

**INCOME FROM
NON-EXCHANGE TRANSACTIONS
(Taxes and Transfers)**

AASB ED180

Submission by

**DG & AB MAXWELL
Consulting Accountants**



INCOME FROM NON-EXCHANGE TRANSACTIONS (Taxes and Transfers)

INTRODUCTION

Our firm provides specialist financial and administration consulting services solely to Local Government throughout Australia. Our senior principal, David Maxwell, is a Fellow of the Institute of Chartered Accountants and an Associate of Local Government Managers Australia with over 35 years experience as Local Government Auditor, Principal Accounting Officer, Chief Executive Officer and Consultant.

He is the editor of the *NSW Rates Administration Cluebook*, which cross-references between legislation, regulation, guidelines and case law affecting the process of making, levying and collecting local government rates in NSW.

Under the name Coalface Software Solutions - who supply a range of spreadsheet templates - to assist Council officers in the preparation of the Annual Financial Statements - we have been contracted by the Local Government Association of South Australia to prepare the Model Financial Statements for use by Councils in that State. Coalface Software Solutions prepares Annual Financial Statements template formats to comply with legislative and reporting requirements for New South Wales, Northern Territory and South Australian Councils.

Coalface Software Solutions sponsors the NSW Annual Financial Statements Award presented by the NSW LGMA Financial Professionals Group, judged by nominees of the NSW Local Government Auditors Association, Finance Professionals Group and Coalface Software Solutions.

Our comments are directed principally in relation to Local Government. There are no matters that we request be treated in a confidential manner.

We have cited a number of references to legislation, principally of New South Wales and South Australia. These may be taken to be generally representative of the type of legislation applying in all jurisdictions.

PREFACE

Local Government in Australia comprises over 550 Councils established pursuant to the *Local Government Acts* enacted by each jurisdiction. Other than portions of New South Wales and South Australia, and off-shore dependencies controlled by the Commonwealth, the whole of the area of Australia is incorporated into a Council area.

In all jurisdictions, all Councils are *reporting entities* for the purposes of the Australian Accounting Standards. Notwithstanding the work currently being undertaken by the International Accounting Standards Board (IASB) and the Australian Accounting Standards Board (AASB) into reporting by SMEs, we anticipate that all Councils will continue to be reporting entities.

We expect that the fair value of the assets - particularly infrastructure assets - of even the smallest Council will exceed the upper limit for classification as an SME. Large Councils will certainly exceed such limits.



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Even if the smallest Councils are below the SME limit, a jurisdiction would have to facilitate a two-tier reporting system for its Councils. We are unable to identify sufficient benefits to the State governments that would provide the incentive for them to do so.

It is suggested that this grouping of over 550 reporting entities is the largest homogenous grouping of users of the new Standard.

By number, more than 50% of Councils are located in areas that may be described as regional, rural or remote. Their location limits access to skilled practitioners in many professions, including accountancy, and we suggest is one of the main drivers underlying the recent substantial reductions in the number of Councils in the Northern Territory and Queensland, and the current proposals for Western Australia.

We submit that the Board, in formulating the new Standard, must ensure that it is able to be readily interpreted by the entire population of the users of the Standard. To this extent, the principles based approach of the Board must be tempered by the practicalities of the user population.¹

A number of jurisdictions prepare guidelines for the interpretation of the Australian Accounting Standards within the context of their legislative framework, and these guidelines usually mandate the format of the principal financial statements, and in some instances, the form and content of the notes to the statements. These guidelines include:

NSW: Local Government Code of Accounting Practice and Financial Reporting update #17 June 2009; Qld: Tropical Shire Council Annual Financial Report, being "Local Government Illustrative Annual Financial Statements"; SA: Model Statements 2009; Vic: Local Government Model Financial Report 2009; WA: The Western Australian Local Government Accounting Manual - hereinafter referred to as "Local Government Accounting Guides".

A meeting of the National Local Government Financial Management Forum in August 2009 considered a report detailing presentation differences between the principal financial statements in the various guidelines, and resolved to encourage the various preparers to adopt consistent terminology and formats. A copy of this report was made available to Mr Robert Keys of the Board's staff.

TAXES - and local government rates

We have reviewed the definition of *taxes* (paragraph 8), together with paragraphs 10, 27-29, 60-71, and IG14-IG15.

1. Notwithstanding that the wording of the definition is equivalent to that in IPSAS 23, we submit that it is an essential and integral component of a *tax* that its payment does not entitle the taxpayer to a benefit by way of goods and services that is directly referable to the quantum of taxes paid. This concept is referred to in paragraph 64 (which should have the words "or

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1. We are aware of another major group of users, being hospitals and health services in some jurisdictions, that have the same characteristics of location and lack of skills



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services provided²ⁿ added immediately after the words “social policies established”), but we submit that it is equally as important a determinant of what constitutes a *tax* as the fact that a *tax* constitutes revenue to a government.

Indeed, we are inclined to go further and suggest that the lack of entitlement to any proportionate benefit is a more important determinant. A compulsory payment that provides income to a government, but also confers an entitlement to services in proportion to the amount paid, should be treated as an exchange transfer (paragraph 11).

2. We submit that another common characteristic of a *tax* is that a penalty is imposed for late payment. The penalty may be calculated in a number of ways and the method for NSW rates is detailed in an example below. While our knowledge of the various taxes levied by governments is not exhaustive, we are not aware of any tax that does not include sanctions (usually financial) for non-compliance. Notwithstanding that process for imposing the penalty may be administered through the courts, the penalty is implicit in - and not severable from - the *tax*.

On this basis, we would suggest that the definition of a *tax* should include the words “other than the *taxation* law” at the end of the existing wording, and that the definition of *fin*es should include the words “other than a penalty forming part of a *taxation* process”.

It is our view that amounts received from penalties form part of the yield of the tax, irrespective of the manner in which the penalty is calculated. Thus a penalty calculated on a simple or compound interest basis retains its fundamental nature as a penalty, and does not represent interest income. We suggest that it would be appropriate to address this in the commentary³ as the treatment varies between the various Local Government Accounting Guides.

3. The word “sovereign” should be deleted from the last line of paragraph 27.

Local government rates are levied, not on the basis of the local government’s sovereign powers, but by virtue of the provisions of the relevant *Local Government Act* established under the State Governments’ sovereign powers. In effect the State Governments have “lent” a portion of their own sovereignty to local governments - subject to the terms and conditions embodied in the relevant *Local Government Act* - to provide a source of general purpose taxation revenue to the local governments.

Local Government Rates

We have below paraphrased paragraph IG14 so as to refer to NSW Council rates, and have bolded our amendments to the paragraph in the exposure draft.

2. Commonwealth and State governments, as well as local, provide many services that cannot be described as falling within the range of “social policies”, such as defence, education, roads infrastructure - indeed, probably more services fall outside the “social policies” range than within it.
3. This point will be more significant if IASB proposals relating to the formatting of the Income Statement to separately disclose operating, investing and financing components come to fruition.



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A local government (reporting entity) levies an ordinary residential rate of 0.008266⁴ cents in the dollar of the assessed land value of all property categorised as residential⁵ within its jurisdiction. The Council's reporting period is July 1 to June 30. The tax is levied⁶ by notices of assessment being sent to property owners in July, and payment of the first instalment due by August 31⁷. If taxes are unpaid on that date, property owners incur penalty interest rate payments calculated at 9.00% per annum of the unpaid amount due and payable⁸. The tax law permits the government to seize and sell a property to collect outstanding rates⁹.

It can be seen that the changes made to paragraph IG14 affect only *nouns*, and that the actions and sense of the paragraph remain unchanged. This, at the least, suggests that Council rates are at least as much of a tax as a State Government land tax. Indeed, in the case of New South Wales, the definition of *land value* used for both is identical, and the valuations used for both are made by the NSW Valuer-General.¹⁰

If we regard the essential elements of a *tax* as being

- ❖ a compulsory payment
- ❖ to a public sector entity
- ❖ to provide income to the entity
- ❖ not conferring an entitlement to the payer to goods or services referable to the amount paid
- ❖ subject to a penalty for non-compliance

then local government rates fully meet all criteria.

Indeed we would suggest that the example in paragraph IG14 be converted to refer to local government rates.

Other Amounts on Rates Notices

Our discussion above has been in relation to *ad valorem* rates levied on a valuation of land (which may also be structured to include a *base amount* or a *minimum amount* of rates payable). These may be *ordinary* or *general* rates that apply throughout the entire area¹¹, or *special* rates in relation to services that benefit only portions of the area (such as water where this is provided by the Council).

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4. The rate quoted is the Wagga Wagga City Council ordinary residential Wagga rate for 2009/10.
 5. The categorisation of land process permits the use of what are described in other jurisdictions as *differential rates* - the charging of a different rate in the dollar depending on the location or use of land.
 6. The NSW *Local Government Act 1993* defines the levying of a rate as the service of the rates notice (section 546(1)). For the meaning of the word "levied", as used here, section 494 (1) provides that "a council must make and levy an ordinary rate for each year on all rateable land in its area." "Year means the period from 1 July to the following 30 June." (Dictionary)
 7. Rates are payable either by a single instalment payable by 31 August, or by four approximately equal instalments due on 31 August, 30 November, 28 February and 31 May (NSW *Local Government Act 1993*, section 562)
 8. NSW *Local Government Act 1993*, section 566; Department of Local Government circular 09/17 advising of maximum interest rates; adopted by Wagga Wagga City Council.
 9. NSW *Local Government Act 1993*, Chapter 17 Enforcement, Part 2 - Proceedings by the Council or its employees, Division 5 - Sale of land for unpaid rates and charges (sections 713-726).
 10. For land tax purposes, the Valuer-General makes a new valuation every year as at 1 January; for Councils new valuations are made every 3 or 4 years as at 1 July. In all other respects the valuations are identical.
 11. With, in most jurisdictions, the ability to declare different *ordinary* or *general* rates depending on the use of land.



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The last twenty years or so has also seen the enactment of legislative provision for *annual charges* (in NSW, *annual service charges* in South Australia and Victoria, *special or service charges* in Queensland). These charges are basically for making the service available, irrespective of the utilisation of the service. Commonly a ratepayer must take an additional step to actually access the service, even though his land is subject to the charge. The amount charged is entirely independent of the use of the service, although different amounts may be charged according to the level of service offered¹².

(NSW example) Thus a ratepayer subject to a water supply availability annual charge must also have a connection to the main to access the water supply, or a ratepayer subject to a domestic waste management annual charge must also obtain a garbage bin to have their garbage collected.

These *annual, annual service, special or service charges* (named according to jurisdiction) are charges on the land and subject to penalties for late payment exactly as if they were rates.

We submit that these are also *taxes*.

Each jurisdiction also has provision for charges (again the names vary by jurisdiction) **made on the basis of actual use**¹³. These are certainly exchange transactions and for practical accounting reasons are usually maintained in separate sub-ledgers, with notices issued separately from the rates notice. They may, or may not, be charges on the land and subject to penalties for late payment.

TAX EXPENDITURES and EXPENSES PAID THROUGH THE TAX SYSTEM

We have read the definition of *expenses paid through the tax system* and *tax expenditures* (paragraph 8) in conjunction with the text in paragraphs 72 - 76, but have been unable to reconcile this with current South Australian requirements for disclosures of rates revenues. (This discussion assumes that local government rates meet the definition of a *tax*, dealt with elsewhere in this submission.)

Under the South Australian *Local Government Act 1999*, effectively all land not owned by the Crown or a Council is subject to local government rates (section 147). However, sections 159-165 set out a series of mandatory rebates¹⁴ that must be granted by the Council. In addition, section 166 provides that a Council may grant discretionary rebates for the various purposes set out in that section.

(Most other jurisdictions grant exemption from rates for the purposes for which South Australia grants mandatory and discretionary rebates.)

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12. Thus a *water availability - unconnected charge* may be less than a *water availability connected charge*.
 13. For example, water use charges.
 14. for health services, community services, religious purposes, etc. Some, but not all, of these rebates are 100% of the rate payable.



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Our understanding of the requirements in SA is that Councils must actually calculate the rate payable on all rateable land, and then reduce the ratepayer's account by the amount of the rebate¹⁵.

As a result, the amount rebated is written off without any collection action being attempted. In this regard it is identical to the write-off of an amount as a bad debt, except that no collection action has been attempted.

We are unable to confidently classify these rebates as *tax expenditures*. There is certainly an expectation in SA that Councils disclose the gross rate revenue before rebates, and separately disclose the amounts of mandatory and discretionary rebates.

We submit that as this is an existing situation, commentary be addressed to clarify the matter.

MEASUREMENT OF FINANCIAL ASSETS AND FINANCIAL LIABILITIES

Financial assets and financial liabilities acquired as a result of non-exchange transactions are proposed to be measured in accordance with the requirements of AASB 139 / NZ IAS 39:

139.43 When a financial asset or financial liability is recognised initially, an entity shall measure it at its fair value plus, in the case of a financial asset or financial liability not at fair value through profit or loss, *transaction costs* that are directly attributable to the acquisition or issue of the financial asset or financial liability.

Other assets acquired are recognised at fair value (paragraph 43) and liabilities are recognised at the best estimate of the present value of the future cash outflows (paragraph 58).

While the transferor may have incurred costs in originally establishing the financial asset or liability, the transferee would not normally have knowledge of the amount of those costs. In particular, where the transferee is a local government, there is a real likelihood that the transferee will not be able to readily access information to enable it to reliably estimate the appropriate amount of transaction costs attributable to the financial asset or liability transferred. We are concerned that some users, in attempting to accurately assess the fair value of the non-exchange transfer, may significantly distort the amounts involved. (We note that Example 6 (IG32 - IG34) ignores the question of transaction costs.)

We submit that the transaction costs recognised in relation to financial assets and liabilities should be limited to those transaction costs directly incurred in the (partial) non-exchange transfer, and that the commentary should clarify this point. No allowance should be made for notional transaction costs.

15. We have been required to reflect these requirements in our drafting of the SA Model Statements.

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STIPULATIONS

Self-Imposition of Stipulations - 1

We concur with the last sentence of paragraph 15, to the effect that an entity cannot impose a stipulation on itself. The following situation may give the appearance of this occurring. (For the time being, we disregard whether the stipulation is a condition or a restriction.)

Pursuant to the NSW *Environmental & Planning Assessment Act 1979*, a Council develops, publicly notifies and adopts a Section 94 Contributions Plan, which sets out the basis of calculation of compulsory contributions to be paid by developers towards the increased demand for certain Council services likely to arise as a result of the successful completion of the development.

A Council undertaking a development subject to contributions is required to contribute the same amount as a private developer would for the same development (and to hold such amount in cash or authorised investments.)

Broadly similar arrangements apply in other jurisdictions.

We view the stipulation to have been imposed by the external (State Government) legislation, rather than by the Council, the actions of the Council merely bringing the external legislation into effect. Commentary on this matter would be beneficial.

Self-Imposition of Stipulations - 2

We report the following circumstances where we can envisage benefits in permitting the self-imposition of stipulations - indeed, the self-imposition of a *condition*.

The Commonwealth Government makes available Financial Assistance Grants (FAGs or Grants Commission Grants) to Councils, paid through Local Government Grants Commissions established by each State Government.

Although the calculation of the amounts paid to individual Councils includes population, local roads & bridges, and equalisation factors, the grants are untied in Council hands, and may be expended for any purpose authorised by the relevant *Local Government Acts*. There are no stipulations, either restrictions or conditions. The grants are usually paid in 4 approximately equal instalments, commonly occurring about 15 August, 15 November, 15 February and 15 May in each year.

Particularly for small remote Councils, the amount of the grant is material, in many cases exceeding Council's gross rate revenue.

The grant is recognised as income when the Council gains control of the asset embodying the transfer. A Council does not become entitled to enforce payment of the grant.



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Late in June 2009, the Commonwealth Government made an early payment of one of the four quarterly instalments relating to the 2009/10 FAGs grant program. The associated information made it clear that the funds were untied, and that Councils were entitled to expend all or part of the amount before 30 June 2009 if they so desired (although the lateness of the payment effectively precluded this).

The associated information also made it clear that the four quarterly instalments due in the 2009-10 financial year would be proportionally reduced.

Consequently, many Councils will record substantial surpluses (or significantly reduced deficits) for the 2008/09 reporting period, and equally substantial deficits for the 2009/10 reporting period. It strikes directly at the purpose of including comparative figures in financial reports, although we understand that most Councils are making appropriate disclosures of the distortionary effects.

It comes at a time when Councils are under strong pressure to demonstrate their ongoing financial sustainability, and in South Australia specific financial indicators have been developed seeking to assess the financial sustainability of Councils using data reported in the annual financial reports. While a simple adjustment will remove the distortion, the fact is that the published results for the 2008/09 and 2009/10 will have been significantly distorted.

Nor do the ramifications end only with the political aspects. In some jurisdictions, for reasons of sound public policy, there are stringent requirements designed to prevent Councils from budgeting for a deficit.

A Council which had not finalised its 2009/10 budget before becoming aware of the reduced level of FAGs grant payments for the year¹⁶ would probably have little option but to have a deficit budget result. Nor would it be appropriate for a State Department of Local Government to advise Councils to falsify their budget by including the grant amounts otherwise expected, as this may lead to other, less benign, budget falsifications.

It is possible that the Commonwealth, having decided that it can politically withstand the adverse effects of an inflated deficit in the 2008/09 year, has deliberately chosen to make payments (via each State's Local Government Grants Commission) to local governments of a type that the Commonwealth must recognise as an expense, and that the local governments must recognise as income.

We do not recommend that any change be made to the Standard to overcome this. It is the first time of which we are aware that this has occurred in over 35 years of active contact with local government. However, it does highlight that the proposed Standard will not be able to prevent deliberate manipulation.

CONDITIONS

In general, we support the proposed recognition of a liability where a transfer is made subject to a condition, and express the view that this is much to be preferred over the treatment in existing AASB 1004 *Contributions*.

16. The announcement was in the fine print of the May 2009 Commonwealth Budget.

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Nature of a Condition

Paragraph 23 refers to a situation where "... a term in a transfer agreement ... requires the entity to perform an action that it has no alternative but to perform, may lead the entity to conclude that the term is in substance neither a condition nor a restriction."

We feel this ignores a situation where both the transferor and transferee have statutory responsibilities in relation to a function or the provision of a service. For example, both State and local governments have responsibilities in relation to the provision of roads infrastructure, often in relation to the same road¹⁷. Administratively, it is common for authorities to act as if different portions of a road are their exclusive preserve, but this is often not reflected in the controlling legislation.

A transferor government may validly make a payment conditional on the transferee undertaking works additional to what the transferee would otherwise complete from its own resources in these cases of shared (or parallel) responsibilities, and in our view this meets the requirements for the existence of a condition.

We suggest that the paragraph be revised to make it clear that requiring an entity to perform actions additional to those it would otherwise have no alternative but to perform can give rise to a condition.

Matching Contributions

We take issue with the approach adopted in paragraph 25, in the circumstances where a transfer is made subject to a stipulation that a (matching) contribution is made.

In our view, this is a condition, and there is a present obligation to refund the transfer which continues until the transferee satisfies the transferor that the required contribution is immediately available (or actually makes the contribution) in accordance with the terms of the transfer.

In our view, the transfer agreement does not become binding (see paragraph 34) until such time as the transferor commits to making the required contribution, as until that time - or more probably later - the transferor cannot have an enforceable claim to the resources.

We submit that any other approach leaves the proposed Standard wide open to manipulation of the type exemplified elsewhere in this paper - see "Self-Imposition of Stipulations - 2" on page 8.

Discharge of Conditions

Once an entity has established that a transfer has been made subject to a condition, the question naturally arises as to when the transferee may assume that the condition has been discharged, and this is a matter that has been raised in discussion with us.

17. For example, for certain classes of roads in NSW, the Roads & Traffic Authority accepts *prima facie* responsibility for the centre 8 metres of the carriageway, and the local government is responsible for the remainder of the road reserve. However, the RTA is not prevented from undertaking works outside of the centre 8 metres, and on occasions the local government may be required to undertake works within the RTA portion.

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In principle, the satisfaction of conditions attaching to a transfer should be a straightforward matter to determine. In practice, this is often not the case. We have expressed the view above that the principles based approach of the Board must be tempered by the practicalities of the user population, and we now extend that to include **the provision of adequate guidance in applying the principles to the practicalities of the transactions involved.**

Many “grants” are made in accordance with specific agreements embodying the terms and condition of the grant. We have seen many such agreements that run to 25 or more pages, and in any agreement of this length there is potential for different interpretation. Some such agreements that we have seen include:

- ❖ requirement for cash accounting procedures (all local governments are required to use accrual accounting) even where absorption costing procedures have been used for (say) the use of plant.
- ❖ agreements structured for small community organisations rather than local governments.
- ❖ financial or accounting procedural requirements that (appear to) breach local government accounting regulatory requirements.
- ❖ definitions of “capital” and “expense” that conflict with general accounting principles and council capitalisation policy thresholds.

All of these can give rise to infringements of the detailed terms and conditions of a grant, and the grantee is unable to predict whether the grantor will regard them as mere “technical”, or substantive breaches. The grantee, being aware of them, is thus placed in a position where he does not know whether he has discharged the conditions to the grantor’s satisfaction or not.

In general, a grantee does not receive confirmation from the grantor that it has satisfied the conditions attaching to the grant, other than where this can be inferred from the payment by the grantor of any balance of the grant payable. Even then, it is not unknown for the grantor to subsequently undertake a review or audit of grant expenditures - months or possibly years later.

We are aware of an instance where a subsequent audit took issue with the way in which a council attempted to modify costs accumulated for the use of plant in an absorption costing system in order to meet the cash accounting conditions of the grant. This occurred approximately 3 years after the relevant works had been completed.

We submit that it may be appropriate to include commentary to the effect that AASB 137. Appendix B provides guidance in assessing whether a provision or a contingent liability should be reported where a condition has been substantially, but not completely, complied with.

FINES

We have read the definition of *finés* (paragraph 8) in conjunction with the text in paragraphs 89 and 90, and make particular reference to the second sentence of paragraph 89.



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"In some jurisdictions law enforcement officials are able to impose fines on individuals considered to have breached the law."

It is possible that some users of the Standard will be able to mis-interpret this sentence as implying that the law enforcement officials personally impose the fines referred to, and of course that is not the intended meaning. What in fact happens is that the fine is imposed by legislation, and the law enforcement official merely records and reports the breach of the law.

These reports are called *expiation notices*¹⁸ in some jurisdictions; in other jurisdictions they are called *penalty notices*¹⁹.

We suggest that the following wording would avoid the risk of misinterpretation, and that the additional clarity would justify the departure from the wording of IPSAS 23:

In some jurisdictions law enforcement officials are able to **issue "expiation" or "penalty" notices** to individuals considered to have breached the law. In these cases, the individual will normally have the choice of paying the fine, or going to court to defend the matter. [wording change emphasised]

DEVELOPER CONTRIBUTIONS

This term is generally used in a local government context to refer to either of two types of transactions:

- ❖ the transfer of title and/or control of land dedicated for public roads and other purposes, and of certain infrastructure, consequent on the subdivision of land, and
- ❖ the payment to the local government of a sum of money (or specified assets in lieu thereof) as a contribution to the capital costs of the provision by the local government of additional services or facilities that will be required in the future as a consequence of a development (not limited to the subdivision of land).

We have chosen to treat these transfers as *non-exchange transfers* although a case could be made that they substantially meet the definition of a *tax*, in that they are compulsory payments to a public sector entity and provide income to the local government and are neither a *fine* nor a *penalty*. In our view, the determining factor in excluding these from *taxes* is the absence of a *penalty* component as discussed above.

Transfer of title to land components (and the dedication as road/reserve) occurs on registration of the subdivision at the Land Titles Office. Infrastructure is accepted following inspection and confirmation by the Council that it meets appropriate construction standards - and developers are invariably keen to obtain the necessary certification, as it removes liability for future maintenance from them. Failure to make required monetary contributions (or alternative arrangements satisfactory to the Council) is prosecuted as *unauthorised development*, as payment of such contributions is a pre-condition for commencement of the development.

18. e.g. South Australia *Expiation of Offences Act 1996*

19. e.g. New South Wales *Local Government Act 1993*, section 679.



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The assets acquired are initially measured at fair value (paragraph 43), and as the responsibility for future maintenance and replacement do not qualify for recognition as a liability, the amount of the increase in equity represents *income* (paragraph 49).

However, this income by its nature has a number of special characteristics that differentiate it from the more usual concepts associated with this term. The quantum and timing of such income is entirely determined by the actions of the developers, not that of the local government. If the income is included in the net result for the year - and that net result for the year is used as the basis for assessing the "financial position, financial performance and cash flows" of the entity (Framework, paras. 15-21) - then a user may be led to draw false conclusions²⁰.

All jurisdictions currently require that Councils audited annual financial statements (formatted as per the various Local Government Accounting Guides) are prepared in accordance with the Australian Accounting Standards. These provide the basis on which each Council's fiscal performance is publicly presented and assessed. Inclusion of income of this type clearly distorts the ability of the financial statements to accurately report the Council's own fiscal performance²¹.

Failure of the Board to ensure that the accounting standards permit the disclosure, on the face of the Income Statement, of a financial result that can reliably used to indicate the Council's own fiscal performance will result in the various jurisdictions instituting regulatory measures that will do so. Already, Victoria has prescribed a "standard statement" by regulation and South Australia requires a "uniform format" in Note 15 to the statements, but generally this requirement has so far been met by rearranging the presentation format of the Income Statement. However, the logical conclusion is a return to the situation before AAS 27, when each jurisdiction had its own prescribed local government accounting procedures, independent of all Australian Accounting Standards.

We note that IPSAS 23 (on which the exposure draft is based) was issued before AASB 101 (September 2007), and hence that the concept of *other comprehensive income* had not been developed.

We submit that *non-exchange transfers* that are received specifically for the purpose of capital expenditure should be classified as *other comprehensive income*.

HYPOTHECATED FUNDS

Hypothecation of funds is a device quite widely used in government operations. Thus, NSW fishing licence fees are paid into the Recreational Fishing Trusts and used to improve recreational fishing. The taxation equivalent paid by the Local Government Finance Authority to the SA Treasurer is hypothecated to the Local Government Taxation Equivalents Fund and is applied for local government development purposes²².

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20. For this reason, all jurisdictions attempt to isolate income items of this type, details of which are set out in the paper referred to in the "PREFACE" on page 2 above.
 21. The amounts are significant - in NSW, in 2008 alone, developer contributions exceeded \$ million, of which over \$275 million was paid in cash.
 22. Section 31A *Local Government Finance Authority Act 1983*



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Developer contributions made in cash are hypothecated in most jurisdictions - that is, they are required to be held in cash or authorised investments until such time as they are expended for the purpose for which the payment is made.

In some jurisdictions, Councils must hypothecate certain amounts for certain purposes. In Victoria, Councils "must establish and maintain an account ... to be called the "Long Service Leave Account" ...for the purpose of making payments for long service leave to which members of Council staff become entitled"²³. In NSW, the proceeds of special rates and charges are hypothecated²⁴.

In some jurisdictions, reserves for future expenditure established by the Council must be "cash-backed" - an equivalent amount of cash must be hypothecated to the purposes of the reserve²⁵.

Because there is little or no potential for refund, these hypothecated amounts are therefore subject to restrictions, rather than conditions. We take no issue on this point.

However, we submit that mere noting of the restriction in the assets sections of the notes to the accounts does not appropriately reflect the limitations inherent in the existence of the restriction. In the case of transfers subject to conditions, the transfer is recognised as a liability until the condition is discharged. In the case of restrictions, the limitations on use are just as strong, and just as enforceable, as is the case with conditions.

In a for-profit environment, equity generally and accumulated surplus in particular are not subject to equivalent legal restrictions. In the public sector however, we submit that some provision for differentiation between "fettered" and "unfettered" equity would be appropriate. In a public sector environment, we submit that equity should not be regarded as merely a residual amount.

On an associated matter, we challenge whether paragraphs 134 - 136 of AASB 101 (September 2007) are appropriate for an Australian government environment.

We submit that it is inappropriate that a transfer subject to a restriction should, as a result of the transfer of the net result from the *Statement of Comprehensive Income*, be included in accumulated surplus together with the general equity of the entity, which is unrestricted. Accordingly, we submit that the total amount of hypothecated funds should be separately reflected in Equity, and clearly identified such.

LIMITATIONS

Sometimes assets constructed by, or transferred to, local governments are subject to what we will term *limitations* on their use. Thus a rural fire brigade station funded by State sourced funding may only be used for rural fire brigade purposes, unless the relevant State Minister subsequently agrees to the contrary.

23. Regulation 18, *Local Government (Long Service Leave) Regulations 2002*

24. Section 409(3), *Local Government Act 1993*

25. In NSW, these are termed "internal restrictions"; other jurisdictions use the more conventional terminology of "reserves"



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Sometimes there appears to be a tacit withdrawal of the limitation. In the 1950s and 1960s many community Mothers & Babies Health Centres were constructed with grants funds and were to be used only for those purposes. As community needs have changed, many of these centres are now being used to provide community health services to other sections of the population, and we are not aware of any instance where the original limitation has been enforced, or of any formal action to widen the limitation.

In all cases of which we are aware, the assets subject to *limitations* are used for purposes within the normal responsibilities of local government. The *limitation* only has practical effect when the relevant asset is proposed to be replaced, or converted to another use. It has no practical effect on the normal operations of the entity.

We do not consider these to comprise *restrictions* within the intent in IPSAS 23, and it is for this reason that we have above recommended that it is only *hypothecated funds* that should be separately identified within equity.

We submit that the commentary in the area of paragraphs 20 - 26 should recognise the existence of these *limitations*. There should only be a requirement for disclosures of *limitations* where these have a material, direct effect on the operations or proposed operations of the entity²⁶.

SERVICES IN-KIND

AASB 1004.44 *Contributions* provides that contributions of services shall be recognised as income when and only when the fair value of those services can be reliably determined, and ***the services would have been purchased if they had not been donated*** [our emphasis].

While paragraphs 102 - 104 of the exposure draft discuss the factors to be considered in developing an accounting policy for the recognition of services in-kind, we feel that insufficient emphasis has been given to the issue of purchase in lieu of donation. Certain in-kind services may be easy to control, easy to measure the fair value, and material in amount, but because they are ancillary rather than germane to the purpose of the entity, would not have been purchased if they were not contributed.

We submit that the inclusion of such "optional extras" would not assist (contrary to paragraphs 110 & 111) in the assessing of the "financial position, financial performance and cash flows" of the entity (Framework, paras. 15-21). Accordingly, we recommend retention of the requirement expressed in AASB 1004.44(b).

(There is debate in some jurisdictions as to the extent to which local government controls the operations of volunteer fire fighting services, and hence paragraph 101(e) may not be appropriate. We note that the reports of the Royal Commission proceedings into the 2009 Victorian bushfires have included minimal references to the local governments involved, but copious references to the CFA. There is no doubt that volunteer fire fighting services are of benefit to the local community, but as the CFA is a State government entity, it may be debatable whether these are services to the local government.)

26. Thus, for example, the continuing use of the rural fire brigade station exemplified above should normally be unreported.



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Not all services to the local community are services to the local government. If the criterion that the entity would have purchased the services if they had not been donated is retained, few local governments will have difficulty in identifying appropriate volunteer services for recognition.

We oppose the proposed paragraph 108(e) in its current form, and submit that the word "received" should be replaced by the word "recognised". Paragraph 109 should be amended to encourage disclosure of services in-kind received but not recognised.

OWNERSHIP OF LOCAL GOVERNMENT

The exposure draft specifically asks for comments on the retention of requirements for restructures of administrative arrangements (currently AASB 1004.54-59, although their ultimate placement is to be determined through the due process).

We support their retention, and indeed, their expansion to include local governments. (We acknowledge the changes made in AASB 2008-11, but argue below that the only area in which local governments are subject to common control is in the definition of areas, and accordingly co-location with other administrative restructures is more appropriate.)

The term "restructure of local governments" has been used in a number of jurisdictions in recent years, but in every case, the term has been adopted by State governments in relation to boundary changes that the State government has compulsorily²⁷ applied to local governments.

A local government is defined by the area it administers.

- ❖ NSW *Local Government Act 1993* s204(1) - "The Governor may, by proclamation, constitute any part of New South Wales as an area" and (s207) "the Governor may, by proclamation, name or rename an area".
- ❖ NT *Local Government Act* s7 - "(a) the Territory is divided into local government areas having regard to ..., and (b) a council is constituted for each area to be responsible for the government and management of the area at the local level."
- ❖ Queensland *Local Government Act 1993* s16(1) - "A regulation may declare a part of the State to be a local government area" and (s17) "There must be a local government for each local government area."
- ❖ South Australia *Local Government Act 1999* s9 - "The Governor may, by proclamation, do one or more of the following: (a) constitute a new council; (b) amalgamate two or more councils to form a single council or two or more councils (being a lesser number than the number of councils subject to amalgamation); (c) define the area of a council; ..."
- ❖ Tasmania *Local Government Act 1993* s16(1) - "The State is divided into municipal areas."

27. For the one apparent exception, South Australia, Councils were given to believe that if they did not take action to voluntarily reduce the number of local governments, the State government would itself initiate proposals to do so.



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- ❖ Victoria *Constitution Act 1975* s74B - "... each Council (a) is responsible for the governance of the area designated by its municipal boundaries; and (b) is constituted by democratically elected Councillors as the governing body ..."
- ❖ Western Australia *Local Government Act 1995* s2.1 - "(1) The Governor, on the recommendation of the Minister, may make an order — (a) declaring an area of the State to be a district; (b) changing the boundaries of a district; (c) abolishing a district; or (d) as to a combination of any of those matters.

In the case of Victoria, legislation is required to alter the boundaries of a local government: in all other jurisdictions, administrative action in the form of a *proclamation, regulation or order* constitutes the formal procedure, although some jurisdictions have other procedures that must first be completed, and it is common for legislation to be put in place to handle the consequences of such boundary changes. Even in the case of Victoria, the consent of the local government(s) involved is not required for a change in a local government's boundaries.

Further, a local government cannot give effect to a change in its boundaries without the consent of the State government. There is therefore no basis for assuming that there is an "acquiring" Council, as is required by AASB 3 *Business Combinations*.

We therefore argue that a "restructure of local government boundaries" is entirely analogous to a "restructure of administrative arrangements" within a State Government, and should be subject to identical accounting procedures.

This conclusion necessarily raises the question as to whether local governments are under the "common control" of State governments.

To this we respond that it is only in relation to the definition of areas of its local governments that "common control" by State or Territory governments exists.

Under existing legislative arrangements, State and Territory governments do not control local governments because:

- (i) they cannot sell the assets of a local government and redeploy the proceeds from the sale towards the State or Territory budget; and
- (ii) the governing body of the local government, whether an elected council or administrators appointed by a government, is bound to deploy its assets for the benefit of the local community (and not the State or Territory government).

(AASB 127.Aus17.9)

We understand that this matter will be further considered in a future AASB project. However, it is expected that the current Western Australian proposals will be actioned before the AASB project comes to fruition, and we believe that these changes should be made at least on an interim basis.



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USE OF IPSASB STANDARDS

On reviewing this submission, we note that we have made a number of recommendations that depart from the wording of IPSAS 23, which was used as the basis of ED 180. Notwithstanding this, we support the ongoing use of the IPSASB standards as the basis of future exposure drafts.

The IPSASB standards are developed for application to the entire range of public sector situations, and their terminology must be selected accordingly. In developing Australian public sector standards, it is appropriate for the AASB to review the terminology commonly used in the Australian public sector, and to ensure that this is reflected in the standards developed. If, in Australia, a tax invariably includes components of non-requital of services, and penalty provisions, then it is appropriate for the Australian definition to reflect this²⁸. World-wide, these components may not invariably be present, and it is therefore appropriate for the IPSAS 23 definition to be silent on the matter.

Provided that the principles embodied in the IPSASB standards are retained - or there is clear disclosure and full explanation when they are not - we submit that increased specificity and more accurate reflection of Australian terminology use is an integral part of the adaption process. (These variations may subsequently feed back into revisions of the IPSASB standard.)

Unlike the private sector, the public sector does not operate internationally - except in the very limited area of diplomacy, any international activities of Australian governments are conducted under the laws applicable to the other country. Accordingly, the pressures for identical wording and interpretation of accounting standards that apply for private sector for-profit entities do not exist to the same extent.

Accordingly, we support the future use of IPSASB standards as the start point for the development of Australian accounting standards applicable to the public sector.

We shall be pleased to supply any further information or explanations that you may require.

David G Maxwell
DG & AB Maxwell

28. There is also a wide range of legislative usage across different Australian jurisdictions. For example, in NSW and Queensland, local government rates are *made and levied*, while in South Australia and Victoria they are *declared*, and these terms must be used as part of the rating process. Thus a NSW council rate that is *declared*, but not *made and levied*, will be invalid as a result of incorrect process.

