



New South Wales
T R E A S U R Y

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Dear Mr Boymal

ED 144 'Proposed Australian Guidance to accompany AASB 1004 Contributions'

New South Wales Treasury welcomes the opportunity to respond to the Board's request for comments on Exposure Draft ED 144 'Proposed Australian Guidance to accompany AASB 1004 Contributions'. Attached are detailed comments.

Overall, NSW Treasury is strongly of the view that this Guidance should not be issued, as it is premature given likely developments in Accounting Standards. Also, most significantly, the proposed Guidance is inconsistent with the current Accounting Standards and the distinction between AASB 118 and AASB 1004. ED 144 is described as a re-interpretation. But this re-interpretation changes the Standards, such that grants are treated on a similar basis to reciprocal transactions.

Most grants received by Governments or agencies from Governments relate to providing services to the community. However, NSW Treasury strongly rejects the view that revenue recognition should be deferred until the goods and services are provided, either under AASB 118 or under AASB 1004. This is because, in NSW Treasury's view, the majority of grants meet the definition of a non-reciprocal contribution under AASB 1004 and are in-substance unconditional transfers. As such, it is inappropriate to link revenue recognition with the provision of goods and services.

Further, NSW Treasury is strongly of the view that it is inappropriate for Guidance to a Standard that does not form part of the Standard to override other Accounting Standards. If this Guidance was issued, NSW public sector agencies would be unable to apply it, given the inherent conflict with current Accounting Standards.

Also, NSW Treasury believes that the proposed Guidance may increase, rather than decrease, confusion and uncertainty. This is because it does not resolve core issues such as whether or not agreements are in-substance agreements for the provision of goods and services. The proposals are also not consistent with the direction of ED 125 *Financial Reporting by Local Governments*, including the focus on the circumstances that give rise to a liability.

Finally, while this is not directly an AEIFRS issue, requiring entities to adopt the AASB 1004 Australian Guidance from 1 January 2005, is contrary to the AASB's previous commitment to finalise any Standards that impact on the first 2005/06 AEIFRS financial report by the end of June 2004. This timeframe has long since expired.

If you have any queries regarding this submission, please do not hesitate to contact me on (02) 9228 3019.

Yours faithfully

Robert Williams
for Secretary

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NSW TREASURY'S COMMENTS ON ED 144 'PROPOSED AUSTRALIAN GUIDANCE TO ACCOMPANY AASB 1004 CONTRIBUTIONS'

(a) Whether guidance should be issued at this stage to accompany AASB 1004, in light of the likelihood of future changes given the various projects being undertaken by the IASB and IPSASB

No. NSW Treasury is strongly of the view that guidance should not be issued at this stage for the following main reasons:

- It is premature given the proposed withdrawal of AAS 29 and AAS 31; review of AASB 120, IPSAS projects and the fundamental review of AASB 1004.
- It is inconsistent with current Accounting Standards and the distinction between AASB 118 and AASB 1004.
- It leads to proposed treatments that Treasury strongly disagrees with.
- It is inappropriate for Australian Guidance that does not form part of the Standard to override other Accounting Standards i.e. as this breaches the AASB 108 hierarchy.
- It does not resolve core issues such as whether or not agreements are in-substance agreements for the provision of goods and services.
- It is not entirely consistent with the direction of the ED 125 proposals and does not focus on the circumstances that give rise to a liability.
- Application is too late for 2005/06.

These reasons are discussed in more detail below.

Issuing Guidance is premature

Treasury's strong view is that any Australian Guidance to AASB 1004 should be deferred because of the number of forthcoming IASB and IPSASB developments, and the proposal to withdraw AAS 29 and AAS 31. All of these developments have the potential to impact on AASB 1004, and therefore it is preferable that this issue be deferred in order to minimise changes in accounting treatment in successive periods.

It is inconsistent with current Accounting Standards

The proposed Guidance is inconsistent with the current Accounting Standards and the distinction between AASB 118 and AASB 1004. The adoption of ED 144 is much more than a re-interpretation. Rather, it makes a fundamental change to the Standards, such that grants are treated on a similar basis to reciprocal transactions. However, no justification or basis for conclusions has been provided to support the change in interpretation.

At present, the discussion in AASB 118, AASB 1004, AAS 29 and AAS 31 is premised on the distinction between reciprocal and non-reciprocal transactions. In simple terms, revenue for reciprocal transactions has been recognised when the good or service has been provided; while for non-reciprocal transactions, revenue has generally been recognised on receipt. Therefore, the need to define reciprocal and non-reciprocal transfers has been driven by the difference in accounting treatment.

However, the effect of ED 144 is that even though the two definitions of reciprocal and non-reciprocal will be retained, in substance the treatment will be identical, albeit under two Standards i.e. AASB 118 and AASB 1004. That is, reciprocal transactions continue to be accounted for under AASB 118 and non-reciprocal under AASB 1004. However, the fundamental change is that contributions with conditions will now only be recognised as revenue when the conditions are satisfied. Where these conditions relate to the provision of goods and services, this will mean that revenue is recognised when the good or service is provided. This is identical to the treatment of reciprocal transactions. This is a fundamental change which effectively means that both reciprocal and non-reciprocal transactions are treated consistently.

In Treasury's view, while ever there are two Accounting Standards i.e. AASB 118 and AASB 1004 and two different definitions for reciprocal and non-reciprocal, any Guidance which eliminates the difference in accounting treatment effectively conflicts with the Accounting Standard requirements.

Further, until withdrawn, the treatment directly conflicts with the AAS 29 and AAS 31 requirements. These Standards require that contributions must be recognised as revenue when the contributed assets qualify for recognition (AAS 29, para 10.10; AAS 31, para 14.1). Under AAS 29 and AAS 31, a liability only arises when an agency fails to meet specific conditions and the amount is required to be repaid (AAS 29, para 10.12.7; AAS 31, para 14.1.4).

It leads to proposed treatments that Treasury strongly disagrees with

Most grants received by Governments or agencies from Governments 'relate' to providing services to the community. However, Treasury strongly rejects the view that revenue recognition should be deferred until the goods and services are provided, either under AASB 118 or under AASB 1004. This is because in Treasury's view, the majority of grants meet the definition of a non-reciprocal contribution under AASB 1004 and are in-substance unconditional transfers. As such, it is inappropriate to link revenue recognition with the provision of goods and services. This and other issues are further discussed in responses to paras (b), (c) and (f) below.

Inappropriate for Australian Guidance to override other Accounting Standards

It is Treasury's strong view that it is inappropriate for Guidance to a Standard that does not form part of the Standard to override other Accounting Standards. The status and relationship of any non-mandatory Guidance is ambiguous in terms of the AASB 108 hierarchy, particularly as it conflicts with Accounting Standards (refer above). If this Guidance was issued, NSW public sector agencies would be unable to apply it, given the inherent conflict with current Accounting Standards.

In particular, if AAS 29 and AAS 31 override the proposed Australian Guidance to AASB 1004 (particularly AAS 29, para 4.1 and AAS 31, para 6.1) then, until withdrawn, public sector jurisdictions will be in the untenable position of having three potentially different treatments across public sector entities, i.e:

- AASB 120 applies to for-profit public sector entities;
- AAS 29 will apply to government departments, which are generally the budget dependent general government sector agencies;
- AASB 1004 will apply to other not-for-profit public sector entities that are not subject to AAS 29. This would generally include non-budget general government sector agencies.

This is not acceptable, particularly given that all three requirements are subject to change in the short term. Also, Treasury does not support the alternative view, put forward in the AASB's recently revised draft public sector strategy (as at 16 November 2005), which proposed that the Australian Guidance to AASB 1004 should apply, irrespective of the AAS 29 and AAS 31 override provisions. It is not clear how this would be achieved. However, in Treasury's view, it is inappropriate for Australian Guidance that is not part of any Standard, to override other Accounting Standards.

It does not resolve core issues such as when an agreement is an in-substance agreement for the provision of a good or service

In Treasury's view, the usefulness of the proposed guidance is very limited, as it does not examine core issues, such as when an agreement is an in-substance agreement for the provision of a good or service. This means there is insufficient guidance as to whether AASB 118 or AASB 1004 applies; and this may increase, rather than decrease, confusion and uncertainty. This is further discussed in paras (b) and (e) below.

It is not entirely consistent with the direction of the ED 125 proposals

The ED 144 Australian Guidance is consistent with the ED 125 proposals to the extent that they both result in a liability being recognised, where previously revenue was recognised. However, there are important differences between the ED 125 proposals and the proposed Australian Guidance. In particular, ED 125 proposed to remove definitions for 'reciprocal' and 'non-reciprocal' transfers, and to instead focus on the concepts of revenue and liability. In contrast, the ED 144 proposals carry forward the 'reciprocal' / 'non-reciprocal' definitions. This is further discussed in paras (b), (c) and (e) below.

Application is too late for 2005/06

ED 144 states that "...it is intended that the proposed guidance be available for annual reporting periods beginning on or after 1 January 2005". It is not clear whether "available" means that an entity is obliged to consider this Guidance from that date or whether this is an option. Treasury does not support agencies being obliged to consider this Guidance from 1 January 2005.

As the AASB itself acknowledges, **this is a re-interpretation that may impact on the current accounting treatment**. Therefore, it is inappropriate at such a late stage to compel not-for-profit entities to revise their current treatment for 2005/06. While this is not directly an AEIFRS issue, requiring entities to adopt the AASB 1004 Australian Guidance from 1 January 2005 is contrary to the AASB's previous commitment that any Standards that impact on the first 2005/06 AEIFRS financial report had to be finalised by the end of June 2004. This timeframe has long since expired.

(b) Usefulness of the proposed guidance on the circumstances in which a contribution is initially recognised as a liability rather than income.

In NSW Treasury's view, the usefulness of the proposed guidance is very limited, as it does not first examine the threshold issue regarding when the definition of a contribution is satisfied and whether AASB 118 or AASB 1004 applies. This contrasts to ED 125, particularly para 8.2.1, which attempts to identify the minimum characteristics of in-substance agreements for the provision of goods and services. ED 125 only addresses the treatment of conditions, *after* determining whether or not an agreement was an in-substance agreement for the provision of goods and services.

Notwithstanding this, Treasury strongly agrees that it is the substance of a transaction that is important and not merely the legal form, consistent with ED 144, para G6. However, para G6 is insufficient, as it does not adequately address what is meant by 'enforceable'. For example, the IFAC Invitation to Comment on Non-Exchange Revenue states that to satisfy the criteria for recognition as a liability, the stipulations must specify such matters as:

- The nature and quantum of the goods and services to be provided;
- Nature of assets acquired;
- Location and characteristics of the recipients of any goods and services;
- The period in which the provision of goods and services is to occur.

These characteristics are similar to the ED 125 criteria for determining in-substance agreements for the provision of goods and services e.g. specific goods and services to be provided; reliable acquittal process etc. The AASB also acknowledged this in its deliberations on the ED 125 comments. The Board decided that rather than distinguish between in-substance agreements for the provision of goods and services and conditional grants, it is sufficient to refer to voluntary arrangements that create non-discretionary obligations (AASB Action Alert, Number 78, October 2004). Therefore, it concluded that it would focus on the features of arrangements that give rise to a liability and that the ED 125, para 8.2.1 features should be expanded to deal with circumstances where conditional grants give rise to recognisable liabilities.

In summary, the Board's ED 125 proposals and subsequent deliberations represent an important shift away from the notion of 'non-reciprocal' transfers in AASB 1004 and the circumstances when AASB 118 applies. Therefore, given this, Treasury believes that ED 144 is premature, as it does not necessarily align with the ED 125 deliberations and the possible future direction of this project.

(c) Whether there are any situations that would result in the guidance leading to a liability being initially recognised, when it is more appropriate for income to be recognised.

Yes. NSW Treasury strongly disagrees with treating contributions granted on the condition that goods and services are delivered to third parties as a liability (per ED 144, para G8). Further, the recognition of revenue when the entity satisfies the condition (para G10) (i.e. when the goods and services are provided) is not supported, as this is only relevant for reciprocal transactions relating to the rendering of services under AASB 118.

In simple terms, Treasury believes that where a transfer is non-reciprocal, the notion that amounts are ‘earned’ as the entity provides goods or services contradicts the definition of a non-reciprocal transfer. The nature of a non-reciprocal transfer is that there is no direct relationship between the amount transferred and the goods and services provided. Therefore, it is not relevant or appropriate to link revenue recognition with the provision of the goods and services.

By nature, where a transfer is non-reciprocal, there can be no in-substance conditions arising in relation to the provision of the good or service. This is because, as a non-reciprocal transfer, any conditions relating to the rendering of services are unenforceable. As such, the transfer is unconditional and should not give rise to the recognition of a liability.

These and other issues are further discussed below.

Different types of conditional grants

The draft Guidance does not adequately distinguish between different types of conditional grants. In particular, para G8 seems to combine a number of different types of conditional grants, as follows:

- Assets granted on condition that they are transferred to a third party;
- Assets grants on condition that they are used to provide goods and services to third parties.

In principle, Treasury has no objections to assets granted on condition that they are transferred to a third party being recognised as a liability. However, as discussed above, Treasury does object to the treatment proposed for the second category i.e. assets granted on condition that they are used to provide goods and services to third parties.

This second category of conditional grants is also, in part, inconsistent with the ED 125 proposals. In particular, ED 125 concluded that the receipt of a non-financial asset with a condition that it be used to provide goods and services to third parties, that is not the subject of an in-substance agreement for the provision of goods and services, *does not* have an associated liability (refer ED 125, para 8.3.14). This is on the basis that there is no clear statement of the specific action to be taken with the granted asset.

Appropriations

Treasury is particularly concerned that, under the proposed Guidance, it is possible that appropriations may inappropriately be construed as conditional contributions or reciprocal transactions, on the basis that agencies provide budget estimates, performance / output information to Government relating to services. However, this is not a straightforward issue and requires further consideration. The ED 144 guidance may cause additional confusion, pending further amendments.

Trivial conditions

The Guidance may also result in the inappropriate recognition of a liability where there are trivial conditions. ED 144, para G6 states that where an entity has no experience of not fulfilling conditions, in the absence of evidence to the contrary, the entity assumes the donor would enforce the condition and therefore it is a condition. This paragraph may mean that a grantor or grantee is able to delay the revenue recognition of unconditional transfers by adding trivial conditions or requesting that they be added.

For example, a trivial condition would include making a contribution conditional on the entity producing an annual report (i.e. or else being required to return the contribution). As the preparation of an annual report is normally a statutory requirement, you would not expect an entity to have had any experience in *not* fulfilling the condition. However, para G6 would require that you assume it would be enforced and that a liability should be recognised. This treatment is not supported, as it is *probable* that the annual report will be produced and it is likely it will be produced irrespective of the condition.

(d) Whether there are any situations that would result in the guidance leading to income being initially recognised, when it is more appropriate for a liability to be recognised.

Yes. ED 144 does not address the treatment of time of use i.e. whether time is a restriction or condition. NSW Treasury believes that there are circumstances where ‘time’ gives rise to a liability. However, application of ED 144 may result in the recognition of a contribution subject to a time ‘restriction’ (rather than a ‘condition’) as income, when it is more appropriate for a liability to be recognised.

Time is indirectly referred to in ED 144 in the discussion regarding involuntary transfers. The draft Guidance concludes that where such transfers are received prior to the taxable event to which they relate, then they must be treated as a prepayment consistent with AASB 118. Treasury agrees that the receipt of an involuntary transfer in advance of the year to which it is to be used or to which it pertains should be recognised as a liability. This is irrespective of whether or not the entity can be required to refund the amount. However, as discussed in the response to para (e) below, Treasury disagrees that this satisfies the definition of a reciprocal transfer that falls within AASB 118.

Treasury is of the view that there should be a separate discussion regarding ‘time of use’ within AASB 1004 and that time may give rise to a liability. Any Guidance that does not discuss this issue may increase, rather than decrease, confusion and uncertainty.

Reference should also be made to the comments made as part of the Heads of Treasuries Accounting and Reporting Advisory Committee (HoTARAC) submission on ED 125 (which NSW Treasury contributed to and strongly supports), regarding the issue of ‘time of use’.

(e) Whether the distinction between applying AASB 118 and AASB 1004 is sufficiently clear

No. NSW Treasury is of the opinion that there is insufficient guidance provided on this issue in ED 144. The draft Guidance only states at para G1, that ‘when amounts received or receivable relate to the rendering of services they are accounted for in accordance with AASB 118...but only if they are not contributions’. However, ED 144 provides no guidance on when the definition of a ‘contribution’ is satisfied and whether or not agreements are in-substance agreements for the provision of goods and services. This is the key issue in determining whether or not AASB 118 or AASB 1004 should be applied.

The approach taken in ED 144 contrasts to ED 125, which addressed the treatment of conditions only *after* determining whether or not an agreement was an in-substance agreement for the provision of goods and services. ED 125 specified the minimum features necessary for an agreement to be regarded as an agreement for the provision of goods and services, as follows (para 8.2.1):

- Specific goods and services to be provided;
- A reliable acquittal process to determine whether goods and services have been provided;
- That the purchaser has the right to refuse payment or demand repayment where the acquittal process indicates the goods and services provided are less than the agreed quantity.

Further, as presently drafted, the relationship between AASB 118 and AASB 1004 is confusing and potentially contradictory¹. For example, the Flowchart asks the question - “Does the substance of the transaction relate to the rendering of services (or other, as referred to in footnote 1 on page 13)?” But this question does not appear to adequately reflect the Guidance at para G1, which states that such amounts are only accounted for under AASB 118, where they are NOT contributions. Therefore, as ED 144 infers that there may be both situations i.e. where amounts relating to the rendering of services are and are not contributions, then the flow chart needs to make clear that AASB 118 only applies if they are NOT contributions. Para G7 also needs to be clarified along similar lines.

Treasury also disagrees that the following transfers are ‘reciprocal’ transactions that must be accounted for in accordance with AASB 118:

- Assets contributed subject to it being returned to the donor if a specified future event does not occur but does not entail a performance obligation (e.g. Australian Government provides funds to a State Government subject to the recipient entity raising a matching contribution) (para G12).
- Amounts received in advance of the taxable event (para G17).

Treasury agrees that these types of transfers should initially be recognised as a liability. However, Treasury disagrees that these transfers meet the definition of a reciprocal transaction. Rather, these types of transfers seem to satisfy the non-reciprocal definition in AASB 1004 and should be accounted for in accordance with AASB 1004, as a liability. This is also discussed in the response to para (d) above.

¹ Also p 5 of ED 144, footnote 1 (in the commentary accompanying the draft Australian Guidance), conflicts with para G1, as it provides that “*contributions* received or receivable that arise from the rendering of services are accounted for in accordance with AASB 118” [italics added]. In contrast, para G1 provides that only those amounts that relate to the rendering of services, that are NOT contributions, are accounted for in accordance with AASB 118.

(f) Whether, instead of treating contributions in relation to the rendering of services under AASB 1004 and using the proposed guidance, such amounts should be treated in accordance with the rendering of services requirements in AASB 118.

No. NSW Treasury is of the strong view that all contributions should be accounted for under AASB 1004 and not AASB 118. A ‘contribution’ may ‘relate’ to the rendering of services but, by definition, the nature of the transfer is ‘non-reciprocal’ i.e. an entity receives services without directly giving approximately equal value in exchange. In contrast, the principle in AASB 118 is meant for reciprocal transfers, with revenue recognised as the goods or services are provided.

However, the only difference between this proposal in para (f) above and the approach taken in ED 144 Guidance is that the para (f) approach *explicitly* requires that such transfers are subject to AASB 118. But, under both approaches the outcome is the same i.e. such contributions are treated consistently as for reciprocal transactions. As discussed in the response to para (a), Treasury is of the view that any proposal that requires contributions to be treated on the same basis as reciprocal transactions, is a fundamental change to the distinction between AASB 118 and AASB 1004; and the distinction between reciprocal and non-reciprocal transfers; and is not supported.

As discussed in the response to (c) above, the AASB 118 treatment is not appropriate for non-reciprocal transfers. That is, Treasury believes that where a transfer is non-reciprocal, the notion that amounts are ‘earned’ as the entity provides goods or services contradicts the definition of a non-reciprocal transfer. Therefore, it is not appropriate to link revenue recognition with the provision of goods and services, as AASB 118 does. All contributions should be accounted for under AASB 1004; but revenue recognition should not be deferred until the good or service is provided.

(g) Other issues

In NSW Treasury’s view, the section in para G16 on the recognition of involuntary transfers is premature, as there is no discussion on reliable measurement. Reliable measurement of taxes, duties, levies and fines etc is a critical issue for Governments. While the taxable events specified in the Guidance may in principle be the appropriate recognition point, in practice, because of difficulties in reliable measurement, a later recognition point may be required.

Reference should also be made to HoTARAC’s previous submission on ED 125 (which NSW Treasury contributed to and strongly supports) for other general comments regarding the treatment of contributions.