LG solutions
Pty Limited

Monday, 3 September 2007

AASB
PO Box 204
Collins St West
VIC 8007

Delivered by email

Dear Sir/Madam,

Re: ED 156 - Proposals Arising from the Short-term Review of the Requirements in AAS 27, AAS 29 and AAS 31

In relation to the AASB's Request for Comments in relation to ED 156, we would like to express a clear opinion that the proposals contained within ED 156 (in respect of Local Government) are supported subject to two major exceptions:

(i) we advocate the AASB seek to move to endorse IPSAS 23 in relation to the accounting for Non Exchange Revenues and in particular move to a liability accounting framework relating to the accounting for Grants as part of its current IPSASB Convergence Project, and

(ii) we advocate that the AASB review as a matter of urgency (before it acts on ED 156) the proposed accounting for Local Government Restructures (under AASB 3 & AASB 5) and instead that the AASB advocate that any such transactions related to restructures (where they are associated with the movement of ratepayers) be deemed Contributions from Owners and Distributions to Owners and accordingly be treated completely within the Statement of Equity, rather than within the Income Statement.

In relation to item (ii) above, we have provided a detailed review of the issues relating to the current and proposed direction of the AASB in relying on AASB 3 & AASB 5 for how Local Governments should account for Restructures, and believe these two standards are neither adequate nor appropriate in properly accounting for the economic substance of the transaction which is in essence a movement of equity between entities as a result of a movement of ratepayers between Local Government jurisdictions.

On Accounting for Local Government Restructures

We note the AASB's conclusions that AASB 3 & AASB 5 are "appropriate & adequate" for restructures of and within Local Governments.

We would question whether AASB 5 is in fact appropriate for how Transferor Councils should account for a restructure - under the "Discontinued Operations" umbrella. In many cases Local Government Restructures do not result in an existing entity ceasing to exist or ceasing to provide certain services. Instead, Local Government entities generally lose part of their Ratepayer base and Community area, but continue to provide the existing services to a different ratebase/community makeup (smaller or larger). Accordingly we do not view such a change of Community Equity as coming under "Discontinued Operations" and the accounting therein.

AASB 5 and the accounting and disclosure therein of "Discontinued Operations" would we believe only be pertinent where a Council is completely disbanded, or under circumstances where a pre existing Council still exists post restructure but is no longer able to or is no longer required to provide certain services.

As per AASB 27 paragraph 74, "A restructure of local governments involves a change in the resources controlled by the local governments involved in the restructure"...however we feel that this definition/comment excludes the fact that there can be (and generally is) also a change/expansion/contraction of community ownership(ie. the Equity holders) relating to an existing (or newly formed) Local Government Reporting Entity and that in fact a Local Government restructure that either involves (i) a new Local Government Entity or (ii) the amalgamation in full or in part between prior existing Local Government Entities, and that the assets & liabilities transferred are essentially akin to "Contributions from Owners".

Accordingly, we feel that Transferor and Transferee Councils (where the restructure involves the movement of communities & ratepayers within LG areas and control) should account for any transfer of Assets and Liabilities solely within the Statement of Equity to reflect the nature of the movement of Community Equity (represented by the movement of ratepayers & communities), rather than the inflow of Revenue & Expenses.

Accordingly, we advocate that the Restructure of Local Governments that specifically reflects a change in makeup of ratepayers and communities across pre existing and new Local Government Entities should be treated as "Contributions by Owners" and accordingly recorded solely within the Statement of Equity .

Further we advocate that this treatment be clearly annunciated thru specific Local Government paragraphs within either AASB 3, AASB 5 or more appropriately AASB 1004.

>>>The proposed new paragraphs 43 & 44 of AASB 1004 would appear to "fit the bill" of advocating the recognition of Contributions by owners (and to owners) as a direct adjustment to equity. <<<

Perhaps AASB 1004 should include commentary that clearly annunciates (for clarity and to avoid confusion) that a Restructure of a Council that involves an underlying change in ratepayer base should account for the inflow or outflow of Assets & Liabilities by Transferor Councils and Transferee Councils as Contributions by (and to) Owners and should therefore be accounted for in accordance with paragraphs 43 & 44.

To account for restructured transfers of assets and liabilities as income and expenses in the Income Statement can be nothing but misleading where the ratepayer base relating to the entity has changed as well!! It might very well be that the remaining ratepayers are better off (on the measurement of Net Equity/No. of Ratepayers and yet the Income Statement could reflect a large loss as a result of the transfer out of Net Assets...or vice versa). To account for assets and liability transfers other than in Equity could very well be misleading in terms of the effects on the "wealth" or residual benefit that belongs to the remaining ratepayers/community!

On the suitability of AASB 5 for a Transferor Local Government Entity:

AASB 5 has been deemed by the AASB as "appropriate and adequate" for the purposes of accounting for a Restructure by a Transferor Local Government Entity (refer Paragraph 2.4 of AASB 5 & the AASB's Paragraph-by-Paragraph Analysis of AAS 27 Financial Reporting by Local Governments at 71 - 75).

On closer inspection, we believe that AASB 5 may not be as appropriate as seems the case for a Transferor Local Government Entity!

In particular,

1. Aus 2.4 states that AASB 5 will apply where a Local Government the transfer of assets & liabilities results in a "discontinued operation".

   The definition of a "discontinued operation" given the definition is:

   *"A **component of an entity** that either has been disposed of or is classified as held for sale and:*

   (a) represents a separate major line of business or geographical area of operations;

   (b) is part of a single co-ordinated plan to dispose of a separate major line of business or geographical area of operations;"

   >>> Problems envisioned with this definition include that the assets & liabilities may not represent a major geographical area of operations whilst an Executive Government direction to transfer assets or liabilities can hardly be seen as "a co-ordinated plan to dispose of a separate major geographical area of operations". <<<

2. Further paragraph 6 of AASB 5 states as the core of the standard that:

"An entity shall classify a non-current asset (or disposal group) as held for sale if its carrying amount will be recovered principally through a sale transaction rather than through continuing use."

Again, an Executive Government direction to transfer assets or liabilities to another Local Government Entity can hardly be deemed the recovery of the carrying amount of the assets & liabilities through "a sale transaction".

3. Should a Local Government Entity decide it can in fact classify any transfer of assets & liabilities from a restructure as a "Discontinued Operation", Paragraph 15 requires the entity to:

"measure a non-current asset (or disposal group) classified as held for sale at the lower of its carrying amount and fair value less costs to sell."

Fair Value is of course defined as

"The amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction."

However, the problem is that while the Net Assets will in fact have a tangible fair value, they are generally in fact transferred for no consideration!! So disclosure of the Discontinued Operations Balance Sheet line items at Fair Value would not seem to convey that in fact they will be handed over for perhaps zero consideration!

We therefore contend that AASB 5 does not lend itself well to the Transferor Council and guidance in accounting for Assets & Liabilities that are to be transferred to another Local Government Entity.

Again we believe the transfer out of assets & liabilities as a result of a restructure (that also includes a change of ratepayers) be accounted for as a reduction in Owners Contributions / Equity nd contained solely within Equity (with appropriate references in AASB 1004).

Accordingly, Aus 2.4 should specifically exclude Local Government Restructures where a change of Ratepayer also occurs. Where the restructure results in a transfer of assets but no change of ratepayers, AASB 5 should be expanded upon to ensure the transferred assets and liabilities can be classified as a discontinued operation and should clarify that Fair Value in these circumstances should represent the actual consideration payable by the receiving Council.

On the suitability of AASB 3 for a Transferee Local Government Entity:

The basis of AASB 3 in accounting for a Business Combination is the application of the "Purchase Method".

Our reading of AASB 3 is that at its core is the premise that there is actually a purchase event that takes place - an acquirer purchases net assets and recognises the assets acquired and liabilities and contingent liabilities assumed .

The effect on the Income Statement of such an acquisition in the books of the combined entity is nil where the cost of the acquisition equates to the Fair Value of the net assets acquired. Where the cost of the acquisition is less than the FV of the Net Assets acquire, paragraph 56 of AASB 3 requires recognition of the difference in the profit & loss.

Generally in a restructure, there is no acquisition price paid - generally because the Net Assets represent the transferred Ratepayers existing Equity which has only moved from one Local Government Controlling Vehicle to another. The Net assets are not sold to other ratepayers or given away to other ratepayers, instead the Net Assets transferred quite simply follow the Ratepayers (ie. Community Owners) to their new controlling entity.

However, AASB 3 does not seem to allow in its advocated Purchase Method for the adequate treatment of Net Assets that are not so much purchased but are rather merged with another entity.

AASB 3 by way of paragraph 56 would result in the reporting of a windfall gain for the new entity - being the difference between the transferred Net Assets' Fair Value and a zero purchase price.

We would contend that such a windfall gain as reported in the Income Statement is hardly an increase in wealth for any of the ratepayers involved in the new Local Government Entity. Instead the windfall gain represents the Net Equity contribution from the transferred ratepayers into the new Local Government Entity or the now Greater Other Local Government Entity!

We therefore contend that AASB 3 does not lend itself well to appropriately recording the core economic substance of the transaction, which is the transfer of net assets as a result of a transfer of equity ownership (ratepayers) at the Transferee Council.

Again we believe that the transfer out of assets & liabilities (from a Local Government Entity) as a result of a restructure which also includes a movement of ratepayers is more appropriately accounted for as an increase in Owners Contributions / Equity (to the fair value of the net assets transferred) and the accounting as such should be contained solely within Equity.

Accordingly, appropriate references should be accommodated for this in AASB 1004 (again to fit within the domain of the proposed new paragraphs 43 & 44) , and that AASB 3 should in fact have a specific scope exclusion for Local Government Restructures that result in Ratepayers being moved across Councils as part of a restructure.

Given our view that all Local Government Entity restructures that involve the transfer of Net Assets and the movement of Ratepayers represents both a Distribution to Owners/Ratepayers (regarding the Transferor Council) and Contributions from Owners/Ratepayers (regarding the Transferee Council), AASB 1004 should perhaps include a definition for Distributions to Owners that includes in it the transfer of Net Assets to other Local Government Entities (where the transfer directly relates to a movement ratepayers from one Council - the transferor, to another - the transferee).

Conclusion

In closing, we would like to thank the AASB for the opportunity to comment. We would be happy to further clarify any points we have raised above if so required.

Yours faithfully,

Ken Crawford
Director – LG Solutions