AASB Staff comments on the ABS review of ABS GFS Manual

March 2013

We have limited our comments primarily to a GAAP/GFS harmonisation perspective. The views expressed are not necessarily those of the AASB.

Paper 1: Increases in the Value of Investment Fund Shares and Retained Earnings of Foreign Direct Investment Funds in ABS GFS

We do not feel we have a sufficient understanding of the issues that are the subject of the paper to express a view on the ABS proposal. Accordingly, in the following, we seek clarification of certain aspects rather than express a view on the merits of the proposal.

- Is our understanding correct that the focus of the issue is on the accounting by the holder of an interest in an investment fund (rather than the accounting by an investment fund as a holder of an interest in its investees)? We find the phrase 'investment fund shares' ambiguous.
- What is contemplated by "the value of investment fund shares (other than from holding gains and after reinvested earnings are deducted)"? We note that the AASB has recently issued an Exposure Draft (ED 228 *Equity Method: Share of Other Net Asset Changes (proposed amendments to AASB 128*), which might address similar kinds of issues.[1] However, until we have an understanding of what "other than from holding gains and after reinvested earnings are deducted" is referring to, we are not in a position to comment.
- Paragraph 10 of the paper uses the phrase "a high degree of control", and paragraph 12 refers to "significant control" and suggests a 50% ownership bright-line rule. It is unclear to us how these phrases relate to GAAP concepts, given that GAAP regards 'control' as a principle, and contrasts it with terms such as 'ownership', 'common control' and 'significant influence'.

Once we have a better understanding of these matters, we would be happy to work with ABS staff to reconsider the 'GAAP implications' section of the paper to help ensure it more directly relates to the issue. Currently, we are concerned that there is a disconnect between the ABS proposal and the description of GAAP implications.

Paper 2: Gross Recording of Payable Tax Credits in ABS GFS

As we have previously noted, the treatment of tax credits (as either expenses or reductions in taxation income) is not explicitly stipulated in GAAP. However, the AASB has previously proposed (back in 2006), but not yet adopted, to explicitly stipulate the treatment of tax credits – and that proposal was consistent with the current ABS proposal. Adoption of the GAAP proposal has been delayed while the AASB considers other aspects of the accounting for income by not-for-profit entities. Indeed, the proposal will be exposed again as part of

1 ED 228 deals with the accounting implications for an investor of events such as movements in the share capital of an investee when that investee issues additional shares to third parties.

another AASB Exposure Draft to be issued in progressing the Income of Not-for-Profit Entities project – the timing of which is expected in the first half of 2013.

Responses from departments of finance and treasuries in all jurisdictions to the 2006 AASB proposals were generally supportive.

From discussions at the ABS GFS Conference in December 2012, we became aware that there continues to be support for the proposal at a conceptual level. However, we understand there are some practical/system implications concerns. We think these concerns could be addressed through transitional arrangements.

Given the AASB is re-exposing the same proposals next year, and in light of the comments made at the ABS GFS Conference, we would modify paragraph 12 of the paper to say "… upcoming proposals to change GAAP …" rather than "… expected future changes to GAAP …".

We will inform you of the outcome of the AASB's due process in relation to this issue.

Paper 3: Treatment of Accrued But Unpaid Interest Added to the Principal of the Underlying Instrument in ABS GFS

We note that paragraph 17 of the paper states 'The ABS uses the creditor approach for the valuation of financial instruments…and follows the accrual approach of reporting interest on financial Instruments. The creditor approach will also be adopted by the revised GFS Manual'. We do not fully understand what is meant by the creditor approach – as noted in our comments for paper 5 below.

Paper 4: The Treatment of Arrears and Interest on Arrears in ABS GFS

We note from paragraph 21 of the paper there is a possibility of divergence between GAAP and the proposed revised ABS GFS Manual, given the difference in treatment of interest of arrears.

To help avoid potential confusion, we suggest the reference to 'recognise … as memorandum items' in the last sentence of paragraph 21 is amended to 'disclose … as memorandum items. 'Recognise' has a technical meaning in GAAP (and refers to incorporating items in the balance sheet or income statement) that distinguishes it from 'disclosure in the notes'. This comment of ours is also applicable to other papers – eg paragraph 48 of paper 5.

Paper 5: Treatment of Concessional Debt, Interest Expenses and Non-Performing Loans in ABS GFS

The scope of the proposals in the paper is not clear to us. For example, the heading of section 1) refers to 'ABS to adopt the market basis of valuation for **financial instruments**' (emphasis added) and paragraph 11 refers to 'recording **government loans** at market values for GFS purposes' (emphasis added) – which seem to be much broader references than the references to concessional debt and non-performing loans in the title of the paper.

Furthermore, it is unclear to us why the proposal relating to concessional debt and the proposal relating to non-performing loans differs. If we understand the proposals correctly, concessional loans would be measured at market value (supplemented with nominal value disclosure as a memorandum item), but non-performing loans would be measured at nominal value (supplemented with market value disclosure in a memorandum item). It is unclear to us how you would propose treating non-performing concessional loans.

Once we have a better understanding of the scope of the proposals, we would be happy to work with ABS staff to reconsider the 'GAAP implications' sections under Sections 1, 3 and 4 of the paper.

In relation to Section 2 of the paper, as noted in paragraph 3 of the paper the ABS currently uses the debtor approach for the recording of interest expenses in ABS GFS, whereas the Australian National Accounts use the creditor approach. The ABS intends to use the creditor approach in the revised ABS GFS Manual. Despite the descriptions in paragraph 24, we are not clear what is meant by the terms 'debtor approach' and 'creditor approach'. We would like to confirm whether the following is a correct explanation for these approaches.

<u>Debtor Approach:</u>

a) fixed rate loan:

- interest expense is recognised as it accrues at the contractual rate at inception (ie the contractual fixed rate);
- loan balance is remeasured for changes in market interest yields (rates) (which do not change the cash flows of the loan).

b) floating rate loan:

- interest expense is recognised as it accrues at the rate at inception (ie a fixed rate that does not change as actual interest cash flows change);
- loan balance is remeasured for changes in market interest rates (which actually do change the cash flows of the loan).

<u>Creditor Approach:</u>

a) fixed rate loan:

- interest expense is recognised as it accrues at the market rate (even if actual interest cash flows are unchanged)
- loan balance is remeasured for changes in market interest rates.

b) floating rate loan:

- interest expense is recognised as it accrues at the market rate (as actual interest cash flows change)
- loan balance is remeasured for changes in market interest rates (which actually do change the cash flows of the loan).

In the debtor approach the interest expense reflects the actual interest cash flows of a fixed rate loan, but not those of a floating rate loan, and in the creditor approach the interest expense reflects the actual interest cash flows of a floating rate loan, but not those of a fixed rate loan.

The creditor approach for floating rate loans and the debtor approach for fixed rate loans seem similar to fair valuing the loan under GAAP; however the paper is silent on whether other changes in fair value, such as credit risk, are also remeasured (presumably they are therefore not remeasured).

In paragraph 10 and 11 the paper notes that the ABS intends to record government loans at market value for GFS purposes (rather than nominal value as prescribed by 2008 SNA and the IMF GFSM) and that this treatment promotes harmonisation between Australian macroeconomic statistics and Australian GAAP. Whilst this seems broadly true there would still remain some differences as the GAAP measures of amortised cost and fair value are not identical to the creditor approach, or indeed the debtor approach, as we understand those approaches. Once we have a better understanding of these approaches, we would be happy to work with ABS staff to reconsider the ‘GAAP implications’ section under Section 2 of the paper.

We also note that, as stated in paragraph 2 of the paper, the nominal value of concessional debt is intended to be reported as a memorandum item to the ABS GFS balance sheet for IMF reporting purposes. We note that the nominal value of debt (including concessional debt) is not currently required to be disclosed by GAAP – although we would not regard this as a GAAP/GFS harmonisation issue as the focus of harmonisation tends to be on differences in recognised amounts rather than disclosures.

Paper 6: Review of the ABS GFS Definition of Debt

In relation to the GAAP Implications section of the paper (paragraph 22), we suggest it could be more comprehensively expressed along the following lines:

> Gross debt and net debt are not key fiscal aggregates and are not required to be reported under AASB 1049 *Whole of Government and General Government Sector Financial Reporting*. However, paragraph 18 of AASB 1049 explicitly allows disclosure of other information additional to the requirements of the Standard, provided that it is made in a way that does not detract from the information prescribed by the Standard. Paragraph 46(l) of AASB 1049 includes ‘net debt’ as an example of a key technical term that might be used in the whole of government or general government sector financial statements. If a jurisdiction elects to disclose net debt, it would be at the discretion of the jurisdiction as to whether it adopts the ABS GFS Manual definition for a key technical term that is not a key fiscal aggregate, but paragraph 41(a)(iii) of AASB 1049 requires an explanation of the key technical term to be disclosed. In addition, paragraphs 18C and 18D of AASB 1049 provide further guidance for the disclosure of fiscal aggregates that are not key fiscal aggregates.
>
> If jurisdictions that currently disclose net debt adopt the proposed revised ABS GFS Manual definition of net debt then they may need to consider if there are any implications under AASB 108 *Accounting Policies, Changes in Accounting Estimates and Errors* in the period of initial application.

As an aside, we note that the proposed definition for 'net debt' and 'gross debt' relate to how financial assets and liabilities are defined, but that the GFS definitions of financial assets and liabilities do not align with GAAP definitions of financial assets and financial liabilities as provided in AASB 132 *Financial Instruments: Presentation*. Because the GAAP definitions are widely understood and used, from a GAAP/GFS harmonisation perspective, we would encourage the ABS to consider aligning the GFS definitions to GAAP.

Paper 7: Review of the GFS Cash Surplus/Deficit Derivation

We agree that the proposal in the paper would remove a GAAP/GFS convergence difference.

Paper 8: The Treatment of Membership Dues and Subscription Fees to International Organisations in ABS GFS

Paragraph 20 of the paper correctly describes the GAAP definition of 'equity instruments' as contracts with a residual interest in the assets of an entity after deducting all of its liabilities . In paragraph 21 the paper notes that the proposed ABS treatment aligns with GAAP and is not expected to create any divergence issues. However, without having a full understanding of the specific terms of membership dues and subscriptions fees on a case-by-case basis we cannot comment on whether there would be any GAAP – GFS difference. Classification in GAAP between debt and equity can be complex and it seems likely that there could be differences in the application in some circumstances.

Paper 9: The Treatment of Contingent Liabilities in ABS GFS

We note there is some, but not complete, alignment between the ABS proposal and GAAP.

We do not think the statement in paragraph 31 of the paper that "The recognition of contingent liabilities in GAAP is aligned with the proposed treatment in the revised ABS GFS Manual…" is accurate. In particular, we note the GAAP and GFS definitions of contingent liability differ. As a consequence, it is conceivable, for example, that a one-off guarantee that the ABS proposal would consider contingent and therefore disclose as a memorandum item would not be contingent under GAAP and would meet the recognition criteria in GAAP. In the spirit of GAAP/GFS harmonisation, we encourage the ABS to give further thought to aligning ABS GFS more closely with the GAAP liability/contingent liability definitions and recognition criteria.

In relation to the observation in paragraph 31 of the paper that GAAP and GFS disclosure requirements differ, our focus in relation to GAAP/GFS harmonisation is on definition, recognition and measurement differences – in general we do not regard differences in disclosure requirements as matters that cause disharmony. We note that typically GAAP specifies minimum disclosure requirements and therefore additional disclosures (including those that would be consistent with ABS GFS Manual disclosures) could be made – so long as they are made in a way that would not detract from the prescribed information (see paragraph 18 of AASB 1049 *Whole of Government and General Government Sector Financial Reporting*).

Paper 10: Treatment of Land Improvements in ABS GFS

Our understanding of the ABS proposal is that land improvements would be separately recognised from land and subject to depreciation. Therefore, from a subsequent accounting perspective, we question the statement in paragraph 18 of the paper that "The aggregate value of assets on the GFS balance sheet will not be affected."

Furthermore, from a GAAP/GFS harmonisation perspective, we note that 'land improvements' might not be depreciated under GAAP. For example, see AASB Interpretation 1055 *Accounting for Road Earthworks* – paragraph 16 of which states that "This Interpretation adopts the view that road earthworks represent, in some circumstances, another exception to the expectation that all tangible assets have limited useful lives." In the spirit of GAAP/GFS harmonisation, we would encourage the ABS to consider acknowledging in the ABS GFS Manual that there may be circumstances when land improvements should not be depreciated.

Paper 11: The Treatment of Research and Development in ABS GFS

We think the proposals are a move in the right direction as they bring GFS into closer alignment with GAAP. However, we think there is an opportunity to achieve even greater alignment, at least in relation to the initial recognition of assets arising from research and development.

It is apparent to us the ABS proposed definitions and recognition criteria for research and development differ to some extent, but arguably not greatly, from the definitions and recognition criteria currently in GAAP (see AASB 138 *Intangible Assets*). Accordingly, we suggest you consider further whether the benefits of aligning ABS GFS with GAAP would outweigh the cost of perhaps minor misalignment with IMF GFS/SNA 2008. The benefits of alignment with GAAP arguably include greater reliability of the data. We would be happy to spend time with ABS staff to fully explore opportunities for greater GAAP/ABS GFS harmonisation.

In relation to subsequent accounting, we note that GAAP/GFS harmonisation is likely to be more difficult to achieve given that currently AASB 138 does not permit the revaluation of intangible assets except by reference to an active market (see paragraph 75 of AASB 138). Given the nature of research and development assets, we would rarely expect an active market to exist.

Just by way of a specific comment on paragraph 46 of the paper, as currently drafted, it implies that under GAAP development costs <u>can</u> be capitalised if it can be shown that the development will generate probable future economic benefits. In fact, under GAAP, an intangible asset arising from development is <u>required</u> to be recognised if, and only if, an entity can demonstrate certain criteria are met.

Paper 12: The Recognition of Environmental Liabilities in ABS GFS

We think the ABS proposal is a move in the right direction from a GAAP/GFS harmonisation perspective.

However, despite the greater alignment that the ABS proposal would bring about between GAAP and GFS from a recognition perspective, we suspect there might be a difference between the circumstances in which the ABS proposal would recognise a liability and when GAAP would recognise a liability. It would seem that the proposal is predicated on there being a related asset against which the liability would be offset. In contrast, the recognition of a liability under GAAP is not predicated on there being a related asset. We understand that the proposal's dependence on a related asset might be due to the absence of an identified counterparty for the liability. Despite this, in the interest of GAAP/GFS harmonisation, we would encourage the ABS to further consider the merits of recognising a liability in the same circumstances in which GAAP would recognise a liability.

In relation to measurement, it is not clear to us from the paper whether measurement of the liability would align with GAAP. Under AASB 137 *Provisions, Contingent Liabilities and Contingent Assets*, the amount to be recognised is the best estimate of the expenditure required to settle the present obligation at reporting date. The best estimate is the amount that an entity would rationally pay to settle the obligation at reporting date or to transfer it to a third party at that time (see paragraphs 37 and 38 of AASB 137). We understand that this amount might differ from the amount under 2008 SNA. However, in the interest of GAAP/GFS harmonisation, we would encourage the ABS to give further consideration to aligning with the GAAP measurement basis. In relation to subsequent measurement of the liability, we refer you to AASB Interpretation 1 *Changes in Existing Decommissioning, Restoration and Similar Liabilities*.

Our understanding from paragraph 7 of the paper is that the proposal is for the environmental liability to be 'embedded' in the value of the related fixed asset or land (paragraph 7 states "… the **value** of a fixed asset or land should be **net of** clean up or decommissioning costs…" (emphasis added)). It is unclear to us whether this is simply a matter of presentation or more fundamentally related to measurement. Under GAAP, the liability would be recognised separately from the related asset (see paragraph 32 of AASB 101 *Presentation of Financial Statements*). Again, in the interest of GAAP/GFS harmonisation, we would encourage the ABS to give further consideration to adopting the GAAP approach of recognising and presenting environmental liabilities separately from related assets.

Papers relating to Classifications

Review of Government Finance Statistics Input Classifications

We note that paragraph 12 of the paper states there are no proposed changes to the ABS Institutional Sector Classification. We continue to encourage the ABS to consider whether the GAAP distinction between 'for-profit' and 'not-for-profit' would be suitable as the basis for distinguishing between 'general government' and 'public corporations'. We think adopting such an approach could assist with GAAP/GFS harmonisation endeavours.

In relation to paragraphs 29 and 30 of the paper on debt maturity classification (and paragraphs 30 and 31 of Attachment A of the paper) GAAP has requirements for disclosure of certain items by maturity, however the maturity disclosures are not aligned to those outlined in paragraphs 29 and 30 of the paper. Whilst there is some overlap there are clearly differences (for example GAAP does not require disclosure of debt that was originally long term debt that is now due for payment within one year or less separately from long term debt due for payment in more than one year).

GAAP requirements relate to 1) current / non-current distinction of assets and liabilities, 2) financial assets that are past due but not impaired and 3) maturity analyses of financial liabilities based on contractual maturity:

1) AASB 101 *Presentation of Financial Statements* paragraph 60 requires separate presentation of current and non-current assets, and current and non-current liabilities in the statement of financial position (except when a presentation based on liquidity provides information that is reliable and more relevant, in which case all assets and liabilities are presented in order of liquidity). Paragraph 61 of AASB 101 requires, under either presentation, disclosure of the amount expected to be recovered or settled after more than 12 months for each asset and liability line item that combines amounts expected to be recovered or settled:

   (a) no more than twelve months after the reporting period, and

   (b) more than twelve months after the reporting period.

2) AASB 7 *Financial Instruments* paragraph 37 requires disclosure by class of financial asset:

   (a) an analysis of the age of financial assets that are past due as at the end of the reporting period but not impaired; and

   (b) an analysis of financial assets that are individually determined to be impaired as at the end of the reporting period, including the factors the entity considered in determining that they are impaired.

   'Past due' is defined in AASB 7 as 'when a counterparty has failed to make a payment when contractually due'.

3) Paragraph 39 of AASB 7 also requires disclosure of:

   (a) a maturity analysis for non-derivative financial liabilities (including issued financial guarantee contracts) that shows the remaining contractual maturities.

   (b) a maturity analysis for derivative financial liabilities. The maturity analysis shall include the remaining contractual maturities for those derivative financial liabilities for which contractual maturities are essential for an understanding of the timing of the cash flows (see paragraph B11B).

(c) a description of how it manages the liquidity risk inherent in (a) and (b).

In relation to paragraph 31 and the ensuing paragraphs, we make the observation that, compared with GFS, GAAP takes a more principle-based approach to identifying classes of assets and liabilities. For example, paragraph 94 of AASB 13 *Fair Value Measurement*, at least for the purposes of meeting the disclosure requirements under that standard, requires classes to be determined on the basis of (a) the nature, characteristics and risks of the asset or liability; and (b) the level of the fair value hierarchy within which the fair value measurement is categorised. As long as the classifications prescribed under GFS are consistent with GAAP classification principles, we would not envisage any GAAP/GFS harmonisation issues arising from the ABS's proposals.

FISIM

Paragraph 66-69 refer to the inclusion of the Financial Intermediation Services Indirectly Measured (FISIM) in interest payments as a memorandum item. We note that FISIM is not addressed in GAAP.

Review of the ABS Government Purpose Classification and Local Government Purpose Classification frameworks

As long as the classifications prescribed under GFS are consistent with GAAP classification principles (which aren't as prescriptive as the GFS approach), we would not envisage any GAAP/GFS harmonisation issues arising from the ABS's proposals.

To provide you with some further background, which you might find useful in progressing your proposals:

- As you would be aware, paragraphs 48 to 51 of AASB 1049 prescribe disclosure by whole of governments and general government sectors of functional information, using the broad functions currently identified in Table 2.6 of the ABS GFS Manual. Those requirements apply to certain expenses **and** assets. Some have questioned the appropriateness of GAAP requiring disclosure of such information about assets. However, AASB 1049 specifies the requirement on the basis that information about the resources committed to particular functions relative to the costs of service delivery that are reliably attributable to those functions facilitates comparisons between jurisdictions and assists users in assessing the significance of financial or non-financial performance indicators reported by governments.
- AASB 1052 *Disaggregated Disclosures* applies to government departments and local governments.
- In due course, the AASB's Disaggregated Disclosure project will address, amongst other things, issues pertinent to the current requirements in AASB 1049 and AASB 1052.