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Dear Mr Boymal

**ED 144 “PROPOSED AUSTRALIAN GUIDANCE TO ACCOMPANY AASB 1004
CONTRIBUTIONS”**

The Heads of Treasuries Accounting and Reporting Advisory Committee (HoTARAC) 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*”. Detailed comments are provided in Appendix 1.

HoTARAC believes that the proposed Guidance should not be issued.

Firstly, the proposed Guidance is inconsistent with the current Accounting Standards and does not recognise the distinction between AASB 118 and AASB 1004. HoTARAC is strongly of the view that it is inappropriate for Guidance to a Standard, that does not form part of that Standard, to override other Accounting Standards. Some jurisdictions have indicated that, if this Guidance was issued, they would be unable to apply it, given the inherent conflict with current Accounting Standards.

ED 144 is described as a “re-interpretation”, but its intention is to change the application of the Standards, such that grants are treated on a similar basis to reciprocal transactions. Most grants received by Governments or by agencies from Governments relate to providing services to the community. As such, it is inappropriate to link revenue recognition with the provision of goods and services. In HoTARAC’s view, the majority of grants meet the definition of a non-reciprocal contribution under AASB 1004 and are in-substance unconditional transfers. In these circumstances, HoTARAC strongly rejects the view that revenue recognition should be deferred under both AASB 118 and AASB 1004 until the goods and services are provided.

Also, HoTARAC 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. In

HoTARAC's view, issuing the proposed Guidance would be premature given likely developments in Accounting Standards internationally.

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 contact Robert Williams, at New South Wales Treasury, on (02) 9228 3019.

Yours sincerely

D W Challen
CHAIR
HEADS OF TREASURIES ACCOUNTING AND
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December 2005

Encl

HoTARAC

**COMMENTS ON ED 144 ‘PROPOSED AUSTRALIAN GUIDANCE TO
ACCOMPANY AASB 1004 CONTRIBUTIONS’**

The following detailed comments are provided in response to each of the issues raised by the AASB:

- (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. HoTARAC does not believe that guidance should be issued at this stage for the following main reasons:

- it is premature to issue guidance given the proposed withdrawal of AAS 29 “*Financial Reporting by Government Departments*” and AAS 31 “*Financial reporting by Governments*”, the review of AASB 120 “*Accounting for Government Grants and Disclosure of Government Assistance*”, International Public Sector Accounting Standards Board (IPSASB) projects and the fundamental review of AASB 1004 “*Contributions*”;
- the proposed guidance is inconsistent with current Accounting Standards and does not recognise the distinction between AASB 118 “*Revenue*” and AASB 1004;
- it leads to inappropriate treatment of Government grants;
- it is inappropriate for Australian Guidance, that does not form part of a Standard, to override other Accounting Standards, as this breaches the AASB 108 “*Accounting Policies, Changes in Accounting Estimates and Errors*” hierarchy;
- the proposed guidance does not resolve core issues such as whether or not agreements are in-substance agreements for the provision of goods and services;
- the proposed guidance is not entirely consistent with the direction of the proposals in ED 125 “*Financial Reporting by Local Governments*” and does not focus on the circumstances that give rise to a liability; and
- the proposed guidance is too late to apply to reporting for the 2005-06 financial year.

Issuing Guidance is premature

A number of forthcoming IASB and IPSASB developments, together with the withdrawal of AAS 29 and AAS 31, have the potential to impact AASB 1004. It is preferable that the issuing of any Guidance be deferred until these impacts are known, in order to minimise changes in accounting treatment in successive periods.

Inconsistencies with current Accounting Standards

The proposed Guidance is inconsistent with the current Accounting Standards and the distinction between AASB 118 and AASB 1004. 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 is recognised when the good or service is provided, while for non-reciprocal transactions, revenue is generally recognised on receipt. The differences in definition drive the difference in accounting treatment.

In HoTARAC's view, there are two Accounting Standards i.e. AASB 118 and AASB 1004 and two different definitions for reciprocal and non-reciprocal. Accordingly, Guidance that eliminates the difference in accounting treatment effectively conflicts with the Accounting Standards requirements.

The fundamental change of ED 144 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 fundamental change means that effectively both reciprocal and non-reciprocal transactions are treated consistently.

The effect of ED 144 is that, notwithstanding that the definitions of reciprocal and non-reciprocal remain, in substance the treatment for both will be identical, albeit under two Standards i.e. AASB 118 and AASB 1004.

Further, until withdrawn, the treatment required under the Guidance 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, paragraph 10.10; AAS 31, paragraph 14.1). Under AAS 29 and AAS 31, a liability only arises when an agency fails to meet specific conditions and the amount is to be repaid (AAS 29, paragraph 10.12.7; AAS 31, paragraph 14.1.4).

Treatment of Grants

Most grants received by Governments or by agencies from Governments "relate" to providing services to the community. In HoTARAC'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. HoTARAC 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 and other issues are further discussed in sections (b), (c) and (f) below.

Guidance overrides other Accounting Standards

It is inappropriate for Guidance, which does not form part of a 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). Some jurisdictions have indicated that they would be unable to apply the Guidance, 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, paragraph 4.1 and AAS 31, paragraph 6.1) then, until withdrawn, public sector jurisdictions potentially have three different treatments across public sector entities:

- AASB 120 for-profit public sector entities;
- AAS 29 for government departments, which are generally the budget dependent General Government Sector agencies; and
- AASB 1004 for 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.

HoTARAC does not support the alternative view, put forward in the AASB's recently revised draft Public Sector Strategy Paper dated 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.

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 HoTARAC's view, the proposed Guidance is of very limited use because 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. This may increase, rather than decrease, confusion and uncertainty. This is further discussed in sections (b) and (e) below.

Differences with ED 125 proposals

ED 144 Australian Guidance and the ED 125 proposals both recognise a liability where currently revenue is recognised. However, ED 125 proposed to remove "reciprocal" and "non-reciprocal" transfers and replace them with the concepts of revenue and liability. In contrast, the ED 144 proposals carry forward the "reciprocal/non-reciprocal" definitions. This is further discussed in sections (b), (c) and (e) below.

Application is too late for 2005-06

ED 144 states "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. HoTARAC does not support agencies mandatory application of the Guidance by agencies from 1 January 2005.

The AASB advises that ED 144 may impact on the current accounting treatment. It is inappropriate at such a late stage to compel not-for-profit entities to revise their 2005-06 current accounting treatment. It also contravenes the AASB's previous commitment that any Standards that impact on the first 2005-06 AEIFRS financial report would be finalised by 30 June 2004.

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

The proposed Guidance has very limited usefulness because it does not examine the threshold issues regarding the definition of a contribution and when AASB 1004 applies. This contrasts to ED 125, particularly paragraph 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 is an in-substance agreement for the provision of goods and services.

As stated, it is the substance of a transaction that is important. However, paragraph G6 is insufficient, as it does not adequately address what is meant by “enforceable”. For example, the International Federation of Accountants (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; and
- 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). The AASB decided to focus on the features of arrangements that give rise to a liability and agreed that the ED 125, paragraph 8.2.1 features should be expanded to deal with circumstances where conditional grants give rise to recognisable liabilities.

The 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. This issue has yet to be resolved for the public sector. Given this, HoTARAC 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. Contributions granted on the condition that goods and services are delivered to third parties potentially fall into this category (ED 144, para G8). Further, the recognition of revenue when the entity satisfies the condition (paragraph 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, HoTARAC 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.

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. Paragraph G8 seems to combine:

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

In principle, HoTARAC 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, HoTARAC 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.

The proposed treatment of this second category of conditional grants may be inconsistent with ED 125 proposals. ED 125 concludes 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, paragraph 8.3.14). This assumes there is no clear statement of the specific action to be taken with the granted asset.

Appropriations

HoTARAC is particularly concerned that, under the proposed Guidance, appropriations may be construed as conditional contributions or reciprocal transactions, on the basis that agencies provide budget estimates, performance / output information to Government relating to services. This issue requires further consideration and the ED 144 Guidance may cause confusion in the meantime.

Trivial conditions

ED 144 (paragraph 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 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, paragraph 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. There are circumstances where “time” gives rise to a liability. 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.

ED 144 indirectly refers to time in the discussion regarding involuntary transfers. 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. HoTARAC agrees that the receipt of an involuntary transfer in advance of the year to which it is to be used 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, this does not satisfy the definition of a reciprocal transfer (AASB 118).

There should be a separate discussion of “time of use” within AASB 1004 including that time may give rise to a liability. Omission of this issue will increase confusion and uncertainty.

Comments on “time of use” are included in HoTARAC’s submission on ED 125.

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

No. ED 144 provides insufficient guidance on this matter. The Guidance states at paragraph 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”. ED 144 provides no guidance as to 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 AASB 118 or AASB 1004 should apply.

In contrast, ED 125 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 (paragraph 8.2.1):

- Specific goods and services to be provided;
- A reliable acquittal process to determine whether goods and services have been provided; and
- 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)?” This question does not adequately reflect the Guidance at paragraph G1, which states that such amounts are only accounted for under AASB 118, where they are NOT contributions. ED 144 infers that amounts relating to the rendering of services may, or may not be, contributions. The flow chart needs to show that AASB 118 only applies if they are NOT contributions. Paragraph G7 also needs to be clarified along similar lines.

HoTARAC 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. the Australian Government provides funds to a State Government subject to the recipient entity raising a matching contribution) (paragraph G12); and
- amounts received in advance of the taxable event (paragraph G17).

These types of transfer should initially be recognised as a liability, but they do not meet the definition of a reciprocal transaction. Rather, these types of transfer satisfy the non-reciprocal definition and should be accounted for in accordance with AASB 1004. 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 paragraph 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, paragraph 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. 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 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.

Unlike the ED 144 Guidance, paragraph (f) explicitly requires that such contributions in relation to the rendering of services are subject to AASB 118. However, the outcome is the same ie such contributions are treated as reciprocal transactions. This is not supported. As discussed in section (a), any proposal that requires contributions to be treated on the same basis as reciprocal transaction is a fundamental change to the distinction between AASB 118 and AASB 1004 and the distinction between reciprocal and non-reciprocal transfers.

As discussed in section (c) above, the AASB 118 treatment is not appropriate for non-reciprocal transfers. 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 in AASB 118.

(g) Other issues

The section in paragraph 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 proposed Guidance may in principle be the appropriate recognition point, in practice, because of difficulties in reliable measurement, a later recognition point may be required.

The AASB may refer to HoTARAC’s previous submission on ED 125 for other general comments regarding the treatment of contributions.