• Reporting of cash and accruals would still be required.</li> <li>• ABN Amro use GFS data due to reliable time series and familiar with measures.</li> <li>• GFS / GAAP harmonisation would be a good idea and makes sense.</li> <li>• GFS/ GAAP harmonisation would be a big step forward for Commonwealth and States for comparative information.</li> </ul>
<p>Loan Council: Rob Sturgiss Manager – State Finances and Reporting Unit Commonwealth – State Relations Division</p> <p>Contact details: (02) 6263 2912</p>	<p>Issues Raised:</p> <ul style="list-style-type: none"> <li>• Comparability between a converged framework with historical GFS time series data would be essential.</li> <li>• The Loan Council governs the Uniform Presentation Framework (UPF) and any potential changes to the UPF would need to be discussed to investigate the impact.</li> </ul>

<b>User Group</b>	<b>Comments</b>
<p><b>Grants Commission:</b>  Malcolm Nicholas – Acting Secretary  Dermot Doherty – Assistant Secretary  Pricilla Kan – Director of Budget Analysis</p> <p>Contact Details:  (02) 6229 8800</p>	<p><b>Issued Raised:</b></p> <ul style="list-style-type: none"> <li>• Uses GFS Operating Performance (eg. revenue and expenses) as main information source. SOEF is not considered by Grants Commission</li> <li>• Any changes to GFS would be significant.</li> <li>• Comparability (stability) between historical time series and any converged framework is essential.</li> <li>• Budget papers are only used to further investigate any significant variances reported.</li> </ul>
<p><b>Standard and Poors</b>  Brendan Flynn  Associate Director – Public Finance Rating</p> <p>Contact Details:  (03) 9631 2042  brendan_flynn@standardandpoors.com</p>	<p><b>Issues Raised:</b></p> <ul style="list-style-type: none"> <li>• Focus on a Government’s ability to meet their debt obligations.</li> <li>• Accrual GFS provides additional information, however no one “key fiscal indicator” and reservations on valuation of government assets. States are unlikely to sell a road to service debt.</li> <li>• Use AAS for Victoria/ACT as it aligns with their Budget presentation, and use Note Disclosure for interpretation. Despite this, focus is on GFS, primarily as it excludes valuation changes.</li> <li>• The two frameworks being reported separately are confusing.</li> </ul>

<b>User Group</b>	<b>Comments</b>
<p><b>Moodys</b> Debra Roane Vice President/Senior Credit Officer Sovereign Risk Group</p> <p>Contact Details: 0011 +212 553 7815 (USA) debra.roane@moodys.com</p>	<p>Issues raised:</p> <ul style="list-style-type: none"> <li>• Focus on ability to service debt.</li> <li>• Require uniformity: across jurisdictions and time series.</li> <li>• New framework will need to be comparable to current GFS.</li> <li>• Prefer cash data and generally focus on General Government and PNFC sectors.</li> <li>• Note disclosure and further disaggregation of statement items on a GFS basis would assist in analysis.</li> <li>• Confusion between the GFS and Australian GAAP financial statements and measures.</li> </ul>
<p><b>Joint Committee of Public Accounts and Audit</b> James Catchpole – Acting Secretary</p> <p>Contact Details: 02 6277 2316</p>	<p>Issues Raised:</p> <ul style="list-style-type: none"> <li>• Confusion between the GFS and Australian GAAP financial statements and measures.</li> <li>• A simplified framework incorporating GFS and GAAP financial statements for both understandability and accountability would assist committee members.</li> </ul>
<p><b>Australian Bureau of Statistics (ABS)</b> Peter Harper First Assistant Statistician Economic Statistics - Economic Accounts Division</p> <p>Contact Details: (02) 6252 6035</p>	<p>Issues Raised:</p> <ul style="list-style-type: none"> <li>• The ABS considers the GFS standard to be the most appropriate framework for analysing the performance of government from an economic perspective and for understanding how the activity of government effects the broader economy</li> <li>• The ABS produces GFS statistics based on the IMF's international standard using information provided by governments</li> <li>• These GFS statistics are a key ABS output in their own right</li> <li>• The GFS statistics are also a very important input into the preparation of Australia's national accounts – the GFS standard is a</li> </ul>

<p>Australian Bureau of Statistics (ABS) – cont</p>	<p>subordinate standard to that used for the national accounts (ie SNA93)</p> <ul style="list-style-type: none"> <li>• In accordance with international obligations, the ABS provides GFS information to the IMF and OECD. These organisations use Australian GFS data in their own work. They also publish the data along with GFS data for other countries.</li> <li>• The ABS places a high emphasis on maintaining a time series of GFS statistics on a consistent basis to aid in the analysis of economic activity over time.</li> </ul>
<p>Commonwealth Treasury (Macroeconomic Group)</p> <p>Steve Morling Specialist Adviser (Forecasting) Domestic Economy Division Macroeconomic Group</p> <p>Contact details: (02) 6263 3748 <a href="mailto:smorling@treasury.gov.au">smorling@treasury.gov.au</a></p>	<p>Issues Raised:</p> <ul style="list-style-type: none"> <li>• Consistency of data with national accounts is important for macroeconomic analysis and forecasting.</li> <li>• GFS data allows for the economic analysis of the public sector (including the contribution of Government to aggregate demand) and impact of fiscal policy on the economy.</li> <li>• Comparability (stability) between historical GFS time series and any converged framework is important.</li> <li>• Important that transactions and revaluations are clearly distinguished.</li> </ul>
<p>State/ Territory Treasuries</p> <p>Wendy Sawford Director, Intergovernment and Financial Policy Branch Department of Treasury and Finance (Tasmania)</p> <p>Contact details: (03) 6233 2835 <a href="mailto:wendy.sawford@treasury.tas.gov.au">wendy.sawford@treasury.tas.gov.au</a></p>	<p>Issues Raised</p> <ul style="list-style-type: none"> <li>• Long term modelling to assess the financial implications (budget pressures) of changes in the economy due to factors such as an ageing population;</li> <li>• Assist in the formulation and management of the Government's Fiscal Strategy;</li> <li>• Determine the financial implications of changes in public policy;</li> <li>• Prepare information for bodies such as CGC and Ratings Agencies;</li> <li>• Review comparative performance with other jurisdictions; and</li> </ul>

State/ Territory Treasuries – cont	<ul style="list-style-type: none"> <li>• Used in negotiations with Commonwealth regarding financial issues (such as the review of Specific Purpose Payments or tax collections).</li> <li>• Comparability and a consistent time series are the key factors to enable the review and monitoring of performance relative to other jurisdictions and modelling of fiscal pressures on the Budget</li> </ul>
Other User Groups meeting planned: <ul style="list-style-type: none"> <li>• Media</li> <li>• Finance Minister’s Office</li> </ul>	

## Possible Format of Harmonised Financial Statements

### Entity

### Statement of Financial Performance

For the period ending 30 June 2xxx

	Notes	2xxx \$m	2xxx \$m
<b>Revenues before re-measurements</b>		X	X
Taxation	2	X	X
Non-taxation	3	X	X
<b>Total revenues before re-measurements</b>		<u>X</u>	<u>X</u>
<b>Expenses before re-measurements</b>			
Employee Expenses		X	X
Goods and Services	4	X	X
Subsidies, benefits and grants	5	X	X
Borrowing costs expense	6	X	X
<b>Total expenses before re-measurements</b>		<u>X</u>	<u>X</u>
Extraordinary items before re-measurements	8	X	X
<b>Net operating result before re-measurements</b>		<u>X</u>	<u>X</u>
<b>Re-measurements</b>			
Net foreign exchange gains/(losses)		X	X
Net exchange gain/(loss) on translation of financial report of self sustaining foreign operations		X	X
Proceeds from sale of assets		X	X
Value of assets sold		(X)	(X)
Net credit/(debit) to asset revaluation reserve		X	X
Superannuation		X	X
Other non-owner related equity movements	9	X	X
Share of net result from associates and joint ventures accounted for using the equity method	10	X	X
Gain/(loss) on re-measurement extraordinary items	8	X	X
<b>Total re-measurements</b>		<u>X</u>	<u>X</u>
Net result after re-measurements		X	X
Net result attributable to outside equity interests	7	X	X
<b>Net result attributable to the parent entity</b>		<u>X</u>	<u>X</u>
Transactions with owners	28	X	X
<b>Supplementary disclosure: Fiscal balance</b>			
<b>Net operating result before re-measurements</b>		X	X
<b>Purchases of non-financial assets</b>		X	X
Less Depreciation		X	X
Less Change in inventories		X	X
Plus Other movements in non-financial assets		X	X
<b>Total net acquisition of non-financial assets</b>		<u>X</u>	<u>X</u>
<b>Net borrowing / lending</b>		<u>X</u>	<u>X</u>

**Entity**  
**Pro-forma Statement of Financial Position**  
For the period ending 30 June 2xxx

	Notes	2xxx \$m	2xxx \$m
<b>ASSETS</b>			
<b>Financial Assets</b>			
Cash and deposits	13	X	X
Receivables		X	X
Accrued revenue / Advances paid	14	X	X
Investments	15	X	X
Other financial assets	16	X	X
<b>Total financial assets</b>		<b>X</b>	<b>X</b>
<b>Non-financial assets</b>			
Inventories		X	X
Property, Plant and Equipment		X	X
Intangibles		X	X
Other non-financial assets		X	X
<b>Total non-financial assets</b>		<b>X</b>	<b>X</b>
<b>Total Assets</b>		<b>X</b>	<b>X</b>
<b>LIABILITIES</b>			
	17		
<b>Payables</b>	18	X	X
<b>Interest bearing liabilities</b>	19	X	X
<b>Provisions</b>	20	X	X
<b>Total liabilities</b>		<b>X</b>	<b>X</b>
<b>Net Assets</b>		<b>X</b>	<b>X</b>
<b>Equity</b>			
<b>Parent entity interest</b>			
Accumulated results		X	X
Reserves		X	X
<b>Total parent entity interest</b>		<b>X</b>	<b>X</b>
Outside equity interests		X	X
<b>Total entity</b>		<b>X</b>	<b>X</b>
Current liabilities		X	X
Non-current liabilities		X	X
<b>Total liabilities by maturity</b>		<b>X</b>	<b>X</b>
Current assets		X	X
Non-current assets		X	X
<b>Total assets by maturity</b>		<b>X</b>	<b>X</b>

**Entity**  
**Pro-forma Statement of Cash Flows**  
For the period ending 30 June 2xxx

	Notes	2xxx \$m	2xxx \$m
<b>Operating activities</b>			
<b>Cash received</b>			
Taxes		X	X
Sales of goods and services		X	X
Interest		X	X
Dividends		X	X
Goods and services tax refunds		X	X
Other		X	X
<b>Total cash received</b>		<u>X</u>	<u>X</u>
<b>Cash payments</b>			
Payments for goods and services		X	X
Grants and subsidies		X	X
Interest		X	X
Personal benefits		X	X
Salaries, wages and other entitlements		X	X
GST payments to taxation authority		X	X
Other payments for operating activities		X	X
<b>Total payments</b>		<u>X</u>	<u>X</u>
<b>Net cash flows from/(to) operating activities</b>		<u>X</u>	<u>X</u>
<b>Investing activities</b>			
<b>Cash received</b>			
Purchases of non-financial assets	20	X	X
Purchases of financial assets (non-policy)	21	X	X
Other	22	X	X
<b>Total cash received</b>		<u>X</u>	<u>X</u>
<b>Cash payments</b>			
Sales of non-financial assets	23	X	X
Sales of financial assets (non-policy)	24	X	X
Other	25	X	X
<b>Total cash used</b>		<u>X</u>	<u>X</u>
<b>Net cash flows from/(to) investing activities</b>		<u>X</u>	<u>X</u>
<b>Net cash Flows from Operating and Investing Activities</b>		<u>X</u>	<u>X</u>
<b>Net cash flows from investments in financial assets for policy purposes</b>		<u>X</u>	<u>X</u>
<b>Net cash flows before Financing Activities</b>		<u>X</u>	<u>X</u>
<b>Financing activities</b>			
<b>Cash received</b>			
Advances received		X	X
Borrowing		X	X
Deposits received		X	X
Other financing		X	X
<b>Total cash received</b>		<u>X</u>	<u>X</u>
<b>Cash paid</b>			
Advances received		X	X
Borrowing		X	X
Deposits received		X	X
Other financing		X	X
<b>Total cash used</b>		<u>X</u>	<u>X</u>
<b>Net cash flows from/(to) financing activities</b>		<u>X</u>	<u>X</u>
<b>Total cash flows</b>		<u>X</u>	<u>X</u>
<b>Net borrowing/lending</b>			
Net cash from operating activities and investments in non-financial assets		X	X
Finance leases and similar arrangements		X	X
<b>Cash surplus/(deficit)</b>		<u>X</u>	<u>X</u>

## Entity

### Pro-Forma Notes Forming Part of the Financial Statements

	<u>20XX</u>	<u>20XX</u>
<b>Note 1 – Accounting Policies</b>		
<b>Note 2 – Revenues from taxation</b>		
Income Tax	X	X
Indirect Tax	X	X
Fringe benefits tax	X	X
Other taxes	X	X
<b>Total taxation revenues</b>	<u>X</u>	<u>X</u>
<b>Note 3 – Non-taxation revenues</b>		
Charges for goods and services	X	X
Current grants and subsidies	X	X
Capital grants	X	X
Interest and dividends	X	X
Other sources of non-taxation revenue	X	X
<b>Total Non-taxation revenues</b>	<u>X</u>	<u>X</u>
<b>Note 4 - Goods and Services</b>		
Employees	X	X
Suppliers	X	X
Depreciation and Amortisation	X	X
Other goods and services expenses	X	X
<b>Total cost of goods and services</b>	<u>X</u>	<u>X</u>
<b>Note 5 - Subsidies, benefits and grants</b>		
Subsidies	X	X
Personal benefits	X	X
Grants	X	X
<b>Total subsidies, benefits and grants</b>	<u>X</u>	<u>X</u>
<b>Note 6 - Borrowing costs expense</b>		
Interest expense	X	X
Nominal superannuation interest expense	X	X
<b>Total borrowing costs expense</b>	<u>X</u>	<u>X</u>
<b>Note 7 - Net result attributable to outside equity interests</b>		
Interest in opening accumulated results as at 1 July 2xxx	X	X
Interest in operating result and abnormal items after income tax	X	X
Interest in amounts transferred (to)/from reserves	X	X
Interest in dividends provided for or paid	X	X
Interest in other movements in accumulated results	X	X
Interest in closing accumulated results	X	X
<b>Interest in opening reserves as at 1 July 2xxx</b>	<u>X</u>	<u>X</u>
Interest in foreign currency translation gain/(loss)		
Interest in amounts transferred (to)/from accumulated results	X	X
Interest in other movements in reserves	X	X
<b>Interest in closing reserves</b>	<u>X</u>	<u>X</u>
<b>Interest in capital</b>	<u>X</u>	<u>X</u>
<b>Total outside equity interests</b>	<u>X</u>	<u>X</u>
<b>Note 8 - Gain/(loss) on extraordinary items</b>		
Details of each extraordinary item	X	X
<b>Note 9 - Other non-owner related equity movements</b>		
Details of other non-owner related equity movements	X	X

## Entity

### Pro-Forma Notes Forming Part of the Financial Statements

	<u>20XX</u>	<u>20XX</u>
<b>Note 10 - Share of net result from associates and joint ventures accounted for using the equity method</b>		
Information disclosed to permit the calculation of the change in market value of the investment(s) after payment of dividends.	X	X
<b>Note 11 – Reconciliation of Fiscal Balance to transactions in financial assets and liabilities</b>		
Net fiscal balance	X	X
Net acquisition of financial assets		
Domestic	X	X
Foreign	X	X
Net incurrence of liabilities		
Domestic	X	X
Foreign	X	X
<b>Total transactions in financial liabilities</b>	<b>X</b>	<b>X</b>
<b>Note 12 – Reconciliation of changes in equity</b>		
Opening balance as at 1 July 2xxw	X	X
Adjustments to opening balance (detailed below)	X	X
Net operating result after re-measurements	X	X
Dividends provided for or paid	X	X
Transfers to/(from)/between reserves	X	X
Changes in accounting policies	X	X
Capital payments made/(repayments received)	X	X
Other movements (detail if material)	X	X
Balance as at 30 June 2xxx	X	X
Less Outside Equity Interests (refer Note 7)	X	X
<b>Total equity attributable to the entity</b>	<b>X</b>	<b>X</b>
<b>Note 13: Cash and Deposits</b>		
Cash at Bank and on hand	X	X
Cash on deposit	X	X
<b>Total Cash and Deposits</b>	<b>X</b>	<b>X</b>
<b>Note 14: Accrued Revenue / Advances Paid</b>		
Accrued taxation revenue	X	X
Accrued interest revenue	X	X
Other accrued revenue	X	X
Other advances paid	X	X
<b>Total Accrued Revenue / Advances Paid</b>	<b>X</b>	<b>X</b>
<b>Note 15: Investments</b>		
<b>Shares</b>		
Shares in international financial institutions	X	X
Shares in companies	X	X
Other	X	X
<b>Total Shares</b>	<b>X</b>	<b>X</b>
Gold holdings		
Deposits	X	X
Government securities	X	X
Debentures	X	X
International money fund	X	X
Financial Instruments (by type)	X	X
Investments - accounted for using equity method	X	X
Other	X	X
<b>Total Investments</b>	<b>X</b>	<b>X</b>

## Entity

### Pro-Forma Notes Forming Part of the Financial Statements

	<u>20XX</u>	<u>20XX</u>
<b>Note 16: Liabilities</b>		
<b>Domestic:</b>		
Payables	X	X
Interest Bearing Liabilities	X	X
Provisions	X	X
<b>Total Domestic Liabilities</b>	<b><u>X</u></b>	<b><u>X</u></b>
<b>Foreign:</b>		
Payables	X	X
Interest Bearing Liabilities	X	X
Provisions	X	X
<b>Total Foreign Liabilities</b>	<b><u>X</u></b>	<b><u>X</u></b>
<b>Total Liabilities</b>	<b><u>X</u></b>	<b><u>X</u></b>
<b>Note 17: Liabilities</b>		
Disclose detailed split of liabilities by domestic and foreign		
<b>Note 18: Payables</b>		
Suppliers	X	X
Personal Benefits	X	X
Subsidies	X	X
Grants	X	X
Other payables	X	X
<b>Total Payables</b>	<b><u>X</u></b>	<b><u>X</u></b>
<b>Note 19: Interest Bearing Liabilities</b>		
Overdraft	X	X
Deposits	X	X
Government Securities	X	X
Loans	X	X
Leases	X	X
Other interest bearing liabilities	X	X
<b>Total Interest Bearing Liabilities</b>	<b><u>X</u></b>	<b><u>X</u></b>
<b>Note 20: Provisions</b>		
Provision for taxation refund	X	X
Employees	X	X
Australian currency on issue	X	X
Other provisions	X	X
<b>Total Provisions</b>	<b><u>X</u></b>	<b><u>X</u></b>
<b>Note 21: Sales of non-financial assets</b>		
Property plant and equipment	X	X
Valuables	X	X
Non-produced assets	X	X
	<b><u>X</u></b>	<b><u>X</u></b>
<b>Note 22: Sales of financial assets</b>		
Details by type of financial asset		
<b>Note 23: Other investing cash flows</b>		
Details by type of transaction		
<b>Note 24: Sales of non-financial assets</b>		
Property plant and equipment	X	X
Valuables	X	X
Non-produced assets	X	X
	<b><u>X</u></b>	<b><u>X</u></b>

### **Note 25: Sales of financial assets**

**Entity**

**Pro-Forma Notes Forming Part of the Financial Statements**

20XX

20XX

Details by type of financial asset

**Note 26: Other investing cash flows**

Details by type of transaction

**Note 27: Financing activities**

Provide a split between domestic and foreign by type of transaction

**Note 28: Transactions with owners**

provide details of the transactions with owners

NOTE: The above notes do not include a number of specific disclosures required by other accounting standards (eg financial instruments, asset details by class, etc) as the primary purpose of these pro-forma notes was to illustrate what might appear on the face of the financial statements and what could be included in the note disclosures.



## Issue: Consolidation Sector/Segment Reporting

### *Summary of differences*

**Accounting** - AAS31 *Financial Reporting by Governments* requires government jurisdictions to prepare general purpose financial reports<sup>1</sup>. The inclusion of entities in these reports is defined by the extent to which the entity is controlled or influenced by government. As a result the focus is on reporting for the Total Public Sector. Disaggregated information for General Government (GG), Public Non-Financial Corporations (PNFC) and Public Financial Corporations (PFC) sectors is published as supplementary statements or schedules to the primary statements. General purpose financial statements cannot be prepared for an individual sector of Government (ie General Government).

**GFS** –GFS standards do not have a particular reporting entity concept<sup>2</sup>. The public sector is classified according to GG, PNFC or PFC. Users prepare financial reports based on these classifications. In addition, GFS also includes two consolidated sectors, being the Non-Financial Public Sector (the consolidation of the GGS and PNFC sectors), and Total Public Sector (represents the consolidation of GG, PNFC and PFC sectors).

### *Accounting treatment*

Paragraph 1.1 of AAS31 classes each Australian government jurisdiction as a reporting entity and therefore requires them to produce general purpose financial reports. Paragraph 9.1 states that an entity is consolidated into these general purpose reports if the government controls that entity<sup>3</sup>.

The standard illustrates that where the government has the capacity to dominate the financial and operating policies of another entity, so as to enable that entity to operate with it in pursuing its own objectives, then control exists.

The government clearly controls the GGS and therefore these agencies are consolidated within the government's general purpose reports. In addition, many Australian government jurisdictions are seen to control many entities in the PNFC Sector and the PFC Sector<sup>4</sup>. As a result these entities would also be consolidated into the government's general purpose report. AAS31 general purpose reports are at a whole of government level, evident in jurisdictions ex-post reporting.

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<sup>1</sup> AAS 29 paragraph 15.12.

<sup>2</sup> IMF staff indicated a preference for total public sector information to be provided together with dissected sector information at a recent IFAC PSC International Working Group meeting.

<sup>3</sup> AAS 24 paragraph 18.

<sup>4</sup> Some jurisdictions have encountered practical difficulties with the notion of control and some entities in other sectors. AAS 31 indicates that establishment of an entity through passage of legislation is an indication of control. However, in practice, jurisdictions may create entities through parliamentary acts that they do not control in any other sense (as described in AAS 24). The Australian National University is an example—although established by a Commonwealth Act, the Commonwealth Government does not meet any of the control tests in AAS 24.

It is possible that the GG Sector could be classified as a parent entity, which is defined in AAS24 *Consolidated Financial Reports* as an entity that controls another entity. Unfortunately Accounting Standards do not discuss the concept of parent entities within government. However, existing private sector practices for similar disclosures, the parent entity's results are displayed next to those of the fully consolidated entity on the face of the financial statements. Given user information needs, this would be preferred in comparison to relegating sectoral reporting to the schedules or notes to the financial statements.

### *GFS Treatment*

GFS standards classify public sector entities into the GG, PNFC or PFC Sector<sup>5</sup>.

- GG Sector entities consist of those public sector entities that provide, in the main, goods and services outside the market mechanism as well as providing for the transfer of income for public policy purposes. The major form of financing of these goods and services is by taxation, imposed by the State, Territory or by the Commonwealth .
- In contrast, the PNFC Sector charge for services provided and hence have a broadly commercial orientation. They do not, however, necessarily operate in competitive markets. While PNFCs are not required to be fully self-funding, a substantial portion of their costs must be met by user charges.
- Public Financial Corporations are the third category of authorities in the GFS framework. This sector comprises those entities that perform central bank functions or have the authority to incur financial liabilities and acquire financial assets in the market on their own account.
- The Non-Financial Public Sector represents the consolidated total of the General Government and PNFC Sectors.
- The Total Public Sector represents the consolidated total of the General Government, PNFC and PFC Sectors.

The scope of each of the above sectors is defined in principle in the *GFS Manual*. In practice, the Australian Bureau of Statistics (ABS) takes sectoral classifications seriously as shifts between sectors can distort financial reports. As a consequence, changes in sectoral classification are only approved by the ABS after extensive consultation and presentation of a case showing what has changed to prompt a change in sectoral classification. Where the change being relied upon has occurred in a prior period, the ABS may require information to permit back casting of the change in sector to preserve the integrity of the time series. It would be appropriate for the relevant public sector accounting standards to require adequate disclosure about any changes in sectoral classification, as any such changes would affect sector reports.

The reporting entity concept does not apply to GFS reporting and so there is no particular emphasis of any sector. Preparers and users of GFS reports will select the sector that is most

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<sup>5</sup> GFS also recognizes commercial activities that function as if they were incorporated as 'quasi corporations' and treats them effectively as if they were incorporated. Quasi corporations are classified as members of the PFC or PNFC sectors. For more information, see *GFS Manual 2001* paragraphs 2.16 to 2.18.

appropriate for analytical purposes, which may be GG, Total Public Sector or any other sector.

### *UPF/Budget Treatment*

The Australian GFS reporting requirements for jurisdictions are confirmed in the UPF (which is developed by Heads of Treasuries in conjunction with other key stakeholders—such as the ABS and Grants Commission). The UPF requires production of Budget estimates for the GG, PNFC and Total Non-Financial Public Sectors. For outcomes reporting, the UPF requires production of GG, PNFC, Total Non-Financial and PFC sectors. Total Public Sector information (eg a whole-of-government consolidated report) is not mandated by the UPF. However, the Australian Bureau of Statistics presents Total Public Sector outcomes data for all jurisdictions.

All jurisdictions focus on the GG Sector for headline Budget reporting. This has arisen because this sector is closely aligned with the entities covered by the parliamentary appropriation bill. As a consequence, reporting of the Budget outcome requires presentation of General Government sector statements.

The issue for convergence will be whether a stand-alone GG financial statement can be classified under Australian accounting standards as a general purpose financial report. Alternatively, could the format of whole of government financial statements be amended to provide appropriate focus on the GG sector to satisfy jurisdiction's Budget outcome reporting requirements.

The GFS standards do not prescribe the breadth of information to be published in a single report (eg one sector, all sectors or consolidated). The preparers of GFS data choose to report on one or more of the above sectors based on user needs. Some government jurisdictions use the GFS GGS reports as their primary financial reports.

### *Standard setters' future work programs*

#### Accounting

No specific projects separate from the GFS convergence project that will address this area of consolidation and reporting.

The AASB has previously undertaken a review of AAS31 and considered the issues with regard to GG Sector, determining that it should not be classified as a parent entity or separate reporting entity. However, it is the considered opinion of the majority of the Working Group that the AASB probably took this decision with incomplete information. In particular, it is likely that the needs of users in respect to the Budget funded sector (General Government Sector) were not given adequate consideration.

When planning to adopt IAS 14 “Segment Reporting”, the AASB has indicated that public sector entities will be excluded and that it plans to consider applying provisions from IPSAS 18 “Segment Reporting” to the public sector.

## *Steps to harmonization*

### *General Government Budget Outcome reporting*

The issue of Budget reporting is being pursued by IFAC PSC, and will not be considered by the AASB as part of the GFS/GAAP harmonisation process. However, any reporting standard will need to provide Governments with a capacity to prepare financial statements with a focus on both the GG Sector (to satisfy Budget outcomes) and, where appropriate, the Total Public Sector (in accordance with the GAAP reporting entity).

Jurisdictions should have discretion as to how they choose to present headline Budget outcomes. This may be as a stand-alone financial statement, or within the consolidated financial statements for the Total Public Sector.

GAAP will currently not allow stand-alone GG financial statements to be classified as general purpose financial statements, as they do not fully comply with the consolidation requirements of AAS24 (ie all controlled entities ie Total Public Sector), but they do meet the definition of a GPFER from SAC 2<sup>6</sup>. [It is noted that some argue that the GGS is not a legal entity and therefore cannot be a reporting entity. Departments and agencies are also not legal entities, yet they have been required to produce GPFERs as reporting entities under AAS 29 for a number of years. Also, many AAS 29 reporting entities have subsidiaries and, consequently, produce consolidated statements. If partial consolidations are a fatal flaw, then the existing practice of reporting by departments is breaching this construct.]

The options for the harmonised reporting framework to allow a continued focus on GG Sector reporting are as follows:

- Define general government as a parent entity within government.
  - Define general government as a reporting entity
  - Define general government as a segment of the government, applying segment reporting principles in this context
  - Produce General Government Budget Outcomes as a special purpose report; and
  - Expand current sector financial reporting within whole of government financial reports,
- Each of these options is discussed in greater detail in the following sections.

### ○ **Defining general government as a parent entity within government, (partial consolidation)**

This arises where the GGS is treated as a parent entity reporting the investment in subsidiaries as a line item in the Statement of Financial Position rather than reporting underlying assets and liabilities of the subsidiaries. The current Australian accounting standards do not discuss the applicability of “the parent entity” for government reporting.

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<sup>6</sup>“ **“general purpose financial report”** means a financial report intended to meet the information needs common to users who are unable to command the preparation of reports tailored so as to satisfy, specifically, all of their information needs.” SAC 2 paragraph 6.

In a recent AASB memorandum dated 20 November 2002, it was noted that unlike the clear legal distinction between a parent and subsidiary in the private sector, as specified in Corporations Law, some element of judgment is used in determining the classification between the GGS and non-GGS. As a result, misclassification is possible. They argue that as a result the GGS is not directly comparable with the parent entity concept because GGS includes what is generally regarded as the government parent entity (ie the “crown”) plus other elements of the whole of government.

The barrier to harmonization on this matter appears to be procedural rather than technical, i.e. if both regulatory bodies could be satisfied on the proper classification of entities, then GGS as a parent entity may be acceptable.

The application of the parent entity concept to the GG Sector has already been considered and rejected by AASB, in the context of the review of AAS31. However, it is the considered opinion of the majority of the Working Group that the AASB probably took this decision with incomplete information.

There is also the possibility as part of the current review process for international accounting standards, there have been indications that the parent entity concept could be removed from the standards. Consequently, this option should not be pursued until the status of the parent entity concept has been clarified.

- **Defining general government as a reporting entity**

Whether a partially consolidated entity is permissible under accounting standards and Statements of Accounting Concepts also depends on whether the GGS constitutes a ‘reporting entity’. A ‘reporting entity’ is defined in SAC 1 to include all entities, in respect of which it is reasonable to expect users dependent on general purpose financial reports for making and evaluating decisions about the allocation of resources<sup>7</sup>. SAC 1 make it clear that the concept of a reporting entity is not dependent on the sector within which it operates, the purpose for which it was created or the manner in which it is constituted<sup>8</sup>). Rather, the concept is linked to the information needs of users in making and evaluating resource allocation decisions<sup>9</sup>). SAC 1 provides that for these purposes:

“... information about all resources able to be deployed by a reporting entity is relevant ... Thus, where an entity controls other entities, there should be disclosed information regarding the resources of controlled entities as well as the resources of the controlling entity because all of these resources may be deployed by the controlling entity for its own advantage.”<sup>10</sup>

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<sup>7</sup> SAC 1 paragraph 40.

<sup>8</sup> SAC 1 paragraph 13.

<sup>9</sup> SAC 1 paragraph 15.

<sup>10</sup> SAC 1 paragraph 16.

On this basis, it may be difficult to argue that a partially consolidated GG sector would satisfy the objective of general purpose financial reporting and constitute a reporting entity. This is consistent with the AASB preliminary view<sup>11</sup>. The AASB concluded that the boundaries of a reporting entity are determined by the notion of control and, as a result, a partially consolidated GG sector does not constitute a reporting entity. The AASB stated that a whole-of-government general-purpose financial report should be prepared on a fully consolidated basis. However, it is unlikely that such a fully consolidated report would, on its own, meet user information needs.

Further the AASB memorandum referred to above stated ‘ arguably a GG Sector is a reporting entity but could only fully satisfy the objective of general purpose financial reporting by preparing fully consolidated financial reports’.<sup>12</sup>

In reaching a harmonized position it would seem that accounting standards would require clear and prescriptive instructions as to the definition of a reporting entity within government. This could be as prescriptive as saying ‘*the GGS sector as defined by the ABS is a reporting entity*’. Given concerns about partial consolidations, such a prescription might also include instructions about how to ensure that users understand the type of financial report they are examining.

It would be reasonable to assume that the general government (GG) sector could be classed as a ‘reporting entity’ under the definition in AAS24. There are currently a significant number of users that are dependent on information about this sector and therefore it can be argued that it is a reporting entity.

This issue has also been considered by the AASB as part of its review of AAS31. The view provided by AASB staff at the time was that a GG financial report does not provide sufficient information regarding the resources controlled by government.<sup>13</sup> This opinion is in direct opposition to existing government practices, particularly in respect to resource allocation decisions and accountability for the outcomes of those decisions.

o **Defining general government as a segment of the government.**

Paragraph 15.12 of AAS31 currently requires general purpose financial reports to present disaggregated financial information. This is not as detailed as AAS 16 *Financial Reporting by Segments* but requires the following disclosures:

The general purpose financial report must disclose, in respect of each broad sector of activity of the government:

- (a) A brief description of the nature of the activity undertaken in that sector, and the basis for the determination of that sector;
- (b) assets and liabilities which are reliably attributable to that sector, classified according to their nature or type and into current and non-current categories; and

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<sup>11</sup> AASB Action Alert No. 57 (AASB 2002a).

<sup>12</sup> AASB Action Alert No. 57 (AASB 2002a).

<sup>13</sup> page 7 of AASB Issues Paper *The implications of acknowledging that a General Government Sector (GGS) is Analogous to a parent entity*, Agenda Paper 7.2 AASB Meeting 4-5 December 2002

- (c) Revenues and expenses which are reliably attributable to that sector, classified according to their nature and type.

The information about assets, liabilities, revenues and expenses must be disclosed without eliminating the effects of transactions between sectors, but by eliminating the effects of transactions between entities within each sector.

This paragraph allows governments to provide budget results on a general government basis while still conforming to Accounting Standards. Unfortunately in terms of presentation, on its own this provision would provide a budget result buried in the notes of a set of financial statements. It is unlikely that this would be acceptable to users, particularly parliamentarians.

Under this option, GG Budget outcomes would be presented either as separate columns in consolidated financial reports or as subsidiary schedules within those financial reports. The statements would be auditable as special purpose financial statements, and this information would remain consistent with that presented in the consolidated financial statements for the Total Public Sector.

- **Expand current sector financial reporting within whole of government financial reports**

GAAP reporting requires disclosure of the consolidated economic entity, being the Total Public Sector. Disclosure of disaggregated information in respect of each sector of government occurs in the notes to the statements<sup>14</sup>). AASB 1018 *Statement of Financial Performance* prohibits any additional disclosures from purporting to be a statement of financial performance<sup>15</sup>.

An option would be for the harmonisation process to allow for sector statements to be prepared for the Total Public Sector (the reporting entity) and its component sectors of government (GGS, PNFC and PFC sectors). This would allow jurisdictions to present the Budget outcome whilst not requiring AASB to amend its reporting entity concept, which is based on the notion of control.

Jurisdictions would also remain able to produce separate Budget outcomes statements for the GG Sector should this be preferred, on the basis that they are special purpose financial statements.

#### *Measurement of Investment in Subsidiary*

An associated harmonisation issue arising from Sector reporting is measurement of the GG Sector interest in the subsidiaries, being the PNFC and PFC sectors.

The ownership interest is clearly demonstrated by the Income Tax Equivalents and Dividend streams that flow from the PNFC and PFC sectors to the GG Sector. The issue arises as to how this investment asset is measured in the GG Sector. AASB1015 *Acquisition of Assets* requires initial measurement at cost. However, for the public sector this acquisition has occurred as a result of administrative arrangement rather than acquisition. With the lack of clear guidance regarding the measurement of the equity investment held by the GG Sector there is varying

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<sup>14</sup> AAS 31 paragraph 15.12.

<sup>15</sup> AASB 1018 paragraph 4.5.

treatment across jurisdictions. Treatment varies from reporting no asset, an asset valued according to the net assets of the sectors, and recording an asset for only the incorporated Government businesses.

The GFS treatment is to record the carrying value of the net assets of the PNFC and PFC sector as a single line equity investment in the GG Sector.

As a step to harmonisation between jurisdiction reports, it is recommended that all jurisdictions adopt the GFS measurement of this equity interest. The AAS could be amended to clarify the standard treatment.

### *Conclusion*

The Working Party recommends that the AASB re-consider the issue of reporting by the general government sector (GGS). There is evidence that users use GGS reports for specific purposes that differ from the uses of consolidated financial statements. The converged standards need to allow the GGS to be treated as a reporting entity. In order to facilitate this, the accounting standards would need to be prescriptive as to what constitutes a reporting entity within government (eg adopting the ABS definition of the general government sector).

In addition, GAAP may need to provide for sector financial statements to be presented within consolidated statements rather than through note disclosure.

The accounting standards should be amended to clarify the measurement of the General Government equity investment in the PNFC and PFC sectors, to align with the GFS treatment.

# Practical Issues Relating to Convergence

## *Introduction*

Convergence between GFS and GAAP will require a number of practical decisions. This paper explores those issues recognised by the HoTARAC Working Group members as being matters that will impact on their work as preparers, analysts and policy setters in government. These issues fall into four principal areas:

1. Scope of convergence
2. Timing of convergence
3. Vehicle for convergence; and
4. Other transitional issues.

### *1. Scope of Convergence*

This section explores two areas regarding the scope of convergence; the conceptual (objectives and framework) and the practical implications (the various levels at which convergence could occur).

#### **1. a) Conceptual**

The Financial Reporting Council (FRC) provided strategic direction to the Australian Accounting Standards Board (AASB) in December 2002 regarding GFS/GAAP convergence. The objective of this convergence process is to achieve a single set of government financial reports that (are):

- satisfy users' requirements;
- understandable<sup>1</sup> by a diverse set of users;
- audited to provide assurance to users, stakeholders and the public at large that they are not materially incorrect;
- consistent with other jurisdictions (domestic and foreign);
- directly comparable with relevant budget documentation and over time (between periods); and
- transparent.

A separate paper on Users and Uses of Public Sector Financial Statements is being prepared and it is important to note that the various financial reports presented must satisfy their requirements.

#### **AASB's Interpretation of the FRC Direction**

The AASB's policy is to promulgate a single set of sector neutral accounting standards that cover for-profit and not-for-profit sectors.

The AASB has, in response to the FRC's strategic direction, outlined a proposed two-phase process to implement GAAP/GFS convergence.

- The first phase will focus on general purpose financial reporting by State, Territory and Commonwealth governments (commonly referred to as whole-of-government). This includes consideration of issues relating to sector reporting (in

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<sup>1</sup> SAC 3 paragraph 36 states that "general purpose financial reports ought to be constructed having regard to the interests of users who are prepared to exercise diligence in reviewing those reports and who possess the proficiency necessary to comprehend the significance of contemporary accounting practices."

particular the general government sector (GGS) financial reporting) included in whole-of-government general purpose financial reports.

- The second phase will focus on general purpose financial reporting by local governments and other public sector entities (such as universities and GBEs).<sup>2</sup>

It is the view of some members of the Working Group that Phase 1 of the process should also include GGS entities. This would align the General Government Sector reports with those produced by General Government Sector entities.

The AASB plans to initially progress the project substantially out of session leveraging off the work being undertaken by the Working Group. The AASB will use a Project Advisory Panel to identify additional issues and will continue liaison with the ABS on better aligning the two methodologies. The AASB will also monitor international activities including the work of IFAC-PSC. The AASB plans to issue the draft Exposure Draft in March-April 2004 with the finalised Standard issued in May 2004.

#### **Incorporated entities controlled by the public sector**

If revised public sector specific standards include specific requirements that are applied to all entities controlled by the entity concerned, competing enterprises may be subject to different recognition or measurement rules. However, if such requirements are not included, the parent entity will need to consolidate information that may be prepared on two different bases.<sup>3</sup>

- Consideration needs to be given as to whether there are problems in relation to different reporting requirements.

More likely will be the situation where an entity within the GGS has corporate subsidiaries that will be consolidated into its financial reports.

- Consideration needs to be given as to whether this raises any complications.

#### **1. b) Practical**

Under the approach proposed by the AASB, incorporating the views of this Working Group, the converged standard will apply initially at the:

- consolidated (whole of government) level
- sector level (eg general government sector); and
- agency level.

The following sectors/entities will be considered in the second phase of the convergence project:

- other public sector entities (eg universities); and
- local governments and local government entities.

Some of these are interrelated in respect of reporting hierarchies.

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<sup>2</sup> GAAP/GFS Convergence: Implementing the FRC strategic direction.

<sup>3</sup> While AAS 24 paragraph 49 provides for adjustments to be made on consolidation of controlled entities with dissimilar accounting policies not required by another accounting standard, practical difficulties remain in the context of GFS/GAAP convergence. For example, under the choice available in AASB 1041 most general government public sector entities measure non-current depreciable physical assets at fair value, but most private sector enterprises have adopted historical cost. Even where there is no direct competition, the GBE's management may see the different or additional requirements as an unnecessary or costly imposition.

### **Consolidated (whole of government) level**

This will be the minimum objective as outlined in the FRC's direction to the AASB, namely that whole-of-government reporting is converged. Ideally, the information to be consolidated will be generated by the individual agencies preparing their financial statements on the same basis (i.e. GG sector entities and GBEs should prepare their financial statements on the same basis). If the financial reports are not prepared on the same basis as the consolidated statements there may appear to be a lack of transparency when comparisons are made between the statements/reports. There is also the challenge of converting the information to meet a different set of requirements.

### **Sector level**

Within the public sector there are three sub-sectors: General Government Sector (GGS), Public Non-Financial Corporation (PNFC) sector and Public Financial Corporation (PFC) sector. These latter two sectors are alternately described as Government Business Enterprises (GBEs).

The GGS receives greater emphasis in government financial reporting, as it is the primary focus of budgets, budget updates and final budget outcomes. This is where governments spend the majority of their funds. The AASB has also given this sector priority with respect to addressing convergence.

### **Agency level**

The AASB has indicated that GGS entities will be considered as part of Phase 2. However, it is the view of some members of the Working Group that this should be incorporated into Phase 1 of the implementation process. The information they collate and present should be in the same format as the consolidated position. However, agencies that are parent entities may need to convert financial information received from subsidiaries that are corporations under the Corporations Law (which are required to report in accordance with different reporting requirements).

***The following entities and sectors are to be considered in Phase 2 of the Convergence Project because of additional issues specific to each group.***

### **Government Business Enterprises (GBEs)**

Governments may have numerous business enterprises that operate with varying degrees of autonomy and commercial focus. Some of these entities will be incorporated so that they are subject to Corporations Law requirements. Some incorporated entities will have 'parent' entities within the GGS (government departments, agencies or statutory authorities). For example, the Commonwealth controls 10 GBEs that are companies incorporated under the Corporations Law.

### **Other Public Sector Entities**

There exist a number of organizations like universities and other quasi government entities that are not controlled by governments. These entities report under accounting standards applicable to private and not-for-profit entities and their data is included within the National Accounts.

### **Local Government**

All levels of government within Australia should have their financial reports presented on the same basis. Local government is likely to have many of the same issues as the other tiers of government. However, it is also probable that they will have unique issues of their own which are not known to the Working Group.

## Conclusion

The Working Group supports the phased approach suggested by the AASB as the best means of achieving convergence at the Whole of Government and GGS within the shortest possible timeframe, so long as Phase 1 includes entities making up the GGS.

## **2. Timing of Convergence**

The technical differences between GAAP and GFS are resolved in the main by the application of the IAS and the adopting of the proposed performance reporting standard. Accordingly, the timing of convergence is influenced by a number of complex and inter-related factors, which can be summarised as:

- The Commonwealth Government endorsed a series of recommendations resulting from the Budget Estimates and Frameworks Review. One of the key recommendations was convergence of GFS and GAAP by 1 July 2004.
- From 1 January 2005, the Australian Accounting Standards applicable to incorporated reporting entities will effectively mirror those issued by the International Accounting Standards Board (IASB). These entities are required to apply the standards for reporting periods beginning on or after 1 January 2005, in effect the initial reporting period will 2005-06. By 31 March 2004, the IASB and AASB plan to have issued all new and revised standards for application from 1 January 2005.
- Unless provision is made for government sector early adoption, these treatments will not be available until the reporting year commencing 1 July 2005.
- In addition to its review of existing standards, the IASB is also working on a Performance Reporting Project, which will change the way all entities report the Statement of Financial Performance. This change is central to long term convergence between GFS and GAAP. The Project aims to develop a Statement of Financial Performance that distinguishes between items that are recognised in the “profit before re-measurements” column and items that are recognised in the “re-measurements”<sup>4</sup> column.
  - There is some uncertainty as to the date from which the Performance Reporting Standard will take effect. It is unlikely to be applicable before 2006 (although its outcomes might be available for early adoption by 1 July 2005).
- The AASB is currently reviewing AAS 27, 29 and 31. This review is expected to be completed by the end of 2003.

### **Conclusion regarding timing**

If GAAP-GFS convergence is to be achieved prior to the adoption of the proposed performance reporting standard and other IASB standards, likely implementation reporting periods commencing on or after 1 January 2005 (eg. the 2005-06 reporting year), an interim vehicle for convergence will be required.

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<sup>4</sup>“Re-measurements” are revisions of prices or estimates that change the carrying amounts of assets or liabilities. “Re-measurements” result from revised expectations of future economic benefits or obligations. They do not include income/expenses that give rise to the initial recognition of assets or liabilities, expenses arising from consumption of assets during the period, and interest income and expense.

The interim vehicle for convergence (see discussion below) will, by necessity, be based on assumptions about the final contents of the performance reporting standard. Given the impact this standard is likely to have on for-profit entities, there is considerable scope for change between what is currently proposed in the standard and its final format. This in turn would be reflected in changes required to the convergence standard.

### **3. *Vehicle for convergence***

This section explores various methods for achieving convergence between Australian accounting standards and Australian GFS on a timely basis. The discussion that follows assumes that, in the longer term, many of the technical/measurement issues will be resolved by adoption of both Australian IFRS and IAS<sup>5</sup> as well as movements by SNA/GFS.

The attachment summarises the technical differences and assesses the extent to which each difference would be resolved by adoption of IFRS/IAS. This analysis confirms that the sector neutral standards will resolve many, but not all, of the GFS/GAAP differences. Also, the AASB's adoption of IAS/IFRS standards will not formally be available until 2005 (or later, in the case of performance reporting). As explained above, this confirms the need to use additional, specific convergence vehicle(s), which would need to include specific provisions to cater for the differences and residual issues as well as pro forma converged financial statements.

The likely residual issues<sup>6</sup> are:

- Extra disclosures to enable internationally compatible GFS (eg IMF GFS) to be derived where required (eg reduced net worth and dividends paid);
- Calculation and presentation of fiscal balance (net borrowing/lending) in the context of operations and underlying cash in the cash flow statement;
- The extent to which general government sector reports can be treated as GPFR;
- Re-measurements that are defined differently than in GFS; and
- Performance reporting format.

Listed below are six options for consideration:

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<sup>5</sup> In this case early adoption refers to the IFRS concepts as adopted in Australian accounting standards, which would not normally be effective until periods beginning on or after 1 January 2005. We note that such partial adoption would probably require the AASB granting an exemption from the IASB's 'all or nothing' adoption principle.

<sup>6</sup> The Working Group notes that this list may not be exhaustive, due to the extent of change in accounting standards in 2004 and 2005 both domestically and internationally. The items in this list are definitely residual, being unlikely to be resolved in any other way. However, there may be a number of technical differences that require specific provisions for public sector treatments in accounting standards. Readers may wish to refer to the Technical Differences Overview for additional information.

Option 1. Develop a special purpose, industry specific standard: This would be a new standard whose sole purpose would be to require specific government sector entities to prepare financial statements that concurrently complied with both Australian GFS and accounting standards (with some specific guidance regarding resolution of the residual issues above).

Pros	Cons
<ul style="list-style-type: none"> <li>• Simple solution</li> </ul>	<ul style="list-style-type: none"> <li>• Contrary to AASB ‘single sector neutral’ objective</li> <li>• Potentially duplicates requirements of AAS 29 and 31</li> </ul>

Option 2. Modify existing industry specific standards: In the context of the AAS 27, AAS 29 and AAS 31 reviews, include clauses addressing residual items so that financial statements could be prepared that concurrently comply with both frameworks.

Pros	Cons
<ul style="list-style-type: none"> <li>• Does not proliferate industry specific standards</li> <li>• Minimises additional work associated with drafting of standard(s)</li> </ul>	<ul style="list-style-type: none"> <li>• May delay current work on these standards or will result in re-opening them within a year of current revisions</li> </ul>

Option 3. Include appropriate government sector specific provisions in each relevant Australian accounting standard: Provide for additional disclosure or otherwise<sup>7</sup> as needed to permit this sector to present financial information on a converged basis.

Pros	Cons
<ul style="list-style-type: none"> <li>• Permits consideration of each issue separately, in context of similar reporting issues for other non-profit and private sector entities</li> </ul>	<ul style="list-style-type: none"> <li>• Piecemeal approach increases risk that some differences will slip through and continue to create confusion</li> <li>• Complex</li> </ul>

Option 4. Seek a UIG determination on government reporting in the interim (eg until convergence achieved).

Pros	Cons
<ul style="list-style-type: none"> <li>• Quick resolution</li> </ul>	<ul style="list-style-type: none"> <li>• Too complex due to number of issues involved</li> <li>• Likely to be beyond the powers of the UIG</li> </ul>

Option 5. Adopt GFS as the sole reporting basis for governments for a limited period of time.

Pros	Cons
<ul style="list-style-type: none"> <li>• Facilitates provision of information to the ABS</li> <li>• Satisfies the needs of many users</li> <li>• Status quo for jurisdictions that currently focus principally on GFS basis reports</li> </ul>	<ul style="list-style-type: none"> <li>• Conflicts with convergence objective</li> <li>• Doesn’t meet the needs of all users</li> <li>• Difficult for jurisdictions that have adopted GAAP as their primary reporting basis</li> </ul>

<sup>7</sup> In a number of instances such provisions may provide for specific treatments, or limit available treatments, applicable to the government sector.

### Option 6. Adopt GAAP with note disclosures for differences with GFS.

Pros	Cons
<ul style="list-style-type: none"><li>• Facilitates audit</li><li>• Will be treated as a GPFR</li><li>• Status quo for jurisdictions that currently focus principally on AAS basis reports</li></ul>	<ul style="list-style-type: none"><li>• Conflicts with convergence objective</li><li>• Doesn't meet the needs of a number of key user groups</li><li>• Difficult for jurisdictions that have adopted GFS as their primary reporting basis</li><li>• Jurisdictions would still have to prepare GFS basis information for submission to the ABS</li></ul>

### **Conclusion regarding vehicle for convergence**

To achieve convergence prior to the introduction of the performance reporting standard, the most likely short term solution is the modification of the existing industry specific standards (Option 2), possibly subject to a sunset clause, with inclusion of public sector specific provisions in each relevant Australian accounting standard (Option 3) as the optimal long term solution.

Related issues that require resolution include:

- The extent to which the government sector would be permitted to “early adopt” some of the AASB accounting standards that, in turn, adopt international accounting standards (rather than the whole suite of international standards)
  - First time application rules will become evident in July 2003
- Whether the government sector (or individual jurisdictions) will be able to early adopt the performance reporting standard or permitted to adapt the concepts of performance reporting in designing a converged operating statement; and
- Ensuring the vehicle adopted to facilitate long-term convergence facilitates adaptation to subsequent changes to either framework.

The Working Party also recommends that jurisdictions need to carefully review the timing of their budget and financial reporting processes to take account of:

- AASB adoption of IASB standards, which will be completed by mid 2004, but will not be effective until periods commencing on or after 1 January 2005
- GFS/GAAP convergence, which is likely to occur either on 1 July 2004 or 1 July 2005, depending the application date of the relevant Australian accounting standard(s); and
- The deferral of the IASB's performance reporting project, which is unlikely to be mandatory before 1 January 2006 (although it may be early adopted).

### **3. *Other transitional issues***

#### **• Impact on Fiscal Strategies**

A converged reporting framework will have an impact on key measures in the budget reporting framework, combining the measures contained within GFS and AAS. As a result, Governments may wish to review the key indicators selected within their jurisdiction for use within the Fiscal Strategy.

### *Conclusions*

Jurisdictions should review the presentation of headline measures and the impact on fiscal strategies/budget reporting framework in the light of the changes in presentation to the financial statements.

- **Changes to jurisdictions' financial management framework**

Each jurisdiction has reviewed their legislation to determine if any amendments are necessary to facilitate GFS/GAAP convergence. No necessary changes have been identified.

<b>Jurisdiction</b>	<b>Changes to financial management legislation to accommodate new standard</b>
ACT	No changes needed
Commonwealth	No changes needed
NSW	No changes needed
NT	No changes needed
QLD	No changes needed
SA	No changes needed
TAS	No changes needed
VIC	No changes needed but regulatory changes required if publication of a single sector (GG) isn't a GPFR
WA	No changes needed

Most jurisdictions will need to change their accounting policies by amending their Treasury Instructions, Finance Minister's Orders, etc. to facilitate GFS-GAAP compliance.

### *Conclusions*

Jurisdictions could start to move immediately on those matters within their control, ie aligning current accounting policies with the GFS and publishing Total Public Sector information and the Statement of Other Economic Flows.

- **Impact upon Ex-Ante Reporting**

The AASB has indicated that it does not intend to develop standards for budgetary reporting. However, the revised ex-post standard will need to provide Governments with the capacity to prepare financial statements with a focus on both the General Government Sector (to provide comparability with the Budget) and the Total Public Sector (in accordance with the reporting entity).

Ideally, the requirements of the standard should be known at the time of developing the budget to which the ex-post report will relate. Most jurisdictions release their Budgets in the April/May/June preceding the Budget year.

### *Conclusions*

If an implementation date of 1 July 2004 is adopted the final form of the standard will not be known when budgets are being developed. This may mean continuing

to prepare separate budget outcome and AAS 31 consolidated statements for another year.

- **Impact on Uniform Presentation Framework (UPF)**

The UPF establishes the reporting requirements for all jurisdictions for budgets, revised budget and outcomes reporting. The UPF is currently based on the GFS reporting framework. However with the implementation of the converged reporting framework, the UPF may need to be updated and based on the new framework.

The UPF currently does not require the production of Total Public Sector information and only requires PFC information for outcomes data. With the emphasis on consistency between budget and outcomes reporting, consideration could be given to inclusion of PFC budget estimates, and as a consequence Total Public Sector information within the UPF reporting requirements.

Summary of the Longer Term Resolution and Timing for Technical Issues<sup>8</sup>

ISSUE AND PROPOSED SOLUTION	EFFECTIVE TIMING <sup>9</sup>	IS ISSUE TOTALLY RESOLVED?
<i>Allowances for bad and doubtful debts</i> SNA 2006 Review	Early adopt 2004-05	Likely to partially resolve the difference depending on the definition adopted by SNA. There is likely to remain a classification difference as accountants would view the period allowance as an expense, but GFS would treat as an other economic flow.
<b>Borrowing costs</b> AASB ED 111	2005-06	100%-- <i>so long as</i> jurisdictions elect expensing treatment permitted under the standard.
<i>Defence weapons platforms</i> SNA 2006 Review	Early adopt 2004-05	100% solved.
<i>Foreign exchange gains and losses</i> Performance reporting	2006-07	Problem is solved for unrealised gains and losses, but realised losses may not be treated as re-measurements by accounting standards.
<i>Non-current, non-financial assets</i> IAS 16 Performance reporting	2005-06 and 2006-07	80+% the combination should result in revaluations being converged.
<i>Premiums and discounts on repurchased debt</i> IAS 39 Performance reporting	2005-06 2006-07	Portion of problem resolved is dependent on the definition of 're-measurement' adopted by the accounting standard setters.
<b>Prior period revisions</b> AASB adoption of IAS 8	2005-06	98%--some differences may still arise due to (a) different definitions of when a change in estimate is a prior period adjustment or (b) initial adoption provisions in new accounting standards.
<b>SGARAS</b> Performance reporting	2006-07	90+% as the principles for separating changes in market value from growth are similar.
<i>Superannuation – actuarial adjustments</i> Performance reporting	2006-07	90+%--on basis of current info about performance reporting. If information were available as to why adjustments arose, in principle GFS would prefer to back cast those portions of the adjustments that related to prior periods.
<i>Swaps and other derivatives</i> Performance reporting	2006-07	Problem is solved for items held at period end, but likely discrepancy for items disposed of during the period (eg on current information 'gain/loss on disposal' is unlikely to be re-valuation) for financial institutions only.

<sup>8</sup> Due to the Commonwealth's need for a converged framework from 1 July 2004, the degree to which the long term solutions can be early adopted will depend on whether or not the AASB chooses to permit the public sector to early adopt some of the proposed Australian equivalents of IAS standards. If not, then specific clauses would need to be included in AAS 31 and AAS 29 to permit selected GFS treatments as described elsewhere in these papers.

<sup>9</sup> Early adoption of SNA revisions is probable. Early adoption of AASB standards adopting IFRS/IAS poses some practical problems, but may be possible if the AASB requires early adoption of specific standards by the government sector. It may be possible to early adopt the AASB standard adopting the IASB performance reporting standard from sometime in late 2004.

## Attachment

ISSUE AND PROPOSED SOLUTION	EFFECTIVE TIMING	IS ISSUE TOTALLY RESOLVED?
<b>Valuation of issued debt securities</b> Proposed revisions to IAS 39 and adoption by AASB	2005-06	100% <i>so long as</i> jurisdictions elect to market value all issued debt securities.
<b>Assets recognised for the first time</b>		Irreconcilable difference that will be resolved by guidance in accounting standards.
<b>Distributions payable to owners</b>	Now	Irreconcilable difference addressed by requiring primary financial statement disclosures to comply with accounting standards and note disclosures to provide sufficient information to derive pure GFS numbers. Will also require disclosure of the departure from GFS in the accounting policy disclosures. ABS publications should also footnote the pure GFS numbers to increase transparency.
<b>Distributions receivable from controlled entities</b>	Now	100% resolved <i>so long as</i> jurisdictions are careful in declaring dividends out of revenues and retained profits and returns of capital from other funds.
<b>Extractive industries</b>	Now	Difficult to measure, so GFS accepts AGAAP amounts and uses estimates for its composite projections. Unlikely to be material in most jurisdictions.
<b>Income from investments in associates</b> Clause in AAS 27,29,31	2004-05	Likely to remain a difference. Convergence achieved by following GAAP on face of statements with adequate note disclosure to support derivation of GFS.
<b>Intangible asset amortisation</b> SNA Review	2005-06	As both SNA/GFS and accounting standards are currently considering this issue, watch developments and encourage convergence via the comments process.
<b>Investment properties</b> Performance reporting	2006-07	Difference created by adopting of IASB standards. Can be partially addressed by adoption of IPSAS definitions.
<b>Reduced net worth for controlled entities</b> Clause in AAS 27,29,31	2004-05	Irreconcilable difference addressed by requiring primary financial statement disclosures to comply with accounting standards and note disclosures to provide sufficient information to derive pure GFS numbers. Will also require disclosure of the departure from GFS in the accounting policy disclosures. ABS publications should also footnote the pure GFS numbers to increase transparency.



## HoTARAC GFS/GAAP CONVERGENCE WORKPLAN

The following high-level milestones are proposed:

HoTARAC Working Party investigates, develops issues, prepares papers, implementation work plan and reports to HoTARAC around conceptual, technical and logistical issues	April – June 2003
HoTARAC/HoTs endorse papers	June - August 2003
HoTARAC Working Party addresses any revisions, lagging issues, and submissions to the ABS for the SNA Review	July – December 2003
Papers submitted to AASB	August - September 2003
AASB Project Advisory Panel consideration of selected papers	September – December 2003
HoTARAC/HoTS considers any additional issues arising	October— December 2003
Papers submitted to the AASB	December 2003
AASB considers issues papers in context of PAP comments	January and February 2004
Cutoff for IASB standards applicable from 1 January 2005	March 2004
Exposure Draft Standard	March 2004
Invitation to Comment	April 2004
AASB considers any comments and endorses new standard	May 2004
Converged Accounting Standard <sup>1</sup>	1 July 2004
AASB standards adopt IASB standards	January 2005
IASB performance reporting standard applies	2006
IMF review of the SNA (papers likely to be considered as developed) [Australian GFS may early adopt proposed changes.]	2005-2006

It should be noted that the proposed timeframe for this project is extremely tight. Against a background of the AASB needing to devote significant resources to adoption of international

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<sup>1</sup> Due to the number of treatment changes required by adoption of international accounting standards, unless specific exemption is provided for public sector early adoption of a prescribed list, it may be appropriate to permit early adoption of the converged GFS/GAAP standard for years beginning 1/7/4 and to require its application from 1/7/5.

accounting standards by January 2005, its ability to deliver on GFS/GAAP convergence may be limited. The Board will need to consider carefully the convergence vehicle (a single standard giving effect to convergence versus a combination of adopted IFRS or changes to AAS 27, 29 and 31).

Consequently, the issue of an accounting standard(s) for a converged general government sector framework for application in 2004/05 may not eventuate.

As a result, jurisdictions will need to appreciate that in 2004-05 dual reporting (eg. the 'status quo' of separate GFS and GAAP reports) may continue.

#### Work accomplished:

The HoTARAC Working Group considered Conceptual, Technical and Logistical issues that relate to and/or arise from convergence between GFS and GAAP. Where additional information would assist with achieving convergence, technical papers have been prepared. Those papers have been reviewed and revised by the Working Group members.

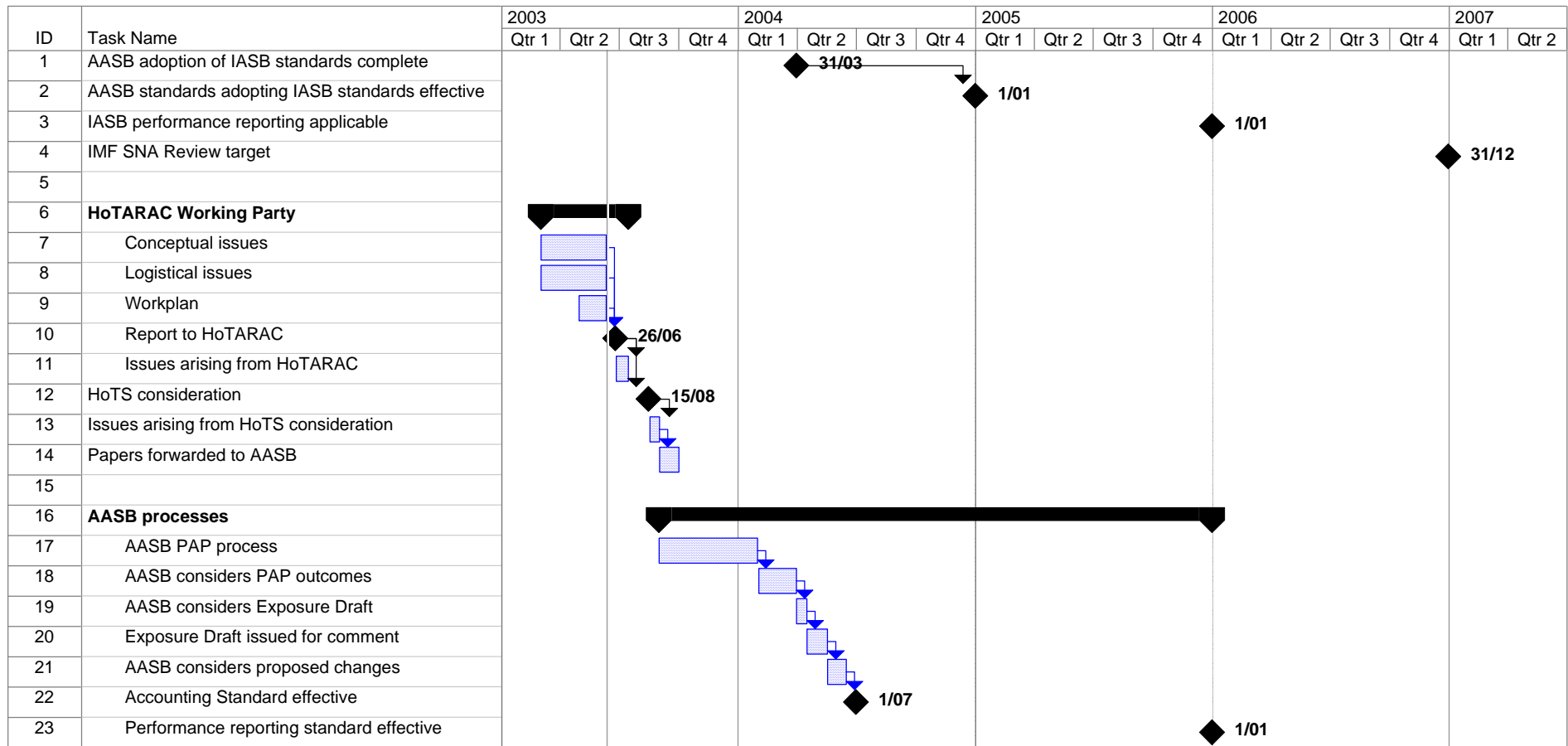
The HoTARAC Working Group also prepared this summary workplan, which provides both a summary of the issues it addressed, but also sets out the timeframe being adopted by all the active stakeholders in the convergence process.

#### Residual issues remaining:

The Attachment to the Users and Uses paper is still under development. Working Group members are visiting representatives from key user groups. Providing a reasonably extensive list of preliminary consultations will facilitate the AASB's PAP process.

The HoTARAC Working Group is not aware of any other residual issues that could be addressed at the current time. However, members expressed willingness to assist with future emerging issues, include assisting with drafting, should such assistance be desired by HoTARAC, HoTS or the AASB.

## DETAILED TIMELINE FOR GFS/GAAP CONVERGENCE





## ISSUE 1.1: REVISIONS RELATING TO PRIOR PERIODS

### *Summary of differences*

**Accounting** – Prior period adjustments arising during a period are normally treated as revenue or expenses of that period. Financial statements for a prior period can only be revised where the revised financial statements are re-issued in full.

**GFS** – In GFS and the *System of National Accounts (SNA) 1993*, there is considerable emphasis on recording transactions and other flows at the time the economic value is created, transformed, exchanged transferred or extinguished on a consistent quarterly or annual time-series basis, stretching over 40 years at times. Therefore, any significant changes caused by revised data, new sources, new methodology, etc. that affect prior period statistics are applied to each relevant past period. In practice, prior period adjustments are effectively treated as other economic flows where only current and one comparable year are published.

### *Accounting treatment*

Under existing Australian Accounting Standards once a reporting period is closed there is no provision for ‘reopening’ the reports of that period. In most cases, the effect of a prior period event is recognised as either revenue or expense in the reporting period during which the item was first discovered. Where a standard or UIG consensus permits, an adjustment is made in the current period against opening retained earnings to exclude the effect of a prior period event from the revenues and expenses recognised in net profit in the current reporting period. There is provision in the accounting standards to amend and reissue financial reports relating to a prior reporting period.

“An error made in a prior reporting period may be corrected by amending and reissuing the financial report relating to the preceding reporting period.”<sup>1</sup>

Where the error has a material effect on the overall financial statements of prior reporting periods as well as individual assets, liabilities or items of equity, the financial reports containing the error are no longer considered to be reliable as at the date they were issued. These errors are referred to as fundamental errors.

Where a fundamental error is discovered and the financial report has not been reissued, the error must be disclosed on the face of the statement of financial performance as a separate line item in the section of the statement of financial performance in which the error was recognised.”<sup>2</sup>

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<sup>1</sup>AASB 1018 “Statement of Financial Performance” paragraph 7.2 and AAS 36 “Statement of Financial Position” paragraph 6.2.

<sup>2</sup> AASB 1018 paragraph 7.3.

The correction of a fundamental error is required to be recognised in the financial report in the reporting period in which it is discovered, unless the financial report relating to the preceding reporting period was amended and reissued.<sup>3</sup> Further, the comparative information must not be restated on the face of the financial position or the statement of cash flows for the fundamental error.<sup>4</sup>

There are some cases which, at first sight, appear to be prior period events but which, on further analysis, are not. For example, a revision of accounting estimates only arises because of a current period revision of a previously made estimate. Accounting standards do not treat revisions of accounting estimates as prior period adjustments.

“The effect of a revision of an accounting estimate must be recognised as a revenue or an expense in the statement of financial performance in the reporting period in which the accounting estimate is revised, if the revision affects that reporting period only, or in the reporting period of the revision and future reporting periods, if the revision affects both the current and future reporting periods. Accounting estimates recognised in reporting periods must not be revised with retrospective effect to prior reporting period financial statements.”<sup>5</sup>

Where it is difficult to distinguish between a change in an accounting policy and a revision of an accounting estimate, the accounting standards require the transaction to be treated as a revision of an accounting estimate.

“The effect of a revision of an accounting estimate must be included in the same category within the statement of financial performance as was used for the estimate in the equivalent preceding reporting period or reporting periods. To ensure the comparability of financial reports for different reporting periods, the effect of a revision of an accounting estimate for an estimate that was previously included in profit or loss/result from ordinary activities is included in that section of the statement of financial performance for the current reporting period. Similarly the effect of a revision of an accounting estimate of an extraordinary item is reported as an extraordinary item.”<sup>6</sup>

It should also be noted that the accounting standards *require the statement of financial position and the profit and loss or other operating statement must be prepared on the basis of conditions existing at reporting date.*<sup>7</sup>

AAS 8 “Events occurring after Reporting Date” describes the events occurring after reporting date and prior to completion of the financial report that must be reflected in the financial report.<sup>8</sup>

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<sup>3</sup>AAS 36 paragraph 6.3.1

<sup>4</sup>AASB 1018 paragraph 7.4 and AAS 36 paragraph 6.3.

<sup>5</sup>AASB 1018 paragraph 6.1 and AAS 36 paragraph 6.2.2

<sup>6</sup>AASB 1018 paragraphs 6.2 to 6.2.1.

<sup>7</sup>AAS 8 “Events occurring after Reporting Date” paragraph 4.1.

<sup>8</sup>AAS 8 paragraph 4.2

The approach adopted in Australian standards can be explained by the standard-setters' concern about the potential for manipulating results and income smoothing. If retrospective adjustments to accumulated results are made, these adjustments would effectively by-pass the operating statement and could result in financial report users not being able to adequately scrutinise the adjustments.

The emphasis on removing the potential for manipulation of results under Australian accounting standards is particularly important because of the view underlying the AASB's approach that financial report users focus on the current period results. Australian standards place more weight on the current and comparative previous period results than a time series of results. They also attempt to provide sufficient information in the notes to enable a user to make informed decisions.

### International accounting standards

Under International Accounting Standard (IAS) 8 "Net Profit or Loss for the Period, Fundamental Errors and Changes in Accounting Policies", the benchmark treatment of fundamental errors and voluntary changes in accounting policies is to adjust opening retained profits and restate the comparative information. Recording the adjustments in the current period's results is an allowed alternative treatment. However it should be noted that the IASB's improvement process proposes to remove the alternative treatment. Australian standards agree with the allowed alternative treatment but not the benchmark treatment which requires prior periods to be restated unless impracticable.<sup>9</sup>

The treatment of revisions to accounting estimates under IAS 8 is the same as under Australian standards.<sup>10</sup>

It should be pointed out that the International Accounting Standards Board (IASB) improvements project proposes to remove extraordinary items from GAAP. The draft changes propose that voluntary changes in accounting policy should be treated retrospectively. The IASB concluded that this was preferable to a cumulative adjustment in the year of change because the profit or loss for the period does not include effects of changes in accounting policies relating to prior periods and the comparative information is presented on the same basis as the current period.

IAS 10 "Events After the Balance Sheet Date" requires the financial report to be adjusted for certain events *that occur between the balance sheet date and the date when the financial statements are authorised for issue* that reflect conditions that existed at balance sheet date<sup>11</sup>. This matches the reporting requirements of AAS 8 "Events occurring after Reporting Date"

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<sup>9</sup> IAS 8 Net Profit or Loss for the Period, Fundamental Errors and Changes in Accounting Policies paragraph 34

<sup>10</sup> IAS 8 paragraphs 23 to 30

<sup>11</sup> IAS 10 paragraph 2

## *GFS treatment*

In GFS, flows are recorded at the time the economic value is *created, transformed, exchanged, transferred or extinguished*<sup>12</sup> (eg. the effects of the economic events are recorded in the period in which they occur). Therefore, revisions affecting prior-period information are applied to each relevant past period to maintain the time-series continuity. In this sense, the published information is not 'locked-in' after initial publication.

Where 'revisions' of past information are identified in accounting reports under descriptions such as extraordinary or prior-period items, they are re-allocated as far as possible to their appropriate back-periods for GFS purposes. Thus an entity's payment of back-pay following a court ruling for example would be re-allocated to all relevant quarterly/annual periods as GFS expenses even though the financial statements of the entity would treat the totality of the back-pay as an expense of the period to which the statement relates.

The GFS approach to prior period adjustments reflects the notion that the result for a reporting period should reflect the entity's economic activity in that reporting period. Results that include revenues and expenses relating to prior periods would conceal the true and actual results from ordinary operations for that period and limit the utility of inter-period and inter-entity comparisons. The emphasis on time series data under GFS provides an indication of the importance placed by the Australian Bureau of Statistics in ensuring the comparability and continuity of the results times series used to facilitate planning and policy-making.

As a consequence, GFS requires items relating to prior periods to be allocated to the prior reporting periods to which they relate if they are material in the prior periods. That is, the GFS approach opens the prior period results and restates them fully. For reasons of transparency, Commonwealth Finance favours the disclosure of actuarial adjustments in the Statement of Other Economic Flows rather than back casting "offline" and adjusting opening net worth.

The approach adopted under GFS requires the accounts of entities to remain open at the end of the reporting period. This is distinctly different from the accounting period principle where entities "close their books" at the end of a reporting period, and prepare financial statements based on the account balances as at a reporting date.

### *When will differences between AAS and GFS arise?*

1. *Revision of accounting estimates* – Under Australian accounting standards, an adjustment resulting from a revision of an accounting estimate must be due to changes occurring in the current period (such as new information) and cannot be classified as a prior period item (unless classified as an error).

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<sup>12</sup> GFS Manual paragraph 3.4

In contrast to Australian accounting standards, GFS will make adjustments to prior period results for revenues or expenses arising from changes in bases or previously known information, but not for new information only available in the current period.

2. *Correction of errors* – Under AASB 1018 ‘Statement of Financial Performance’ (paragraph 7.1) an error made in a prior reporting period must be corrected in the reporting period in which the error is discovered. A revenue or an expense item is to be recognised in the statement of financial performance in that reporting period. This standard also prohibits restatements of comparative information on the face of the current financial statements. As an alternative, AASB 1018 (paragraph 7.2) allows prior period financial reports to be amended and reissued to rectify an error made in a prior period.

Under GFS, the effects of an error relating to prior periods are adjusted against the relevant prior period’s revenue and expenses. The effects of any prior period adjustments are absorbed into the opening net worth balance in the Balance Sheet and no separate disclosures are required in the current period.

3. *Voluntary change in accounting policy* – At present, accounting standards require an entity to recognise the effect of a voluntary change in accounting policy in the current reporting period and to restate comparative information in the notes (and not on the face). Where this is not practicable, the new accounting policy is applied from the beginning of the current financial year.

Under GFS, the effects of a voluntary change in accounting policy are adjusted against the relevant prior period results where the change impacts on the recording of economic transactions.

4. *Change in accounting policy due to the initial adoption of an Accounting Standard or UIG Consensus View* – Any resulting change in accounting policy must be accounted for in accordance with the specific transitional provisions in that accounting standard or UIG Consensus View. Initial adjustments may, for example, be taken to the current period’s Statement of Financial Performance or require an initial retrospective adjustment against opening retained profits (surplus), or accumulated losses (deficiency) (to occur at the beginning of the reporting period to which the Standard is first applied).

In the second scenario, where retained profits or accumulated losses are adjusted, it is not permitted to restate the comparative information provided in financial reports unless otherwise required in an accounting standard.

Under GFS, the effects of adopting a new accounting policy are adjusted against the relevant prior period results.

### *Standard setters' future work programs*

The IASB is currently reviewing IAS 8. They have issued an Exposure Draft that proposes that a change in accounting policy or correction of an error shall be applied retrospectively by re-stating the comparative amounts for prior periods. When the error occurred before the earliest prior period presented, the Exposure Draft would restate the opening balance of retained earnings for that period. The current alternative option will be removed.

The AASB plans to issue a new standard only once before 2005 after the improvements and short-term convergence stages. The AASB is most likely to reissue the "improved" IASB standard as an Australian standard in February /March 2004 without further due process (as long as the IASB does not make substantive amendments that are unsuitable for the Australian environment).

### *Steps to harmonisation*

Adoption of the proposed treatment in IAS 8 would result in apparent alignment between Australian accounting standards and GFS.

GFS and GAAP treatment is aligned where a change in estimate is based on new information and on correction of prior errors where financial reports are re-issued.

Changes in accounting policy due to the initial adoption of an Accounting Standard or UIG Consensus View are treated on a case-by-case basis and therefore may cause differences to remain.

### *Conclusion*

Based on the above analysis, the Working Group recommends the adoption of the GFS principle for 2004-05 and take prior period adjustments against net results as an interim arrangement. This will align with the proposed international treatment in IAS 8 and will substantially resolve this difference permanently. The two frameworks may perceive the timing of a change in estimate differently (accounting might view a change in accounting estimate as arising currently, but GFS could back-cast). Consequently IAS developments should be monitored to ensure convergence is achieved.

## ISSUE 1.2: BORROWING COSTS ON QUALIFYING ASSETS

### *Summary of differences*

The treatment of qualifying assets' borrowing costs under accounting standards impacts both whole-of-government and sector financial statements. The different treatment of borrowing costs (being expensing under GFS and capitalising under GAAP) is particularly apparent where one part of government arranges all financing transactions for the government as a whole. Where borrowing costs are capitalised, the impact continues throughout the life of the qualifying asset as the item is depreciated.

**Accounting** – Borrowing costs<sup>1</sup> attributable to the acquisition, construction or production of a qualifying asset<sup>2</sup> must be capitalised as part of the cost of the asset.

**GFS** - GFS treats “borrowing costs” as separate elements according to its nature, e.g. whether relating to interest or payments for services (service charges). As a result these costs are treated as expenses. This treatment is necessary as the components impact different ‘sub-accounts’ within the chart of accounts for the national accounts.

### *Accounting treatment*

AAS 34 “Borrowing Costs” requires borrowing costs to be capitalised when they are directly attributable to the acquisition, construction or production of a qualifying asset. These costs are to be determined as the borrowing costs that would have been avoided if the expenditure on the qualifying asset had not been made.

Borrowing costs must be recognised as an expense in the reporting period in which they are incurred, except to the extent that they are capitalised.<sup>3</sup>

### International accounting standards

While IAS 23 “Borrowing Costs” allows a choice, the benchmark requirement of IAS 23 and IPSAS 5 “Borrowing Costs” are for all borrowing costs to be treated as expenses in the periods they are incurred. The mandatory capitalisation requirement of the Australian standard is an “allowed alternative treatment” under the existing international standards.

### *GFS Treatment*

The term “borrowing costs” is not a classification item in SNA93 or GFS. The SNA splits borrowing costs into its constituent elements and treats each element separately.

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<sup>1</sup> Any interest, fees, and similar costs directly related to borrowing or finance charges on finance leases

<sup>2</sup> Any asset that takes a substantial period of time to ready for use or sale

<sup>3</sup> AAS34 *Borrowing Costs* – paragraph 4.1

Amounts that are explicitly described as interest (or are in the nature of interest) are treated as interest expenses.

### *Standard setters' future work program*

The AASB issued ED 111 adopting IAS 23, which allows a choice between the benchmark approach (expensing) and the allowed alternative treatment (capitalisation). The AASB's policy is to not allow choices. Consequently, it has expressed a clear preference for expensing.

### *Steps to harmonisation*

The effective adoption of IAS 23 in Australian accounting standards will provide for the benchmark treatment. Jurisdictions would need to adopt the expensing option as their accounting policy.

### *Conclusion*

The working group supports the adoption of the GFS practice of expensing as an short term measure for 2004-05 to achieve convergence in the treatment of borrowing costs on assets that take a substantial period of time to ready to use or sale. In the longer term, the adoption of ED 111 (IAS 23) will provide a permanent solution, provided jurisdictions choose to adopt the policy of expensing borrowing costs.

## ISSUE 2.1: GOVERNMENT DEFINED BENEFIT SUPERANNUATION SCHEMES: ACTUARIAL ADJUSTMENTS

### *Summary of differences*

Reporting of actuarial adjustments of an employer's liability differ between Generally Accepted Accounting Principles and GFS treatments.

**Accounting** - From a Generally Accepted Accounting Principles perspective, these adjustments are treated as either revenue or expense items in the Statement of Financial Performance.

**GFS** – Actuarial adjustments directly adjust net worth through the Statement of Other Economic Flows.

### *Accounting treatment*

Australia currently has no accounting standard addressing how employers should account for defined benefit superannuation plans.

Relying on general principles, recognised actuarial adjustments of the member benefits liability are treated as either a revenue or expense in the current accounting period (new information rather than errors in past periods). This adjustment is expensed in the entity's statement of financial performance in the current period and ensures that the financial statements are presented at fair value as at the reporting date.

### International accounting standards

IAS 19 "Employee Benefits" requires recognition of actuarial gains or losses of a superannuation plan as revenue or an expense by the employer. This will equate to a change in the superannuation liability where a plan is totally unfunded.

- Expected changes to the defined benefit obligation (net of expected returns on assets) are recognised immediately.
- At the option of the employer entity, recognition of unexpected changes in measurement of the *defined benefit* obligation (net of unexpected returns on assets) may be subject to a smoothing mechanism (frequently referred to as the "corridor").

“Actuarial gains and losses may result from increases or decreases in either the present value of a defined benefit obligation or the fair value of any related plan assets.<sup>1</sup>

In the long term, actuarial gains and losses may offset one another. Therefore, estimates of post-employment benefit obligations are best viewed as a range (or 'corridor') around the best estimate. An enterprise is permitted, but not required, to recognise actuarial gains and losses that fall within that range. This Standard requires an enterprise to

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<sup>1</sup> IAS 19 Employee Benefits paragraph 94

recognise, as a minimum, a specified portion of the actuarial gains and losses that fall outside a 'corridor' of plus or minus 10%. The Standard also permits systematic methods of faster recognition, provided that those methods satisfy the conditions ... Such permitted methods include, for example, immediate recognition of all actuarial gains and losses, both within and outside the 'corridor'. ....<sup>2</sup>

This option (corridor smoothing mechanism) is not permitted for *defined contribution* schemes, instead requiring the amount of any unpaid employer contributions to be recognised as a liability of the employer. [Note: It is questionable whether the corridor approach in IAS 19 is consistent with SAC 4 “Definition and Recognition of the Elements of Financial Statements”.] Also it is likely that the International Accounting Standards Board (IASB) will remove the option that permits smoothing.

### *GFS Treatment*

In GFS, the movement in the unfunded liability of government superannuation schemes resulting from actuarial adjustments of the value of the liability is treated as revaluations in the current period and revisions to transactions recorded for previous periods. However, in practice, except in exceptional circumstances, actuarial adjustments are disclosed in the Statement of Other Economic Flows rather than back casting “offline” and adjusting opening net worth.

In GFS, flows are recorded at the time the economic value is *created, transformed, exchanged, transferred or extinguished*<sup>3</sup>, i.e. the effects of the economic events are recorded in the period in which they occur.

### *Standard setters' future work programs*

The IASB is likely to address the differences in accounting for defined benefit plans between IAS 19 and the UK accounting standard FRS-17 “Retirement Benefits”. In broad terms, IAS 19 permits actuarial gains and losses that comprise part of the change in the net liabilities or net assets of a plan to be recognised as a revenue or an expense. FRS-17 requires the total actuarial change in the net liability or net asset of a plan to be recognised in the Statement of Total Recognised Gains and Losses.

The IASB has agreed to propose removing the “corridor approach” to actuarial gains and losses. The IASB’s Performance Reporting project is linked to IAS 19, in that the IASB has agreed not to issue one without the other. A version of IAS 19 revised to remove the option to use the “corridor approach” may be available by 2005 but the likely mandatory operative date will be 2006.

The AASB plans to issue two EDs on IAS 19 as follows:

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<sup>2</sup> IAS 19 paragraph 95

<sup>3</sup> GFS Manual paragraph 3.4.

- a) Per the AASB timetable, an ED is to be issued in August/September 2003 (although it may be issued earlier depending upon the IASB convergence project), based on the existing IAS 19. This ED will be operative for 2005.
- b) an ED is to be issued in the fourth quarter of 2003 and will be based on an improved IAS 19. This ED is targeted to be operative for 2006, and will seek comments mainly focused on proposed amendments to the standard to emerge from the ED described immediately above.

### *Steps to harmonisation*

The IASB are currently reviewing the IAS 19 treatment of actuarial adjustments. Proposed changes include recognition of the amount in the “re-measurements” column under the Performance Reporting project.

There is an opportunity for the AASB to influence the replacement method for corridor approach in IFRS. If this is implemented by the IASB, the AASB will adopt the international standard (as harmonisation with International Accounting Standards is currently one of the top priorities of the AASB).

If the IASB adopts a columnar approach to its statement of comprehensive income as a result of the Performance Reporting project, this is likely to assist with this convergence issue because the definition of re-measurements will include actuarial adjustments.

### *Conclusion*

Based on the above analysis, the main difference between the GAAP and GFS treatments of defined benefit superannuation schemes relates to the movements in the actuarial valuation of any unfunded liability. As a short term solution, the working group recommends that the GFS treatment be adopted for 2004-05 reporting along with a revised operating statement format based on the proposed Statement of Comprehensive Income under the Performance Reporting project.

In the longer term, the adoption of the IASB’s proposed Statement of Comprehensive Income is likely to result in these adjustments being treated as re-measurements.

The international accounting standard setters no longer view the corridor approach as appropriate accounting treatment. However, as it is an allowable option under existing standards, some jurisdictions currently use this method. When the IASB (and subsequently the AASB) address accounting for post-employment benefits, the current variations in treatment should be considered by the AASB. The developments in the Reporting Performance project need to be monitored to ensure that long-term convergence is achieved.



## **ISSUE 2.3: NON-CURRENT / NON-FINANCIAL ASSETS - REVALUATIONS AND PROFIT OR LOSS ON DISPOSAL**

### *Summary of differences*

Although there are differences in the reported operating results between the Australian Accounting Standards and Government Finance Statistics (GFS) frameworks the balance sheet impacts are aligned.

**Accounting** - AAS treat gains and losses on the disposal of assets as part of the operating result for the period. The gains or losses are determined as gross proceeds, less cost of sales less carrying amount of the asset. The AAS consider the history of an asset class as a group when taking up a revaluation.

Upward revaluations are taken to a specific reserve in equity (asset revaluation reserve), except where they reverse a previous downward revaluation that was treated as an expense. Downward revaluations are written down and treated as an expense during the period except to the extent they reverse a previous upward revaluation that has been recorded in the reserve.

**GFS** - In GFS, all assets and liabilities should be recorded at market value. However, as the GFS operating statement only includes economic transactions, all market movements, including revaluation amounts, are reported in the Statement of Other Economic Flows. As assets are recorded at market value, there is no gain or loss on disposal of assets. The net effect of the Statement of Other Economic Flows impacts directly on the Balance Sheet.

It should be noted that GFS specifically treats expenses related to asset disposal (e.g. agent's fees, transfer charges, etc) as being separate from either the gross proceeds or costs of the item sold. These expenses are recorded against specific expense types (e.g. brokerage fees, legal fees, prospectus costs, etc.). For example, the costs of selling Telstra shares are recorded as a GFS expense while the remaining profit on sale is recorded as an other economic flow.

### *Accounting treatment*

The accounting treatment of assets is conceptually based on assets being an investment to produce future economic benefit (eg. income streams in the private sector). When dealing with market movements for assets held, AAS manages assets as groups or classes, such as: Plant and Equipment; Land; Buildings; and Financial Assets. When valuing assets "...subsequent to initial recognition as assets, each class of non-current assets must be measured on either: (a) the cost basis; or (b) the fair value basis.

### Profit or loss on sale of assets

Under AASB 1041 “*Revaluation of Non-Current Assets*”, a net revaluation increment relating to class of assets must be credited directly to an assets revaluation reserve. Where that net revaluation increment reverses a net revaluation decrement previously recognised as an expense in the net result in respect of that class of assets, it must be recognised immediately as revenue in the net result.

A net decrement relating to a class of non-current assets must be recognised immediately as an expense in the net result. If there is a credit balance in the asset revaluation reserve in respect of that class of non-current assets, then the net revaluation decrement must be debited to the asset revaluation reserve.

AASB 1018 “*Statement of Financial Position*” requires the net gain or loss on the disposal of non-current assets, including property, plant and equipment, to be disclosed in the notes.

AAS 15 “*Revenue*” requires the gross proceeds on disposal of non-current assets to be included as revenue for the period and the carrying amount of the non-current asset to be included as an expense for the period.

ED 105 “*Statement of Financial Performance: amendments to AASB 1018/AAS1*” proposed that the net effect of disposing of property, plant and equipment must be included in reported revenues or expenses, with separate disclosure of the net amount either on the face of the operating statement or in the notes. This proposal is not included in the recently revised AASB 1018. The AASB will be considering the issue when it reviews the results of the IASB’s Performance Reporting project, with an AASB exposure draft due for release in late 2003.

#### Asset revaluations

AASB 1041 requires each class of non-current assets to be measured on either a cost or fair value basis (excluding financial assets of registered schemes, inventory, foreign currency and goodwill). From 1 July 2002, most jurisdictions are expected to use the fair value method for the majority of their assets (Victoria and Queensland, for example, use cost for some types of plant and equipment, the Commonwealth will have defence weapons and intangibles at cost). Both deprival and fair value are market basis valuation methods.

Upward revaluation of an asset will increase the asset revaluation reserve in the equity section of the balance sheet, to the extent it does not reverse a prior entry. This illustrates that there is an unrealised increase in the value of the assets that reflects fair value.

Downward revaluations - except to the extent they reverse a prior upward revaluation recorded in the asset revaluation reserve previously - are generally written down and treated as an expense during the period. Recoverable amount write-downs are treated as

expenses. These are recognised in the calculation of net profit or loss/result presented on the face of the Statement of Financial Performance, as they reflect a decline during the period of the value of the assets.

Accounting standards neither require revaluing non-current assets immediately prior to disposal nor prohibit an entity from doing so, provided that other assets within the class of asset are revalued at substantially the same date. The value of the asset group must not be materially different from fair value at the reporting date.

#### International accounting standards

IAS 16 “*Property Plant and Equipment*” is broadly similar to AASB 1041 “*Revaluation of Non-Current Assets*” for both disposals and revaluations (historical cost as the ‘benchmark treatment’ and fair value as the ‘allowed alternative’).

IFAC’s IPSAS 17 “*Property, Plant and Equipment*” also follows the above treatment with regard to the requirement for the recognition of revenue where a previous write-down of the same class of assets was recognised as an expense. Under paragraph 17, when the surplus is realised (e.g. assets retired, asset class disposed of or depreciated in use), the amount may be transferred directly to accumulated results.

Where items are recorded at cost, revaluations are not relevant. A write-down is required where the carrying amount is greater than the recoverable amount. All recoverable amount write-downs are expensed in the Statement of Operating Performance for the relevant period.

IAS 16 and IPSAS 17 differ in that IPSAS 17 requires revaluation increase and decreases to be accounted for on a class basis as opposed to the IAS 16 requirement for revaluation increases and decreases to be on an individual asset basis.

#### *GFS Treatment*

Under GFS, “...the value of an asset at any given time is its current market value, which is defined as the amount that would have to be paid to acquire the asset on the valuation date, taking into account its age, condition, and other relevant factors.” However, it should be noted that in practice ABS will accept the GAAP assets values that are not necessarily current market values. A holding gain or loss or changes in the quality and quantity of assets are recorded as other economic flows and do not impact on the Net Operating Balance.

Under GFS, the gain or loss that is typically recognised in business or commercial financial accounts on the disposal of an assets is regarded as a revaluation to the asset's selling price that takes place just before the disposal. Since the gain or loss is not a

“transaction”, it is excluded from the GFS Operating Statement. The revaluation that is recorded increases or decreases Net Worth. Asset impairments are treated by GFS in the same way. In essence, the GFS treatment decomposes the change in Net Worth into that due to transactions and that due to other flows.

### *Standard setters' future work programs*

#### Accounting

IAS 16 “*Property, Plant and Equipment*” was part of the IASB Improvements ED and the AASBs Invitation to Comment which were both issued in May 2002. The improved IAS 16 is scheduled to be reissued in quarter 2 of 2003. The AASB plans to issue an ED likely to focus on public sector or not-for-profit issues in quarter 3 of 2003 with a revised standard for quarter 1 of 2004.

In 2002, the IASB requested the Canadian Accounting Standards Board (CASB) undertake a research project on measurement objectives for recognised assets and liabilities. As noted at the March 2002 IASB meeting, this work continues, with the second stage of the project to focus on objectives for re-measurement of assets and liabilities.

### *Steps to harmonisation*

The current IASB Project on Performance Reporting may present an opportunity for convergence in relation to valuations. The proposed Statement of Comprehensive Income (SCI) will allocate components of reported performance between two columns: “profit before re-measurements” and “re-measurements”. At this stage of the project, the IASB has decided that for the most part, changes in the fair value of non-current assets are to be reported as re-measurements in the proposed SCI. The project generally focuses on issues of presentation.

GFS treats any changes in fair value as revaluations (or holding gains or losses) and would report these in the Statement of Economic Flows (SOEF), which is considered conceptually similar to reporting these changes in the re-measurement column of the proposed SCI.

Reliance on the proposed CASB re-measurement standard, in respect to the treatment of revaluations, will depend on the definitions adopted for revenue as opposed to realised gain or loss. This would mean that the treatment of the profit or loss on sale of assets would no longer be a harmonisation issue. Requiring a revaluation to fair value of single assets immediately prior to disposal would markedly increase compliance workloads.

### *Conclusion*

The differences relating to asset disposals can be eliminated. In the shorter term, the most promising avenues would be for the AASB to adopt a similar treatment to GFS that allows all revaluation increments and decrements to be treated as revenues and expenses, so that they could be included on the face of the operating statement (but shown separately from GFS revenues and expenses) as revaluation increments and decrements which are conceptually revenues and expenses.

In the longer term, the adoption in Australia of a comprehensive operating statement (as a result of international accounting standards) would assist with resolution of harmonisation issues related to asset revaluations. That is, the revaluations will be disclosed in the operating statement as re-measurements.

The ongoing development of an international standards relating to the revaluation of assets will need to be monitored to ensure that the issue of grouping of assets as opposed tracking individual assets changes to ensure that no convergence issues will result.



## ISSUE 2.4: SELF-GENERATING AND REGENERATING ASSETS

### *Summary of differences*

**Accounting** – Under AAS 35 “Self-Generating and Regenerating Assets” changes in the net market value of self-generating and regenerating (ie non-human living) assets primarily held for commercial purposes are revenues/expenses of the period during which they occur<sup>1</sup>. The non-living produce of Self-Generating and Regenerating Assets (SGARAs) (eg felled timber) is classified as an inventory<sup>2</sup>. Where assets are measured at net market value, the recoverable amount test does not apply<sup>3</sup>.

**GFS** –Items for one time use (cattle raised for slaughter and trees for timber) are classified as inventory<sup>4</sup>. Valuation of cultivated assets is at net market value for similar items of a given age (usually animals). If not available (usually for plants), then written down replacement cost may be used instead<sup>5</sup>. The natural growth in tangible, non-produced assets, such as forests and fish stocks, is recorded as other economic flows<sup>6</sup>.

### *Accounting treatment*

The sale of the SGARA primarily held for commercial purposes or extracting non-living produce from the SGARA and selling that produce is typically revenue. The requirements of the accounting standards to recognise increases or decreases in the net market values as revenues or expenses means that there are no gains or losses on disposal of SGARAs. Therefore proceeds from the sale of SGARAs are not recognised as revenues.

“Any increments or decrements in the net market values of SGARAs must be recognised as revenues or expenses in the profit and loss or other operating statement for the reporting period in which the increments or decrements occur.”<sup>7</sup>

“Any difference between the net market value of non-living produce extracted from SGARAs and the costs of extraction, as at the date of extraction, must be recognised as revenues or expenses in the profit and loss or other operating statement for the reporting period in which the non-living produce is extracted.”<sup>8</sup>

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<sup>1</sup> AAS 35 “Self-Generating and Regenerating Assets” paragraph 5.4

<sup>2</sup> AAS 35 paragraph 5.6

<sup>3</sup> AAS10 “Recoverable Amount of Non-Current Assets” paragraph 2.2

<sup>4</sup> IMF GFS Manual paragraph 7.48

<sup>5</sup> IMF GFS Manual paragraph 7.50

<sup>6</sup> IMF GFS Manual paragraph 10.40

<sup>7</sup> AAS 35 paragraph 5.4.

<sup>8</sup> AAS 35 paragraph 5.5.

## International accounting standards

The equivalent international standard on Self-Generating and Regenerating Assets is IAS 41 on Agriculture. It deals with the valuation of biological assets and agricultural produce. It requires the disclosure of the aggregate gain or loss arising on initial recognition of biological assets and agricultural produce and from the change in fair value less estimated point-of-sale costs of biological assets.<sup>9</sup> IAS 41 encourages but does not require separation of the fair value less estimated point-of-sale values into either physical changes or price changes.<sup>10</sup>

It should be noted that IAS 41 is narrower than the scope of AAS35, in that IAS 41 excludes from its scope:

- non-human living animals and plants that are not agricultural activities, such as an investment in a forest as a carbon sink giving rise to carbon credits that can be sold or used to offset pollution caused by the entity; and
- non-human living assets other than animals and plants, such as viruses and blood cells.

Such assets would be measured at net market value under AAS 35, but at cost or other value under relevant IASB GAAP.

## *GFS treatment*

The GFS Manual discusses “cultivated” assets as part of fixed assets. Cultivated assets are the GFS equivalent of SGARAs under GAAP. However, there are some differences to this.

“Cultivated assets consist of animals and plants that are used repeatedly or continuously for more than one year to produce other goods or services. Animals and plants for one-time use, such as animals raised for slaughter and trees grown for timber, are classified as inventories rather than fixed assets.”<sup>11</sup>

“Only animals and plants cultivated under the direct control, responsibility, and management of general government units are cultivated assets or inventories. All other animals and plants either are classified as non-produced assets or are not economic assets.”<sup>12</sup>

Increases and decreases in the net market value of such assets arising from the natural increase (self generation or regeneration) in these assets are treated as other economic flows, not revenue or expenses.

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<sup>9</sup> IAS 41 “Agriculture” paragraph 40

<sup>10</sup> IAS 41 paragraph 51

<sup>11</sup> GFS Manual paragraph 7.48

<sup>12</sup> GFS Manual paragraph 7.49

“Many tangible non-produced assets, such as forests and fish stocks, will increase in volume on their own accord. Although these resources are economic assets, growth of this kind is not under the direct control, responsibility and management of a [government] unit. Accordingly the increase in the value of the assets is treated as an other volume change rather than a result of productive activity.”<sup>13</sup>

### *When will differences between AAS and GFS arise?*

Movements in the net market value of SGARAs are recognised as revenue and expenses under GAAP. Such movements are treated under GFS in the same way as other asset revaluations (ie recognised in the Statement of Other Economic Flows).

### *Standard setters’ future work programs*

The proposed Statement of Comprehensive Income under the IASB’s Reporting Performance project allocates components of reported performance between the “profit before re-measurements” and “re-measurements” columns. Based on present IAS 41, where separation of the fair value less estimated point-of-sale values is done, physical changes would be recognised in the “profit before re-measurements” column whilst price changes would be recognised in the “re-measurements” column. It is possible that, where separation of the fair value less estimated point-of-sale values is not done, the IASB’s Reporting Performance project will require the total fair value change to be recognised in either column depending on whether physical or price changes contributed the most to the total change in fair value.

### *Steps to harmonisation*

The adoption of the proposed Statement of Comprehensive Income under GAAP may lead to resolution of this issue where the movement in net asset valuation is separated from operating activities.

Another avenue may be restructuring the operating statement to include revaluation/’other economic flows’, such as market movements in the value of SGARAs, separately from non-revaluation revenues and expenses.

### *Conclusion*

Australian GAAP treats changes in net market value as revenues/(expenses) in the period during which they are recognised. GFS treatment separates movements into natural growth (impacts operating statement through change in inventory) and price movements (other economic flows). In the short term adopting the GFS treatment for 2004-05 of distinguishing movements in the value of SGARAs (separated between growth and price changes) with a revised operating statement format based on the proposed Statement of Comprehensive Income under the Reporting Performance project.

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<sup>13</sup> GFS Manual paragraph 10.40

Longer term the adoption of the proposed Statement of Comprehensive Income under the Reporting Performance project is likely to result in these treatments being treated as re-measurements. The developments in the Reporting Performance project need to be monitored to ensure that long-term convergence is achieved.

## ISSUE 2.6: INITIAL RECOGNITION OF ASSETS

### *Summary of differences*

**Accounting** – Under AGAAP<sup>1</sup>, recognition of assets for the first time is generally recorded as revenues, regardless of the genesis of the assets.

**GFS** - The effects of recognizing assets for the first time, other than as a result of transactions or the production process, are recorded as other economic flows in GFS.

### *Accounting treatment*

#### Australian GAAP

Assets are recognised upon the identification of probable future economic benefits, controlled by an entity as a result of past transactions or events, that possess a cost or other value that can be reliably measured<sup>2</sup>.

Revenues are enhancements of future economic benefits, other than resulting from transactions with owners as owners<sup>3</sup>. An inflow of economic benefits can result from a transaction or otherwise. An example of the latter is a downwards revaluation of a employee superannuation liability as a result of an actuarial revaluation. Consequently, where an item meets the asset definition and recognition criteria for the first time, it should be recognised as an asset in the financial statements of the controlling entity.

In some cases, however, AGAAP may require the revenue resulting from the initial recognition of an asset to be credited directly to equity, eg where it arises from the first time application of an Accounting Standard.

First time recognition as a result of an error made in a previous period is outside the scope of this paper (cf Issue 1.1 *Revisions Relating to Prior Periods*).

#### International GAAP

The IASB *Framework for the Preparation and Presentation of Financial Statements* and IPSAS 1 *Presentation of Financial Statements* employ definitions of assets and revenues (referred to as income in the IASB framework) that are substantially the same as those of AGAAP.

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<sup>1</sup> Australian generally accepted accounting principles.

<sup>2</sup> SAC 4, paragraphs 14 and 38

<sup>3</sup> SAC 4, paragraphs 111

## *GFS Treatment*

For GFS, assets are those items over which general government sector units enforce ownership rights and from which they may derive economic benefits<sup>4</sup>.

Apart from transactions or the production process, new assets are recorded in GFS as a result of:

- items that were previously known to exist but acquire economic value for the first time as a result of a change in relative prices, technology or some other factor<sup>5</sup>;
- government units may create an economic asset by exerting ownership rights over a naturally occurring asset, such as the electromagnetic spectrum or fishstocks in exclusive economic zones<sup>6</sup>;
- discovery of new resources, such as subsoil resources<sup>7</sup>; and
- seizure of assets without equivalent compensation<sup>8</sup>.

All the above are recorded as other economic flows in GFS.

## *Standard setters' future work program*

The IASB Income Statement (Reporting Performance) project is proceeding on the basis that remeasurements should be separately identified on the face of the operating statement. The current IASB project summary includes the following definition of remeasurements:

Re-measurements are revisions of prices or estimates that change the carrying amounts of assets or liabilities. Re-measurements result from revised expectations of future economic benefits or obligations. Re-measurements do not include (in particular): income or expenses resulting from transactions or events of the period that give rise to the initial recognition of assets or liabilities; expenses arising from the consumption of assets during the period; and interest income and expenses<sup>9</sup>.

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<sup>4</sup> *GFS Manual 2001* paragraph 7.4.

<sup>5</sup> *GFS Manual 2001*, paragraph 10.30.

<sup>6</sup> *GFS Manual 2001*, paragraph 10.45.

<sup>7</sup> *GFS Manual 2001*, paragraph 10.48.

<sup>8</sup> *GFS Manual 2001*, paragraph 10.49.

<sup>9</sup> <http://www.iasb.org.uk/docs/projects/rfp-ps.pdf>

The above would suggest that first time recognition of assets would not be classified as a remeasurement under the outcomes of the IASB project.

There are no other current standard setters' projects that are likely to change the accounting treatment of first-time asset recognition.

### *Steps to harmonisation*

Treating first time recognition of assets as revenues would be a fundamental breach of GFS principles. It appears unlikely that the IASB Reporting Performance project will result in first time recognition of assets being treated as remeasurements. However, the IASB Reporting Performance project should be monitored until this becomes clear.

In the short-term, consideration could be given to separately reporting remeasurements on the face of the operating statements of government entities, adopting a definition of remeasurements for reporting by government entities that encompassed first time recognition of assets in line with GFS.

### *Conclusion*

There is a fundamental conceptual difference between GFS and AGAAP on this issue at the moment.

In the short term it would appear that the best prospect for the early resolution appears to be the separate reporting of remeasurements on the face of the operating statement, with a definition of remeasurements that harmonises with GFS treatments.

In the longer term, the adoption in Australia of a comprehensive operating statement (as a result of international accounting standards) would assist with resolution of harmonisation issues related to the initial recognition of assets for the first time. That is, the revaluations will be disclosed in the operating statement as re-measurements.

The ongoing development of an international standard relating to performance reporting will need to be monitored to ensure that no convergence issues will result.



## ISSUE 3: FINANCIAL INSTRUMENTS

### *Incorporating issues:*

- *Premiums and discounts on repurchased debt*
- *Swaps and other derivatives*
- *Valuation of debt securities*

### *Summary of Differences*

**Accounting** - there is no Australian accounting standard that deals specifically with the recognition and measurement of financial instruments. Australian standards only include requirements regarding the disclosure and presentation of financial instruments. Interest flows are recognized as revenues and/or expenses.

**GFS** - GFS prefers that all assets and liabilities be revalued at market values, and views realised and unrealised changes in value of derivatives and other financial instruments as holding gains / losses, reporting them in the Statement of Other Economic Flows. Net cash settlement payments in interest rate swaps, forward rate agreements and cross-currency interest rate swaps are treated as "other economic flows" and not investment income (eg. interest revenues or expenses) as there is no provision of capital in establishing the contract.

### *Accounting treatment*

Australian Accounting Standards do not directly deal with the recognition and measurement of financial instruments, but provide guidance on disclosure and presentation<sup>1</sup>. Specifically:

- Terms, Conditions and Accounting policies<sup>2</sup>
- Interest Rate Risk<sup>3</sup>
- Credit Risk<sup>4</sup>
- Net Fair Value<sup>5</sup>
- Financial Assets Carried at an Amount in Excess of Net Fair Value<sup>6</sup>

In practice generally, many entities recognise the issuance of such securities and adopt the amortised cost basis as this is viewed as the most reliable measure of the amount actually owed by the issuer.

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<sup>1</sup> AAS 33 *Presentation and Disclosure of Financial Instruments*

<sup>2</sup> AAS 33 – paragraph 5.2

<sup>3</sup> AAS 33 – paragraph 5.4

<sup>4</sup> AAS 33 – paragraph 5.5

<sup>5</sup> AAS 33 – paragraph 5.6

<sup>6</sup> AAS 33 – paragraph 5.7

The AASB plans to adopt both IAS 32 *Financial Instruments: Disclosure and Presentation* and IAS 39 *Financial Instruments: Recognition and Measurement* standard by January 2004 with application on or after 1 January 2005<sup>7</sup>.

#### International accounting standards

**Initial measurement** – both the existing and proposed amended IAS 39 require financial assets and financial liabilities to be measured at cost on initial recognition, which is the fair value of the consideration given in the case of an asset or received in the case of a liability plus transaction costs that are directly attributable to the acquisition or issue.

The fair value of consideration given (asset) or received (liability) is estimated as the sum of all future cash receipts (asset) or payments (liability) discounted using the prevailing market rate of interest for a similar instrument of an issuer with a similar credit rating.

#### **Measurement subsequent to initial recognition:**

*Financial Assets* - both the existing and proposed amended IAS 39 require financial assets, including derivatives that are assets, to be measured at fair value except for:

- (a) loans and receivables originated by the entity;
- (b) held-to-maturity investments; and
- (c) investments in equity instruments that do not have a quoted market price in an active market and whose fair value cannot be measured reliably and derivatives that are linked to, and must be settled by delivery of, such unquoted equity instruments

Note: longer term investments in associates and subsidiaries are not subject to IAS 39.

Loans and receivables originated by the entity and held-to-maturity investments, both of which are defined, are to be measured at amortised cost using the effective interest rate method. Investments in equity instruments as described in (c) above are to be measured at cost.

*Financial Liabilities* - both the existing and proposed amended IAS 39 require financial liabilities that are held for trading and derivatives that are liabilities to be measured at fair value, except for derivatives that are linked to and must be settled by delivery of unquoted equity instruments, whose fair value cannot be reliably measured. All other financial liabilities are to be measured at cost or amortised cost. Financial liabilities that are held for trading and derivatives are defined in the IASB Exposure Draft.

**Impairment of financial assets** - both the existing and proposed amended IAS 39 prescribe the methods for determining the recoverable amounts of available-for-sale financial assets and financial assets that are measured at cost or amortised cost. The IASB Exposure Draft proposes to change the method of determining impairment inherent in a group of loans, receivables or held-to-maturity investments.

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<sup>7</sup> AASB plans for adopting IASB standards by 2005

## International accounting standards (cont)

### ***Hedge accounting:***

***Hedging instruments*** - the general rule under both the existing and proposed amended IAS 39 is that only derivatives can be designated as hedging instruments. The standard does identify one exception for hedges of foreign currency risk. Non-derivative financial instruments can be designated as hedging instruments in hedges of foreign currency risk. Written options can only be designated as hedging instruments of purchased options.

***Types of hedging relationships*** - both the existing and proposed amended IAS 39 identify three types of hedging relationships:

- (a) Fair value hedge. This is a hedge of the exposure to changes in fair value of a recognised asset or liability. The IASB Exposure Draft proposes to treat a hedge of the exposure to changes in fair value of a firm commitment to buy or sell an item at a fixed price as a fair value hedge;
- (b) Cash flow hedge. This is a hedge of the exposure to variability in cash flows that is attributable to a particular risk associated with a recognised asset or liability or a forecast transaction; and
- (c) Hedge of a net investment in a foreign operation.

***Recognition of gains or losses from hedging instruments*** - Under both the existing and proposed amended IAS 39, the treatment of gains or losses from hedging financial instruments depends on the type of exposure that the financial instrument is hedging. Gains or losses from hedging financial instruments comprise changes in fair value of derivatives and translation gains or losses of the foreign currency component of non-derivative financial instruments. The recognition of the three types of hedges is as follows:

- (a) gains or losses from hedging instruments of fair value hedges to be recognised immediately in net profit or loss. The associated gain or loss on the hedged item is required to be fair value recognised in net profit or loss. This applies even if the hedged item would otherwise have been measured at cost. For example, a commitment to purchase a piece of equipment that would normally be unrecognised until the item is delivered or received would be recognised to the extent that it is hedged;
- (b) gains or losses from hedging instruments of cash flow hedges to be recognised directly in equity to the extent that they relate to the portion of the instrument that is determined to be an effective hedge. For all cash flow hedges other than hedges of a forecast transaction that result in the recognition of an asset or liability, the existing IAS 39 and the proposed revised IAS 39 require gains or losses accumulated in equity to be transferred to net profit or loss in the same period or periods during which the hedged transaction affects net profit or loss; and

- (c) gains and losses from hedging instruments of hedges of a net investment in a foreign operation to be recognised directly in equity to the extent that they relate to the portion of the instrument that is determined to be an effective hedge. Accumulated gains or losses are transferred to net profit or loss in the same period as the disposal of the foreign operation.

### *GFS Treatment*

GFS values financial instruments at market value, with market price fluctuations brought to account in the Statement of Other Economic Flows<sup>8</sup>. Where a debt is retired, its character as debt is retained and is offset by an equivalent asset, until it is formally cancelled. Consequently, realised and unrealised gains and losses on derivatives are excluded from the GFS net operating balance, GFS net lending and surplus/deficit measures.

Any explicit commissions or charges paid to brokers or other intermediaries for arranging financial derivative contracts are treated as GFS expenses while implicit charges are treated as transactions in financial derivatives as it is usually not possible to estimate these elements<sup>9</sup>.

### *Standard setters' future work programs*

#### Accounting

The IASB has proposed amendments to IAS 32 “*Financial Instruments: Disclosure and Presentation*” and IAS 39 “*Financial Instruments: Recognition and Measurement*” as part of its Improvements Project and released an exposure draft in mid - 2002. In line with the IASBs work program, the AASB expects to issue improved IAS 32 and IAS 39 in quarter 3 of 2003 with a mandatory operative date of 1 January 2005. A summary of the requirements in the proposed revised IAS 39 is provided below.<sup>10</sup>

**Recognition** - The IASB Exposure Draft proposes requiring that, if a hedge of a forecast transaction results in the recognition of an asset or a liability, the gains or losses accumulated in equity are not permitted to be adjusted against the carrying amount of the hedged asset or hedged liability. Instead, the gains or losses are to be transferred to net profit or loss in the same period or periods during which the asset acquired or the liability incurred affects net profit or loss. For example, accumulated gains or losses arising from changes in fair value of a financial instrument that is hedging the price of a piece of

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<sup>8</sup> Government Finance Statistics Manual 2001, December 2001 – paragraph 3.73 and 7.22

<sup>9</sup> Update to the System of National Accounts 1993 *New Standard for Financial Derivatives*, March 2000 – paragraph 11.34

<sup>10</sup> Extract from the AASB preface to the AASB’s Invitation to Comment “Proposed Improvements to International Accounting Standards IAS 32 “*Financial Instruments: Disclosure and Presentation*” and IAS 39 “*Financial Instruments: Recognition and Measurement*” issued in June 2002 (pages 6 to 9).

equipment which the entity anticipates that it will purchase in the future will not be adjusted against the carrying amount of the asset. Instead, the gains or losses accumulated in equity will be amortised over the useful life of the asset.

***Recognition of changes in fair value*** - The proposed revised IAS 39 requires all gains or losses arising from changes in fair value of financial assets or financial liabilities to be recognised in net profit or loss except for gains or losses arising from changes in fair value of available-for-sale financial assets and of financial instruments that are designated as hedging instruments of cash flow hedges or of hedges of a net investment in a foreign operation.

The proposed revised IAS 39 requires gains or losses arising from changes in fair value of available-for-sale financial assets to be recognised directly in equity. Gains or losses arising from changes in fair value of available-for-sale financial assets are to be transferred to net profit or loss when the financial assets is derecognised or impaired. The existing IAS 39 has the same requirement except that gains or losses arising from changes in fair value of available-for-sale financial assets are permitted to be recognised either in net profit or loss or directly in equity.

The treatment of gains and losses arising from changes in fair value of financial instruments that are designated as hedging instruments of cash flow hedges and of hedges of a net investment in a foreign operation is discussed below under hedge accounting.

***De-recognition:***

***Financial assets*** - Under the proposed changes, an entity derecognises a financial asset or a portion of a financial asset when either the entity's contractual rights to the cash flows expire or are forfeited or the entity transfers the contractual rights to the cash flows and it has no continuing involvement. The IASB Exposure Draft also proposes the circumstances under which a transferor is considered to have no continuing involvement. For example, a financial asset is not derecognised if the transferor has a right or an obligation to repurchase the same or substantially the same asset.

***Financial liabilities*** - The existing IAS 39 and the proposed revised IAS 39 require a financial liability or a portion of a financial liability to be derecognised when and only when the obligation specified in the contract is discharged or cancelled or expires. An obligation is not discharged when it is subject to an in-substance defeasance. This will change the existing practice in Australia. Under AASB 1014 and AAS 23 "Set-off and Extinguishment of Debt", a financial liability is treated as having been extinguished and accordingly must be derecognised when it has been subject to an in-substance defeasance.

***Transitional arrangements*** - the IASB Exposure Draft proposes that the changes to IAS 39 be applied retrospectively except for any gains or losses relating to cash flow hedges that have been included in the carrying amount of non-financial items.

***Fair value election*** - The IASB Exposure Draft proposes that an entity can elect to measure all financial assets and financial liabilities at fair value, with gains and losses being recognized in profit and loss<sup>11</sup>. Any financial instrument may be designated as held-for-trading, however, only upon initial recognition.

***Impairment of financial assets*** - the IASB Exposure Draft also proposes that impairment losses recognised on unquoted equity instruments that are measured at cost because fair value cannot be reliably measured, and on available-for-sale financial assets, cannot be reversed.

### *Steps to harmonisation*

The current IASB Project on Performance Reporting may present an opportunity for convergence in this regard. The proposed Statement of Comprehensive Income (SCI) will allocate components of reported performance between two columns: “profit before re-measurements” and “re-measurements”. At this stage of the project, the IASB has decided that for the most part, changes in the fair value of financial instruments are to be reported as re-measurements in the proposed SCI. The project generally focuses on issues of presentation.

Under specific circumstances IAS 39 will allow a gain or loss to be taken directly to the equity section of the Statement of Financial Position (for example gain or loss on the effective portion of cash flow hedge). The proposed revised IAS 39 will allow any financial instrument to be designated as held-for-trading on initial recognition, which promote convergence with GFS. That is, being designated as held-for-trading requires the financial instruments to be valued at fair value, which is conceptually similar to GFS.

A recognised gain or loss arising from change in the fair value of a financial instrument that is part of a hedging relationship may in specific circumstances be taken directly against equity in the statement of financial position.

Similarly, if no election is made at initial recognition this may cause a convergence issue in respect of both the current and proposed IAS 39. These allow, in specific circumstances, gains or losses associated with a change in value of the financial instrument to be taken directly against equity in the Statement of Financial Position. However, to eliminate this possible convergence issue jurisdictions should elect to value all financial instruments at fair value on initial recognition.

GFS treats any changes in fair value as revaluations (or holding gains or losses) and would report these in the Statement of Other Economic Flows (SOEF), which is considered conceptually similar to reporting these changes in the re-measurement column of the proposed SCI.

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<sup>11</sup> Exposure draft of revised IAS 39 – paragraph 10, 17a and 18a

## *Convergence Issues*

### Transaction costs:

A related fringe issue also requires consideration being the treatment of incidental costs of acquisition/disposal. Accounting convention treats direct acquisition costs as part of the capitalised amount, while GFS would consider these costs to be expenses of the period during which they are incurred. Similar treatment applies to disposal costs, but the effects are not as long-lasting. Whilst this technical difference will remain, it is unlikely that transaction costs will result in a material difference between GFS and GAAP.

### Fair value (IAS) v Current Market value (GFS):

The definition of fair value as stated in IAS<sup>12</sup> compared with the definition of current market value in GFS<sup>13</sup> are conceptually similar and will not give rise to any convergence issue.

### Interest Rate Swaps

According to GFS, “the net cash settlement payments in these financial derivatives should be classified as financial transactions rather than as interest”<sup>14</sup> and treated as “other economic flow”<sup>15</sup>. This may give rise to a convergence issue in that AAS 31 recognises and records the interest flow as revenues and/or expenses.<sup>16</sup>

As a general principle payments that flow as a result of an underlying instrument (or principal) will generally be treated under both AAS and GFS as interest. However, any flow that may result on the basis of a “notional amount of principal” will generally be recognised as an “other economic flow” in GFS, however, AAS will still recognise the amount as interest.

## *Financial Instruments Matrix (attachment 1)*

### Scope:

The main purpose of the attached matrix is to highlight the measurement at acquisition, valuation (at end of reporting periods) and disposal differences between GFS, the current IAS 39 and the proposed amended IAS 39. The matrix is proposed as a guide only with no attempt having been made to capture every possible financial instrument available. This matrix has not addressed any presentation and disclosure issues that may relate to financial instruments.

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<sup>12</sup> IAS 39 – paragraph 67

<sup>13</sup> GFS Manual – paragraph 3.75

<sup>14</sup> Update to the system of National Accounts 1993 (March 2000) – page 4

<sup>15</sup> Budget Paper No.1, Table 1 – page 8-12

<sup>16</sup> Budget Paper No.1, Table 1 – page 8-12

The matrix has not included any discussion of Australian standards as noted earlier there is no specific Australian standard that deals with the recognition and measurement of financial instruments.

### *Conclusion*

There are two specific issues relating to financial instruments. Firstly, the recognition and measurement of financial instruments and secondly, the treatment and presentation of re-measurements (holding gains or loss).

Measurement - Australian GAAP permits either cost or market valuation methods. International standards permit a similar choice, however, certain criteria must be met before the election can be made. GFS requires current market valuation.

Re-measurements (holding gains or loss) – Australian GAAP treats the realised and, for market valued instruments, unrealised gains or losses as either revenues or expenses in the period in which they arise. International GAAP is likely to treat changes in value as re-measurements. GFS treats any change in market value as “other economic flow”.

In the short term to promote convergence jurisdictions should look to elect a market valuation (fair value) basis as their own accounting policy. The IASB Exposure Draft proposes that an entity can elect to measure all financial assets and financial liabilities at fair value. This would generally resolve any convergence issue when the proposed IAS 39 “*Financial Instruments: Recognition and Measurement*” standard is released. The proposed revised IAS 39 is expected to be released in the third quarter of 2003, for application in 2005. Another avenue may be restructuring the operating statement to include “re-measurements” / “other economic flows”, such as market movements in value of financial instruments, separately from revenues and expenses.

Convergence could be achieved in the medium to long term with the adoption of IASB standards, although it does depend on the outcomes of both IASB projects on financial instruments and performance reporting. The standard on Performance Reporting is expected to be issued in early 2004, for application in 2006, with the option of early adoption.

HoTARAC needs to monitor developments in both performance reporting and financial instruments to ensure that long term convergence is achieved.

## Financial Instruments Matrix

Financial Instruments		GFS <sup>1</sup>			IAS <sup>2</sup> (current)			IAS <sup>2</sup> (proposed amended)			
		Assumption	Acquisition	Valuation	Disposal	Acquisition	Valuation	Disposal	Acquisition	Valuation	Disposal
Monetary Gold		Market value <sup>3</sup>	Market value <sup>3</sup>	Market value <sup>3</sup>	Not within the scope of IAS 39	Not within the scope of IAS 39	Not within the scope of IAS 39	Not within the scope of IAS 39	Not within the scope of IAS 39	Not within the scope of IAS 39	
Special Drawing Rights (SDRs)	Available for sale	Market value <sup>3</sup>	Market value <sup>3</sup>	Market value <sup>3</sup>	Acquisition Cost – fair value of consideration including transaction costs <sup>4</sup>	Fair Value <sup>5</sup>	Carrying amount less (proceeds + prior adjustments to equity to reflect fair value) to profit and loss <sup>6</sup>	Acquisition Cost – fair value of consideration <sup>7</sup>	Fair Value <sup>8</sup>	Carrying amount less (proceeds + prior adjustments to equity to reflect fair value) to profit and loss <sup>9</sup>	
<i>Financial Derivatives:</i>											
Financial Assets	Interest Rate Swaps	Not designated as a hedge	Market value <sup>3</sup>	Market value <sup>3</sup>	Market value <sup>3</sup>	Acquisition Cost – fair value of consideration including transaction costs <sup>4</sup>	Fair Value <sup>5</sup>	Carrying amount less (proceeds + prior adjustments to equity to reflect fair value) to profit and loss <sup>6</sup>	Acquisition Cost – fair value of consideration <sup>7</sup>	Fair Value <sup>8</sup>	Carrying amount less (proceeds + prior adjustments to equity to reflect fair value) to profit and loss <sup>9</sup>
	Interest Rate Swaps	Derivatives linked to and settled with unquoted equity instruments	Market value <sup>3</sup>	Market value <sup>3</sup>	Market value <sup>3</sup>	Acquisition Cost – fair value of consideration including transaction costs <sup>4</sup>	Cost <sup>10</sup>	Carrying amount less (proceeds + prior adjustments to equity to reflect fair value) to profit and loss <sup>6</sup>	Acquisition Cost – fair value of consideration <sup>7</sup>	Cost <sup>14</sup>	Carrying amount less (proceeds + prior adjustments to equity to reflect fair value) to profit and loss <sup>9</sup>
	Currency Swap	Not designated as a hedge	Market value <sup>3</sup>	Market value <sup>3</sup>	Market value <sup>3</sup>	Acquisition Cost – fair value of consideration including transaction costs <sup>4</sup>	Fair Value <sup>5</sup>	Carrying amount less (proceeds + prior adjustments to equity to reflect fair value) to profit and loss <sup>6</sup>	Acquisition Cost – fair value of consideration <sup>7</sup>	Fair Value <sup>8</sup>	Carrying amount less (proceeds + prior adjustments to equity to reflect fair value) to profit and loss <sup>9</sup>
	Currency Swap	Derivatives linked to and settled with unquoted equity instruments	Market value <sup>3</sup>	Market value <sup>3</sup>	Market value <sup>3</sup>	Acquisition Cost – fair value of consideration including transaction costs <sup>4</sup>	Cost <sup>10</sup>	Carrying amount less (proceeds + prior adjustments to equity to reflect fair value) to profit and loss <sup>6</sup>	Acquisition Cost – fair value of consideration <sup>7</sup>	Cost <sup>14</sup>	Carrying amount less (proceeds + prior adjustments to equity to reflect fair value) to profit and loss <sup>9</sup>
	Options	Not designated as a hedge	Market value <sup>3</sup>	Market value <sup>3</sup>	Market value <sup>3</sup>	Acquisition Cost – fair value of consideration including transaction costs <sup>4</sup>	Fair Value <sup>5</sup>	Carrying amount less (proceeds + prior adjustments to equity to reflect fair value) to profit and loss <sup>6</sup>	Acquisition Cost – fair value of consideration <sup>7</sup>	Fair Value <sup>8</sup>	Carrying amount less (proceeds + prior adjustments to equity to reflect fair value) to profit and loss <sup>9</sup>
	Options	Derivatives linked to and settled with unquoted equity instruments	Market value <sup>3</sup>	Market value <sup>3</sup>	Market value <sup>3</sup>	Acquisition Cost – fair value of consideration including transaction costs <sup>4</sup>	Cost <sup>10</sup>	Carrying amount less (proceeds + prior adjustments to equity to reflect fair value) to profit and loss <sup>6</sup>	Acquisition Cost – fair value of consideration <sup>7</sup>	Cost <sup>14</sup>	Carrying amount less (proceeds + prior adjustments to equity to reflect fair value) to profit and loss <sup>9</sup>
	Warrants	Not designated as a hedge	Market value <sup>3</sup>	Market value <sup>3</sup>	Market value <sup>3</sup>	Acquisition Cost – fair value of consideration including transaction costs <sup>4</sup>	Fair Value <sup>5</sup>	Carrying amount less (proceeds + prior adjustments to equity to reflect fair value) to profit and loss <sup>6</sup>	Acquisition Cost – fair value of consideration <sup>7</sup>	Fair Value <sup>8</sup>	Carrying amount less (proceeds + prior adjustments to equity to reflect fair value) to profit and loss <sup>9</sup>
	Warrants	Derivatives linked to and settled with unquoted equity instruments	Market value <sup>3</sup>	Market value <sup>3</sup>	Market value <sup>3</sup>	Acquisition Cost – fair value of consideration including transaction costs <sup>4</sup>	Cost <sup>10</sup>	Carrying amount less (proceeds + prior adjustments to equity to reflect fair value) to profit and loss <sup>6</sup>	Acquisition Cost – fair value of consideration <sup>7</sup>	Cost <sup>14</sup>	Carrying amount less (proceeds + prior adjustments to equity to reflect fair value) to profit and loss <sup>9</sup>
Bonds	Held to maturity investment	Market value <sup>3</sup>	Market value <sup>3</sup>	Market value <sup>3</sup>	Acquisition Cost – fair value of consideration including transaction costs <sup>4</sup>	Amortised cost <sup>11</sup>	Carrying amount less (proceeds + prior adjustments to equity to reflect fair value) to profit and loss <sup>6</sup>	Acquisition Cost – fair value of consideration <sup>7</sup>	Amortised cost <sup>15</sup>	Carrying amount less (proceeds + prior adjustments to equity to reflect fair value) to profit and loss <sup>9</sup>	
Bonds	Held for trading OR Available for sale	Market value <sup>3</sup>	Market value <sup>3</sup>	Market value <sup>3</sup>	Acquisition Cost – fair value of consideration including transaction costs <sup>4</sup>	Fair Value <sup>5</sup>	Carrying amount less (proceeds + prior adjustments to equity to reflect fair value) to profit and loss <sup>6</sup>	Acquisition Cost – fair value of consideration <sup>7</sup>	Fair Value <sup>8</sup>	Carrying amount less (proceeds + prior adjustments to equity to reflect fair value) to profit and loss <sup>9</sup>	
Loans and Receivables	Held to maturity investment OR originated loan and receivable	Nominal Prices: unless active secondary markets then market value <sup>18</sup>	Nominal Prices: unless active secondary markets then market value <sup>18</sup>	Nominal Prices: unless active secondary markets then market value <sup>18</sup>	Acquisition Cost – fair value of consideration including transaction costs <sup>4</sup>	Amortised cost <sup>12</sup>	Carrying amount less (proceeds + prior adjustments to equity to reflect fair value) to profit and loss <sup>6</sup>	Acquisition Cost – fair value of consideration <sup>7</sup>	Amortised cost <sup>16</sup>	Carrying amount less (proceeds + prior adjustments to equity to reflect fair value) to profit and loss <sup>9</sup>	
Loans and Receivables	Held for trading OR available for sale	Nominal Prices: unless active secondary markets then market value <sup>18</sup>	Nominal Prices: unless active secondary markets then market value <sup>18</sup>	Nominal Prices: unless active secondary markets then market value <sup>18</sup>	Acquisition Cost – fair value of consideration including transaction costs <sup>5</sup>	Fair Value <sup>5</sup>	Carrying amount less (proceeds + prior adjustments to equity to reflect fair value) to profit and loss <sup>7</sup>	Acquisition Cost – fair value of consideration <sup>8</sup>	Fair Value <sup>8</sup>	Carrying amount less (proceeds + prior adjustments to equity to reflect fair value) to profit and loss <sup>10</sup>	

	Financial Instruments	Assumption	GFS			IAS (current)			IAS (proposed amended)		
			Acquisition	Valuation	Disposal	Acquisition	Valuation	Disposal	Acquisition	Valuation	Disposal
Financial Assets (cont)	Equity Instruments	Fair value can be reliably measured	Market value <sup>3</sup>	Market value <sup>3</sup>	Market value <sup>3</sup>	Acquisition Cost – fair value of consideration including transaction costs <sup>6</sup>	Fair Value <sup>19</sup>	Carrying amount less (proceeds + prior adjustments to equity to reflect fair value) to profit and loss <sup>8</sup>	Acquisition Cost – fair value of consideration <sup>9</sup>	Fair Value <sup>20</sup>	Carrying amount less (proceeds + prior adjustments to equity to reflect fair value) to profit and loss <sup>11</sup>
	Equity Instruments	Fair value can NOT be reliably measured	Market value <sup>3</sup>	Market value <sup>3</sup>	Market value <sup>3</sup>	Acquisition Cost – fair value of consideration including transaction costs <sup>7</sup>	Cost <sup>19</sup>	Carrying amount less (proceeds + prior adjustments to equity to reflect fair value) to profit and loss <sup>9</sup>	Acquisition Cost – fair value of consideration <sup>10</sup>	Cost <sup>20</sup>	Carrying amount less (proceeds + prior adjustments to equity to reflect fair value) to profit and loss <sup>12</sup>
<i>Financial Derivatives:</i>											
Financial Liabilities	Interest Rate Swaps	Not designated as a hedge	Market value <sup>3</sup>	Market value <sup>3</sup>	Market value <sup>3</sup>	Acquisition Cost – fair value of consideration including transaction costs <sup>4</sup>	Fair Value <sup>5</sup>	Carrying amount less (proceeds + prior adjustments to equity to reflect fair value) to profit and loss <sup>6</sup>	Acquisition Cost – fair value of consideration <sup>7</sup>	Fair Value <sup>8</sup>	Carrying amount less (proceeds + prior adjustments to equity to reflect fair value) to profit and loss <sup>9</sup>
	Interest Rate Swaps	linked to and settled with unquoted equity instruments	Market value <sup>3</sup>	Market value <sup>3</sup>	Market value <sup>3</sup>	Acquisition Cost – fair value of consideration including transaction costs <sup>4</sup>	Cost <sup>13</sup>	Carrying amount less (proceeds + prior adjustments to equity to reflect fair value) to profit and loss <sup>6</sup>	Acquisition Cost – fair value of consideration <sup>7</sup>	Cost <sup>17</sup>	Carrying amount less (proceeds + prior adjustments to equity to reflect fair value) to profit and loss <sup>9</sup>
	Currency Swap	Not designated as a hedge	Market value <sup>3</sup>	Market value <sup>3</sup>	Market value <sup>3</sup>	Acquisition Cost – fair value of consideration including transaction costs <sup>4</sup>	Fair Value <sup>5</sup>	Carrying amount less (proceeds + prior adjustments to equity to reflect fair value) to profit and loss <sup>6</sup>	Acquisition Cost – fair value of consideration <sup>7</sup>	Fair Value <sup>8</sup>	Carrying amount less (proceeds + prior adjustments to equity to reflect fair value) to profit and loss <sup>9</sup>
	Currency Swap	linked to and settled with unquoted equity instruments	Market value <sup>3</sup>	Market value <sup>3</sup>	Market value <sup>3</sup>	Acquisition Cost – fair value of consideration including transaction costs <sup>4</sup>	Cost <sup>13</sup>	Carrying amount less (proceeds + prior adjustments to equity to reflect fair value) to profit and loss <sup>6</sup>	Acquisition Cost – fair value of consideration <sup>7</sup>	Cost <sup>17</sup>	Carrying amount less (proceeds + prior adjustments to equity to reflect fair value) to profit and loss <sup>9</sup>
	Options	Not designated as a hedge	Market value <sup>3</sup>	Market value <sup>3</sup>	Market value <sup>3</sup>	Acquisition Cost – fair value of consideration including transaction costs <sup>4</sup>	Fair Value <sup>5</sup>	Carrying amount less (proceeds + prior adjustments to equity to reflect fair value) to profit and loss <sup>6</sup>	Acquisition Cost – fair value of consideration <sup>7</sup>	Fair Value <sup>8</sup>	Carrying amount less (proceeds + prior adjustments to equity to reflect fair value) to profit and loss <sup>9</sup>
	Options	linked to and settled with unquoted equity instruments	Market value <sup>3</sup>	Market value <sup>3</sup>	Market value <sup>3</sup>	Acquisition Cost – fair value of consideration including transaction costs <sup>4</sup>	Cost <sup>13</sup>	Carrying amount less (proceeds + prior adjustments to equity to reflect fair value) to profit and loss <sup>6</sup>	Acquisition Cost – fair value of consideration <sup>7</sup>	Cost <sup>17</sup>	Carrying amount less (proceeds + prior adjustments to equity to reflect fair value) to profit and loss <sup>9</sup>
	Warrants	Not designated as a hedge	Market value <sup>3</sup>	Market value <sup>3</sup>	Market value <sup>3</sup>	Acquisition Cost – fair value of consideration including transaction costs <sup>4</sup>	Fair Value <sup>5</sup>	Carrying amount less (proceeds + prior adjustments to equity to reflect fair value) to profit and loss <sup>6</sup>	Acquisition Cost – fair value of consideration <sup>7</sup>	Fair Value <sup>8</sup>	Carrying amount less (proceeds + prior adjustments to equity to reflect fair value) to profit and loss <sup>9</sup>
	Warrants	linked to and settled with unquoted equity instruments	Market value <sup>3</sup>	Market value <sup>3</sup>	Market value <sup>3</sup>	Acquisition Cost – fair value of consideration including transaction costs <sup>4</sup>	Cost <sup>13</sup>	Carrying amount less (proceeds + prior adjustments to equity to reflect fair value) to profit and loss <sup>6</sup>	Acquisition Cost – fair value of consideration <sup>7</sup>	Cost <sup>17</sup>	Carrying amount less (proceeds + prior adjustments to equity to reflect fair value) to profit and loss <sup>9</sup>
	Bonds	Not held for trading	Market value <sup>3</sup>	Market value <sup>3</sup>	Market value <sup>3</sup>	Acquisition Cost – fair value of consideration including transaction costs <sup>4</sup>	Amortised cost <sup>11</sup>	Carrying amount less (proceeds + prior adjustments to equity to reflect fair value) to profit and loss <sup>6</sup>	Acquisition Cost – fair value of consideration <sup>7</sup>	Amortised cost <sup>15</sup>	Carrying amount less (proceeds + prior adjustments to equity to reflect fair value) to profit and loss <sup>9</sup>
	Loans and Receivables	Held for trading OR Available for sale	Nominal Prices: unless active secondary markets then market value <sup>18</sup>	Nominal Prices: unless active secondary markets then market value <sup>18</sup>	Nominal Prices: unless active secondary markets then market value <sup>18</sup>	Acquisition Cost – fair value of consideration including transaction costs <sup>4</sup>	Fair Value <sup>5</sup>	Carrying amount less (proceeds + prior adjustments to equity to reflect fair value) to profit and loss <sup>6</sup>	Acquisition Cost – fair value of consideration <sup>7</sup>	Fair Value <sup>8</sup>	Carrying amount less (proceeds + prior adjustments to equity to reflect fair value) to profit and loss <sup>9</sup>
Loans and Receivables	Not held for trading	Nominal Prices: unless active secondary markets then market value <sup>18</sup>	Nominal Prices: unless active secondary markets then market value <sup>18</sup>	Nominal Prices: unless active secondary markets then market value <sup>18</sup>	Acquisition Cost – fair value of consideration including transaction costs <sup>5</sup>	Amortised cost <sup>12</sup>	Carrying amount less (proceeds + prior adjustments to equity to reflect fair value) to profit and loss <sup>7</sup>	Acquisition Cost – fair value of consideration <sup>8</sup>	Amortised cost <sup>16</sup>	Carrying amount less (proceeds + prior adjustments to equity to reflect fair value) to profit and loss <sup>10</sup>	

	Financial Instruments	Assumption	GFS			IAS (current)			IAS (proposed amended)		
			Acquisition	Valuation	Disposal	Acquisition	Valuation	Disposal	Acquisition	Valuation	Disposal
Designated Hedged Items	<i>Financial Derivatives:</i>										
	Bonds	Fair value Hedge	Market value <sup>3</sup>	Market value <sup>3</sup>	Market value <sup>3</sup>	Acquisition Cost – fair value of consideration including transaction costs <sup>4</sup>	as per treatment of the above listed financial assets and liabilities, ADJUSTED for gain or loss on hedged item attributable to hedged risk <sup>21</sup>	Carrying amount less (proceeds + prior adjustments to equity to reflect fair value) to profit and loss <sup>6</sup>	Acquisition Cost – fair value of consideration <sup>7</sup>	as per treatment of the above listed financial assets and liabilities, ADJUSTED for gain or loss on hedged item attributable to hedged risk <sup>22</sup>	Carrying amount less (proceeds + prior adjustments to equity to reflect fair value) to profit and loss <sup>9</sup>
	Bonds	Cash flow Hedge OR hedge of net investments in a foreign operation	Market value <sup>3</sup>	Market value <sup>3</sup>	Market value <sup>3</sup>	Acquisition Cost – fair value of consideration including transaction costs <sup>4</sup>	as per treatment of the above listed financial assets and liabilities, NO ADJUSTMENT due to all gains and losses are related to the financial instrument movement NOT the hedged item <sup>23</sup>	Carrying amount less (proceeds + prior adjustments to equity to reflect fair value) to profit and loss <sup>6</sup>	Acquisition Cost – fair value of consideration <sup>7</sup>	as per treatment of the above listed financial assets and liabilities, NO ADJUSTMENT due to all gains and losses are related to the financial instrument movement NOT the hedged item <sup>24</sup>	Carrying amount less (proceeds + prior adjustments to equity to reflect fair value) to profit and loss <sup>9</sup>
	Loans and Receivables	Fair value Hedge	Market value <sup>3</sup>	Market value <sup>3</sup>	Market value <sup>3</sup>	Acquisition Cost – fair value of consideration including transaction costs <sup>4</sup>	as per treatment of the above listed financial assets and liabilities, ADJUSTED for gain or loss on hedged item attributable to hedged risk <sup>21</sup>	Carrying amount less (proceeds + prior adjustments to equity to reflect fair value) to profit and loss <sup>6</sup>	Acquisition Cost – fair value of consideration <sup>7</sup>	as per treatment of the above listed financial assets and liabilities, ADJUSTED for gain or loss on hedged item attributable to hedged risk <sup>22</sup>	Carrying amount less (proceeds + prior adjustments to equity to reflect fair value) to profit and loss <sup>9</sup>
	Loans and Receivables	Cash flow Hedge OR hedge of net investments in a foreign operation	Market value <sup>3</sup>	Market value <sup>3</sup>	Market value <sup>3</sup>	Acquisition Cost – fair value of consideration including transaction costs <sup>4</sup>	as per treatment of the above listed financial assets and liabilities, NO ADJUSTMENT due to all gains and losses are related to the financial instrument movement NOT the hedged item <sup>23</sup>	Carrying amount less (proceeds + prior adjustments to equity to reflect fair value) to profit and loss <sup>6</sup>	Acquisition Cost – fair value of consideration <sup>7</sup>	as per treatment of the above listed financial assets and liabilities, NO ADJUSTMENT due to all gains and losses are related to the financial instrument movement NOT the hedged item <sup>24</sup>	Carrying amount less (proceeds + prior adjustments to equity to reflect fair value) to profit and loss <sup>9</sup>

<sup>1</sup> Government Finance Statistics

<sup>2</sup> International Accounting Standards

<sup>3</sup> GFS Manual - paragraph 7.22 and 9.6

<sup>4</sup> IAS 39 - paragraph 66

<sup>5</sup> IAS 39 - paragraph 69

<sup>6</sup> IAS 39 - paragraph 43

<sup>7</sup> Proposed amendments to IAS 39 - paragraph 66

<sup>8</sup> Proposed amendments to IAS 39 - paragraph 69

<sup>9</sup> Proposed amendments to IAS 39 - paragraph 46

<sup>10</sup> IAS 39 - paragraph 73

<sup>11</sup> IAS 39 - paragraph 70

<sup>12</sup> IAS 39 - paragraph 73

<sup>13</sup> IAS 39 - paragraph 93

<sup>14</sup> Proposed amendments to IAS 39 - paragraph 69 c)

<sup>15</sup> Proposed amendments to IAS 39 - paragraph 69 (b)

<sup>16</sup> Proposed amendments to IAS 39 - paragraph 69 (a)

<sup>17</sup> Proposed amendments to IAS 39 - paragraph 89A

<sup>18</sup> GFS Manual - paragraph 7.111

<sup>19</sup> IAS 39 - paragraph 69 c)

<sup>20</sup> Proposed amendments to IAS 39 - paragraph 69 c)

<sup>21</sup> IAS 39 - paragraph 153

<sup>22</sup> Proposed amendments to IAS 39 - paragraph 153

<sup>23</sup> IAS 39 - paragraph 158

<sup>24</sup> Proposed amendments to IAS 39 - paragraph 158



## ISSUE 3.3: FOREIGN EXCHANGE GAINS AND LOSSES

### *Summary of differences*

**Accounting** - Accounting standards require recognition of both realised and unrealised foreign exchange gains and losses as revenues and expenses in the Statement of Financial Performance, for the period during which they “occur”.<sup>1</sup> However, foreign exchange movements relating to a qualifying asset are included in the cost of the asset, net of any hedge effects.<sup>2</sup>

**GFS** – “The value of an asset [and liability] at any given time is its current market value, which is defined as the amount that would have to be paid to acquire the asset on the valuation date, taking into account its age, condition, and other relevant factors.”<sup>3</sup> Market movements, including foreign exchange movements, are taken to the Statement of Other Economic Flows as market value adjustments.<sup>4</sup> Additionally, all changes in the value of revenue and expenses are taken to the Statement of Other Economic Flows.<sup>5</sup>

### *Accounting treatment (including International Accounting Standards)*

Under AASB 1012 *Foreign Currency Translation*, “...exchange differences must be recognised as revenues or expenses in net profit or loss/result in the reporting period in which the exchange rates change.”<sup>6</sup> Under IAS 21 *The Effects of Changes in Foreign Exchange Rates*, exchange differences “...should be recognised as income or as expenses in the period in which they arise”<sup>7</sup> A foreign exchange gain or loss may occur either:

- On settlement: representing the movement in the exchange rate between the date of recording the transaction in the financial system (or the recorded value as at the last financial report) and the date of payment, or
- On the reporting date: representing the movement in the exchange rate for assets and liabilities denominated in foreign currency where settlement has not occurred.<sup>8</sup>

Generally, mark to market asset and liabilities are updated throughout the reporting period. Foreign exchange movements relating to qualifying assets are capitalised as part of the asset (similar to borrowing costs) as these are part of the cost of obtaining the asset.<sup>9</sup> This reflects the notion of a modified historical cost framework that considers foreign exchange movements as part of the cost of acquiring an asset. The rationale for

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<sup>1</sup> AASB 1012, para 5.5 and IAS 21, para 15

<sup>2</sup> *ibid.*, paragraph 5.6, and paragraph 22

<sup>3</sup> GFS Manual 2001, paragraph 7.5

<sup>4</sup> *ibid.*, paragraph 10.4

<sup>5</sup> *ibid.*, paragraph 4.50

<sup>6</sup> Paragraph 5.5

<sup>7</sup> Paragraph 15

<sup>8</sup> *ibid.*, paragraph 5.5.1 and *ibid.*

<sup>9</sup> *supra* no. 2

capitalising foreign exchange gains and losses on qualifying assets are the same as those for capitalising borrowing costs on qualifying assets [refer discussion in Issue Paper 1.2].

### *GFS Treatment*

“A holding gain or loss is a change in the monetary value of an asset or liability resulting from changes in the level and structure of prices, assuming that the asset or liability has not changed qualitatively or quantitatively.”<sup>10</sup> For assets and liabilities denominated in a foreign currency, a change in the exchange rate can give rise to a holding gain or loss.<sup>11</sup> Holding gains (and losses) are treated as revaluations and not as transactions (for an explanation of these terms refer to Issue Paper 2: *Asset Revaluations*). These gains and losses are “other economic flows”.

### *Standard setters’ future work programs*

The IASB developed an exposure draft on performance reporting that affects comprehensive ‘income’. One of the methods separates the ‘income’ component of comprehensive income from ‘valuation adjustments’. It is likely that foreign exchange gains and losses would be re-measurements.

### *Steps to harmonisation*

One approach towards harmonisation would be the adoption of a comprehensive income statement that separates valuation changes from transactions. There is no change proposed for the ABS/GFS context.

### *Conclusion*

As a short term solution, the Working Group recommends that the GFS treatment be adopted for 2004-05 reporting along with a revised operating statement format based on the proposed Statement of Comprehensive Income under the Performance Reporting project.

In the longer term, the adoption in Australia of a comprehensive operating statement (as a result of international accounting standards) would assist with resolution of harmonisation issues related to foreign exchange gains and/or losses. That is, the revaluations will be disclosed in the operating statement as re-measurements.

The ongoing development of an international standard relating to performance reporting will need to be monitored to ensure that no convergence issues will result.

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<sup>10</sup> 10.2

<sup>11</sup> supra no.4

## **ISSUE 4.1: DEFENCE WEAPONS (COMMONWEALTH ONLY)**

The treatment of destructive weapons is one of the treatment differences between generally accepted accounting principles (GAAP) and SNA/GFS.

### *Summary of Treatments*

**Accounting** - Destructive weapons are treated as an asset and capitalised on acquisition. Items are then depreciated as consumed (over their useful lives), written off when destroyed (or consumed), and / or recognise a profit or loss on disposal.

**SNA/GFS** - All destructive weapons are treated as non-productive assets. Acquisition costs are expensed in the year of acquisition, on the basis that these are non-productive items and assuming that consumption takes place in that year. The GFS Balance Sheet therefore excludes destructive weapons with a resultant reduction in GFS net worth. Profits on sale of previously expensed defence weapons would be reflected in the Statement of Other Economic Flows, with the items marked to market prior to sale.

### *Accounting treatment*

Accounting standards do not differentiate between destructive weapons and other assets. Accounting standards primarily describe assets in terms of two key characteristics (a) control and (b) the item's potential to produce future economic benefits, or service potential. The generation of future cash flows (in a commercial context) is not necessary to the concept of service potential. Instead, the ability of an item to contribute to organisational objectives over time is relevant when determining whether service potential exists. The organisational objectives of national armed forces normally include national security roles for destructive weapons in use or ready for use and, to a lesser extent, ceremonial roles.

Destructive weapons are considered to provide benefits over their useful lives and are included in property, plant and equipment. Destructive weapons provide future economic benefits, (which includes 'service potential') and thus meet the accounting definition of an asset. In addition to their active or operational use, destructive weapons have an on-going role in deterring armed conflict.

Accountants would distinguish between the delivery device (e.g. weapon, ship, aircraft) and the munitions. The delivery device or platform can be used again and again (indeed some ships and planes have been refitted for use long beyond their initial anticipated lives), but the munitions are a single use item. Consequently, accountants would capitalize the device or platform and amortise its value over its expected life whilst expensing the munitions as a consumable, unless they were classed as inventory, in which case they would be expensed upon use.

IFAC's IPSAS 17, "*Property, Plant and Equipment*", paragraph 3, supports this. It states that: "This standard applies to property, plant and equipment including:

- (a) Specialist destructive weapons; and
- (b) Infrastructure assets."

Paragraph 20 also states that:

"Specialist destructive weapons will normally meet the definition of property, plant and equipment and should be recognised as an asset in accordance with the standard."

IPSAS 17 suggests that destructive weapons be treated as a separate asset class.

The general accounting rules for assets apply to destructive weapons, which means:

- Assets are capitalised at their cost of acquisition as they are purchased or cost of manufacture if produced.
- Useful lives of the assets are estimated and the asset is depreciated as they are consumed over their useful lives.
- Assets can be revalued to fair value (a market value).
- Assets must be written off as a result of obsolescence, destruction, or other detriment.

In addition to the above, the following explanations have been given in support of the accounting treatment:

1. Classifying weapons as assets provides a more accurate view of the financial position of the entity at a point in time. As these items are used by the entity over more than one reporting period, their value should be charged (as depreciation in the Statement of Finance Performance) over the corresponding periods.
2. Treating defence weapons as assets minimises opportunities for income smoothing (intentionally minimising fluctuation in earnings over a period of time). If the assets are to be expensed in the period of purchase, rather than capitalised, decisions to purchase destructive weapons might primarily occur in "good years", with deferral of weapons replacements in "bad years".
3. The current period cost of military operations would be reflected in the financial statements, i.e. the carrying value of assets damaged or destroyed would be recognized as an expense in the period of occurrence. This more closely reflects the timing and consequences of current government decisions.
4. Treatment of defence weapons is by the nature of the item rather than its use. In GFS the distinction between weapons and other assets may be unnecessarily arbitrary. That is to say, treating the police and internal security as a service generator and military or national security as non-productive appears to create artificial distinctions. It may present some governments with opportunities to manipulate financial reports as items could be purchased by the military and loaned to the police forces or vice versa, depending on the bottom line impact desired. We note that many countries have paramilitary forces that are neither police nor military, but with some of the characteristics of each.

## *GFS Treatment*

The GFS system records (in keeping with SNA93) acquisitions of destructive weapons and weapon delivery systems as current expenses, regardless of the end use of those weapons and systems (ie military/non-military purposes). Destructive weapons are not treated as capital assets because they are not used repeatedly or continuously in production (although durable, they are viewed as single-use goods). By extension, weapons platforms or delivery systems (warships, submarines, military aircraft, tanks, missile carriers and launchers, etc.) with the function of launching such weapons are treated by convention as having been consumed in the period during which they are acquired.<sup>1</sup>

Non-weaponry used by the military such as airfields, docks, roads, and hospitals (and the equipment associated with them) are treated as capital assets in SNA93 and the GFS system. These assets are continuously used in production in the same way as similar civilian structures (they are often switched from military use to civilian use and back again). Where it is difficult to distinguish between weapons delivery platforms from other equipment (such as transport equipment, computers and communications equipment), SNA 93 recommends that the whole cost default to immediate consumption.<sup>2</sup>

Where light weapons and armoured vehicles are used for non-military activities, such as police or internal security forces, then SNA93 would treat these as assets.<sup>3</sup> However, where the same light weapons and armoured vehicles are used for national security purposes, they are not capitalised.<sup>4</sup>

## *Convergence rationale*

### Accounting Standards

- Given the fundamental principles in GAAP, it is extremely unlikely that accounting standards would be amended to treat one class or category of fixed assets differently to other fixed assets on the basis of use or purpose. If an item meets the definition of an asset, is material in value, and has a useful life extending beyond a single financial period, accrual accounting has long held that that item's value should be apportioned to the periods during which it is consumed. Accounting treats any destruction as a disposal for no return.
- Consumables, which are expensed in the period acquired, are items that are either for a single use or immaterial in value.

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<sup>1</sup> System of National Accounts 1993 paragraphs 10.65 to 10.68 and Government Finance Statistics Manual 2001 paragraphs 6.26, 7.36, and 7.152. We have been told that there was considerable international debate about this treatment during the development of SNA93, but the description above is how the standards were agreed.

<sup>2</sup> System of National Accounts 1993 paragraph 10.67.

<sup>3</sup> System of National Accounts 1993 paragraph 10.68.

<sup>4</sup> System of National Accounts 1993 paragraph 10.68.

## SNA/GFS

- The current treatment is inconsistent between different uses of the same asset—the same item used by the military for national security is expensed on acquisition, but capitalized if used by internal security deliverers such as police departments.
- The current treatment can result in inter-period manipulation of results.
- The current treatment is effectively that of a cash-basis framework, although the items in question are used over multiple periods.
- One of the arguments used to support the current treatment is that destructive weapons are non-productive because they are used to destroy lives or property. However, such use is done with the intention of preserving national security. In this context national security is no different to internal security—it is a service to the citizens of the country.
- A further argument for the current treatment may be that there is a much higher risk that destructive weapons will be destroyed than other assets, such that governments are effectively incurring an expense by purchasing these weapons. However, these items are used over multiple periods by governments around the world indicating that this risk of destruction is overstated.
- Finally, the current treatment is conceptually inconsistent with accounting principles and standards without an adequate justification of the difference.

## *Conclusion*

To achieve convergence in the short term, adopt GAAP treatment with additional note disclosure to enable the ABS to make adjustments for GFS presentation. The ABS has pushed for a change to be made to the SNA through the current review of SNA 93. The Expert Group responsible has recently endorsed the change, with the proposal likely to be formally considered in early 2004. If adopted, ABS will anticipate the change to the revised SNA (and associated statistical standards such as GFS) and adopt this treatment from 2004.

In the longer term, encourage the SNA review is likely to result in a change of treatment to capitalise defence weapons platforms.

## ISSUE 4.2: ALLOWANCES FOR BAD AND DOUBTFUL DEBTS

### *Summary of differences*

**Accounting** – Accounting treatment of bad and doubtful debts is to take up, as an expense and reduction in receivables (contra-asset), a reasonable estimate of the likely difference between the carrying value of the asset receivable and the amount expected to be collected. This reflects the reduction in future economic benefits attributable to that asset.<sup>1</sup>

**GFS** – GFS does not include contra-assets in the Balance Sheet for allowances for bad debts. If debts are revalued, any change in value is taken to the Statement of Other Economic Flows. If debts are to be written down the mutual agreement test has to be met before a charge is raised against bad debts expense for the period. Unilateral write-downs (such as by a contra asset or recognition of repayment being unlikely) are excluded from both GFS expenses and the balance sheet. Further, no recognition is made under GFS of an allowance for doubtful debts.

### *Accounting treatment*

An entity will generally not be able to collect 100 % of monies owing to it over time for a variety of reasons. Based on historical information, entities will generally be able to estimate the percentage of debtors at a point in time that will not be able to pay (aging).

The accounting treatment for debts, where it is not probable that future economic benefits will be obtained (SAC 4), is to create (or increase) the associated contra asset in the current period for the proportion of debts that are not expected to be collectable.

This effectively matches the expense of debt write-offs to the period in which the change in debt status relates (as the revenue has also been recognised in the current or prior periods).

*The reporting of receivables net of a ‘provision’ for doubtful debts is not setting-off assets and liabilities because these ‘provision’ are not liabilities<sup>2</sup>. Any ‘provision’ is disclosed separately in the general purpose financial reports<sup>3</sup>. The contra asset for bad and doubtful debts is not a liability of the entity, but are rather an offset to the stated value of the related receivable. Where actual write-offs of customer amounts are made, they are offset against the contra asset already made.*

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<sup>1</sup> Accounts receivable is a financial asset for purposes of IAS 39. IAS 39.109 requires that at each balance sheet date an entity should assess whether there exists any objective evidence that a financial asset may be impaired. If any such evidence exists, the entity shall estimate the recoverable amount of the amounts receivable and recognise any impairment loss. IAS 39.111 requires the impairment in receivables to be recognised either as a net amount of the asset value or as a contra asset. The display of receivables as the gross amount, with the allowances as a deduction, is generally used on the basis that this provides useful information.

<sup>2</sup> AAS36 paragraph 5.3.1

<sup>3</sup> as required by AAS36 paragraph 8.1 (b)

By creating a contra asset for bad and doubtful debts, an entity is ensuring that the fair values of their receivables are reflective of the real value to the entity.

### *GFS treatment*

In the GFS system, bad debts are only recognised as economic flows when written off, not when the provision or allowance is raised in the accounting records of reporting entities. The raising of the provision or allowance per se does not meet the requirements of 'transactions' and 'other flows' as outlined under 'asset revaluations' above. It is a bookkeeping entry that is internal to an entity (eg. it is not a transaction between institutional units and therefore does not appear in the System of National Accounts).

Bad debts written off from provision or allowance accounts are treated as 'other changes in the volume of assets' if they are written off unilaterally by the creditor or as capital transfers if they are written off by mutual agreement between creditor and debtor. A similar treatment is applied to debts written off directly without prior provisioning.

Where a loan is written down by a creditor, the reasons for doing so would determine the GFS treatment. If the creditor unilaterally writes the loan down in view of, say, an impending bankruptcy of the debtor, then treatment as an "other change in volume" would be appropriate. If however, it is done in consultation with the debtor (i.e. agreement is reached to write down or write off the debt) then a capital grant expense for the creditor and a capital grant revenue for the debtor would be appropriate.

There is no provision or allowance in SNA93 or GFS for a debtor to unilaterally opt out of a loan contract. Debt repudiation is therefore not recognised in statistics.

For the national accounts to be measured correctly, the above treatments affect both parties to a transaction. One of the major difficulties with revaluing receivables is identifying the counter party, whose sectoral account liabilities must also be revalued. Because of this, provisions for doubtful debts are not currently recognised in either the national accounts or GFS.

The failure of GFS and SNA to permit provision or allowance being made for estimated non-recovery of receivables is contrary to the fundamental economic principle of market valuation. By writing receivables down to a "recoverable amount" entities are effectively market-valuing debt.

### *Standard setters' future work programs*

There are currently no items proposed by the standard setting bodies. The accounting treatment of bad and doubtful debts is unlikely to change in the near future. One possible change is to fair value the receivables, which would have substantially the same effect as the current accounting treatment, but without separately disclosing the contra asset.

### *Steps to harmonisation*

Adoption of the IASB Statement of Comprehensive Income may promote harmonisation if receivables were valued at market value.

- Harmonisation would be enhanced by GFS recognising allowances for doubtful debts (at least in the Statement of Other Economic Flows and Balance Sheet).

This issue is being considered as part of the current SNA review. The ABS will prepare a submission seeking convergence between international statistical standards and accounting standards. Any change to SNA will flow through to the IMF GFS manual. It is not clear at this stage what the outcome will be, but by the end of 2003 a consensus should have emerged.

### *Conclusion*

In the short-term, convergence will be achieved by adopting the GAAP treatment for reporting with additional note disclosure in the financial statements to provide the required information for the ABS to make the necessary adjustments for its GFS presentation. The ABS has indicated that it would be willing to early adopt any outcomes from the SNA review in this regard.

In the longer term encourage the ABS to support changes to debt valuation through the SNA Review and adopt a revised operating statement based on comprehensive income statement principles.

It is also important to monitor the SNA Review's progress and the IASB's reporting performance project to ensure long-term convergence is achieved.



## ISSUE 4.5: RESEARCH AND DEVELOPMENT COSTS AND OTHER INTANGIBLES

### *Summary of differences*

**Accounting** - AAS 13 (and ASRB 1011) requires that research and development costs either be expensed for the period during which they are “incurred”, except to the extent that they meet the criteria for deferral,<sup>1</sup> and amortised where these costs are expected beyond any reasonable doubt to be recoverable.<sup>2</sup> IAS 38 requires all expenditure on research to be recognised as an expense when it is incurred.<sup>3</sup> Development expenditure should be recognised as an intangible asset when certain criteria is met.<sup>4</sup> Neither AAS 13, AASB 1011 and IAS 38 allow previously expensed outlays to be subsequently capitalised.

**GFS** - In GFS, research and development costs are treated as items of expenditure.<sup>5</sup> However, GFS does recognise that computer software and other intellectual property, produced on own account, should be valued at the costs of production and revalued to current costs basis each year.<sup>6</sup>

### *Accounting treatment*

#### Research and Development

**Current Australian GAAP** - AAS 13 *Accounting for Research and Development Costs* states that “...costs incurred during the period on research and development projects should be deferred to future periods only to the extent that future benefits are expected, beyond any reasonable doubt, to equal or exceed those costs, any previously deferred costs, and any future costs necessary to give rise to the future benefits.”<sup>7</sup> These deferred costs “...should be amortised over future accounting periods in order to match such costs with related benefits.”<sup>8</sup> Where “...expected future benefits are too uncertain to justify carrying the expenditure forward, the costs ought to be treated as an expense and charged to the profit and loss account as incurred.”<sup>9</sup> AAS 13 specifically prohibits capitalising previously expensed costs.<sup>10</sup>

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<sup>1</sup> AAS13 Paragraph 31

<sup>2</sup> AAS13- Paragraph 32

<sup>3</sup> IAS 38 - Paragraph 42

<sup>4</sup> IAS 38 - Paragraph 45

<sup>5</sup> GFS Manual 2001 Paragraph 6.24

<sup>6</sup> GFS Manual 2001 Paragraph 7.55

<sup>7</sup> AAS13 Paragraph 32

<sup>8</sup> AAS13 Paragraph 33

<sup>9</sup> AAS13 Paragraph 23

<sup>10</sup> Paragraph 37

**Current International Accounting Standards** - IAS 38 requires that research expenditure be expensed and that development costs should be capitalised where an entity can demonstrate certain conditions can be met.<sup>11</sup>

#### Other Intangibles

**Current International Accounting Standards** – Intangible assets should only be recognised under international accounting standards when it is probable that future economic benefits will flow and the cost can be reliably measured.<sup>12</sup> Furthermore, the intangible assets should only be measured at cost.

IAS 38 also prohibits recognition of internally generated brands, mastheads, publishing titles, customer lists and items similar in substance.<sup>13</sup>

It is noted that In Process Research and Development (IPRD) is capitalised on acquisition at cost if acquired separately or at fair value if it is part of a business combination.

Under IAS 38 there is a rebuttable presumption that the useful life of an intangible asset will not exceed twenty years from the date when the assets is available for use.<sup>14</sup> Amortisation should commence when the asset is available for use. The amortisation charge will generally be treated as an expense.<sup>15</sup>

#### *GFS Treatment*

##### Research and Development

GFS specifically prohibits “...outlays on research and development, staff training, market research, and similar activities (to be) treated as intangible fixed assets even though some of them may bring future benefits. These outlays are treated as expense.”<sup>16</sup>

However, certain research and development expenditures associated with the creation of assets (eg software) may be reflected in the values of the assets.

. When a government grants patent protection to an invention, the value of the invention is captured as a non-produced intangible asset, via the statement of other economic flows

<sup>17</sup>

#### Other Intangibles

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<sup>11</sup> IAS 38 – paragraph 45

<sup>12</sup> IAS 38 – paragraph 19

<sup>13</sup> Paragraph 51

<sup>14</sup> IAS 38 – paragraph 79

<sup>15</sup> IAS 38 – paragraph 88

<sup>16</sup> GFS Manual 2001 Paragraph 7.51

<sup>17</sup> GFS Manual 2001 Paragraph 10.35

To qualify as an intangible fixed asset, the item must have been produced, be intended for use in production for more than one year and its use is restricted to the units that have established ownership rights over it or to units licensed by the owner.<sup>18</sup> GFS identifies a number of intangible fixed assets including mineral exploration, computer software (including internally developed software) and literary originals. Depreciation on these assets is treated as an expense.

GFS also includes intangible non-produced assets, which are constructs of society evidenced by legal or accounting actions. Examples include patents, leases and other contracts, and purchased goodwill.<sup>19</sup> Amortisation under GFS for an intangible non-produced asset is generally over its service or legal life and is classified as another economic flow rather than a transaction.<sup>20</sup>

### *Standard setters' future work programs*

The AASB is presently undertaking a joint project with the IASB on intangible assets. One of the issues to be dealt with, as part of this project is the accounting treatment of research and development costs. It is uncertain at this time as to whether a revised Standard on research and development costs. Will be finalised prior to Australia's adoption of international accounting standards on 1 January 2005.

Furthermore, the IASB Business Combinations project is proposing changes IAS 38, however, there is no anticipated change to the current research and development requirements.

### *Steps to harmonisation*

Under current international GAAP and GFS treat research costs in a similar fashion – these costs should be fully expensed. The conflict between GAAP and GFS relates to the limitations on capitalising development costs under GFS.

Given the uncertainty with regard to the finalisation of a revised international accounting standard on accounting for research and development (see the “Standard setters' future work programs” section above), a convergence strategy at this point in time will need to consider likely developments in the short and medium term.

### Short Term (pre-2005)

Given the time agenda of the IASB, it is likely that a revised international accounting standard will not be finalised prior to Australia's adoption of international accounting standards on 1 January 2005. Therefore, any attempts to harmonise in the short term should be directed towards the current international standard (IAS 38).

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<sup>18</sup> GFS Manual 2001 Paragraph 7.51

<sup>19</sup> GFS Manual 2001 Paragraphs 7.78 to 7.81

<sup>20</sup> GFS Manual 2001 Paragraph 8.52

The treatment of research costs under GFS is consistent with current IAS 38. However, the treatment of development costs under GFS differs from the treatment under IAS 38. Adoption of IAS 38 would result in an increase in recognition of intangible assets arising from development expenditure.

#### Medium Term (post-2005)

Given the AASB/IASB's intentions to reconsider the accounting for research and development costs as part of the joint intangible assets project, it is possible that the current accounting treatment within IAS 38 will be amended. This will impact any attempts to harmonise GFS with international standards in the short term

At present research and development outlays are not capitalised under GFS. However, the ABS has indicated that there are current discussions being held as part of the SNA review that may change the current GFS treatment and allow for research and development cost to be capitalised. This would not cause divergence if similar rationale for capitalisation to international accounting standards were adopted. However, if research costs were to be capitalised with development costs this may cause a convergence issue between the two frameworks, as international accounting standards do not allow research costs to be capitalised.

#### *Conclusion*

Despite the work being done by both the SNA Review and IASB, this is likely to remain to some extent a permanent difference. Pending clarification, the fallback would be to disclose GAAP in primary statements together with adequate note disclosure to enable ABS to adjust as required. Standard setters from both frameworks should monitor development to seek opportunities for achieving greater convergence.

Another consideration is the outcome from the SNA review that may change the current GFS treatment for research and development costs. Should the review require capitalisation of research costs and any significant change in methodology for treating development costs from IAS 38, this would cause a convergence issue. The SNA review participants are aware of this possibility.

The treatment of the amortisation charge relating to intangible non-produced assets is different under the two frameworks as GAAP treats as an expense where GFS treat as another economic flow. The IASB Performance reporting framework project may resolve the treatment of revaluations.. The work on the SNA Review is considering this issue.

Alternatively, applying the principle from the IASB standard on Investment Properties, if intangibles were valued at fair value, all changes in value could be classed as re-measurements.

In its consideration of the issue of "intangibles" it may be that the SNA Review may suggest that a broader set of intangible assets (eg brand names, mastheads) be recognised which could cause further divergence with GAAP.

In its consideration of the issue of “intangibles”, the SNA Review may suggest that a broader set of intangible assets (eg brand names, mastheads) be recognised, which could cause further divergence with GAAP.



## ISSUE 5.1: DISTRIBUTIONS PAYABLE TO OWNERS

### *Summary of differences*

Distributions to owners generally take one of two forms: a dividend (eg. out of surpluses, profits, or retained earnings); or a return of equity/capital. The discussed differences are typically eliminated on consolidation for intra-sector and whole-of-government reports. However, sectoral reports will highlight inter-sector distributions.

**Accounting** - Accounting standards require distributions to owners to be classified and treated as either a return of capital (eg a reduction in equity) or dividends (eg reduction in retained earnings). The distributions are treated as a reduction in equity by the paying entity and the focus is on the nature of the payment as declared by the paying entity. Distributions to owners are recognised when they are declared, determined or publicly recommended.

**GFS** - The GFS definition of ‘dividends’ excludes payments from proceeds of non-financial asset sales: “Large and exceptional one-off payments based on accumulated reserves, privatization receipts and other sales of assets, or holding gains are withdrawals of equity rather than dividends”.<sup>1</sup> As these payments are treated as returns of equity, they do not impact on the operational bottom line. GFS dividends are paid out of operating surpluses and are expensed by the paying entity when declared or when paid, if there is no declaration.

### *Accounting treatment*

When an entity pays a distribution to an owner, accounting treatment for the transaction by the paying entity is not dependent on the nature of its relationship with the investor entity. A liability is recognised when the dividend is “...declared, determined or publicly recommended<sup>2</sup>”:

The accounting treatment of dividends does not depend on the source of the funds or the sector of the entity paying the dividend (for example, whether it is a general government entity or a public non-financial enterprise). Treatment of the payment as a dividend or return of equity, can be determined through a formal designation by the transferor or parent entity.<sup>3</sup>

Under current Australian standards dividends are not treated as an expense.

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<sup>1</sup> GFS Manual 2001 Paragraph 6.74

<sup>2</sup> AASB1044 Paragraph 13.1

<sup>3</sup> UIG 38 Paragraphs 7, 40

## *GFS Treatment*

In GFS, dividends arising from 'operating surpluses' are recorded when declared payable or actually take place if no prior declaration occurs<sup>4</sup>. Large dividends reported to the ABS are examined to determine whether they are being paid out of operating surpluses or from the sale of assets. If they are being paid from the former they are treated by the paying entity as GFS expenses and as determinants of the GFS net operating balance of the public corporations. If sourced from the latter they are treated as a return of equity. Reporting by the entity receiving the dividend mirrors this treatment.

## *Standard setters' future work program*

There are currently no items proposed by the standard setting bodies. However, the expected adoption of IAS 10 *Events After the Balance Sheet Date* may have some implications concerning dividends, specifically, the timing of recognition of dividends.

## *Steps to harmonisation*

The AASB could give consideration to clarify and expanding the guidance from UIG 38 to more fully address re-distributions of revenue and capital in a public sector context. This would be achieved through additional research regarding the impacts of performance reporting, UIG 38 and IAS proposed treatments.

## *Conclusion*

This issue is unlikely to be resolved in the short term due to the conceptual differences in definition of an expense.

The preferred convergence option in the short term would be to adopt the GAAP treatment in the presentation of jurisdictions financial statements with additional Note disclosure to allow ABS to convert dividends according to its own conventions. Where this results in a material difference between results presented by the ABS and jurisdictions disclosure of the difference and potentially a reconciliation footnote would be required.

In the medium term to assist in harmonisation of GFS and GAAP, the concepts of UIG 38 could be used, whereby jurisdictions could formally designate that distributions to owners will be classified as dividend/return of equity in accordance with GFS principles.

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<sup>4</sup> GFSM 2001, Paragraph 3.64.

## **ISSUE 5.2: REDUCED ‘GFS NET WORTH’ FOR COMMERCIAL GOVERNMENT OPERATIONS**

### *Summary of differences*

The fundamental difference between the two frameworks on this issue arises from the underlying valuation premise, where accounting uses modified historical cost and GFS uses market values. Furthermore, GFS treats shares and other equities (including outside equity interest) as liabilities of the entity to the economy or market, whereas accounting treats shares and other equities as equity (separate from liabilities).

**Accounting** – Accounting standards generally treat government commercial operations as either associates or subsidiaries, depending upon the degree of influence or control exercised over the entity. Accounting standards set out the treatment of these related entities and specify that these investments can never have a negative carrying value. Net worth is considered to be an alternative expression for net asset value (eg assets less liabilities). It is an entity viewpoint measurement and is not affected by the market value of the entity’s equity securities.

**GFS** – GFS net worth is an analytical balance calculated as net assets less shares and contributed capital (measured at market value and treated for this purpose as a form of liability). The subtraction of shares and contributed capital will result in zero net worth for the PNFC Sector. The statistical concept of net worth is different from net assets used in business accounting and it can be positive, zero or negative. It is an indicator of the differences in valuation placed by claimants or investors on the one hand and the entity or sector’s valuation of its assets/liabilities on the other hand. Negative net worth can arise for commercial government operations when the balance sheet net assets amount is less than the market value placed on a listed entity.

### *Accounting treatment*

The treatment under accounting standards of investments, depending on the degree of influence or control, would fall under either the consolidation or equity accounting standards.

Where an entity exercises control over another entity, for example as a result of its shareholding in that entity, the controlling entity will consolidate the controlled entity. This will include the elimination of all inter-entity transactions. AAS 24 provides instructions on how and when this would occur.

Where an entity exercises significant influence (but not control), one entity is the ‘associate’ of the other. In this situation, the investment in the associate is recorded in the accounts of the holding entity using the equity method of accounting. AAS 14 addresses various issues relating to accounting for investments in associates.

The carrying amount of the investment in an unconsolidated associate is measured on a modified historical cost basis. The carrying amount cannot be valued above the recoverable amount for the investment<sup>1</sup>. This is to ensure that the fair value of the entity's assets is not overstated. Nor can the carrying amount be below zero<sup>2</sup>. Therefore, the investment can never be recorded at a negative net value (or net worth) in the books of the investor.

### *GFS Treatment*

Negative net worth, although common in private sector national accounts reporting (but not disclosed there for specific entities), generally arises in the public sector as a consequence of privatisation. This is a consequence of the ownership interests being measured by the market price (which will always include a variety of intangible factors) and then comparing the aggregate value of the ownership interests with the net assets. As internally generated goodwill, trademarks, strategic advantage and other intangibles are generally not booked as assets, the ownership value often exceeds the net asset value. GFS then reports this as a negative net worth, thus reflecting that the particular entity or sector owes other sectors of the economy more in performance than its current net asset value.

Therefore, negative net worth results where the market value of shares and other contributed capital exceeds the value of the net assets (i.e. assets less liabilities). That is, when the balance sheet net assets amount is less than the market value placed on a listed entity<sup>3</sup>.

The market value for the entity may exceed the fair value of the net assets of the entity where;

- the entity has internally generated goodwill or other intangibles which are not recorded in their accounts
- non-financial assets are valued at historic cost rather than market value
- there is a market advantage perceived by the investors; or
- the market is not a perfect environment.

A negative net worth figure is difficult to explain to users of the financial data as a negative sign generally implies a negative, or unfavourable, result.

The statistical treatment of net worth is different from that conventionally used in corporate and business accounting under the same and related terms such as net equity, net assets, net shareholders' funds, net residual value, etc.

The statistics are compiled from a macro-perspective and it is essential that there is symmetry in the recording for all institutional sectors in the economy. As shares (and related instruments such as equity and contributed capital) are financial

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<sup>1</sup> AAS 14 paragraph 5.15.

<sup>2</sup> AAS 14 paragraph 5.13.

<sup>3</sup> *GFS Manual 2001* paragraph 7.140.

assets of the holders, they have to be treated as if they were liabilities of the issuers.<sup>4</sup>

The symmetrical treatment of shares and contributed capital in this manner makes it possible to compile consolidated statistics. Such symmetry does not have the same relevance in business or corporate accounting as these accounts are prepared from a "micro" perspective, which rightfully ignores the treatment by counter-parties.

### *Standard setters' future work programs*

There are currently no items proposed by the accounting standard setting bodies.

The ABS has indicated that the IMF may be commencing work on measurement and reporting of intangible assets.

The AASB is also undertaking work on the recognition and measurement of intangible assets in the context of harmonisation with the IASB. However, it is expected that the recognition of internally generated intangible assets (including goodwill) would be subject to greater restrictions than those that may arise out of the IMF work.

### *Steps to harmonisation*

The Statement of Financial Position would continue to present Net Assets and Equity, in accordance with GAAP. However, additional information would be provided in the Notes to the Accounts to allow ABS to derive pure GFS. Both relevant ABS publications and financial statements to include notes to adequately disclose the treatment.

### *Conclusion*

The present situation arises from application of macro-economic measurement methods, which are appropriate in the context of national accounts and other statistics at a macro level. However, the accounting treatment of such items may be more appropriate for individual jurisdiction reporting.

This represents a fundamental difference between GFS and GAAP reporting. As a result, to achieve convergence, both short and long term, jurisdictions should adopt the GAAP treatment and use additional note disclosures to provide additional information to enable the ABS to make adjustments for GFS presentation.

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<sup>4</sup> *System of National Accounts 1993* paragraph 13.83.



## ISSUE 5.3: INVESTMENTS IN ASSOCIATES USING THE EQUITY METHOD OF ACCOUNTING

### *Summary of differences*

The following table summarises the main differences in accounting treatment by an investor of an investment in an associate.

	<b>GAAP Equity method</b>	<b>GFS</b>
<b>Initial acquisition of investment</b>	<i>An investment asset is recorded at cost.</i>	<i>An investment asset is recorded at cost.</i>
<b>Subsequent measurement</b>	<i>Investor's share of the net assets of the associate</i>	<i>At market value (or if no market value investor's share of net assets)</i>
<b>Dividends paid by associate to investor</b>	<i>Investment asset value is reduced (Cr) i.e. treated as a an asset re-measurement.</i>	<i>Shown as dividend revenue (Cr) in determination of net operating balance in the operating statement</i>
<b>Investor's share of the associate's post-acquisition profit or loss</b>	<i>Investment value is changed (Dr if there is a profit, Cr if there is a loss) and recognised in the operating statement (Cr if a profit, Dr if a loss)</i>	<i>The increase/decrease in value of an investment over a period is recorded by the GGS as an increase(Dr)/decrease(Cr) in the investment and as a positive(Cr)/negative(Dr) other economic flow</i>
<b>Investor's share of the post acquisition increments or decrements in the associate's reserves for the period, to the extent that these movements are not already reflected in the carrying amount of the investment</b>	<i>Investment value is changed with a corresponding change in the investor's reserves</i>	<i>The increase/decrease in value of an investment over a period is recorded by the GGS as an increase(Dr)/decrease(Cr) in the investment and as a positive(Cr)/negative(Dr) other economic flow</i>

### **Accounting**

Under AAS 14 "Accounting for Investments in Associates" investments in associates are initially recorded at cost. Where the equity method is used the carrying amount of the investment is, at the end of a period:

- increased or decreased by the amount of the investor's share of the associate's post-acquisition profit or loss adjusted for distributions to preference equity holders,

dissimilar accounting policies (where possible), revisions in depreciation of the associate's depreciable assets, amortisation of goodwill, and unrealised profits and losses on transactions between the associate and the investor or the investor's subsidiaries or other associates (AAS 14 paragraph 5.3(a)). This amount must be recognised in the profit or loss or other operating statement (AAS 14 paragraph 5.4(a));

- decreased by the amount of dividends received or receivable from the associate (AAS 14 paragraph 5.3(b)). Thus dividends are not treated as revenue but as a reduction in an asset value (re-measurement); and
- increased or decreased by the amount of the investor's share of the post acquisition increments or decrements in the associate's reserves for the period, to the extent that these movements are not already reflected in the carrying amount of the investment. This amount is required to be reflected in the investor's reserves (AAS 14 paragraph 5.4(b)).

## **GFS**

The GFS Manual does not deal explicitly with the concept of an associate. It identifies a category of financial assets as "shares and other equity". If the relationship between the investor and investee is one of control the investee's accounts are consolidated.

In the GFS system GGS investments in other entities are measured at market value. Where the entity has shares that are traded in an active market their value is used to obtain market value. The increase in value over a period is recorded by the GGS as an increase in the investment and as an other economic flow. Any dividends paid to the GGS are recorded as an increase in cash and as dividend revenue.

Where the entity does not have shares an approximation to market value is obtained by reference to the net asset value of the entity. Thus an increase in net asset value of an entity over a period is recorded by the GGS as an increase in the investment and an other economic flow. Dividends paid by such entities to the GGS are recorded by the GGS as an increase in cash and dividend revenue.

### *Accounting treatment*

#### **What is an associate?**

AAS 14 paragraph 3.1.1 states that "In some cases, the relationship between an investor and its investee does not extend beyond an investor/investee relationship. However, in other cases, a special relationship between the investor and the investee exists which is characterised by the investor's control of, or significant influence over, an investee. This Standard deals with circumstances where an investor has significant influence over an investee. In these cases, the investee is known as an associate."

## **How does an investor account for an investment in an associate?**

Both AAS 14 and IAS 28 “Accounting for Investments in Associates” require the use of the equity method in an investor’s consolidated accounts. As the focus of GFS is on consolidated accounts for the GGS this paper focuses on the equity method.

Where consolidated accounts are prepared AAS 14 “requires investments in associates to be accounted for in the investor’s separate financial report in accordance with the “cost method” (that is, by initially recognising the investments at their cost of acquisition and subsequently recognising them either at cost or at fair value in accordance with AASB 1041)”.<sup>1</sup>

“Where an investor prepares consolidated financial reports, IAS 28.12 permits investments in associates to be accounted for in the investor’s separate financial report either at cost, by applying the equity method, or at fair value without any deduction for disposal costs in accordance with IAS 39” [“Financial Instruments: Recognition and Measurement”].”<sup>2</sup> But note that:

“It is proposed under the IASB Improvements ED that an investment in an associate be accounted for in the investor’s separate financial statements in accordance with paragraphs 29, 30 and 33 of IAS 27 “Consolidated and Separate Financial Statements”. Those paragraphs require equity-accounted associates to be accounted for at either cost or in accordance with IAS 39 in the separate financial statements. Investments accounted for in accordance with IAS 39 in the consolidated reports must also be treated on that basis in the separate financial statements. AASB 1016 [and AAS 14] does not permit an allowed alternative accounting treatment. Australia does not currently have an equivalent to IAS 39.”<sup>3</sup>

Where there are no consolidated accounts the equity method must be used under AAS 14, whereas “IAS 28 presently permits an investment in an associate to be measured according to the cost method, the equity method or under IAS 39. It is proposed under the IASB Improvements ED that the equity method to be applied to all investments in associates where there are no consolidated statements.”<sup>4</sup>

It should also be noted that AAS 14 excludes certain types of investments from its application as explained in the following paragraphs:

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<sup>1</sup> AASB 2002 “The Australian Convergence Handbook” p113

<sup>2</sup> AASB 2002 “The Australian Convergence Handbook” p113

<sup>3</sup> AASB “Analysis of proposed improvements to IAS 28”. Invitation to Comment Proposed Improvements to International Accounting Standards and their Impacts on Australian Standards. May 2002.

<sup>4</sup> AASB “Analysis of proposed improvements to IAS 28”. Invitation to Comment Proposed Improvements to International Accounting Standards and their Impacts on Australian Standards p 66. May 2002.

**“1.3 Except for the requirements of paragraph 6.1, this Standard does not apply where, in accordance with another Australian Accounting Standard, investments are measured at *net market value* and changes in net market value are *recognised* as revenues or expenses in the *profit and loss or other operating statement* in the reporting period in which the changes occur.**

1.3.1. Paragraph 6.1 of this Standard requires certain disclosures to be made about all *associates*, whether the *investor* applies the equity method or the net market value method of accounting for investments.”

Similarly, it is proposed under the IASB Improvements ED for IAS 28 that it exclude from its scope investments in associates held by venture capital organisations, mutual funds, unit trusts and similar entities that are permitted to use a fair value model for investments under IAS 39. “The IASB at its 29 April to 2 May 2003 meeting decided that:

“The improvements to IAS 28 *Accounting for Investments in Associates* should clarify that the entities permitted to use a fair value model for investments in associates include not only venture capital organisations, mutual funds, unit trusts and similar entities, but also similar insurance structures in which policyholders participate directly in the risks and returns from those investments.”<sup>5</sup>

### **The cost method**

According to AAS 14 paragraph 4.1.2 the general features of the cost method are:

- “(a) an investment in the equity of another entity is initially recognised at its cost of acquisition
- (b) revenue attributable to the investment is recognised only to the extent of dividends received or receivable out of post-acquisition profits (results) of the investee
- (c) dividends received or receivable from pre-acquisition profits (results) are considered to be a recovery of part of the cost of the investment and are accounted for by reducing the carrying amount of the investment
- (d) the carrying amount of the investment may be revalued in accordance with Australian Accounting Standard AAS 10 "Accounting for the Revaluation of Non-Current Assets".

### **The equity method?**

According to AAS 14 paragraph 3.1.3

“Under the equity method, the investment is initially recorded at the *cost of acquisition* and adjusted thereafter for post-acquisition changes in the investor's

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<sup>5</sup> IASB Update April 2003

share of the net assets of the investee. The profit and loss or other operating statement reflects the investor's share of the *result (profit or loss)* of the investee”.

### **How is the carrying amount of the investment changed over time under the equity method?**

“In each period that the equity method is applied, AASB 1016 [and AAS 14] (paragraph 5.3) requires the carrying amount of an investment in an associate to be:

- increased or decreased by the amount of the investor’s share of the associate’s post-acquisition profit or loss adjusted for distributions to preference equity holders, dissimilar accounting policies (where possible), revisions in depreciation of the associate’s depreciable assets, amortisation of goodwill, and unrealised profits and losses on transactions between the associate and the investor or the investor’s subsidiaries or other associates;
- decreased by the amount of dividends received or receivable from the associate; and
- increased or decreased by the amount of the investor’s share of the post acquisition increments or decrements in the associate’s reserves for the period, to the extent that these movements are not already reflected in the carrying amount of the investment.

IAS 28 is consistent with, but not as detailed as AASB 1016. IAS 28.3 requires the carrying amount of the investment to be adjusted for the post-acquisition movement in the investor’s share of net assets of the investee, and IAS 28.16 comments that many of the procedures appropriate for the application of the equity method are similar to the consolidation procedures set out in IAS 27 “Consolidated Financial Statements and Accounting for Investments in Subsidiaries”.<sup>6</sup>

But note that the equity method must be discontinued and the investment recorded at zero where the investor's share of deficits (losses) and reserve decrements reduces the carrying amount of the investment below zero (AAS 14 paragraph 5.13).

In addition

**“The carrying amount of an investment in an associate must not exceed its *recoverable amount*. Where the recoverable amount of an investment has declined below its carrying amount, the carrying amount must be written down to that recoverable amount. The amount of the reduction must be recognised in the profit and loss or other operating statement in the reporting period in which the reduction occurs.” (AAS 14 paragraph 5.15).**

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<sup>6</sup> AASB 2002 “The Australian Convergence Handbook” p118

**“Where an investment in an associate has been written down to recoverable amount as at a previous reporting date in accordance with paragraph 5.15, the write-down must be reversed to the extent that the recoverable amount as at the current reporting date exceeds the written-down carrying amount. The amount of the reversal must be recognised in the profit and loss or other operating statement in the reporting period in which the reversal occurs.” (AAS 14 paragraph 5.16)**

**“Where the equity method is applied, the maximum amount at which an investment in an associate can be recognised in the financial report is the carrying amount determined by applying the equity method.” (AAS 14 paragraph 5.17)**

Moreover:

The application of the equity method precludes the recognition of increases in the carrying amount of the investment through revaluations made in accordance with Australian Accounting Standard AAS 10 "Accounting for the Revaluation of Non-Current Assets".(AAS 14 paragraph 5.17.1)

The IAS Improvements project is planning some changes in the area of write downs as follows:

“It is proposed under the IASB Improvements ED for IAS 28 that losses recognised under the equity method in excess of the investor’s investment in ordinary shares are applied to the other components of the investor’s interest in an associate in the order of their seniority (that is, priority in liquidation). Other components of the investor’s interest includes preferred shares and long-term receivables or loans, but not trade receivables or trade payables. After the investor’s interest is reduced to nil, additional losses are provided for, and a liability recognised, only to the extent that the investor has incurred obligations or made payments on behalf of the associate.

Under AAS 14 the equity method must be discontinued when the carrying amount of the investment reaches zero. UIG Abstract 24 “Equity Accounting – Carrying Amount of an Investment in an Associate” provides guidance that the carrying amount includes ordinary shares and other financial instruments which satisfy the characteristics of an ownership interest. There is no specific guidance in Australian Standards (or in UIG Abstracts) on recognising additional losses. The proposed amendment is likely to give rise to a difference from [AAS 14] and UIG Abstract 24 because long-term receivables or loans do not usually qualify as an ownership interest. In addition, Abstract 24 provides that other forms of interest are subject to the recoverable amount test to determine whether impairment has occurred. Whilst there is no specific guidance on additional losses, a liability

should be recognised if it satisfies the recognition criteria for liabilities in SAC 4.” (Improvements Invitation to Comment)<sup>7</sup>

At its 18 – 20 December 2002 meeting the IASB decided to clarify that:

- the amount to be reduced to nil when an associate incurs losses should include only long term interests, which are in substance part of the net investment
- the investor applies the requirements of IAS 39 to determine whether any additional impairment loss is recognised with respect to that net investment, and
- the investor applies the requirements of IAS 39 to determine whether any impairment loss is recognised with respect to items that are not part of the net investment.

The Board agreed that receivables for which good collateral existed, like secured loans, should not be included in the amount to be reduced to nil when an associate incurs losses.<sup>8</sup>

### **How is the investor’s share of net assets, profits and reserves accounted for and calculated?**

In applying the equity method AAS 14 requires:

- the investor’s share of an associate’s adjusted post-acquisition profit or loss for the period to be recognised in the investor’s statement of financial performance and the investor’s share of the associate’s post-acquisition increments or decrements in reserves for the period to be recognised in the investor’s reserves (paragraph 5.4);
- the investor’s share of the associate’s net assets, profit or loss and reserves to be determined in accordance with the investor’s ownership interest in the associate (paragraph 5.5); and
- where the associate is a parent entity, the investor’s share of the associate’s net assets, profit or loss and reserves to be determined based on the net assets, profit or loss and reserves reflected in the associate’s consolidated financial report and attributable to members of the parent entity (paragraph 5.6).

“IAS 28 does not explicitly address these issues other than to require that the statement of financial performance reflects the investor’s share of the results of the operations of the investee (IAS 28.3).”<sup>9</sup>

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<sup>7</sup> AASB “Analysis of proposed improvements to IAS 28”. Invitation to Comment Proposed Improvements to International Accounting Standards and their Impacts on Australian Standards. May 2002.

<sup>8</sup> IASB Update December 2002

<sup>9</sup> AASB 2002 “The Australian Convergence Handbook” p119

## *GFS Treatment*

The GFS Manual does not deal explicitly with the concept of an associate. It identifies a category of financial assets as “shares and other equity”. If the relationship between the investor and investee is one of control the investee’s accounts are consolidated.

In the GFS system GGS investments in other entities are measured at market value. Where the entity has traded shares their value is used to obtain market value. The increase in value over a period is recorded by the GGS as an increase in the investment and as an other economic flow. Any dividends paid to the GGS are recorded as an increase on cash and as dividend revenue.

Where the entity does not have shares an approximation to market value is obtained by reference to the net asset value of the entity. Thus an increase in net asset value of an entity over a period is recorded by the GGS as an increase in the investment and an other economic flow. Dividends paid by such entities to the GGS are recorded by the GGS as an increase in cash and dividend revenue.

## *Standard setters’ future work program*

### **IAS 28**

The AASB plans to issue the “improved” IAS 28 standard as an AASB standard, provided the IASB does not make substantive amendments at forthcoming IASB meetings that are unsuitable for the Australian environment.

However, it should be noted that the AASB has provided input to the IASB consideration of IAS 28 that recommends the **removal of equity accounting** in favour of a fair value approach consistent with IAS 39. The AASB has written:

“We generally do not support the equity method as a measurement basis. Although the equity method provides users with profit and loss information of the associate, it is uncertain as to what the carrying amount of an equity-accounted investment represents (for instance, the carrying amount is not necessarily indicative of current value). We believe that financial statements prepared using either the fair value method required by IAS 39 or the cost method is more appropriate (particularly in terms of providing users with relevant information). Using the fair value method required by IAS 39 would provide an indication of current value. Alternatively, any investment in an associate that does not have a quoted market price in an active market and whose fair value cannot be reliably measured would be recorded at cost. Even under the cost method, users would be provided with relevant information in terms of the dividend income received.

We believe that the equity method of accounting should be abandoned. We would recommend that investors should be required to account for their investment in an associate using either the fair value method required by IAS 39 or the cost method. In fact, if such an approach were adopted, an individual standard on accounting for investments in associates would not be necessary given that all such investments would ultimately be accounted for under IAS 39. Furthermore, if the equity method of accounting were abandoned, it may force investor entities to consider more carefully their relationship with investees and whether or not the relationship is based on control.”<sup>10</sup>

At its meeting on 29 April 2003 to 2 May 2003 the IASB decided (in the context of its discussion of IAS 31 “Joint Ventures”) that the usefulness of equity accounting should be reviewed by IASB staff.

“The Board also decided that it would be useful to consider whether the equity method is suitable for accounting for interests in joint ventures and the usefulness of the equity accounting method in general. It was noted that any such project should examine the alternatives of fair value (under IAS 39 *Financial Instruments: Recognition and Measurement*), the expanded equity method and the gross equity method. A number of Board Members noted that the expanded equity method and the gross equity method might suffer from the same criticisms often made of proportional consolidation. Other members noted that they find the additional information provided by the expanded and gross equity methods useful, particularly when an entity conducts a large proportion of its existing operations through joint ventures. Under equity accounting, the balance sheet and income statement effectively “shrink” due to the netting that occurs in the application of the equity method and information is lost. The Board acknowledged the work of the G4+1 in the areas of joint ventures (1999) and equity accounting (unpublished).

The Board decided that the Australian Accounting Standards Board should be responsible for the broad research project and should initially prepare a project plan, probably based on staging the project initially to cover only IAS 31 issues, with subsequent work to be scheduled on IAS 28 *Accounting for Investments in Associates*.”<sup>11</sup>

### *Steps to harmonisation*

In the medium term it appears likely that equity accounting will continue. However, the IASB has proposed that a project led by AASB look at the usefulness generally of equity accounting. The AASB has expressed its view that equity accounting should be abandoned in favour of a fair value approach in IAS 39 except where such a value can

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10 AASB Submission on IASB Exposure Draft "Proposed Improvements to International Accounting Standards" (Sept. 2002)

<sup>11</sup> IASB Update April 2003

not be reliably measured (in which case a cost based approach would be used). Should this approach be introduced the issues of harmonisation relating to investments in associates would be similar to those covered in issues paper 3 “Financial Instruments”.

### *Conclusions*

In the short to medium term this issue is unlikely to be resolved due to the conceptual differences between GAAP equity accounting treatment and GFS treatment of investments in associates.

The preferred convergence option in the short term would be to adopt the GAAP treatment in general purpose financial statements and provide additional note disclosure to allow the ABS to convert to its own conventions. Where this results in a material difference between results presented by ABS and jurisdictions’ disclosure of the difference, potentially a reconciliation footnote would be required.

The IASB’s performance reporting project should be monitored to identify any implications for the GAAP treatment of investments in associates.

### *References*

#### *Australian*

AAS 14 and AASB 1016 “Accounting for Investments in Associates” (August 1998)

UIG Abstract 20 “Equity Accounting – Elimination of Unrealised Profits and Losses on Transactions with Associates” (October 1998)

UIG Abstract 24 “Equity Accounting – Carrying Amount of an Investment in an Associate” (November 1998)

AASB Submission on IASB Exposure Draft "Proposed Improvements to International Accounting Standards" (Sept. 2002)

AASB “The Australian Convergence Handbook” (2002)

#### *International*

IAS 28 “Accounting for Investments in Associates” (revised 2000)

## ISSUE 6.1: INVESTMENT PROPERTY

### *Summary of differences*

Investment property is property held for rental income or expectation of capital gain.

**Accounting** – 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.

**GFS** - Changes in the market value of fixed capital are recognised in the Statement of Other Economic Flows, which directly affects net worth.

### *Accounting treatment*

ED 103 *Investment Property (and Consequential Amendments to AASB 1021/AAS 4 and AASB 1041)*, issued in December 2001, was largely based on IAS 40 *Investment Property*. It applies to property held for rental income or capital appreciation. This might include public rental housing and property held by one department and rented to other departments. IPSAS 16 *Investment Property*, which applies to the public sector excluding government business enterprises, includes guidance that property held to provide a social service is not investment property and falls outside the scope of the standard although the property may generate cash flows.

IAS 40/ IPSAS 16 offers a choice of accounting treatments. One alternative is to measure the property at cost and depreciate it in the same way as any other property and plant. Note disclosure of the fair value is required. It is assumed that governments will adopt the alternative treatment, which is to measure the property at fair value and include any gain or loss arising from the change in fair value in net profit or loss/ surplus/deficit for the period in which it arises. It should be noted that when the AASB issued ED 103 there was some support for splitting disclosure of this gain or loss between a depreciation charge and a fair value change.

### *GFS Treatment*

GFS treats investment property in the same way as other “Fixed Capital” assets. The asset should be recorded in the balance sheet at market value, but adjustments to this value at each period end are split into the two components of consumption of fixed capital and revaluation. Consumption of fixed capital is recognised as an expense in the statement of Government operations. Other changes in the market value of fixed capital are recognised in the Statement of Other Economic Flows, which directly affects net worth.

## *Standard setters' future work program*

As part of the adoption in Australia of accounting standards based on International Standards the AASB intends to issue a standard largely based on IAS 40 *Investment Property*.

The IASB also has a project intended to improve the predictability of performance reporting. For investment property, buildings at fair value are not depreciated and all changes in fair value are to be recognized and disclosed as a "re-measurement". Investment property held at cost is depreciated in the same way as other property and plant. The performance reporting proposals for property and plant are that depreciation is disclosed as "profit before re-measurements" and revaluations are disclosed as "re-measurements".

## *Steps to harmonisation*

When issuing a standard for investment property the AASB should be encouraged to adopt the exclusions of IPSAS 16 to ensure sector neutrality. This would probably eliminate the issue for the consolidated General Government (GG) sector, although there may still be issues for individual departments and possibly for other public sector entities such as universities who might have other forms of investment property.

HoTARAC should also recommend to the IASB that in developing its performance reporting project the operating statement impact of changes in the value of investment properties is split into its components with the portion attributable to depreciation recognised and disclosed as *business profit before re-measurement* and other changes in valuation recognised as *re-measurements*. This could be justified on the grounds of improving predictability and giving greater consistency with the treatment of property, plant and equipment as well as assisting GAAP/GFS convergence. Such treatment would give clear guidance on the appropriate policy to apply to any property measured at fair value but scoped out of an investment property standard. The AASB should be encouraged to strongly support this recommendation.

## *Conclusion*

Short term the frameworks are aligned.

Longer term the AASB should consider including the exclusions from IPSAS 16 as public sector specific provisions when adopting IAS 40. This will minimise divergence.

- Also encourage the AASB to comment to the IASB that, in the context of the Reporting Performance project, the change in fair value of investment properties should be split into components (eg 'profit before re-measurement' and 're-measurement').
- It is important to continue to monitor developments regarding IAS 40 and the reporting performance project to look for opportunities for convergence.

## **ISSUE 7.2: DISTRIBUTIONS RECEIVABLE FROM CONTROLLED ENTITIES**

### *Summary of differences*

Distributions from controlled entities to a parent entity generally take one of two forms, either a dividend or a return of capital. The differences outlined below are typically eliminated on consolidation for intra-sector and whole-of-government reports. However, sectoral (segment) reports will highlight inter-sector (inter-segment) distributions.

**Accounting** - Accounting standards require distributions from controlled entities to be recognised as either a return of capital (eg a reduction in investment for parent) or a dividend (eg revenue of the parent). The sources of the funds underlying a distribution (eg. the classification or type of entity) are not considered by the parent entity. Distributions are recognised when they are declared, determined or publicly recommended.

**GFS** - The GFS definition of ‘dividends’ excludes payments from proceeds of non-financial asset sales; “Large and exceptional one-off payments based on accumulated reserves, privatization receipts and other sales of assets, or holding gains are withdrawals of equity rather than dividends”.<sup>1</sup> As these payments are treated on receipt as returns of equity, with no impact on the operating bottom line. GFS dividends are paid out of operating surpluses and are recognised as revenue by the receiving entity when declared.

### *Accounting treatment*

When an investing entity receives a distribution to owners, accounting treatment for the transaction is dependent on the nature of the relationship with the investee entity. Where that relationship is either control or less than significant influence over the paying entity, “...dividend revenue must be recognised when the entity's right to receive payment is established.”<sup>2</sup> Where the relationship is one of significant influence over the operations of the other entity, “...dividends received or receivable from pre-acquisition profits (results) are considered to be a recovery of part of the cost of the investment and are accounted for by reducing the carrying amount of the investment.”<sup>3</sup> Even if a distribution were funded out of a realised capital gain, accounting would treat that as revenue of the receiving entity.

The source of the distribution, that is the source of the funds or the sector of the entity paying the distribution (for example, whether it is a general government entity or a public enterprise) are not relevant for recognition purposes. Treatment of the distribution as a

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<sup>1</sup> GFS Manual 2001 Paragraph 6.74

<sup>2</sup> AAS 15 Paragraph 8.2 (d)

<sup>3</sup> AAS 14 paragraphs 4.1.2 (c) and 5.3

dividend or return of equity can be determined through a formal designation by the transferor or parent entity.<sup>4</sup>

Where dividends are declared, determined or publicly recommended subsequent to the reporting date but before completion of the financial report, they are disclosed (in aggregate) in the financial report. This disclosure may be made in either or both of the statement of financial position (as a separate component of equity) and the notes.

### *GFS Treatment*

In GFS, dividends arising from 'operating surpluses' are recorded when declared. Large dividends reported to the ABS are examined to determine whether they are being paid out of operating surpluses or from the sale of assets. If they are being paid from the former they are treated as GFS expenses and as determinants of the GFS net operating balance of the public corporations. If sourced from the latter they are treated as a return of equity.

### *Standard setters' future work program*

There are currently no items proposed by the standard setting bodies. However, the IASB tentatively concluded in October 2002 as part of its Performance Reporting project that all returns on equity investments should be treated as valuation adjustments i.e. remeasurements or, in GFS terms, holding gains.<sup>5</sup>

### *Steps to harmonisation*

The AASB could give consideration to clarifying and expanding the guidance from UIG 38 to more fully address re-distributions of revenue and capital in a public sector context. This would be achieved through additional research regarding the impacts of performance reporting, UIG 38 and IAS proposed treatments.

### *Conclusion*

To achieve convergence in the short and long term, jurisdictions should formally designate whether distributions to owners will be classified as dividends or returns of equity in accordance with principles from UIG 38; and adopt the GAAP treatment in the presentation of financial statements with additional note disclosure to allow ABS to make adjustments for GFS presentation.

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<sup>4</sup> UIG 38 "Contributions by Owners made to Wholly-owned Public Sector Entities" paragraph 40

<sup>5</sup> The IASB Income Statement (Reporting Performance) Project Update December 2002 page 5

## **ISSUE 7.3: DEPRECIATION / CONSUMPTION OF FIXED CAPITAL AND VALUATION OF NON-CURRENT ASSETS**

### *Summary of differences*

**Accounting** - Depreciation is expensed systematically for the purpose of allocating the depreciable amount of a depreciable asset over its useful life.

Valuation subsequent to initial recognition is measured at either cost or fair value.

**GFS** - Depreciation refers to the estimated consumption of non-financial assets during the accounting period.

Valuation of all assets and liabilities should be valued at their current market value, which is defined as the amount that would have to be paid to acquire the asset on the valuation date.

### *Accounting treatment*

#### Depreciation

AASB 1021 and 1041 require that the depreciable amount of a depreciable asset must be allocated on a systematic basis over its useful life. The depreciation method applied to an asset must reflect the pattern in which the asset's future economic benefits are consumed or lost by the entity. The allocation of the depreciable amount must be recognised as an expense, except to the extent that the amount allocated is included in the carrying amount of another asset.

IAS 16 requires long-lived assets (other than land) to be depreciated on a systematic basis over their useful lives. The depreciation method should reflect the pattern in which the asset's economic benefits are consumed by the enterprise. The useful life should be reviewed periodically and any change should be reflected in the current period and prospectively. Significant costs to be incurred at the end of an asset's useful life should either be reflected by reducing the estimated residual value or by charging the amount as an expense over the life of the asset.

#### Valuation

AASB 1041 and IAS 16 prescribe the manner in which non-current assets are measured subsequent to initial recognition at cost or fair value. The depreciable amount is cost less estimated residual value. For an asset measured at fair value subsequent to initial recognition, the asset's depreciable amount is the revalued depreciable amount. Revaluation 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 balance sheet date.

## *GFS Treatment*

### Depreciation

GFS requires all "Fixed Capital" assets to be measured at market value at all times, and recognizes changes in market value in the Statement of Other Economic Flows. In the Statement of Government Operations, GFS recognises as an expense the Consumption of Fixed Capital, which is defined as "the decline during an accounting period in the value of fixed assets, major improvements to land, and the costs of ownership transfer incurred on the acquisition of valuables and non-produced assets as a result of physical deterioration, normal obsolescence, or normal accidental damage. It is based on the average prices of assets for the period. Changes in the asset's value due to changes in the price of the asset are excluded."<sup>1</sup>

Depreciation is treated as an expense in the operating statement and as negative component of net acquisition of non-financial assets. Expenses are defined as outflow of economic value arising from operational transaction. Depreciation refers to the estimated consumption of non-financial assets during the accounting period. In Australia's GFS, depreciation estimates provided by jurisdictions, measured in accordance with accounting standards, is recorded in lieu of the national accounting concept of consumption of fixed capital. The estimate of consumption of fixed capital in the national accounts is derived independently by the ABS and is in insufficient detail to be used in the GFS system.

### Valuation

All assets and liabilities should be valued at their current market value, which is defined as the amount that would have to be paid to acquire the asset on the valuation date.

## *IFAC PSC Analysis*

At the IFAC PSC presentation to the OECD Colloquium on Accrual Accounting in February 2003, IFAC noted depreciation as a "technical difference" in comparing IPSAS and GFS. IFAC PSC's concerns may stem from the reference in the IMF GFS manual at paragraph 6.33, where it states that "consumption of fixed capital may deviate considerably from depreciation...calculated using the original costs of fixed assets".

IFAC staff has subsequently indicated that the words in the GFS manual and the words in IPSAS 17 do not lead to the conclusion that depreciation and consumption of fixed capital are fundamentally different, apart from the value vs. cost distinction.

## *Standard setters' future work programs*

Depreciation is reflected in the future work program. For example revised IAS 16 resulting from short-term convergence with FASB would include the accounting treatment for the depreciation of assets held for disposal or idle assets.

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<sup>1</sup> GFS Manual 6.33

## *Discussion regarding related emerging issues*

### Method of calculating depreciation

There is an issue of how depreciation might actually be calculated. Most (if not all) accountants use the "straight line" technique. There is a body of economic literature that suggests that this is not the most appropriate way of "reflecting the pattern in which the asset's economic benefits are consumed by the enterprise" (per the accounting standard). More sophisticated measures of depreciation than straight line are required to better reflect the consumption of economic benefits, along the lines of those used in the national accounts.

Once an appropriate methodology to calculate the annual consumption of the asset is adopted, depreciation of ODV/WGCC valued assets would be very much the same thing as the National Accounts consumption of fixed capital concept.

### *Steps to harmonisation*

Where, subsequent to initial recognition, an entity uses the cost method in accounting basis statements (as opposed to market valuation methods) a harmonisation difference would arise, as ABS requires market value as the basis for assets, to which depreciation estimates are applied. However, most State and Commonwealth jurisdictions have adopted fair value as their valuation basis, and although the definitions of market value and fair value may differ, in practice in the majority of cases the reported value under the two will align.

In practice depreciation does not represent a harmonisation issue so long as assets are measured at market value. HoTs should be aware that some jurisdictions may elect to continue using asset valuation methodologies that may cause convergence issues (such as, historical cost). Those jurisdictions that elect to use such methodologies will still be required to prepare two separate sets of financial statements. Hence all jurisdictions should endeavour to adopt asset valuation methodologies that will promote convergence.

Jurisdictions should be encouraged to adopt more sophisticated measures of depreciation than "straight line" to better reflect the consumption of economic benefits.

AASB should be encouraged when issuing any new standards to ensure the fundamental requirement to charge depreciation remains.

### *Conclusion*

There is no practical harmonisation issue between GFS and GAAP in relation to depreciation, so long as assets are valued at their fair values.

However, should jurisdictions continue to value non-current assets at cost this would cause a convergence issue.