

Response to Review of ED260 : Income of Not-for-Profit Entities

August 3, 2015

The Chair
Australian Accounting Standards Board
PO Box 204
Collins Street West Victoria 8007

Dear Sir/Madam

The organisation that I work for is a not for profit company in the Health Services industry, providing services and a 'recovery' program for people who have experienced a mental health issue. Some of our programs are activity and day living programs, some are HASI programs (Housing and Accommodation Support Initiatives), some are employment assistance programs and some include operating community businesses and social enterprises. We provide services specifically to adult programs and also for women and children's programs and also youth programs such as the Headspace program.

95% of our income, approximately 100 contracts, is derived from government contracts with both state and the federal government. We operate predominantly in NSW but with a couple of contracts in southern Queensland.

While the term most often used to describe our income is 'from government grants' this is really a misnomer as all of our contracts require performance of a task and if not undertaken the funds are returnable to the funder. It would be better if our contracts were known as **government service contracts** as this is what they are, no different to any other contract where there is a performance requirement and a consideration proportionate to that performance.

Notwithstanding this, over the last few years, our auditor has believed that our contracts have been non reciprocal in nature and taken the view that since we are usually paid in advance (quarter by quarter or twice yearly in advance), we have control of the funds and the economic benefits have flowed to us and the amount is known.

We have been vehemently opposed to this interpretation of our operations believing that as governments still have the right (and act on that right) to request the return of unspent funds or to request return of funds for less than full performance and that we must spend the funds under their contractual direction, that we do not have control, even if clause 12 (b) and (c) of AASB1004 are met. Equally we only have a 'right' to receive it when we have performed the service required in the contract.

In most cases the problem occurs, where the contract starts late, due to awarding the contract late and surplus funds result. While we believe that this should be a liability, due back to the funder (to be spent at the funder's direction or returned), the auditor requires that it be recognised in income, in total, immediately leading to a false surplus, that surplus being shown in the form of a "Restricted Reserve" in Equity.

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In some cases we are then in breach of contract, as the contract specifically states that funds, not spent, **must** be shown as a liability and not as equity.

It is therefore that we welcome the release of the exposure draft ED260, which follows the broad theme that common sense will prevail.

In relation to your request on page 13 for **Specific Matters for Comment:**

1(a) Yes, we would agree that the concept of 'reciprocity' is a poor determinate of contractual obligations. If one goes back to the fundamentals of why there is a need for 'an accounting system' and that is to record performance of a business by comparing the inflows of income against the outflows of expense, (i.e. the matching principle), then the concept of matching income against the contractual performance (as in AASB15) is much closer to that principle, than the concept of simply judging based on the three points 12 (a), (b) and (c) (although I don't believe *control* was properly defined), as to whether the income be recognised regardless whether there had been any contractual service provided.

2 (a) Yes, I agree with this principal. But it is important to define the difference between a contractual obligations and a donation. I believe the contractual obligation is created based on business law and that is, there is a legal agreement with the contractual provider to provide goods or services and the provision of goods and services must be offset by a consideration paid by the other contractual partner. The important thing here is that the provider of goods and services must be answerable, contractually, to the payer of consideration. It is not important that the goods or services service be provided to the payer of consideration, but the clear 'business law' definition of a contract must prevail.

If the 'consideration' is paid without a contractual obligation, then this would be a gift or donation and this could well fall under AASB1004.

3 (a) See my response to question 2. If the payment 'donation' (consideration, if it were contractual) but it is not contractually enforceable, thus it is a gift or donation, I believe that this should be predominantly instantly recognised as income either within AASB1004 (as non reciprocal) or by any other standard covering this type of payment.

The issue is one of accountability. A donation may request expenditure spent in a specific way, but it is not contractual. If the donor wishes proof of expenditure and a level accountability and a possible requirement that the unspent funds are returnable, or can only be spent under direction of the donor, then this is contractual and should fall clearly under AASB15.

A not for profit, that receives much of its funding from donations relies on its donations for a more general expenditure umbrella than a contractual obligation. An organisation relying on donations may have a surplus at the end of the financial year, but does not consider such a surplus as returnable to donors. Nor is there a contract, expressed or implied that they should do so.

Focusing on the question, I would believe that a donation component of a contract would not be contractual in itself. Thus the non-payment would not give

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rise to a case of breach of contract, it could only be breach of promise. As such it would fall under AASB1004 and as long as the three criteria are met (clauses 12 (a),(b) and (c), it should be recognised in income.

4. I am less certain of the benefit of showing the value of volunteer services as income even if the fair value of volunteer services can be measured reliably.

The value of volunteer services can be calculated by the actual cost of non-volunteer services that it might replace. However, the value of the work that volunteers do is much more difficult to measure unless they were producing an output that was able to be calculated. To stop those responsible for the production of financial reports from over or under stating the value of the income in comparison to the costs of the work achieved, thereby producing an asset or liability, which is by nature impaired, if volunteer work is costed, it should be a separate note in the accounts and be shown as separate lines in the income statement in both the income and expense, so as not to mislead users of those financial statements. It should be clearly stated in the standard that the costing of the income value must be equal to the expenses for that volunteer service in each financial year. A further issue arises in how such time could be audited as no financial transaction takes place.

5. I believe that such an assessment must be made on a contract by contract basis or even by subject within a contract basis.

The first issue is whether part of the funding received from the grantor, as part of an all encompassing contractual program, is not contractual and can then be treated as a gift or a donation. For the grantor's payment to be contractual it must be in the form of consideration, which then says that the grantee is accountable back to the grantor for the provision of goods and services. While included in the all encompassing contract, if an amount is not accountable, for example a set up allowance of say \$250K, then that might be treated as a donation and immediately treated as income (but for matching purposes might be shown as revenue in advance and the income matched against the expenditure as incurred). However, the grantor might also give to the grantee equipment, it formerly used itself, with a remaining shelf life of two years. In this instance, the equipment given to the grantee should be shown as income immediately, creating an asset with a two year life, which is then amortised as depreciation over the remaining two years.

I believe it is thus important to review on a by contract basis.

6. & 7. The term 'contributions by owners' in the not for profit industry segment would predominantly represent a donation of time or materials or cash from a member. If a donation of time, that would be a volunteer activity, if a donation in money or materials, that would be a gift. Such a contribution should be dealt with under those two headings, not as a 'contribution by owners'.

Sections 48-53 of AASB1004 deals with government and the same 'ownership' issue does not prevail with NFPs.

8. no comment

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9. Yes I agree with the transitional provisions as outlined in Appendix C of draft AASB 10XX

10. no comment

11. I believe this question understates the situation, as it currently exists.

Nearly all of our contracts are acquitted to either the State or Commonwealth Government. The acquittal is always accompanied by the company AFS. Other outside parties who receives a copy of our annual financials statements is our bank, our insurance broker and of course the ACNC/ASIC.

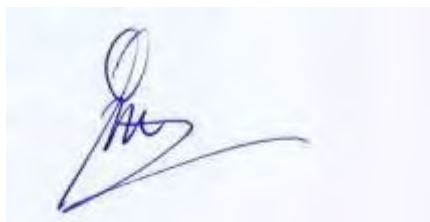
The types of people who read financial statements are interested predominantly in the Profit and Loss statement and in the Balance Sheet. In the majority of cases, they are not accountants and tend to only look at headline issues. They do not read the details and most would not read the notes accompanying the AFS.

The result of AASB1004 is that in a year that we received funds from new contracts, awarded just before financial year end (and therefore had little expenditure against them), resulted in the company booking an unfair and unreasonable profit and this was followed in the subsequent year when the expenditures against those just awarded contracts could not be offset by income (which had been recorded in the year previously), resulting in an unfair and unreasonable loss. All of this resulted in accounts being issued which were not 'true and fair'. The foundation purpose of presenting accounts is to match income with the expenditure against it; that is, the matching principle. The purpose of the AFS is not to present a set of books which need to be read together with the accounting standards to be meaningful. While this might be technically correct, almost 100% of the recipients of our AFS are not accountants.

12. Therefore these proposals are in the best interests of Australia.

13. see comment 11 above.

Yours sincerely

A handwritten signature in blue ink, appearing to be 'M.A. Smallsman', written on a light blue background.

M.A Smallsman FCPA
CFO of a large NFP
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