17/08/2015

The Chair
Australian Accounting Standards Board
PO Box 204 Collins Street West Victoria 8007
AUSTRALIA

Submission on ED 260 Income of Not-for-Profit Entities

Introduction

The South Australian Local Government Financial Management Group Inc (SALGFMG) represents financial management professionals in local government in South Australia. Membership of the SALGFMG is open to all councils and currently 62 of the 68 councils are members. The SALGFMG actively considers issues of relevance to local government financial management and works with the Local Government Association of South Australia and relevant State government entities to discuss, advise on and improve the quality of financial management in local government in South Australia. It aims to promote best practice in financial management through meetings, newsletters, workshops and seminars.

We greatly appreciate the opportunity to comment on ED 260. Please find our comments below.

Comments on ED 260: Specific Matters for Comment

1. *In relation to the AASB's proposal to replace the reciprocal / nonreciprocal transfer distinction in AASB 1004 with income recognition requirements based on whether a not-for-profit entity needs to satisfy a performance obligation:*

  a. *do you agree that this proposal would provide a faithful depiction of a not-for-profit entity's financial performance?*

  b. *if not, what alternative approach to income recognition would you recommend for not-for-profit entities? Please provide your reasons.*

Please refer to our comments to question 2.

2. *In relation to the AASB's proposal that, to qualify as a performance obligation, a not-for-profit entity's promise to transfer a good or service to a counterparty in a contract must be 'sufficiently specific' to be able to determine when the obligation is satisfied (see paragraph IG13 of Part A):*

   a. *do you agree with this proposal?*

   b. *if not, what factors or criteria should apply to determine whether a not-for-entity has a performance obligation? Please provide your reasons.*

Our Position

We disagree with the proposed wording in IG13 (d) and IG15 of Part E of ED 260.

We ask the AASB to consider the inclusion of guidance that untied grants or subsidies received by local governments are classified as fulfilling a sufficiently specific promise regarding a performance obligation when, based on professional judgement:

a) the amount is paid or received as an allocation in relation to a specified period of time; and
b) there is evidence that the intention of the recipient is that the transfer of goods or services to a counterparty occur in this specified period of time e.g. grants committed to be expended within this specified period of time via a budget approved by a Council.

Rationale

a) Lack of clarity in the application of IG13 to local government grant funding

Per IG13, a necessary condition for identifying a performance obligation in respect of a not-for-profit entity's promise to transfer goods or services to a counterparty in a contract is that the promise is sufficiently specific to be able to determine when the obligation is satisfied.

IG 15 states *"In relation to paragraph IG13(d), a condition that a not-for-profit entity must transfer unspecified goods or services within a particular period does not, of itself, meet the 'sufficiently specific' criterion— the nature or type of goods or services to be transferred by that entity over that period must also be specified. For example, a transfer to be used by a not-for-profit entity for any purpose in its operations would not meet the 'sufficiently specific' criterion."*

Additionally, in relation to circumstances where a transfer of assets to a not-for-profit entity relates to a particular time period, BC36 concludes that promises to use transferred assets consistently with the entity's general objectives are not promises to transfer a good or a service.

Applying this interpretation to the receipt of certain significant grants, such as the Financial Assistance Grants, is problematic. The grants are untied and the nature or type of goods or services to be transferred by the Council over the period to which the grant relates is not explicitly specified in any agreement with the Grantor.

There are minimal specifications regarding how the grants are to be used, aside from that they are to be used for purposes consistent with the Council's service-delivery objectives as set out in its enabling legislation. The Council's specific promise to transfer goods or services to the community is not made within the contract for the funding itself, nor to the grantor directly – rather, the "promise" occurs through an extensive budgeting process involving significant input from third party beneficiaries e.g. from the community and other stakeholders. This budgeting process is built on an underlying assumption that the Financial Assistance Grant funding relates to, and will be spent in, the period specified by the grantor.

It is unclear whether this scenario would classify as a "sufficiently specific promise" under IG13.

b) Example – Receipt of local government Financial Assistance Grants

The Australian Government has brought forward instalments of the Financial Assistance Grants over the past 5 years (as detailed below). The value of these grants is often highly material for Councils.

Grant Year	Paid in Advance	Timing of Advance Payment
2015/2016	2 Quarters	June 2015
2014/2015	No Early Payment	
2013/2014	2 Quarters	June 2013
2012/2013	2 Quarters	June 2012
2011/2012	1 Quarter	June 2011

As these grants are untied, they are treated as operating revenue, and are recognised in the year they are received in accordance with AASB 1004.

Receiving grant funds early does not, however, change the perspective of Local Government that the funds are for the future year. This assumption is reflected in the budgets and financial decision making of Councils. The communication that accompanies the Financial Assistance Grant uses descriptors of "in advance" and "early payment", which supports the view that the grantor also believes that the funds are intended to support the activities of Local Government in the year the funds are allocated for, not the year in which they are paid. This is further supported by the timing of the payment which is typically 29 or 30 June, which makes it highly unlikely for any Council to expend these funds prior to the end of financial year.

c) Problems resulting from current accounting treatment of Local Government Financial Assistance Grants

i) Decision making by Ratepayers

The current accounting treatment of Financial Assistance Grants (i.e. recognition as revenue on receipt) results in confusion for users due to the variability in results that it causes.

SAC 2, paragraph 12 states that GPFS should assist assists ratepayers in deciding "…whether they should support the particular programmes of their local government and who should represent them on the local government council".

Under the current treatment, the ratepayers are left to form this judgement based on GPFS that show significant variations in results year on year as the impact of the timing of the financial assistance grant is sufficient to generate significant surpluses and deficits. This makes it difficult for the community to make a fair assessment as to the performance of their Council, and elected members, and to appreciate the need for rate increases where significant surpluses are being reported.

ii) Decision making by Elected Members

As is the case for the ratepayers, the variability in results makes it difficult for elected members to make a fair assessment as to the performance of their Council. Elected members may also struggle to understand the accounting treatments that cause the significant variability in results, and this can erode trust in both the information being provided and in the professionals who prepare it.

iii) Financial sustainability measurement

Financial Sustainability indicators are a key tool in assessing the performance of local government councils. In SA we measure and report three indicators, the operating surplus ratio, the asset sustainability ratio and the net financial liability ratio. These material variations in the timing of revenue recognition impact significantly on these indicators.

Analysing these sustainability indicators resulting from the application of the current accounting standards across local government does not provide a fair assessment of the financial sustainability of the sector, requiring stakeholders to do further analysis and re-calculation to determine the true underlying results of the sector.

To address the impact of the timing variances of the financial assistance grant payments many Councils are electing to also report an adjusted operating surplus ratio, which removes the timing impacts of the grant. Other additional disclosures may be included in the GPFS to try to assist stakeholders in understanding the timing impacts. Adjusted ratios and additional disclosures are far from an ideal solution, as being hidden in the notes and being contrary to the figures reported in the primary statements creates risks of the adjusted information not being considered by decision makers, or creating further confusion. In addition, these solutions are inconsistently applied.

iv) Financial Statements do not faithfully represent Council revenue

Under the *Framework for the Preparation and Presentation of Financial Statements*, financial statements are required to have the qualitative characteristic of reliability. To be reliable, information must be able to be depended upon by users to represent faithfully that which it either purports to represent or could reasonably be expected to represent.

We believe that the current treatment (i.e. grants are recognised as revenue when received) does not result in a faithful representation of the financial performance and position of local government councils. This contributes to confusion and misinterpretation among users, in particular ratepayers and council members.

v) Potential for deliberate manipulation of reporting results

The current accounting treatment for recognition of grants and subsidies such as the Financial Assistance Grant is subject to potential misuse by deliberately manipulating the timing of expense recognition by grantors e.g. by paying grants late in the financial year and recognising the associated expense, which can then reduce reported expenses in the following financial year. This may be of benefit, for example, by manipulating the timing of reported surpluses and deficits to match political agendas.

Conclusion

We disagree with the proposed wording in IG13 (d) and IG15 of Part E of ED 260.

The proposed wording is problematic for the timing of recognition for some significant grants received by local government Councils, such as the Financial Assistance Grants. We believe that despite the grants not being legally tied to a performance obligation, the substance of the transactions are such as that the grants are intended by the grantor and grantee to be used to fund operating expenses over the period specified by the grantor. This intention is reflected in the words and actions of all parties. As a result, we believe that they should be treated as revenue in the period in which these expenses are intended to be incurred.

We believe that this would result in a more faithful representation of local government financial statements. Such treatment would result in better comparability across periods and improved information to assist users of local government financial statements in making decisions and evaluating the operations of Councils.

Our concern is that the current wording of IG13 (d) and IG15 does not support this treatment in the absence of further clarification regarding the criteria for fulfilling a sufficiently specific promise regarding a performance obligation.

As such, we ask the AASB to consider that untied grants or subsidies received by local governments are classified as fulfilling a sufficiently specific promise regarding a performance obligation when, based on professional judgement:

a) the amount is paid or received as an allocation in relation to a specified period of time; and
b) there is evidence that the intention of the recipient is that the transfer of goods or services to a counterparty occur in this specified period of time e.g. grants committed to be expended within this specified period of time via a budget approved by a Council.

If you have any questions regarding this letter, please do not hesitate to contact me on 0407 791 634 or SZbierski@campbelltown.sa.gov.au.

Regards,

Simon Zbierski
President
SA Local Government Financial Management Group