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Dear Keith

Comment Letter - Tier 3 Exposure Draft proposals

We are pleased to respond to the AASB's Invitation to Comment on ED 334 *Limiting the Ability of Not-for-Profit Entities (NFPs) to Prepare Special Purpose Financial Statements* and ED 335 *General Purpose Financial Statements – Not-for-Profit Private Sector Tier 3 Entities*.

Response on ED 334

We welcome the AASB's intention within ED 334 to apply the same conceptual framework to both the for-profit and not-for-profit sector, using the same requirements to determine whether general purpose financial statements are necessary.

Our position at the time of the introduction of the revised conceptual framework for for-profit entities was that it was appropriate to remove the option to prepare special purpose financial statements ("SPFS"). We believe the same arguments apply in the not-for-profit sector. Indeed, many not-for-profit entities arguably have a greater range of stakeholders and potential users, given that their purpose is often public service or charitable works, rather than the generation of profit, which strengthens the argument against the continuance of special purpose financial statements.

The existing self-assessment framework to determining a not-for-profit entity's reporting status was no longer fit for purpose, and resulted in the provision of financial statements on public record that served little use, and may even in some cases provide information that is misleading. We believe that the requirement for General Purpose Financial Statements ("GPFS") to be prepared instead of SPFS would result in financial statements that would be more useful to users.

In our view, once legislation requires an entity, whether for-profit or not-for-profit, to prepare financial statements which are available on public record, those financial statements should no longer be considered special purpose, since those charged with governance within the preparing entity will be unaware of who is using the financial statements.

The current framework effectively places those charged with governance in an impossible position. To determine their reporting requirements, they must assess who the users of their financial statements are. However, once financial statements of an entity are made publicly available, the entity and its management may have no knowledge of who might be reading their financial statements, or for what purpose.

Given that we support the proposal to apply the same conceptual framework to not-for-profit entities, we would agree that it is appropriate for the AASB to amend the framework to incorporate 'Aus' paragraphs highlighting matters relevant to not-for-profit entities.

We are also in agreement with the proposed transitional provisions and commencement date of the new standard.

Response on ED 335

We note that the key proposal within ED 335 is the development of a Tier 3 of financial reporting for small not-for-profit entities. Tier 3 would be available to those entities with income between $0.5m and $3m. Crucially, the proposal is that Tier 3 should have not just reduced disclosures, but also simplified recognition and measurement requirements. As such, it represents a break with the AASB's previous approach to the Australian financial reporting framework, which is to ensure a consistent basis of recognition and measurement for all entities regardless of size.

We do not support the creation of a separate tier of financial reporting with different recognition and measurement requirements for Tier 3 entities, for the following reasons

- We believe that any departure from the principle that there is a single basis of recognition and measurement detracts from the consistency and comparability of financial statements, which in turn detracts from their usefulness to users. It would appear counter-intuitive to solve the "problem" of special purpose financial statements by introducing a solution that formalises the existing problems of inconsistency and incomparability

- Creation of a separate basis will create an additional burden on entities who move between the tiers. Given the relatively narrow "window" of Tier 3, being income between $0.5m and $3m, we would expect it to be relatively frequent that entities may only sit within that tier for a few years before either moving up to Tier 2, or shrinking to a size where financial reporting is no longer required. The proposed framework will create additional cost for entities who move between Tiers, as they will need to adapt from one basis to another. This will also create complexity in respect of the extent to which AASB 1 *First-time Adoption of Australian Accounting Standards* applies when moving between Tiers.

- Given that the proposed framework will be a unique set of recognition and measurement requirements within a relatively small population of entities, it will create an additional burden on not-for-profit entities, requiring them to either provide training to their finance team in the new requirements, or to source assistance from outside consultants. By contrast, the existing framework for not-for-profit entities is well understood by most accountants working in the not-for-profit sector, and therefore can be adopted easily.

- Similarly, we believe the creation of a unique financial reporting framework will place an additional burden on auditors when performing assurance services over the financial reports prepared under Tier 3. While many entities within the Tier 3 threshold will be subject to a review rather than an audit, in our view any assurance practitioner would still require a thorough understanding of the relevant financial reporting framework in order to conduct a review. Furthermore, many entities within the Tier 3 threshold may need an audit for other reasons, such as the requirements of their constituting documents, or the needs of funding bodies. With Tier 3 being a relatively niche area, comprised of smaller entities, it is likely that not all auditors will wish to incur the cost and difficulty involved in upskilling their audit staff on an entirely new recognition and measurement framework. This may lead to many existing providers withdrawing from the Tier 3 sector. The result would be less choice, and likely higher costs, for entities within Tier 3 in respect of their auditors and other professional service providers.

As such, we do not believe the benefits of the proposed Tier 3 outweigh the costs. We would instead suggest that the AASB seek to introduce a revised Tier 3 with further reduced disclosures, but no separate recognition and measurement requirements.

Reduction of Compliance Burden on small not-for-profit entities – income recognition

The justification for the creation of a Tier 3 financial reporting framework is that some of the existing requirements of Australian Accounting Standards may be too complex and costly for not-for-profit entities, and require simplification.

We agree with this assessment, but would query whether the creation of a Tier 3 framework is the appropriate solution. A framework that is too costly and complex for an entity with revenue of $2m is likely to be equally too costly and complex for an entity with revenue of $4m, or $10m, and is perhaps an indication of an underlying issue with the framework for all not-for-profit entities.

We believe this issue would be better addressed by the AASB seeking to reduce the existing complexity and challenges in the existing financial reporting framework for all not-for-profit entities. In our experience, by far the biggest issue with the current framework for not-for-profit entities is the application of AASB 1058 *Income of Not-for-Profit Entities*

We note that ED 335 proposes to replace AASB 1058 with a revenue recognition model with the ability to defer recognition of revenue if there is a common understanding that is evidenced between the provider and the entity on how the cash or other assets received should be used.

We believe that the AASB should seek to develop this model further, with a view to it replacing the existing AASB 1058 requirements for all not-for-profit entities, not just Tier 3. We believe it would provide better and more relevant information to users than the current AASB 1058 model which often results in a mismatch between the timing of revenue and expenses. There is currently considerable frustration faced by many NFPs in AASB 1058's requirement to recognise all income on receipt where the "sufficiently specific" requirements of AASB 15 are not met, even if funding has been ring-fenced for a specific purpose. While other forms of income are affected, grant income is the area which continues to cause most concern, and we believe AASB 1058's requirements have resulted in decreased understanding of financial information presented to users of the statements, with particular impact on non-financially experienced persons.

Financial reporting under the existing AASB 1058 has become a burden for NFPs, where income recognised under AASB 1058 in the financial statements is often recognised over a period reflecting expenditure or length of funding period in the management accounts requiring additional work to prepare annual financial statements.

Furthermore, the immediate recognition requirements of AASB 1058 have resulted in instances where preparers have attempted to defer income by analysing contracts or grant acquittal terms so as to tenuously identify specific outputs that can be deemed "sufficiently specific performance obligations", even when those outputs are secondary to the overall purpose of the funding, or do not reflect the actual intent of the arrangement, in an effort to achieve what they believe is a sensible presentation under AASB 15.

We acknowledge that, in drafting Appendix F to AASB 15, the AASB has produced a very substantial amount of guidance in attempting to assist preparers in applying AASB 1058. However, the volume of guidance necessary is, in our view, symptomatic of the problem, which is that the standard is difficult to understand and apply, and leads to non-intuitive results. We would contrast this with the requirements for for-profit entities under AASB 120 *Accounting for Government Grants and Disclosure of Government Assistance.* AASB 120 has minimal guidance and implementation examples, because it is not necessary. The requirements are easily understood and lead to outcomes which appear reasonable.

One of the stated aims of ED 335 is to reduce the reporting burden on smaller NFP entities. In our view, reform of income recognition requirements for all not-for-profit entities would achieve this objective more effectively, with the added benefits of also reducing the compliance burden for medium and larger not-for-profit entities, as well as promoting more consistent and higher quality financial reporting. We would recommend that the AASB focus its efforts in this area in preference to the further development of a separate Tier 3 recognition and measurement framework for a subset of not-for-profit entities.

We would be pleased to discuss our firm's views further with you. Please contact me on 08 9261 9374 or at ralph.martin@rsm.com.au should you wish to discuss our comments.

R.R. Martin

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