

**GAAP/GFS Harmonisation for Not-for-Profit Entities within the GGS:
*Giving effect to the GFS distinction between transactions and other economic flows in a
GAAP reporting entity context***

1 Introduction

- 1.1 Of relevance to the subject matter of this paper, the minutes of the 30 July 2010 AASB meeting's discussion of GAAP/GFS harmonisation for entities within the GGS record [under agenda item 14, attachment B, under the sub-heading 'Agenda Paper 14.2'] – emphasis added:

The Board directed staff to **consider alternative ways of giving effect to the substance of the GFS distinction between transactions and other economic flows in a GAAP reporting entity context**, for consideration by the Board at a future meeting. This is because the ABS GFS Manual definitions of those terms are not necessarily effective at the level of a not-for-profit entity within the GGS, given the nature of many reporting entities at that level compared with the GFS notion of 'institutional units' (which is included in the GFS definition of 'transactions').

The bolded text provides the focus for this paper.

- 1.2 The GFS definitions of 'transactions' and 'institutional unit' are particularly relevant in giving effect to the above decision of the Board. The ABS GFS Manual (and Appendix A of AASB 1049 *Whole of Government and General Government Sector Financial Reporting*) defines them as follows:

Institutional unit: An economic entity that is capable, in its own right, of owning assets, incurring liabilities and engaging in economic activities and in transactions with other entities. Defined in the ABS GFS Manual (Glossary, page 257)

Transactions: Interactions between two institutional units by mutual agreement or actions within a unit that it is analytically useful to treat as transactions. Defined in the ABS GFS Manual (Glossary, page 263).

- 1.3 Other pertinent extracts from the ABS GFS Manual are:

Paragraph 2.13 ... government departments and authorities that are primarily funded from budget allocations and subject to centralised control of their finances through the public accounts ... do not qualify as single legal entities in the Australian units model. Thus, in concept, each jurisdiction (i.e. the Commonwealth and each state and territory) includes an enterprise that comprises all departments and authorities included in the jurisdiction's public accounts.

Paragraph 2.14 However, individual departments and other budget-funded authorities of the Commonwealth, state and territory governments are separately identified as enterprise units in the computer systems supporting the ABS GFS system ... This procedure is adopted to provide the flexibility to compile data available for the lower-level units should such compilation be required. Because the departments and authorities carry the same unit classifications as their parent enterprise, the procedure has no effect on the accuracy of the unit-classified data reflected in GFS.

2 The issue

- 2.1 Although some not-for-profit entities within the GGS satisfy the GFS definition of 'institutional unit', which is integral to the definition of 'transactions', many (such as government departments, which are administrative structures rather than legal structures) do not satisfy that definition. The issue is how to express the proposal that

not-for-profit entities within the GGS be required to disclose information about in-substance 'transactions', given that, literally, many such entities do not undertake any transactions as that term is defined in GFS.

3 Alternative solutions to the issue

3.1 **Approach A: Retain the definition of 'institutional unit' and 'transactions' unamended and without additional guidance on how they apply to departments**, on the basis that:

- (a) the second leg of the definition of 'transactions' states that 'actions within a unit that it is analytically useful to treat as transactions' are transactions. Arguably, for GAAP/GFS harmonisation purposes, it is analytically useful to treat an interaction between, say, two government departments, as a transaction even though those two departments might be within the one GFS institutional unit. If this argument is accepted, some might form the view that a standard on GAAP/GFS harmonisation should contain such a clarification of the meaning of 'analytically useful to treat as transactions'. However, as noted in agenda paper 14.2 of the AASB's 30 July 2010 meeting, it is questionable whether it would be appropriate to attempt to clarify the meaning of that phrase for the purposes of the GAAP/GFS harmonisation project, because:
 - (i) GFS's focus is on facilitating analysis of fiscal policy at a macro-economic level, which is not the focus of GAAP, particularly at an entity within the GGS level; and
 - (ii) despite the importance of the phrase to the distinction between transactions and other economic flows, arguably it should not be explicitly defined in a GAAP context because its very nature presumes an understanding of the analytic framework and analytic objectives of GAAP, which are addressed in the *Conceptual Framework* (for example, in relation to the objective of financial reporting). Accordingly, the very nature of the phrase requires the application of professional judgement that is beyond precise definition. To clarify the phrase to help resolve the problem that is the subject of this paper could lead to unforeseeable consequences for how the phrase would apply in other circumstances; and/or
- (b) it is reasonable to expect that preparers would understand the substance of 'transactions' in the context of entities within the GGS even if such entities do not literally meet the definition of 'institutional units'. In support of this view, it is relevant to note that concern about the issue was not raised as a significant issue in response to ED 174 *Amendments to Australian Accounting Standards to facilitate GAAP/GFS Harmonisation for Entities within the GGS* [AASBs 101, 107 and 1052]. However, the respondents to ED 174 might reflect the views of those constituents who are reasonably familiar with GFS concepts – an unfamiliar preparer might take a more literal reading of the requirements.

3.2 **Approach B: Amend the definition of 'institutional unit'** by broadening it to include entities that, although without legal rights, have administrative authority/responsibility. However, because this approach would not be consistent with the definition of 'institutional unit' in AASB 1049, it would create complexity in Standards by defining one term in different ways in different Standards. It is possible

this problem could be addressed by amending the definition of ‘institutional unit’ in AASB 1049 in the same way. However, the existing definition in AASB 1049 is not a problem in that Standard, and retaining the definition is consistent with the concept of GAAP/GFS harmonisation.

- 3.3 **Approach C: Amend the definition of ‘transactions’** by replacing the reference to ‘institutional units’ with a more general term, like ‘entities’. This approach gives rise to similar concerns to those outlined in relation to Approach B.
- 3.4 **Approach D: Retain the definitions of ‘institutional unit’ and ‘transactions’ unamended, and explicitly deem all entities within the GGS to be institutional units.** This approach has the benefit of consistency with AASB 1049, and is broadly consistent with the pragmatic approach taken by the ABS as outlined in paragraph 2.14 of the ABS GFS Manual (see paragraph 1.3 above). Some might argue that:
- (a) it is only necessary to deem not-for-profit entities within the GGS (being those entities that would be subject to the proposals in the Exposure Draft) to be institutional units. However, such an approach would potentially exclude in-substance ‘transactions’ between those entities and certain for-profit entities within the GGS; or
 - (b) it is necessary to deem all GAAP entities to be institutional units. However, that is not necessary as transactions with institutional units outside the GGS are adequately dealt with through the existing definitions, as is evident from the application of AASB 1049 and the ABS GFS Manual, neither of which have found it necessary to deviate from the current GFS definitions of ‘institutional units’ and ‘transactions’.

4 Staff recommendation

- 4.1 On balance, our preference is Approach D – retain the ABS GFS Manual definitions unamended, and explicitly deem entities within the GGS to be institutional units – on the basis it retains the GFS definitions and provides a simple, clear and pragmatic way of dealing with the issue. To give effect to our recommendation, we suggest the Exposure Draft addressing GAAP/GFS harmonisation for not-for-profit entities within the GGS include text in the Preface, Body and Appendix A Definitions, along the lines shown below. The objective of the suggested text is to clarify the application of the GFS notion of ‘transactions’ in a GAAP/GFS harmonisation context whilst minimising (rather than avoiding) the need for preparers to refer to the ABS GFS Manual in implementing the notion. To the extent something needs to be said on the issue in the Basis for Conclusions, that would be drafted once we have clear directions from the Board on the issues addressed in this paper.
- 4.2 To give effect to Approach D, text along the following lines could be included in the Preface to the Exposure Draft:

GFS and its Relationship to GAAP Financial Reporting for Entities within the GGS

The principles and rules upon which GFS is based are contained in the Australian Bureau of Statistics (ABS) publication *Australian System of Government Finance Statistics: Concepts, Sources and Methods* (referred to in this Exposure Draft as the ABS GFS Manual), available on the ABS website (www.abs.gov.au).

For GFS purposes, a government is regarded as comprising three sectors: the GGS, the PNFC sector and the PFC sector. Given its non-market nature and its important role as the vehicle by which a government implements its fiscal policy, the GGS is distinguished from the other, more market-oriented, government sectors.

Entities within the GGS

As defined in the ABS GFS Manual, the GGS is an institutional sector comprising all government units and non-profit institutions controlled and mainly financed by government. Government units are legal entities established by political processes that have legislative, judicial, or executive authority over other units and which provide goods and services to the community or to individuals on a non-market basis; and redistribute income and wealth by means of taxes and other compulsory transfers. Non-profit institutions are created for the purpose of producing or distributing goods and services but are not permitted to be a source of income, profit or other financial gain for the government.

The ABS GFS Manual (paragraph 2.13) notes that government departments and authorities that are primarily funded from budget allocations and subject to centralised control of their finances through the public accounts do not qualify as single legal entities in the Australian GFS units model. However, as noted in paragraph 2.14 of the ABS GFS Manual, individual departments and other budget-funded authorities of the Australian, state and territory governments are separately treated as enterprise units in the computer systems supporting the ABS GFS system.

In contrast to GFS, GAAP does not restrict the notion of a reporting entity to legal entities. Accordingly, the notion of reporting entity in GAAP includes entities that arise from administrative arrangements and other organisational structures, such as government departments, that fall within the boundaries of the GGS as defined by GFS. Lists of entities within the GGS are generally available in each government's budget papers, annual report and on its website.

Given the nature of entities within the GGS, some of those entities are for-profit entities for GAAP purposes because they do not meet the GAAP definition of not-for-profit entity (see paragraph Aus6.1 of AASB 102 *Inventories*). The proposals in this Exposure Draft are only applicable to entities within the GGS that meet the GAAP definition of not-for-profit entity.

- 4.3 Text along the following lines could be included in the body of the Exposure Draft, to give effect to the proposed requirement that not-for-profit entities within the GGS classify income and expenses as transactions or other economic flows:

- 10 The financial statements shall disclose by way of note the schedules described in paragraph 11 of this Standard. ...**
- 11 The schedules referred to in paragraph 10 shall comprise:**
 - (a) ...;
 - (b) **a schedule in the form of a single statement of comprehensive income that is prepared in a manner consistent with AASB 101 and presents:**
 - (i) **income and expenses, classified as *transactions* or *other economic flows* determined in a manner consistent with the ABS GFS Manual; and**
 - (ii) **the *net operating balance* (which is the net result of transactions); and**
 - (c) ...
- 12 Paragraph 11(b)(i) requires all amounts relating to an item included in the schedule in the form of a single statement of comprehensive income to be classified as transactions or other economic flows determined in a manner consistent with the ABS GFS Manual. For the purpose of applying the definition of transactions, which includes the term 'institutional unit', an entity within the GGS is regarded as being an institutional unit. The following examples illustrate how this approach applies to particular items:**
 - (a) net profit/(loss) from associates. This comprises two components where there is a difference between the entity's share of net profit/(loss) from associates and dividends from associates during a reporting period:
 - (i) one component, 'dividends from associates (part of share of net profit/(loss) from associates)', are classified as transactions, but are not included in the line item that includes dividends from entities other than associates; and
 - (ii) the remaining component, 'share of net profit/(loss) from associates, excluding dividends', is classified as other economic flows;

- (b) changes in the fair value of financial instruments¹ measured at fair value, that do not arise from undistributed interest or dividends. These are classified as other economic flows, irrespective of whether the instruments are classified as 'fair value through profit or loss' or 'available-for-sale';
- (c) actuarial gains and losses relating to defined benefit superannuation plans. These are classified as other economic flows, irrespective of whether they are included in the calculation of operating result/profit or loss, or the other non-owner changes in equity section of the statement of comprehensive income;
- (d) a change in the fair value of investment property. This comprises two components where there is a difference between the total change and the change attributable to the consumption of capital:
 - (i) one component, relating to consumption of capital, is classified as transactions, calculated by applying the principles of depreciation contained in AASB 116 *Property, Plant and Equipment*. Although the consumption of capital might be considered to be similar in nature to depreciation, it is not included in the line item that includes depreciation; and
 - (ii) the remaining component, relating to price changes, is classified as other economic flows;
- (e) depreciation of defence weapons platforms. This is classified as a transaction, by analogy with the GFS classification of depreciation of other plant and equipment;
- (f) doubtful debts. These are classified as other economic flows, by analogy with the GFS classification of revaluations of other assets;
- (g) bad debts. These are classified as transactions to the extent they are mutually agreed, otherwise they are classified as other economic flows;
- (h) the income and expense recognised as a result of liabilities such as defined benefit superannuation or long service leave being assumed by another entity (for example, the government) in accordance with paragraph 41 of AASB 1004 *Contributions*. These are classified as transactions, on the basis that they are an interaction between the entity within the GGS and another entity;
- (i) a capital asset charge, which might be imposed by a government on the written-down value of non-current physical assets controlled by an entity within the GGS. This is classified as transactions on the basis that it is an interaction between the entity and the government. It differs in nature from finance costs referred to in paragraph 82(b) of AASB 101;
- (j) amounts previously recognised in other comprehensive income that are reclassified to operating result/profit or loss (referred to as reclassification adjustments) under certain Australian Accounting Standards. These are classified as other economic flows to the extent they arise from the realisation of previously recognised other economic flows; and
- (k) dividend income. This is classified as transactions, to the extent the ABS GFS Manual accounts for it as dividends, otherwise it is classified as other economic flows.

4.4 Text along the following lines could be included in the definition section of the Exposure Draft:

Entity within the GGS Any legal, administrative, or fiduciary arrangement, organisational structure or other party (including a person) within the GGS having the capacity to deploy scarce resources in order to achieve objectives.

1 Staff note to Board: we suggest that the Exposure Draft is written in the context of mandatory Standards. This is particularly relevant to the references to financial instruments (subject to AASB 139). The IASB is in the process of replacing IAS 39 *Financial Instruments: Recognition and Measurement*, which is currently incorporated into AASB 139, in phases. The IASB has issued IFRS 9 *Financial Instruments* (which is incorporated into AASB 9), dealing at this stage with classification and measurement of financial assets, and plans to add requirements on the classification and measurement of financial liabilities, impairment of financial assets at amortised cost and hedging in 2010/11. We think our suggested approach in relation to AASB 139 is justified on the basis that the IASB has signalled that IFRS 9 will not be mandatory until periods beginning on or after 1 January 2013, which for Australian not-for-profit entities within the GGS would be for periods ending on or after 30 June 2014. Of particular relevance is that the new requirements change the categories of financial assets measured at fair value.

Institutional unit An economic entity that is capable, in its own right, of owning assets, incurring liabilities and engaging in economic activities and in transactions with other entities. Defined in the ABS GFS Manual (Glossary, page 257)

(Additional guidance relating to this definition: For the purpose of this Standard, an entity within the GGS is treated as an institutional unit.)

Transactions Interactions between two institutional units by mutual agreement or actions within a unit that it is analytically useful to treat as transactions. Defined in the ABS GFS Manual (Glossary, page 263).

(Additional guidance relating to this definition: Paragraphs 2.61 – 2.64 of the ABS GFS Manual provide further explanation of the notion of transactions. In relation to ‘mutual agreement’, depreciation is classified as a transaction because the entity is regarded as operating simultaneously in two different economic capacities – as owner of the depreciating asset and as consumer of the service provided by the asset. Furthermore, transactions are not necessarily entered into voluntarily. Thus, tax payments are regarded as mutually agreed interactions because there is collective acknowledgement and acceptance by the community of the obligation to pay taxes. The types of interactions intended to be excluded from the definition of transactions include events such as illegal seizure.)