ED174 sub 4

Kathleen John

From: Robert Keys
Sent: Monday, 18 May 2009 10:04 AM
To: Kathleen John
Cc: Chris Pang
Subject: FW: ED 174 GAAP/GFS for Entities within the GGS: Submission [SEC=UNCLASSIFIED]
Categories: UNCLASSIFIED
Attachments: 2009_AASB_Submission on ED174.doc; IASB for AASB.zip

From: Sue Newberry [mailto:S.Newberry@econ.usyd.edu.au]
Sent: Monday, 18 May 2009 9:38 AM
To: Chris Pang
Subject: RE: ED 174 GAAP/GFS for Entities within the GGS: Submission

Dear Chris
I attach my submission on ED174 as well as a zip file showing the implications of the IASB's current proposals on financial reporting. This is relevant to ED174.
My submission reflects reservations about the wisdom of attempting to harmonise GAAP and GFS, and I do recognise that the AASB has been assigned this task. As stated in my submission, the requirement to harmonise seems to reflect unexamined assumptions about the validity of the information at both macro and micro levels.
I very much appreciated the AASB's effort to hold roundtable meetings about ED174 and the manner in which the roundtable was run.
Yours sincerely
Sue Newberry

Submission on ED174: ***Amendments to Australian Accounting Standards to facilitate GAAP/GFS harmonisation for entities within the GGS***

Submitted by: Associate Professor Sue Newberry, University of Sydney, s.newberry@econ.usyd.edu.au

Attachments: This submission is accompanied by attachments from the IASB: http://www.iasb.org/Current%20Projects/IASB%20Projects/Financial%20Statement%20Presentation/Discussion%20Paper%20and%20Comment%20Letters.htm. These attachments illustrate more clearly than does ED174 the implications of including in financial reporting requirements a distinction between transactions and other economic flows.

General comment:

This submission on ED174 comments further on some of the questions discussed at the AASB's roundtable event in Canberra on 8 May. The roundtable was a helpful forum and the AASB's effort to facilitate such an event is greatly appreciated.

The order in which questions were presented for discussion at the roundtable in Canberra, and the priority attributed to those questions raise doubts about the extent to which users of the financial reports receive any serious consideration. The unshaded questions were to be considered only if time were available, and yet usefulness to users is, supposedly, the *raison d'etre* of accounting standard-setting.

The AASB appears to have no established dialogue with users of governmental financial reports. Mr McPhee commented more than once that he does have access to users through estimates committees etc. My impression of the experience he reported was that, although such users may have some basic understanding of financial reports, they tend to be puzzled by the complexities of current public sector financial reports. The AASB should explain how and why the proposals in ED174 will produce useful information, and might assist users by demonstrating the appropriate use of that information.

Question a

Are the proposals in ED 174 necessary and/or sufficient to satisfy the objective of GAAP/GFS harmonisation for entities within the GGS?

I recommend attention to the "necessity" aspect of this question. Are the information requirements for macro-level (ie whole of GGS) purposes really suitable for the purposes at the micro-level (ie entities within the GGS)? The effort to harmonise the frameworks seems to reflect unexamined assumptions that the valuation approaches and information presentation requirements of the IMF for GFS purposes are appropriate for all other users of governmental financial reports at both the whole of GGS level and for entities within the GGS.

The GFS requirements focus on macro-economic matters. It is clear from IMF publications that it regards sovereign debt management as a crucial issue and, consequently, seems to regard governments as financial institutions. See, for example, the IMF's 2003 Guidelines for Public Debt Management which draw a comparison between governments and insurance companies, and seek a similar approach to financial reporting. The GFS requirements, including as they do the requirement to use liquidity order for reporting seem to reflect the IMF's interests and reporting purposes. While this might be an understandable reporting approach for GFS at a whole of GGS level, it is difficult to understand why the same approach would be driven through to individual entities within the GGS. One obvious reason for doing so is for ease of preparation of whole of GGS reports, but this has little to do with the espoused objective of publishing reports that users find useful.

A similar comment may be made about other proposed requirements such as removing choice within standards to mandate GFS requirements. While this may force together the two frameworks (GFS and GAAP), the two frameworks are quite different. Under such circumstances, the "harmonisation" is only superficial, and the forcing process risks undermining the validity of both frameworks.

The requirement to harmonise GAAP and GFS inevitably will introduce increased complexity to public sector financial reporting. Given the sentiments reflected in Senator Murray's report that preceded Operation Sunlight, it seems apparent that there is a need to reduce the complexity, at the very least by removing any of the pre-existing requirements that are unnecessary. The disaggregated disclosures requirement in AASB1052 represents just one case in point. Why are such disaggregated disclosures required? There are no signs in the ED of efforts to reduce any of the pre-existing requirements. I recommend attention to these. A further matter of concern about these disclosure requirements is that the mandating of particular GFS requirements will have a flow-on effect to the calculations required to meet the disaggregated disclosures.

Question b

Is it appropriate for the proposals in ED 174 to apply to for-profit entities within the GGS?

The AASB has long argued for its sector neutral approach on the basis that what is deemed appropriate for profit-oriented entities is also appropriate for non-profit-oriented entities in both the public and private sectors. The issue remains controversial. In question b, it is interesting to note that the issue is reversed.

Question c

Should entities within the GGS be subject to the principle in AASB 1049 *Whole of government and general government sector financial reporting* that where there is a choice in GAAP that aligns with GFS, that choice is mandated (see para BC11 of ED 174 and paras BC43-BC45 of AASB 1049).

Firstly, calling it a "principle" that such a choice be mandated does not make it a principle and neither does it achieve alignment between GFS and GAAP. It is simply the imposition of a rule that will create a superficial appearance of alignment between GFS and GAAP but at the risk of undermining both systems. This effort to compress into one set of requirements GFS, IFRS, IPSAS and pre-existing Australian public sector accounting requirements seems so pressured that any theoretical coherence underpinning the individual frameworks seems to have been forgotten. This is one of the most worrying aspects of the whole initiative. Accrual accounting, long advocated as a means of improving the meaningfulness of governmental financial reports, risks becoming increasingly meaningless and incomprehensible because it forces together different frameworks developed for different purposes.

Question d

Is it appropriate to expand the application of paragraphs 15-21 of AASB 1052 *Disaggregated Disclosures* beyond government departments (see paras BC13 of ED 174)?

I question the appropriateness of imposing this requirement at all. Superficially it might be thought to provide some sort of comparison point for the revenues and costs involved in public sector services. To the extent that efforts have been made to create a competitive environment for government departments and local governments, the requirement to disclose such information puts those entities at a significant competitive disadvantage. It should be noted that when public services are contracted out, private sector service providers are not required to present such information. If this requirement for disaggregated disclosures arises from the greater need for public accountability when taxpayer funds are used, the same disaggregated disclosure requirement should be imposed on private sector contractors engaged in taxpayer funded public services. A further concern, as noted above, is that the mandating of particular GFS "choices" will flow through to the calculations required to meet these disclosure requirements.

Question e

Should entities within the GGS be subject to the same kind of budgetary reporting requirements that are specified in paragraphs 59-65 pf AASB1049 (see paragraph BC14 of ED 174)?

GFS does not require budget comparisons. GAAP as applied to business accounting practices does not require budget comparisons. This seems to be yet another instance of going further than merely harmonising GFS and GAAP. These are requirements that neither GAAP nor GFS encompasses.

Question f

Is there a need for specific transitional requirements to facilitate the adoption of the proposals in ED 174 (see para BC 16 of ED 174)?

Discussion in the roundtable revealed some concerns about potential unintended consequences in the absence of transitional requirements

Question g

Overall would the proposals in ED 174 result in financial statements that would be useful to users?

As noted above, this question seemed to be an afterthought.
The AASB seems not to have access to users. Mr McPhee, who does have access to some users, suggested the existing financial reporting requirements are already too complicated. He seemed concerned that ED 174 would add to the difficulties users face. Senator Murray's report also reflects concerns that financial reporting requirements are not useful. Academic research on the usefulness of governmental reports for users (see for example, Mack and Ryan's recent work referenced below)

similarly questions the usefulness. When the shift to accrual accounting first occurred at the federal level, the DOFA published on its web-site a "Guide to the financial statements of the Commonwealth of Australia." Surprisingly, this has never been updated despite significant changes since the introduction of accrual accounting. There is a need to consider what should be done to ensure that readers of governmental financial statements can understand and use them.

Question h

Are the proposals in the best interest of the Australian economy?

A request for clarification of what was meant by this question revealed that this question too seemed to be an afterthought. Obtaining meaningful answers would require more clarity about the reason for asking the question and what is meant by the best interest of the Australian economy.

Question i

Does the draft illustrative example provide guidance that is appropriate/helpful in implementing the proposals in ED 174?.

The presentation requirements include distinctions between financial and non-financial assets, as well as distinctions between transactions and events.

The GFS rely on a conceptual idea that a valid analytical distinction can be drawn between transactions and "other economic flows", the other economic flows including revaluations but, surprisingly, not depreciation. GAAP is based on an asset and liability approach to accounting that does not draw such a sharp distinction between transactions and events. Several GAAP accounting standards regard changes in value as an integral part of a company's annual profit or loss (eg agriculture, financial instruments). Separating transactions and "other economic flows" for analytical and reporting purposes make it inevitable that recycling from one to the other will occur. For example, when a financial instrument that has undergone value changes is subsequently disposed of, the value changes would need to be reversed from the "other economic flows" section and shifted to the transactions section of the financial statement. This complication becomes even more complicated when other analytical separations are required as well. The draft illustrative example neatly avoided this issue. Although the example illustrated how to deal with continuing vs discontinued operations, the accompanying notes acknowledge the example is based on an assumption that the discontinued operations comprise only transactions. This is unrealistic.

For some years the IASB has been grappling, unsuccessfully, with efforts to introduce similar distinctions between transactions and other events. It has made little progress, as is apparent from its project web-site:
http://www.iasb.org/Current%20Projects/IASB%20Projects/Financial%20Statement%20Presentation/Due%20process%20steps%20completed.htm
Recently, the IASB issued a discussion paper on the reporting style it is contemplating. I have included as an attachment, the IASB's sample of how the analytical separations between transactions and other events will affect the statement of financial performance (the full set is available on the IASB's web-site.) This highlights the implications of applying the GFS approach to all GGS entities.

The matrix style proposed for reporting is clearly complicated and still in early stages. It seems likely that if this approach to reporting were to be imposed on entities within the GGS it would add to both preparation and understanding difficulties, not least because the approach is clearly not agreed or fully understood. Because the illustrative draft financial statements provided with ED174 neatly sidestep this aspect of the likely presentation complexities, it gives the impression that imposing GFS requirements at the individual entity level will be relatively straightforward. For this reason, I think that the illustrative statements are misleading and unhelpful because they fail to draw out the implications of the proposed requirements.

References

Ryan, Christine M. and Mack, Janet (2007) *Is there an audience for public sector annual reports: Australian evidence?* International Journal of Public Sector Management, 20(2). pp. 134-146.

Ryan, Christine M. and Mack, Janet (2006) *Reflections on the Theoretical Underpinnings of the General Purpose Financial Reports of Australian Government Departments.* Accounting, Auditing and Accountability Journal, 19(4). pp. 592-612.

ToolCo Statement of comprehensive income matrix for the year ended 31 December 2010

A	B	C	D	E	F
Statement of comprehensive income		Changes in assets and liabilities, excluding transactions with owners			
		not from remeasurements		from remeasurements	
	Comprehensive income (C + D + E + F)	Cash flows	Accruals, allocations and other	Recurring valuation adjustments	All other
BUSINESS					
Operating					
Sales—wholesale	2,790,080	2,108,754	681,326		
Sales—retail	697,520	703,988	(6,467)		
Total revenue	*3,487,600*	*2,812,742*	*674,859*		
Cost of goods sold					
Materials	(1,043,100)	(935,544)	(107,556)		
Labour	(405,000)	(418,966)	13,966		
Overhead—depreciation	(219,300)		(219,300)		
Overhead—transport	(128,640)	(128,640)			
Change in inventory	(60,250)		(60,250)		
Pension	(51,975)	(170,100)	109,125	9,000	
Overhead—other	(32,160)	(32,160)			
Loss on obsolete and damaged inventory	(29,000)				(29,000)
Total cost of goods sold	*(1,969,425)*	*(1,685,409)*	*(264,016)*	*9,000*	*(29,000)*
Gross profit	*1,518,175*	*1,127,333*	*410,843*	*9,000*	*(29,000)*
Selling expenses					
Advertising	(60,000)	(65,000)	5,000		
Wages, salaries and benefits	(56,700)	(58,655)	1,955		
Bad debt	(23,068)		(23,068)		
Other	(13,500)	(13,500)			
Total selling expenses	*(153,268)*	*(137,155)*	*(16,112)*		
General and administrative expenses					
Wages, salaries and benefits	(321,300)	(332,379)	11,079		
Pension	(51,975)	(170,100)	109,125	9,000	
Depreciation	(59,820)		(59,820)		
Share-based remuneration	(22,023)	(3,602)	(12,171)	(6,250)	
Interest on lease liability	(14,825)	(50,000)	35,175		
Research and development	(8,478)	(8,478)			
Other	(15,768)	(12,960)	(2,808)		
Total general and administrative expenses	*(494,189)*	*(577,519)*	*80,580*	*2,750*	
Income before other operating items	*870,718*	*412,659*	*475,311*	*11,750*	*(29,000)*
Other operating income (expense)					
Gain on disposal of property, plant and equipment	22,650	37,650	(15,000)		
Share of profit of associate A	23,760				23,760
Realised gain on cash flow hedge	3,996	3,402	(594)	1,188	
Loss on sale of receivable	(4,987)	8,000	(8,000)		(4,987)
Total other operating income	*45,419*	*49,052*	*(23,594)*	*1,188*	*18,773*
Total operating income	**916,137**	**461,711**	**451,717**	**12,938**	**(10,227)**
Investing					
Dividend income	54,000	54,000			
Realised gain on available-for-sale financial assets	18,250	56,100	(37,850)		
Share of profit of associate B	7,500				7,500
Total investing income	**79,750**	**110,100**	**(37,850)**		**7,500**
TOTAL BUSINESS INCOME	**995,887**	**571,811**	**413,867**	**12,938**	**(2,727)**
FINANCING					
Interest income on cash	8,619	8,619			
Total financing asset income	**8,619**	**8,619**			
Interest expense	(111,352)	(83,514)	(27,838)		
Total financing liability expense	**(111,352)**	**(83,514)**	**(27,838)**		
TOTAL NET FINANCING EXPENSE	**(102,733)**	**(74,895)**	**(27,838)**		
Profit from continuing operations before taxes and other comprehensive income	*893,154*	*496,916*	*386,029*	*12,938*	*(2,727)*
INCOME TAXES					
Income tax expense	(333,625)	(281,221)	(52,404)		
Net profit from continuing operations	*559,529*	*215,695*	*333,625*	*12,938*	*(2,727)*
DISCONTINUED OPERATIONS					
Loss on discontinued operations	(32,400)	(12,582)			(19,818)
Tax benefit	11,340		11,340		
NET LOSS ON DISCONTINUED OPERATIONS	**(21,060)**	**(12,582)**	**11,340**		**(19,818)**
NET PROFIT	**538,469**	**203,113**	**344,965**	**12,938**	**(22,544)**
OTHER COMPREHENSIVE INCOME (after tax)					
Unrealised gain on available-for-sale financial assets, net	17,193			17,193	
Unrealised gain on cash flow hedge	1,825			1,825	
Foreign currency translation adjustment—consolidated subsidiary	2,094				2,094
Foreign currency translation adjustment—associate A	(1,404)				(1,404)
Revaluation surplus	3,653			3,653	
TOTAL OTHER COMPREHENSIVE INCOME	**23,361**	**-**	**-**	**22,671**	**690**
TOTAL COMPREHENSIVE INCOME	561,830	203,113	344,965	35,609	(21,855)

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