

14 August 2015

Ms Kris Peach
Chair
Australian Accounting Standards Board
PO Box 204
Collins St West
Melbourne Victoria 8007

Dear Ms ~~Peach~~, *Kris*

ACAG submission on Exposure Draft ED 260 - Income of Not-for-Profit Entities

The Australasian Council of Auditors-General (ACAG) would like to express our support for the proposed new Australian Accounting Standard aimed at the income recognition and measurement requirements for not-for-profit entities as contained in the Exposure Draft *Income for Not-for-Profits Entities* (ED 260).

ACAG supports the proposal to replace the income recognition requirements of non-reciprocity in AASB 1004 *Contributions* with a performance obligation model. However, ACAG recommends clearer and more extensive implementation guidance and structured examples to assist users with their assessment of the sufficiently specific criterion as part of the performance obligation assessment.

ACAG supports retention of the existing definition of “*Contribution by Owners*” and the AASB Interpretation 1038 *Contributions by Owners Made to Wholly-Owned Public Sector Entities* as they both promote consistency and comparability of public sector financial reports. However, ACAG recommends the AASB consider a separate project to address the concept of owner transactions in the public sector that will address current application issues.

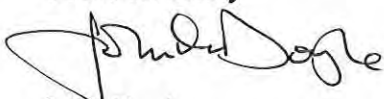
ACAG also recommends that the AASB consider whether the differentiation in accounting requirements specific to local governments, government departments, general government sectors and whole of governments, which have been incorporated in the proposed standard, should remain. In particular, ACAG recommends that the AASB re-consider the appropriateness of differentiation in accounting for government departments from other NFP entities within governments.

The view expressed in this submission represents that of all Australian members of ACAG.

Please find attached our responses to the specific matters for comment outlined in the Exposure Draft.

The opportunity to comment is appreciated and I trust you will find our feedback useful.

Yours sincerely



John Doyle
Chairman
ACAG Financial Reporting and Auditing Committee

ATTACHMENT

1. **In relation to the AASB’s proposal to replace the reciprocal / non-reciprocal 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.**

ACAG supports the proposal to replace the income recognition requirements of non-reciprocity in AASB 1004 *Contributions* with a performance obligation model. ACAG’s audits of public sector agencies regularly encounter application issues when making distinctions between reciprocal and non-reciprocal transfers.

Typically, the entity receives the contribution late in the financial year, and the entity has little or no opportunity to deliver the public services that it was provided for. However, the non-reciprocal transfer definition is satisfied as the entity has not provided equal value in exchange to the other party of the transfer, and immediate income recognition is required. Provided that there are sufficiently specific performance obligations in the agreement, the proposed standard will likely result in the deferral of the income to the period when the services are delivered.

Additionally, as the terminology used under the new model is more consistent with existing and proposed revenue recognition standards, it is more likely to be uniformly applied.

Therefore, ACAG agrees that this proposal will provide a faithful depiction of a not-for-profit (NFP) entity’s financial performance in its annual financial report.

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-profit entity has a performance obligation? Please provide your reasons.**

ACAG supports the proposal to use the “*sufficiently specific*” criterion to determine if there is a performance obligation associated with income received for promises to transfer a good or service.

ACAG agrees that the use of professional judgement is required to determine whether a promise is ‘sufficiently specific’. However, ACAG recommends clearer and more extensive implementation guidance and examples to assist users with their assessment of the “*sufficiently specific*” criterion and the exercise of their professional judgement.

ACAG has identified the following application and interpretation issues of the current “*sufficiently specific*” definition and related guidance.

- Where an entity has pre-determined objectives and scope of public services to deliver via its enabling legislation or ministerial direction, and it receives government funding to perform this role, then it could be interpreted that the sufficiently specific criterion is met. Whilst this is not ACAG’s interpretation, ACAG suggests further explanation and clarity of ‘sufficiently specific’ should be provided in the proposed Appendix E of AASB 15 (rather than just Example 3B) to avoid any misinterpretation.

ACAG considers the determination of when the performance obligation is satisfied will be problematic as it may be difficult to identify when the customer obtained the benefits from the service provided due to the lack of specificity. Therefore, ACAG supports the interpretation in IG15 and Example 3B, which concludes that the existence of general objectives is not enough to be considered ‘sufficiently specific’ and a performance obligation does not exist.

- Refund clauses in contracts/agreements - It is common for a grant agreement to contain a refund clause, which typically states that:
 - if the grantee fails to comply with the terms and conditions of the grant, it may be required to return some or all of the monies received, and
 - an entity may be required to return any unspent funds.

The exposure draft is not clear whether the existence of a refund clause in a funding agreement by itself would result in a performance obligation. ACAG’s preferred interpretation of the implementation guidance is that the existence of the refund clause by itself is not enough to support a performance obligation. The existence of a refund clause in a contract would be used to determine the contract’s enforceability.

- When determining if there is a “*sufficiently specific*” promise to deliver services or goods, ACAG considers that the emphasis should be placed on the entity’s obligation to provide outputs and outcomes, rather than the activities being undertaken. This approach aligns with the revenue recognition premise of the customer obtaining the benefits from the services/goods provided.

ACAG supports the “*enforceability*” requirement for a performance obligation to exist, as it adds weight to the promise on the entity. Without enforceability, there are potentially little or no consequences for not fulfilling the promise, and in substance, there is no liability. ACAG agrees with the principle that individual performance obligations do not necessarily need to be enforceable, as long as the contract/agreement is enforceable.

ACAG supports the guidance in paragraph IG5, that the capacity to impose a severe penalty for non-performance can exist without a capacity to require a return of transferred assets. In ACAG’s experience, a Minister has exercised his/her rights to dismiss a governing body and/or chief executive officer of an entity for its non-performance or maladministration.

ACAG supports the broader “*contract*” definition for NFP entities that includes agreements and customary business practices, as outlined in IG9 and IG10. In the public sector, the existence and use of contracts is not prevalent and reliance is generally placed on an entity’s enabling legislation or charter to determine the entity’s corporate objectives and functions. For example, a state government department provides funding to a portfolio agency without a contract or agreement in place, but relies on the entity’s established responsibilities and roles to determine its funding needs and performance objectives.

3. Do you agree with the proposal in paragraphs IG19-IG30 of Part A that a not-for-profit entity would recognise a donation component in a contract with a customer as immediate income only if:

- a) a qualitative assessment of available evidence indicates that the customer intended to make a donation to the not-for-profit entity; and**
- b) the donation component is separately identifiable from the goods or services promised in the contract? (See also paragraphs BC36-BC49 of the Basis for Conclusions.)**

If not, under what circumstances should a not-for-profit entity identify and account separately for a donation that is provided as part of a contract with a customer?

In relation to the criteria for a donation component to be recognised immediately as income, ACAG does not agree with part (a) but does agree with part (b). The difficulty with part (a) is that the entity needs to be able to determine what the customer's intention was at the time of the transaction. For some transactions, the amount of evidence to support the donor's intention will be limited or non-existent. ACAG doesn't consider this intention test to be necessary to recognise a donation component and it imposes an unnecessary hurdle.

ACAG supports part (b) as a suitable test to recognise a donation component. If the donation component is separately identifiable from the goods or services in the contract, then it should be recognised separately. The criteria outlined in IG24 would appear to be sufficient to enable revenue recognition of the donation component.

4. In relation to the AASB's proposals to:

- permit any not-for-profit entity to recognise volunteer services as income if the fair value of those services can be measured reliably; and**
- carry forward the requirement in paragraph 44 of AASB 1004 that particular public sector entities must recognise volunteer services if those services would also have been purchased if they had not been donated,**

The AASB seeks views on:

- a) whether the requirements (if any) for the recognition of volunteer services should be the same for all not-for-profit entities, regardless of whether they operate in the public or private sector; and**
- b) if your answer to (a) is 'yes', whether the recognition of volunteer services should be:
 - i. optional, provided that the fair value of those services can be measured reliably; or**
 - ii. required if those services would also have been purchased if they had not been donated. (See also paragraphs BC59-BC63 of the Basis for Conclusions.)****

ACAG generally supports the consistent application by all NFP entities, regardless of whether they are in the public or private sector.

However, in respect of volunteer services, ACAG supports differential requirements to:

- require public sector NFP entities to recognise volunteer services under the circumstances specified in paragraph 19 of AASB 10XX, and
- provide private sector NFP entities with the option to recognise volunteer services where they can be measured reliably.

ACAG acknowledges that a standard that allows choice for whether a NFP entity recognises volunteer services will reduce comparability between similar entities.

Public sector entities utilise volunteer services to perform material public services, which would be purchased if not donated. The recognition, measurement and disclosure of such services are useful to understanding the true cost of delivering public sector services. ACAG encourages uniform adoption within the public sector to enable transparent and accountable financial reporting.

The conceptual basis for limiting the mandatory recognition of qualifying volunteer services in the public sector to those entities in paragraph 19 is not clear. Some public sector NFP entities are highly reliant on volunteer services, such as volunteer fire-fighting, but are not government departments, and consequently are not captured by paragraph 19.

ACAG acknowledges that AASB has not pursued further consideration of extending the mandatory requirements in the interests of not delaying the project to replace AASB 1004, as noted in BC61. In respect of the public sector, ACAG encourages the AASB to expedite their consideration of whether such differentiation in respect of public sector NFP entities justifies different accounting requirements. ACAG suggests that an interim measure to aid comparability could be to extend the application of paragraph 19 of the proposed standard to all public sector NFP entities.

ACAG acknowledges that comparability is not necessarily achievable due to issues in determining what can be measured reliably. Implementing processes (e.g. time recording systems) to capture the extent of the services provided and to determine the fair value of those services is a costly exercise, which would, in many cases, outweigh the benefits of reporting this information.

ACAG also notes that differentiation in accounting requirements for public sector NFP entities is not limited to the issue of volunteer services. Considering the differences in how governments are structured and operate today, as compared with when AAS29 was written, it is timely for the AASB to consider whether such differentiation remains appropriate.

- 5. Do you agree with the proposal in paragraph 38 of [draft] AASB 10XX that, when inventories are donated to a not-for-profit entity other than as part of a contract with a customer, assessments of whether the donations are material should be made on an individual transaction basis without reassessment at a portfolio or other aggregate level?
(See also paragraphs BC50-BC51 of the Basis for Conclusions.)**

ACAG supports the proposal (para 18 and 31 of 10XX) that an entity needs to assess the materiality of a donation at the transaction level rather than the aggregate level. ACAG notes that donated inventory is not a common or material transaction in the public sector.

Other comments

ACAG supports the proposal to initially measure an asset at fair value and consequently to recognise any donation component as income as required by paragraphs 28 and 29 of AASB 10XX. However, ACAG acknowledges the practical challenges for NFP entities to determine any donation component, including the assessment of lease contracts, the acquisition of non-financial assets, and the fair value of these assets.

- 6. Australian Accounting Standards applicable to for-profit entities do not include a definition of ‘contributions by owners’. Further, concerns have been expressed by some that the definition of ‘contributions by owners’ in AASB 1004 is too narrow. Do you consider that a definition of ‘contributions by owners’ is still necessary, or appropriate, in Australian Accounting Standards? If so, would you prefer using:**
- a) the definition of ‘contributions by owners’ presently in AASB 1004; or**
 - b) the definition of ‘ownership contributions’ in the Public Sector Conceptual Framework issued by the International Public Sector Accounting Standards Board (IPSASB)? (See also paragraphs BC84-BC91 of the Basis for Conclusions.)**

ACAG's preference is for the retention of the current definition of "*contribution by owners*" in AASB 1004, and supports the need for a definition of "*contribution by owners*" for use in public sector reporting.

Governments make decisions about whether to inject equity into their controlled entities that enables that entity to deliver public services to the community. Governments also make decisions about what form that investment shall be, e.g. cash, land, and infrastructure. A "*contribution by owners*" definition enables governments to appropriately classify the government's investment into a controlled entity as either revenue or equity. A definition of "*contribution of owners*" promotes consistent application between various governments and increases comparability of financial performance.

From a General Government Sector (GGS) reporting perspective (the owner), the total investment contributed to controlled entities is a material and significant asset account balance. For example, the Victorian GGS recognises an investment in Public Financial Corporations and Public Non-Financial Corporations of approximately \$76 billion.

While ACAG supports retaining the current definition, ACAG believes there is a need to address the concept of owner transactions in the public sector. There are current application issues with the designation requirements of owner contributions, which result in some equity transactions being recorded as income because the designation requirement is not met. ACAG recommends the AASB consider a separate project to address these concerns.

7. The AASB also seeks views on the following issues related to contributions by owners:

- a) whether, in view of concerns expressed by some that using AASB 1004's definition of 'contributions by owners' in AASB Interpretation 1038 *Contributions by Owners Made to Wholly-Owned Public Sector Entities* (which includes for-profit public sector entities in its scope) might prevent a for-profit entity in the public sector from making an unreserved statement of compliance with IFRSs, AASB Interpretation 1038 should be:
- i. withdrawn;
 - ii. retained but with narrower application [that is, limited to not-for-profit entities in the public sector, and possibly also confined to identifying which not-for-profit public sector entities should account for transfers between them when they are controlled by the same parent (government)]; or
 - iii. retained without amendment? (See also paragraphs BC84-BC94 of the Basis for Conclusions.)

ACAG supports option (iii) - retained without amendment. Jurisdictional financial reporting requirements are based on AASB Interpretation 1038 to provide direction and consistency in the accounting for transactions between wholly owned public sector entities. Consequently, AASB Interpretation 1038 is regularly considered by preparers and auditors and should be retained.

However, in line with ACAG's previous comments, the AASB should consider addressing the concept of owner transactions within the public sector as part of a separate project.

- b) whether requirements for restructures of administrative arrangements (presently set out as paragraphs 54-59 of AASB 1004) should still be included in Australian Accounting Standards (see also paragraph BC90 (b) of the Basis for Conclusions);

ACAG supports the retention of the requirements for restructures of administrative arrangements in Australian Accounting Standards. Governments readily change the way they structure the delivery of public services, which results in transfers of assets, liabilities, net assets, net liabilities and reclassification of equity balances. The existing accounting requirements and guidance are actively used by preparers and auditors of public sector financial reports. The consistency and comparability of public sector reports would likely be reduced without the requirements of paragraph 54-59 of AASB 1004.

- c) whether requirements for distributions to owners (presently set out as paragraphs 49 and 53 of AASB 1004) should still be included in Australian Accounting Standards (see also paragraphs BC94-BC96 of the Basis for Conclusions);

ACAG supports the retention of the requirements for "distribution to owners" in Australian Accounting Standards. ACAG recommends further guidance is provided that clarifies the nature of a "distribution to owner" and when and how it should be measured. It is not unusual for a Government to require a return of its investment from a controlled entity, especially when the controlled entity has sold some or all of its assets and the proceeds are to be used by that Government for a different purpose.

- d) whether requirements for liabilities of government departments assumed by other entities (presently set out as paragraphs 39-43 of AASB 1004) should still be included in Australian Accounting Standards (see also paragraphs BC97-BC98 of the Basis for Conclusions); and**

ACAG supports the retention of the requirements for "*liabilities of government departments*" in Australian Accounting Standards.

- e) the practical implications if the definition of 'contributions by owners' and AASB Interpretation 1038 were to be withdrawn?**

ACAG has detailed the practical implications in the responses above.

8. In relation to disclosure requirements regarding compliance by government departments with appropriations, do you agree with:

- a) omitting the requirement in paragraph 64(e) of AASB 1004 to disclose the nature and probable financial effect of any non-compliance by the government department with externally-imposed requirements for the period, other than any non-compliance reflected in material variances between amounts appropriated and amounts expended? (See paragraphs BC99-BC103 of the Basis for Conclusions.)**
- b) extending the scope of the retained disclosure requirements for government departments (i.e. those regarding any non-compliance reflected in material variances between amounts appropriated and amounts expended) to also apply to any other public sector entities that obtain part or all of their spending authority from parliamentary appropriations? (See also paragraphs BC99-BC103 of the Basis for Conclusions.)**

ACAG supports the proposed changes to the disclosure requirements regarding compliance with parliamentary appropriations by government departments. ACAG considers the extension of the scope to capture other public sector entities that obtain part or all of their spending authority from parliamentary appropriations is appropriate to ensure full transparency and accountability of public monies.

This issue demonstrates that differentiation on the basis of whether a public sector NFP entity is a government department has less conceptual meaning than in the past. Accordingly, as noted in our comments on question 4, ACAG encourages the AASB to expedite their consideration of whether it is appropriate to continue to differentiate accounting requirements on this basis.

9. Do you agree with the proposed transitional provisions in Appendix C of [draft] AASB 10XX? In particular:

- a) do you agree with the transitional provisions for non-financial assets and finance lease assets and liabilities, the cost of which was not measured at fair value on initial recognition; and
- b) do any other issues warrant additional transitional provisions and, if so, which transitional provisions do you suggest? (See also paragraphs BC104-BC109 of the Basis for Conclusions.)

ACAG supports the proposed transitional provisions contained in Appendix C of AASB 10XX, which allows a choice between full retrospective application and cumulative effect application. However, ACAG acknowledges that, in accordance with paragraph 52 of AASB 108, it may be impracticable to determine the fair value of donations (e.g. assets) as at a past date due to the need to use hindsight. Therefore, some past donations may remain unrecognised.

10. Whether there are any regulatory issues or other issues arising in the Australian environment that may affect the implementation of the proposals, particularly any issues relating to:

- a) not-for-profit entities; and
- b) public sector entities, including GAAP/GFS implications (discussed above).

ACAG does not consider there to be any regulatory or other issues.

11. Whether, overall, the proposals would result in financial statements that would be useful to users.

Overall, ACAG's view is that the proposals would result in financial statements that would be useful to users.

12. Whether the proposals are in the best interests of the Australian economy.

ACAG has no specific comments.

13. Unless already provided in response to specific matters for comment 1 – 9 above, the costs and benefits of the proposals relative to the current requirements, whether quantitative (financial or non-financial) or qualitative. In relation to quantitative financial costs, the AASB is particularly seeking to know the nature(s) and estimated amount(s) of any expected incremental costs, or cost savings, of the proposals relative to the existing requirements.

ACAG's view is that there will be one-off implementation costs for Auditors-General including:

- staff education and training,
- time incurred gathering and analysing new documents to support performance obligations, separation of donation components and volunteer services, and
- development of changes to audit programs to address the new accounting requirements.

In addition, there will be recurring audit costs associated with the additional time required to execute the new audit programs that includes the annual audit of performance obligations in contracts and agreements. Auditors will need to obtain a greater understanding of the legal requirements of contracts and of the business itself, leading to increased compliance costs. The new requirements may also require more time from senior audit staff. The recurring costs could be passed on to audited agencies as part of the reasonable cost of performing the audit.

ACAG expects there to be a cost burden for public sector entities due to the time and effort required to gather and analyse contracts and agreements to identify performance obligations. The quality of an entity's current contract management will determine the extent of resources required to prepare sufficient documentation for audit purposes. The proposals may also result in additional legal costs to determine whether a contract exists, whether a transfer has occurred, whether the entity has met performance obligations, and to re-write contracts to meet accounting requirements.

Overall, ACAG believes the benefits of the new accounting requirements will result in greater transparency of the revenue required to deliver the performance obligations in a contract, and this benefit should outweigh the costs of the new requirements.