FINPRO
Local Government Finance Professionals

27 November 2009

The Chairman
Australian Accounting Standards Board
PO Box 204
Collins Street West
Vic 8007

Comments on ED 180 "Income from Non-Exchange Transactions (Taxes and Transfers)"

1. FinPro – Local Government Finance Professionals

FinPro is the professional association representing finance professionals working in Local Government entities in Victoria, Australia. Our members are chief financial officers, financial and management accountants and Council officers working in the finance field.

The predominant users of financial reports prepared by Councils are ratepayers and other community members, many of whom are not experienced in reading financial statements and rely on the expertise of the financial professionals to present the information in an easy-to-understand format.

The comments provided in this submission represent the views of our members.

2. Overall Opinion

The proposals, as a whole, are not supported by FinPro members.

We *do not support* the proposals as they relate to grant non-exchange transactions.

We *do support* the proposals as they relate to other non-exchange transactions.

Further comments to support our overall opinion are provided below.

3. Response to Specific Issues Requested by AASB

FinPro's response to the various aspects and issues for which the AASB has specifically requested a response are contained in **Appendix A** to this submission.

4. Grant Non-Exchange Transactions

The proposals contained in ED180

- Will not fully meet the objective stated in ED180 of obtaining consistency in treatment and timing of recognition of grant revenue.
- Will result in ongoing confusion as to whether the stipulations contained in a grant funding agreement are conditions or restrictions.
- Do not recognise and acknowledge the strength of additional, statutory reporting frameworks applicable to local government entities in Victoria that operate in addition to the Australian Accounting Standards.
- Will provide an Accounting Standard for application by not-for-profit entities that is inconsistent with the theory and application of another Accounting Standard. AASB 120, applicable by for-profit entities, identifies the practicalities of receipts by grant recipients but denies such reporting to not-for-profit organisations.
- May not result in true and fair reporting in the timing of recognition of revenue.

4.1 Reporting Framework applicable to Local Government Entities in Victoria

Local government entities prepare and publish annual general purpose financial reports in accordance with Australian Accounting Standards.

In addition to the Accounting Standard framework, the Local Government Act and Regulations (Vic) require Councils to:

- Prepare and adopt a budget annually. The legislative timetable requires the budget preparation process, including budgeting for grant revenue expected, to commence in February/March each year. A public consultation process follows, with adoption of the budget by August for the current financial year.
- Prepare and consider financial reports at least every quarter that compare the actual results for that quarter against budget expectations.
- After the end of the financial year, publish audited Standard Statements, comparing the adopted budget against the reported results in the financial reports prepared in accordance with Australian Accounting Standards. The Standard Statements are special purpose financial reports.

Current Accounting Standards, which determine timing of revenue recognition on the basis of control of funds, disrupt the reporting against budget when timing of cashflow from another level of government to Councils is in advance of the prior year end, or prior to the expenditure to which it relates. Variances between reported grant income and budgeted income are being caused by the Accounting Standards, not necessarily the operations or financial management of the Councils.

FinPro do not believe the proposals contained in ED180 in relation to grant non-exchange transfers will result in improved reporting to users under either the Accounting Standard or Local Government Act frameworks. Instead, the volatility in reported results and variability in interpretation of Accounting Standard requirements will persist.

4.2 Inconsistencies with Framework for the Preparation and Presentation of Financial Statements

4.2.1 Accrual based accounting

The nature of non-exchange transactions is that there is a reciprocal benefit provided, but not to the grantor. Funding provided for non-exchange transactions is generally aimed to be profit-neutral to the entity. Any accounting directive that does not apply the accrual basis, a principal underlying assumption in the Accounting Standard Framework, and match the income with the relevant outflow of benefits will distort the reporting by the entity.

The guidance discussion and tests for grants which indicate that time is not a condition, merely a restriction, is inconsistent with the application of accrual based accounting.

4.2.2 Comparability between entities

The proposals contained in ED180 will still allow discretion and require judgement as to whether a stipulation is a condition or restriction.

Example:

A Victorian Council was recently awarded a grant of $5 million.

The text of the funding agreement states, inter alia:

> *"If you fail to Commence Construction as required by this Activity within six months of the date of this Agreement, We may ...do one or more of the following:*
>
> *(a) recover the Funding from You; and*
>
> *(b) withhold future instalments of funding".*

The application of ED180 definitions of conditions, restrictions and substance over form would allow differing interpretation of the above stipulation.

- If the Council had previously received such a grant, had not met the condition, and had had to repay the funding, this stipulation could be a condition and a liability recognised and matched against the relevant expenditure.
- If the Council had previously received such a grant, had not met the stipulation but funding had not been repaid, the substance over form requirement would require this to be classed as a restriction and recognised as income.
- If the Council had not previously received such a grant, it would have no basis for forming a conclusion on substance over form. The use of the word "may" means the classification of this stipulation as a condition (liability) or restriction (income) is ambiguous.

ED180 does not provide sufficient guidance to resolve this and would result in inconsistent interpretation.

Whether the stipulations contained within the agreement have been enforced or not, the enforcement is not at the discretion of the recipient.

The practical application of ED180 would raise a number of questions for each grant receipt in the distinction between conditions and restrictions.

- How would an entity determine whether conditions are "generally enforced"?
- What percentage of past grants would need to have been enforced to demonstrate that a stipulation is a condition not a restriction? Over what time period?
- Is the size and materiality of the grants not enforced a consideration?
- Restrictions may later become enforceable, but as the recognition rules for grants with restrictions require recognition of income, a prior year correction may be required if the stipulation is later enforced.

4.2.3 Comparability with prior financial periods

The narrow interpretation of "conditions" within ED180 will result in many grant stipulations being classified as restrictions and recognised as income on receipt. This would be consistent with the current Accounting Standard requirements for not for profit entities.

The current requirements are resulting in volatility in the reporting of operating income and operating surplus/deficit, as demonstrated in **Appendix B**.

4.2.4 Definition of "liability"

The definition of a liability in the Accounting Standard Framework (paragraph 49) is generally adopted by ED180, but the interpretation of what gives rise to a "present obligation" is narrowed by ED180.

The Framework definition of a liability recognises that the present obligation is for a future outflow of economic benefit.

ED180 only allows recognition of a liability for grants received where there are enforced conditions. The further distinction between conditions and restrictions, and the recognition of grants with only restrictions as income, does not acknowledge the wider framework definition of a liability representing future outflow of economic benefits.

The framework does not require any obligation to repay funds received in order to acknowledge that a present obligation exists. ED180 assumes that a lack of enforceable or documented conditions means a present obligation does not exist, and therefore a liability does not need to be recognised, even though the recipient entity has not given up resources embodying economic benefits (Framework paragraph 62).

4.3 Inconsistency with True and Fair Reporting

One of the objectives of Australian Accounting Standards is to result in true and fair reporting to users of financial statements prepared in accordance with this framework.

FinPro do not believe the current Standards applicable by not-for-profit entities are providing true and fair reporting of grant income.

Further, FinPro do not believe the distinction between grants with conditions (liability) and grants with restrictions (income) will improve the reporting to users.

Financial reports by not-for-profit entities will continue to:

- Report volatility in income, despite a strong legislative budget framework designed to identify and explain such volatility. Variance reporting will continue to focus on explaining the variance caused by application of Accounting Standards specific to not for profit entities, instead of explaining variances caused by the operational or financial management of the Council.
- Result in variations in practice in the interpretation of the stipulations attached to grant funding.

5. Inconsistencies with AASB 120 "Accounting for Government Grants and Disclosure of Government Assistance"

AASB 120 is not available to not-for-profit entities in Australia, despite not-for-profit entities being the predominant recipients of government grant funding.

AASB 120 provides unambiguous and practical direction to the identification and recognition of grant revenue.

In contrast, ED180 does not separately define "grants", but includes grant income with transfers such as donations, fines, bequests, gifts, debt forgiveness and goods and services in kind.

AASB 120 "Accounting for Government Grants and Disclosure of Government Assistance" defines government grants as (AASB 120 paragraph 3):

> *Government grants are assistance by government in the form of transfers of resources to an entity in return for past or future compliance with certain conditions relating to the operating activities of the entity. They exclude those forms of government assistance which cannot reasonably have a value placed upon them and transactions with government which cannot be distinguished from the normal trading transactions of the entity.*

These definitions are not inconsistent with ED180, but ED180 changes the accounting recognition point by including grants with other transfers.

AASB 120 paragraphs 7 and 8 defer recognition of a government grant "*until there is a reasonable assurance that the grant will be received. Receipt of a grant does not of itself provide conclusive evidence that the conditions attaching to the grant have been or will be fulfilled*". These paragraphs imply a presumption against recognition as revenue until it is clear that all conditions are fulfilled. This is different from the proposals in ED 180.

ED180 also focuses on "certain conditions" and draws further distinction between conditions and restrictions, rather than focussing on the creation of an obligation for past or future compliance in the context of operating activities.

AASB 120 paragraph 16

> *It is fundamental to the income approach that government grants be recognised as income on a systematic and rational basis over the periods necessary to match them with related costs. Income recognition of government grants on a receipts basis is not in accordance with the accrual accounting assumption… and would only be acceptable if no basis existed for allocating a grant to periods other than the one in which it was received.*

AASB 120 also acknowledges that grants are rarely provided without restriction, and recognises the matching principal in the application of accrual accounting.

The issue of ED180 as an Accounting Standard would result in different and incompatible timing of recognition of grant income between for-profit entities able to apply AASB 120, and not-for-profit entities. The difference in treatment is illustrated in **Appendix B**.

FinPro recognises that AASB 120 in its current form could raise further issues for the recognition of grant revenue by local government authorities. However, FinPro is still of the opinion that the principles set out in paragraphs 7 and 8 of AASB 120 would result in more consistent and comparable accounting for grant income by not-for-profit entities if the application restriction were removed. If these principles in AASB 120 could be applied by not-for-profit entities, ED180 could be simplified and the inconsistencies identified in this submission would cease to be an issue.

6. Other Non-Exchange Transactions

The transactions to which ED180 relates covers more than grants. Other non-exchange transactions are also significant source of revenue to local government.

6.1.1 Taxes

Rate revenue for local government would be recognised as taxes (ED180 paragraphs 60 to 71). FinPro do not anticipate any significant change to the timing of the recognition of rate revenue or measurement of rate revenue as a result of the proposals in ED180.

6.1.2 Contributions

Local councils receive contributions for development as both cash and infrastructure assets. Developer's contributions are major revenue items for councils in growth areas. Asset contributions are measured at fair value and are recognised at the time the Council assumes control of the asset.

FinPro do not anticipate any significant impact to the recognition or measurement of contributions revenue as a result of the proposals in ED 180.

6.1.3 Fines

Councils impose fines under local by-laws for a variety of breaches, for example, parking fines.

FinPro do not anticipate any significant impact to the recognition or measurement of fines as a result of the proposals in ED 180.

6.1.4 Volunteer Services

The co-ordination of local volunteer programs by Councils is an important means by which services are delivered to the community. A number of common community programs depend on the participation of volunteers, for example, meals on wheels, community transport programs, festivals and events and planned activity groups.

Whilst Councils value volunteer participation highly, the service provided to the community could not be measured with sufficient reliability to recognise the service as revenue.

FinPro support the proposal in ED 180 to allow discretion on the recognition of volunteer services, on a class-by-class basis.

7. Contact details:

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FinPro – Local Government Finance Professionals - Response to ED180

APPENDIX A

Response to Specific Questions in ED 180

1. Further guidance and illustrative examples

Further guidance specific to local government entities would be useful in application of the proposed Standard. Local government is a significant sector within the Australian economy. Local Council's have both diverse operations, and revenue transactions unique to this sector.

Non-exchange transactions are the dominant source of revenue for local government. Illustrative examples of the following would be useful:

- Operating and capital grants, with example application of conditions and restrictions.
- Advance receipts of grant transfers, specifically an illustration of the circumstances under which a grant could be recognised as in advance.
- Rate revenue recognition point (date the rate is struck or recognised during the period).

2. Definition and treatment of conditions on transferred assets

The definitions of conditions and restrictions in relation to grant transfers are insufficiently clear to achieve the stated objective of ED180, being consistency in application of recognition criteria.

The diverse nature of grants received by local government and both form and substance of stipulations in grant funding agreements is such that differing interpretation will continue.

With reference to our further discussion on the inconsistencies between ED180 and the approach to recognition of grant income applied by AASB 120, we believe that if the definitions and recognition of present obligation and liability were consistent, the distinction between "conditions" and "restrictions" would not be necessary.

3. Treatment of advance receipts – specifically in relation to grant transfers

ED180 paragraph 106 requires resources received before a transfer arrangement becomes binding to be recognised as a liability.

The term "binding" is not defined or discussed within ED180. Our opinion is that such a discussion and illustration is essential in determining when a receipt may be treated in advance.

The AASB Basis for Conclusions paragraphs BC22-24 states "*A stipulation that transferred assets should be utilised over a stated period (such as the next financial year) is not a condition as defined. Such time requirements would represent only a restriction on transferred assets.*"

We do not agree with this assessment, given the strong budgetary and acquittal framework within which local government operates. Councils publish a comparison of budget against actual performance. In substance and practice, Councils could not apply advance receipts to current year service delivery without having to publicly explain that use of funds.

APPENDIX A

Response to Specific Questions in ED 180

If time is not a condition, merely a restriction (ED180 Basis for Conclusions paragraph BC23), the concept of recognition of advance receipts is inconsistent with the required recognition of income for transfers with restrictions.

Instead, the general provisions relating to recognition of a liability for grant transfers should be drafted in such a manner to recognise the matching principal acknowledged by AASB 120, thereby making any discussion about advance receipts redundant.

4. Permitting, but not requiring, recognition of contributions of services

FinPro supports the approach in ED180 as a practical option for the recognition of contributions of services.

Local government entities and the wider community are the beneficiaries of diverse services provided by multiple volunteers eg meals on wheels delivery. Reliable measurement of the value of such volunteer services provided would be difficult.

5. Prospective application per the transitional provisions

FinPro agree that the transitional provisions contained within ED180 are practical and appropriate.

The option for retrospective application will be sufficiently flexible to allow recognition of liabilities for grant receipts that may be held over a number of future periods, where the grant was received and recognised as income in a prior period.

AUSTRALIAN SPECIFIC QUESTIONS

6. Whether, overall, the proposals would result in financial statements that would be more useful to users

FinPro *do not* believe the proposals would result in financial statements that would be more useful to users. The distinction between conditions and restrictions relating to grant transfers and the AASB's stated view that time stipulations are not conditions will continue to result in inconsistent reporting and volatile operating results for local government entities.

FinPro – Local Government Finance Professionals - Response to ED180

APPENDIX B

Example Application of ED180 - Grants

Victorian Council's receive significant grant funding from the Commonwealth Government, allocated by the Victorian Grants Commission (VGC). This is regular and recurrent funding, received annually by each Council in Victoria. The Commonwealth grant allocations are administered to local government by the State commissions. In Victoria, this grant funding is administered in accordance with the Local Government (Financial Assistance) Act 1995. There are no additional funding agreements between the grantor and recipient.

In 2008-09, the Commission allocated $439.716 million to Victorian Councils. This was comprised of $321.124 million in general purpose grants and $118.593 million in local roads grants.

Both grants are "untied", which means that the Commonwealth cannot direct how they are spent by Councils.[1]

VGC grants are allocated for a July – June financial year in accordance with the Act, and are paid in four quarterly instalments. All 79 Councils within Victoria receive funding at the same time.

All Victorian Councils received the first quarterly grant for 2009/10 (ie the following financial year) in the last week of June 2009. Across the local government sector, this represented in excess of $110 million received prior to the commencement of the 2009/10 year.

Council's were required to recognise this receipt as income in 2008/09, in accordance with AASB 1004 and AASB 118. This has resulted in *five* quarterly instalments recognised as income in 2008/09, with only the remaining *three* quarterly instalments to be recognised as income in 2009/10.

Impact on reporting in 2008/09:

- Councils reported increased revenue, and consequential increased operating result in 2008/09.
- Operational and capital expenditure funded by this grant will be recognised in 2009/10. For some Councils, this will result in a reported operating deficit for 2009/10, despite prudent management and a budgeted surplus from operations.
- Significant variance between reported current year and prior year comparative income.
- Significant variance between the adopted budgets for both 2008/09 and 2009/10 and actual result, as reported in the Standard Statements for each Council.

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[1] Source: Department of Planning and Community Development website http://www.dvc.vic.gov.au/web20/dvclgv.nsf/allDocs/RWPDA3475ECD8376216CA25712E0016D1A8?OpenDocument

APPENDIX B

Example Application of ED180 - Grants

- Reporting in accordance with accrual principals and the AASB financial reporting framework, without the interference of current Accounting Standards would have resulted in comparable and consistent income recognition from year to year, and against budgets set in accordance with the Local Government Act.

Would the proposed recognition requirements of ED180 result in more true and fair reporting of this scenario?

Analysis in accordance with ED 180:

Does the inflow give rise to an item that meets the definition of an asset?	Yes	AASB 138
Does the inflow satisfy the criteria for recognition as an asset	Yes	ED180 paragraph 32
Does the inflow result from a contribution from owners?	No	ED180 paragraph 38-39
Is the transaction a non-exchange transaction?	Yes	ED180 paragraphs 40-42
Has the entity satisfied all of the present obligations related to the inflow?	Yes **Refer below**	ED180 paragraphs 51-57
Conclusion: **Recognise an asset and recognise income** (same timing of recognition as under current Standards)		ED180 paragraph 45

Has the entity satisfied all of the present obligations related to the inflow?

VGC funding is provided in accordance with the Local Government (Financial Assistance) Act 1995. There are no additional funding agreements between the grantor and recipient.

VGC funding is provided for a specific financial year. In this example, the relevant financial year is 2009/10.

The Local Government (Financial Assistance) Act 1995 does not impose any performance obligations on the Councils for operational funds. There are strong acquittal processes with some capital funding requirements (eg. the Roads to Recovery program).

Therefore, there are no stipulations (conditions or restrictions) attached to this grant funding.

However, in a practical sense, receipt of funds in the final week of the financial year would not provide sufficient time for any delivery of service to the community.

FinPro – Local Government Finance Professionals - Response to ED180

APPENDIX B

Example Application of ED180 - Grants

Would the receipt be treated as an Advance Receipt under ED180?

As the VGC grants are untied and the Act under which this is paid does not compel the Council to do any particular action, there is nothing to "bind" the transfer on the part of the recipient.

The funding is provided in relation to a financial year. However, the AASB's stated view is that a time stipulation is only a restriction, not a condition (ED180 Basis for Conclusions paragraph BC24). Accordingly, this receipt would have to be recognised as income at 30 June 2009. The advance receipt provisions would have no effect.

How would this receipt have been accounted for if AASB 120 "Accounting for Grants and Disclosure of Government Assistance" applied?

This receipt would have been recognised as a liability at 30 June 2009, if local government entities were "for profit" entities, or if AASB 120 was available to not-for-profit entities.

Councils would have been able to match the income received for 2009/10 against the operational and capital expenditure for which it was provided in the 2009/10 year.

Income and operating surplus/deficit reporting for both 2008/09 and 2009/10 would have enabled a meaningful comparison of current to prior year in the financial statements prepared in accordance with Accounting standards.

Reporting of actual income and operating surplus/deficit against the adopted budget in the Standard Statements required by the Local Government Act would have been more meaningful to users, without the distortion of income.

Conclusion

The above is just one example of the potential application of ED 180. Local government authorities encounter similar instances of receipt of grants paid by State government departments ahead of the relevant service period each year. Further examples include formula based funding directly linked to the regular service provided by Council to members of the community (e.g. health, aged and child services) for which grant non-exchange transfers may be received in advance of the provision of the service.

Application of the above analysis and comparison of accounting treatment to AASB 120 would yield the same conclusions.