UHY Haines Norton
Chartered Accountants

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The Chairman
Australian Accounting Standards Board
PO Box 204
Collins Street West Vic 8007

Comments on ED 180 "Income from Non-Exchange Transactions (Taxes and Transfers)"

1. UHY Haines Norton, Chartered Accountants

UHY Haines Norton is an association of independent chartered accounting firms with offices throughout Australia and New Zealand.

UHY Haines Norton provide audit, financial reporting, accounting and taxation advice to small – medium not for profit entities and have been advisors and auditors of local government entities in Western Australia, Victoria, South Australian and New South Wales for many years.

2. Overall Opinion

UHY Haines Norton do not support the proposals contained in ED 180 as a whole.

We support the proposals as they relate to non-exchange transactions other than grants however, we *do not support* the proposals as they relate to grant non-exchange transactions.

Further comments to support our overall opinion are provided below.

3. RESPONSE TO SPECIFIC ISSUES REQUESTED BY THE AASB

3.1 The Board's approach of developing the proposals based on IPSAS 23

With reference to our further comments below, our opinion is that the development of ED 180 based on IPSAS 23 will result in an Accounting Standard that is inconsistent with the Accounting Standards Framework definition of a liability in relation to grant non-exchange transfers, and in conflict with AASB 120, based on IAS 20.

Our opinion is that AASB 120 demonstrates a better understanding of the nature of grant income for not-for-profit entities and would result in improved consistency in application and more true and fair reporting, if the restriction on application for not-for-profit entities was removed.

3.2 Further guidance and illustrative examples for local government

Further implementation guidance and illustrative examples specific to local government would be desirable.

Non-exchange transactions are the dominant source of income for local government entities. The diverse range of non-exchange transactions collected at this level of government includes grants, rates (taxes), fines, contributions in the form of both cash and assets, and volunteer services.

The proposed Standard will be the primary reference for the accounting of revenue for the local government sector.

We note, however, that the AASB's recent practice has been to remove illustrative guidance from accounting standards after implementation.

3.3 Definition and treatment of conditions on transferred assets

The definition of conditions on transferred assets and illustrative discussion in ED180 in relation to grant non-exchange transactions is not adequate to meet the stated objective of the proposed Standard. Attempting to apply the proposed criteria to a grant transferred assets will perpetuate inconsistency in interpretation and therefore application to the recognition of revenue.

The distinction between conditions and restrictions unnecessarily complicates the recognition criteria for recognition of liabilities. The criteria for recognition of a liability should be consistent with the accounting standard framework, and focus on the probable outflow of economic resources by the entity, which could be in the form of service delivery not just return or refund of the transferred asset.

3.4 Treatment of advance receipts

ED180 requires a liability to be recognised where resources are received prior to a transfer agreement becoming binding.

ED180 does not define the term "binding" or provide adequate examples of the circumstances in which a receipt could be classified as an advance receipt liability.

The AASB Basis for Conclusions paragraphs BC22-24 states "*A stipulation that transferred assets should be utilised over a stated period (such as the next financial year) is not a condition as defined. Such time requirements would represent only a restriction on transferred assets.*"

If a time stipulation is not a condition and merely a restriction, the circumstances in which a grant transfer could be recognised as an advance receipt liability are difficult to envisage. Otherwise, the interpretation of the application of the advance receipt paragraphs as *not* being a condition is in contradiction to the treatment of transfers with restrictions.

3.5 Permitting, but not requiring, recognition of contributions of services

The proposal to permit, but not require, recognition of contributions of services is a practical response to this type of non-exchange income.

For an entity such as a local government authority, volunteer services can be essential to the delivery of significant resources.

However, the reliable measurement of the value of services provided could present a barrier to the recognition of income.

3.6 Measurement requirements

The recognition of income from non-exchange transactions as conditions are met is sound in theory, but requires further guidance to be of use in practice.

Inconsistency in interpretation could continue. For example, if a grant is received for the purpose of construction of a major capital asset, should income be recognised as the asset is constructed in stages, or should recognition of income be deferred in its entirety until the asset is completed?

3.7 Prospective application per the transitional provisions

Prospective application of the proposed Standard is a practical response to transition.

AUSTRALIAN SPECIFIC QUESTIONS

3.8 Whether, overall, the proposals would result in financial statements that would be more useful to users

The proposals in relation to grant non-exchange transactions would not result in financial statements that would be more useful to users because variances in interpretation of the distinction between restrictions and conditions would persist. Users are likely to presume the existence of a liability within an entity when the transferred asset is the subject of any unperformed documented stipulations and conditions.

The proposals in relation to other non-exchange transactions will provide clarity in interpretation, but may not result in any change to the practical recognition of income for many not-for-profit entities.

4. GRANT NON-EXCHANGE TRANSACTIONS

4.1 Overall support for *intent* of ED 180

Not-for-profit entities have struggled to apply the current revenue recognition Accounting Standards in relation to the recognition of grant revenue, as there is a common opinion amongst not-for-profit entities that the resulting financial statements do not result in true and fair reporting to users.

Not-for-profit entities have a budgeting and accountability framework that is at least as strong as for-profit entities. Current recognition requirements, which are primarily based on recognition of income at the point the relevant asset is controlled (often a cash-based recognition) is distorting operating results. Significant volatility in reported operating results does not provide comparable financial statements from year to year, or between similar entities.

Further, recognition of income in advance of related operating or capital expenditure can have practical implications for sound financial management of funds. Whilst entities such as large local government authorities have the resources and systems to internally allocate and manage grant funds received, small entities or not-for-profit entities with volunteer management or governing boards have difficulty matching income recognised at the point of receipt, with expenditure in a subsequent period.

We support the objective of ED 180 in providing stronger guidance for the recognition of grant income. However, the distinction between restrictions and conditions in ED 180 will not achieve the stated objective.

4.2 Inconsistent definition of liabilities

The definition of a grant liability in ED 180 is a narrower definition than that contained in the Framework for the Preparation and Presentation of Financial Statements (the Framework). The result could be the treatment of grants received as income under ED180, which should be recognised as liabilities according to the Framework.

> Framework paragraph 49
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> *(b) A liability is a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.*

The receipt of a grant

- Creates a *present obligation* on the recipient to perform an action or incur expenditure. Grant funding is provided for either operational activities, in which case it is usually a material source of income, or for a specific purpose;
- Arises from past events, being the decision to grant funds;
- Raises an expectation of an outflow from the recipient entity of resources, being either operating expenditure, provision of services, construction of capital assets etc.

The same definition is used in ED180 paragraphs 51 and 52, but is then narrowed in paragraph 56.

> ED 180 paragraph 56
> *Conditions on a transferred asset give rise to a present obligation on initial recognition that will be recognised in accordance with paragraph 51.*

ED 180 does not acknowledge that restrictions create a present obligation in the strong acquittal and public accountability framework in which not-for-profit entities operate. The mere receipt of a non-exchange transaction can give rise to a present obligation.

The ED 180 discussion of conditions essentially requires on obligation to repay funds if the stipulations are not met, in order for a grant non-exchange transaction to be recognised as a liability.

In contrast, the Framework does not require any obligation to repay funds received in order to acknowledge that a present obligation exists.

> Framework paragraph 60
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> *An essential characteristic of a liability is that the entity has a present obligation. An obligation is a duty or responsibility to act or perform in a certain way. Obligations may be legally enforceable as a consequence of a binding contract or statutory requirement....Obligations also arise, however, from normal business practice, custom and a desire to maintain good business relations or act in an equitable manner.*

ED180 assumes that a lack of enforceable or documented conditions means a present obligation *does not* exist, and therefore a liability does not need to be recognised, even though the recipient entity will give up resources embodying economic benefits, often in the normal business practice of a not-for-profit entity.

4.3 Inconsistency with the Accrual Assumption

The guidance discussion and tests for grants which indicate that time is not a condition, merely a restriction, are inconsistent with the application of the underlying assumption of accrual based accounting, as described with the Framework.

> Framework paragraph 22
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> ***Accrual Basis***
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> *In order to meet their objectives, financial reports are prepared on the accrual basis of accounting. Under this basis, the effects of transactions and other events are recognised when they occur (and not as cash or its equivalent is received or paid) and they are recorded in the accounting records and reported in the financial periods to which they relate.*

The nature of non-exchange transactions is that there is a reciprocal benefit provided, but not to the grantor. Funding provided for operating grant non-exchange transactions is generally aimed to be profit-neutral to the entity. Any accounting directive that does not match the operating income with the relevant outflow of benefits will distort the reporting by the entity.

4.4 Conditions versus restrictions

The distinction made between conditions and restrictions in ED 180 will still leave the timing of recognition of grant income open to interpretation. Grant funding agreements are not necessarily specific in relation to stipulations. In some circumstances, the grant funding is received in advance of the funding agreement, yet would be considered "binding" following a public announcement by the grantor.

Theoretically, the approach of requiring substance over form is consistent with the Framework and is necessary.

Restrictions may later become enforceable in substance if the stipulations of a grant are not met. However, as the recognition rules for grants with restrictions do not require recognition of a liability first, income may be recognised and in a later year have to be corrected. The earlier recognition of income would not be considered prudent.

ED 180 fails to recognise that whether stipulations contained within the agreement have been enforced or not, the enforcement is not at the discretion of the recipient.

4.5 Practical considerations distinguishing between conditions and restrictions

ED 180 paragraphs 21 to 26 require recipients of grants to determine whether conditions of a grant funding are generally enforced.

The practical application of this requirement will introduce further judgement and discretion in the decision as to whether a stipulation is a condition (liability recognised) or a restriction (income recognised).

For example:

What percentage of past grants would need to have been enforced?

Over what time period?

Is the size of the grants not enforced a consideration?

This analysis may result in initial recognition of a grant received as income on the basis of historical behaviour, with subsequent correction to liability if a condition is later enforced.

4.5 Inconsistency with AASB 120

AASB 120 "Accounting for Government Grants and Disclosing Government Assistance" does not apply to not-for-profit entities in Australia, yet provides a more informative and more accurate description of the nature of grant income received by not-for-profit entities than ED 180.

ED180 classifies and deals with grants as "transfers", together with donations, fines, bequests, gifts, debt forgiveness and goods & services in kind. "Grants" are not specifically defined in ED180.

> ED180 paragraph 8 definition of transfers:
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> *Transfers are inflows of future economic benefits from non-exchange transactions other than taxes.*

AASB 120 (paragraph 3) "Accounting for Government Grants and Disclosure of Government Assistance" defines government grants as:

> *Government grants are assistance by government in the form of transfers of resources to an entity in return for past or future compliance with certain conditions relating to the operating activities of the entity. They exclude those forms of government assistance which cannot reasonably have a value placed upon them and transactions with government which cannot be distinguished from the normal trading transactions of the entity.*

These definitions are not inconsistent, but ED180 changes the accounting recognition point by including grants with other transfers. ED180 focuses on "certain conditions" and draws further distinction between conditions and restrictions, rather than focussing on an obligation for past or future compliance in the context of operating activities.

AASB 120 acknowledges that grants are rarely provided without restriction. The recognition of the appropriateness of the matching principle, and accrual accounting assumptions is acknowledged in AASB 120:

> AASB 120 paragraph 16
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> *It is fundamental to the income approach that government grants be recognised as income on a systematic and rational basis over the periods necessary to match them with related costs. Income recognition of government grants on a receipts basis is not in accordance with the accrual accounting assumption... and would only be acceptable if no basis existed for allocating a grant to periods other than the one in which it was received.*

The application of AASB 120 to a grant with restrictions as defined by ED 180, would result in a different accounting treatment. AASB 120 does not distinguish between condition and restriction stipulations, and permits a time stipulation to be sufficient to recognise a liability.

The concurrent issue of conflicting accounting recognition standards in AASB 120 with application by for-profit entities, and ED 180 for not-for-profit entities should not be supported.

5. TAXES NON-EXCHANGE TRANSACTIONS

In Western Australia, the state *Local Government Act 1995* permits, in addition to general rates, two other taxes by a local government being:

- a service charge [Sec 6.37] and
- a specified area rate [Sec 6.38]

Which are required to be transferred to a cash backed reserve and refunded to the land owner if the money is not used for the purpose it was collected.

Considering the requirement to refund any unspent portion, the treatment of these two taxes will require interpretation by practitioners and auditors to determine if the circumstances surrounding the levy of the tax will create a stipulation and a condition leading to the recognition of a liability until the revenue is expended.

The main issues being:

- Will the action of establishing the rate or service charge meet the definition of a stipulation? Is it an arrangement imposed by entities external to the reporting entity?
- If a stipulation is established with sufficient specific requirements, is the transfer made on a condition that meets the definition?

Guidance in this area would be of assistance.

6. OTHER NON-EXCAHNGE TRANSACTIONS

We support the proposals contained in ED 180 in relation to other non-exchange transactions (fines, contributions). We do not anticipate any significant change to current recognition practices in relation to these other types of non-exchange transactions.

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