

5 December 2005

Professor David Boymal
Australian Accounting Standards Board
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Dear David

ED 144 Proposed Guidance to accompany AASB 1004 Contributions

We are pleased to submit our comments in relation to Exposure Draft ED 144 *Proposed Guidance to accompany AASB 1004 Contributions*.

Overall, we support the AASB's decision to provide guidance to accompany AASB 1004. We believe that despite the various projects being undertaken by the International Accounting Standards Board (IASB) and International Public Sector Accounting Standards Board (IPSASB) in relation to revenue recognition and that the proposed guidance may be pre-empting the result of these projects, guidance on when a contribution to a not-for-profit entity should be initially treated as a liability versus income is highly needed.

Our main concern with AASB 1004 and the proposed guidance relates to the distinction between reciprocal or non-reciprocal transactions. AASB 1004 defines a 'non-reciprocal transfer' as 'A transfer in which the entity receives assets or services or has liabilities extinguished without directly giving approximately equal value in exchange to the other party or parties to the transfer.'. We believe that the guidance should address what is meant by 'directly' in this context. Specifically, whether the transfer that a not-for-profit entity receives to provide goods and services to a third party to satisfy an obligation of the transferor (such as a community service obligation) is a reciprocal transfer. The clarification of the distinction between reciprocal and non-reciprocal transfer has substantial effect on whether the transaction is a non-reciprocal transfer within the scope of AASB 1004 or whether the transaction is a reciprocal transfer and should be accounted for in accordance with AASB 118 *Revenue*.

Without this clarification, the definition of non-reciprocal transfer has the potential to be interpreted to mean that all transfers in which goods and services are provided to third parties will be classified as non-reciprocal transfers. This may lead to transfers being initially recognised as income rather than a liability. Please refer to our comments on question (d) below for further information.

Our comments on the specific proposals outlined in the Exposure Draft and other issues, which we would like to bring to your attention, are addressed below.

1. SPECIFIC MATTERS FOR COMMENT

- (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*

As indicated in our general comments, we support the AASB's decision to provide guidance to accompany AASB 1004. We believe that despite the various projects being undertaken by the IASB and IPSASB in relation to revenue recognition and that the proposed guidance may be pre-empting the result of these projects, guidance on when a contribution to a not-for-profit entity should be initially treated as a liability versus income is highly needed.

At present there is a lot of uncertainty regarding when to recognise income from contributions and this leads to inconsistency in recognising contributions and a lack of comparability of the financial reports of not-for-profit entities. We believe that providing guidance to accompany AASB 1004 goes a long way in addressing these concerns. We do acknowledge that the guidance pre-empts the result of various international projects on revenue recognition, and that it is conceivable that entities may be required to change their policies for accounting for contributions as a result of these projects. However, there is also uncertainty regarding the timing of the completion of the international projects and the effect that the international projects (especially the IPSASB's Revenue from Non-exchange Transaction project) will have in the Australian environment. Accordingly, we support the AASB issuing guidance to accompany AASB 1004.

- (b) *the usefulness of the proposed guidance on the circumstances in which a contribution is initially recognised as a liability, rather than income*

Subject to our other comments in this submission, we consider that the guidance is useful.

- (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*

We have not identified any specific situations in which this circumstance would arise.

- (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*

As noted in our general comments, we believe that the guidance needs to clarify what is meant by the use of the word 'directly' in the definition of 'non-reciprocal transfers'. Specifically, whether the transfer that a not-for-profit entity receives to provide goods and services to a third party to satisfy an obligation of the transferor (such as a community service obligation) is a reciprocal transfer. The clarification of the distinction between reciprocal and non-reciprocal transfers has substantial effect (as indicated in guidance paragraph G1) on whether the transfer is a non-reciprocal transfer within the scope of AASB 1004 or whether the transfer is a reciprocal transfer and should be accounted for in accordance with AASB 118 *Revenue*.

This clarification will assist many entities in the performing arts industry who obtain transfers (grants) from the Australian Arts Council and other organisations to provide community services such as opera, theatre or orchestral performances at a reduced cost to the general public. In such

circumstances, the funding body may provide funds to the performing arts entities in advance of the year of the performance to which it relates. In many circumstances there is a performance obligation (i.e. to provide the opera, theatre or orchestral performances, for example) that the organisation commits to via contracting artists, venues, advertising and subscriber programs well in advance of the scheduled performance time. The transfers provided in the financial period before that in which the performance occurs are used to enable the organisation to make such payments as are required to secure their future activities and commit to future performances. Repayment obligations related to the transfer often do not exist given the significant performance obligations that do exist. If the transfer was considered to be a non-reciprocal transfer because the Australian Arts Council or other funding organisation did not directly receive approximately the equal value in exchange, then the transfer would be accounted for in accordance with AASB 1004 and the proposed guidance would require the funding to be recognised when the performing arts entity gains control of it, which is generally when the funding is received.

Conversely, if the transfer was considered to be a reciprocal transfer because the Australian Arts Council or other funding organisation directly received approximately equal value in exchange through satisfying an obligation that it has to provide community services such as opera or theatre performances, then the transfer would be accounted for in accordance with AASB 118. This would lead the initial recognition of deferred income (a liability) when the performing arts entity gains control of it and the deferred income to be subsequently recognised as income by reference to the stage of completion of the terms of the transfer i.e. as the opera or theatre performances have occurred.

We believe that the accounting derived from treating the transfer as a reciprocal transfer is appropriate because it matches income with the associated expenses. We note that if this accounting treatment is not established by the guidance to AASB 1004 then transfers in the future have the potential to be structured to ensure that this accounting treatment is obtained by the performing arts entities receiving the funding on the first day of the financial year to which the funding relates.

An alternate solution to keep the amounts within the scope of AASB 1004 would be for the guidance to require two criteria for a liability to be initially recognised, being (1) the performance obligation and (2) a constructive obligation (instead of specifically stating a return obligation). We believe if a not-for-profit entity is operating under good governance and that governance leads to the establishment of a constructive obligation to use funds as specified or to return or repay the funds, then this should lead to the recognition of an initial liability. The initial recognition of a liability is consistent with the manner in which such transfers are currently being accounted for.

We also do not agree that local government rates as specified in guidance paragraph G3 and G18 are non-reciprocal transactions. We believe that any homeowner subject to these rates would indicate that they directly receive benefit from the use of the rates that they pay whether it is through garbage collection or local government expenditure in maintaining roads, footpaths, parks etc. Therefore we would consider rates to be a reciprocal transfer that should be accounted for in accordance with AASB 118 by reference to the stage of completion method. In our view, this would probably best be determined by recognising rates as deferred income and amortising the rates evenly throughout the rating period.

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

Please refer to our comments on question (d).

(f) *whether, instead of treating contributions in relation of 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*

We believe that only reciprocal transfers should be accounted for in accordance with AASB 118. Please also refer to our comments on question (d) relating the clarification between non-reciprocal transfers and reciprocal transfers.

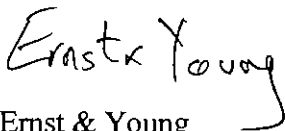
2. OTHER COMMENTS

- We note that the Preface to ED 144 indicates that proposed guidance intends to be operative for annual reporting periods beginning on or after 1 January 2005. We believe that clarification is needed or transitional provisions are required on the interaction between the guidance and AASB 1 *First-time Adoption or Australian equivalents to International Financial Reporting Standards*. Specifically, when the application of the guidance, which does not form part of AASB 1004, results in different accounting treatments being achieved, whether entities would be required in accordance with AASB 1 to retrospective apply the accounting treatment indicated in the guidance. Given the late stage that the proposed guidance is being considered, we believe that the guidance should be applied prospectively for annual reporting periods beginning on or after 1 January 2005 with an exemption being provided for comparative information.
- Paragraph G1 – We believe that the second sentence is confusing and should be reworded as “When amounts received or receivable fall within the scope of AASB 118 *Revenue* (or AASB 111 *Construction Contracts*) they should be accounted for accordingly.” This rewording, together with further clarification on the distinction between reciprocal and non-reciprocal transactions will assist in determining what Accounting Standard should be applied. We also believe that if footnote 1 is to remain in the guidance, the scope of AASB 118 should be written in full rather than abbreviated to assist users in quickly establishing whether AASB 118 applies.
- Paragraph G5 – The 3rd question “Does the substance of the transaction relate to the rendering of services (or other, as referred to in footnote 1 on page 13)?” should be reworded consistently with the amendments arising from paragraph G1.
- Paragraph G5 – The 4th question “Is the inflow a contribution by owners?” should be reworded as “Is the inflow a non-reciprocal transfer from an owner?”.
- Paragraph G5 – The 5th question “Do the stipulations attached to the contribution specify that future economic benefits must be consumed or an asset returned?” should be reworded as “Are there conditions attached to the contribution?”, consistent with paragraph G4.

- Paragraph G6 – We agree that the substance, rather than the legal form of the stipulation should determine the accounting treatment of the contribution. However, we note that applying a substance approach is inconsistent with the proposed requirements in the recently issued IASB ED on *Proposed Amendments to IAS 37 Provisions, Contingent Liabilities and Contingent Assets and IAS 19 Employee Benefits* and the equivalent Australian exposure draft, ED 140.
- Paragraph G12 – We believe that this paragraph does not provide a clear explanation of how amounts received or receivable in relation to the examples provided are considered to be reciprocal transactions falling within the scope of AASB 118.

We would be pleased to discuss our comments further with you. Please contact John O'Grady on (03) 8650 7659 if you wish to discuss any of the matters raised in this response.

Yours faithfully


Ernst & Young