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30 November2009

The Chairman
Australian Accounting Standards Board
PO Box 204
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AUSTRALIA

Director - Accounting Standards
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Dear Board Members

Exposure Draft AASB ED 180 and FRSB ED 118 *Income from Non-exchange Transactions (Taxes and Transfers)*

The Australian and the New Zealand firms of Ernst & Young are pleased to submit our joint comments on Exposure Draft AASB ED 180 and FRSB ED 118 *Income from Non-exchange Transactions (Taxes and Transfers)* (AASB ED 180 and FRSB ED 118 or the ED).

Overall, subject to our comments on the specific matters included in Appendix A, we support the issue of a joint accounting standard to address the accounting for income from non-exchange transactions as it is a matter of high importance to not-for-profit entities (NFPs) in Australia and public benefit entities (PBEs) in New Zealand.

We believe that providing accounting guidance on the recognition and measurement of income from non-exchange transactions will improve the comparability of financial statements in Australia and New Zealand as currently there is divergence in practice.

We believe that using IPSAS 23 *Revenue from Non-exchange Transactions (Taxes and Transfers)* provides a sound basis for establishing a standard for the accounting for non-exchange transactions and agree with the Boards that it is an efficient way of developing a comprehensive standard.

We note however that in adopting IPSAS 23 as the basis for a proposed Australian/New Zealand accounting standard, the Boards have made only minor changes to the Standard required to facilitate application of the requirements in each jurisdiction. However, we believe there are aspects of IPSAS 23 where improvements or clarifications are needed to ensure the standard is operational in practice. There are a number of areas where we have concerns with the approach in IPSAS 23, and hence the ED proposals, which we discuss further below. In particular, we have concerns about the interaction between the requirements in the ED and the existing standards on financial instruments.

We also note that while we support the proposals in the ED, we do so in the context of an interim solution. We believe that there is a need for a more fundamental review of the conceptual basis for financial reporting, including performance reporting, by NFPs and PBEs. We therefore encourage the Boards to move forward and consider the conceptual issues and the needs of users of financial reports of entities in this sector.

We would be pleased to discuss our comments further with you. Please contact Lara Pope on (64) 274 899 896 or Georgina Dellaportas on (613) 9288 8621 if you wish to discuss any of the matters raised in this response.

Yours sincerely

Ernst & Young

Wellington

Appendix A

Specific matters for comment

Questions for both Australian and New Zealand Constituents

(a) the Boards' approach of developing the proposals based on IPSAS 23

As discussed in our covering letter, we support the Boards' approach in developing the proposals based on IPSAS 23. We note however that in adopting IPSAS 23, the Boards have made only minor changes to the Standard required to facilitate application of the requirements in each jurisdiction. We encourage the Boards to make improvements to AASB ED 180/NZ FRSB ED 118 which are necessary to enhance the proposed Standard and to align it with the existing body of literature. Our suggestions for improvement are included below.

(b) whether there are any differences between Australia and New Zealand that would override the Boards' desire for converged Standards for non-exchange transactions

We are not aware of any differences that would indicate that there should not be converged Standards for non-exchange transactions.

(c) whether further guidance or illustrative examples are required in distinguishing exchange and non-exchange transactions or components of transactions, e.g. for local government rates

We have concerns in relation to the application of the proposals to transactions which are part exchange and part non-exchange, as we do not believe that the ED provides clear guidance around when transactions give rise to an exchange and a non-exchange transaction but rather refer to the exercise of judgement. The ED indicates that the identification of exchange and non-exchange components is determined by measurement under the equivalent standard. As such, we believe that further guidance and examples should be provided on this issue.

The exchange/non-exchange issue is also exacerbated for transactions that include financial liabilities/financial assets. AASB ED 180/NZ FRSB ED 118 requires financial assets and financial liabilities to be measured in accordance with AASB 139 and NZ IAS 39. However these Standards have specific requirements on initial measurement, including situations in which the transaction price may differ from the fair value of the financial asset or financial liability on initial recognition.

We believe that further guidance should be included in the ED to make it clear that while AASB 139/NZ IAS 39 is referred to for measurement, any difference between the assets and liabilities recognised is accounted for as per the ED and not AASB 139/NZ IAS 39.

We note that the IPSASB has as part of its adoption of standards equivalent to IAS 32/39 included proposed amendments to IPSAS 23 including guidance regarding concessional loans together with an example which should assist with such clarification.

We also comment further on the interaction between the ED and AASB 139/NZ IAS 39 in point (h) below.

(d) the definition and treatment of conditions on transferred assets

We understand that the basis for the recognition of liabilities in non-exchange transactions is the existence of conditions on transferred assets, and that such conditions must include both performance and return obligations. While this concept does not align with the existing standards on liabilities (financial and non-financial) nor revenue recognition, we support the use of this concept as providing an appropriate basis for accounting for non-exchange transactions. However, we believe that the issue of economic compulsion should be addressed. A number of entities receiving assets through non-exchange transactions may not have a specified contractual requirement to return the funding. However, not returning the funding if the stipulations are not met could jeopardise any future funding received or the approval of future projects. In such situations, the entity may feel economically compelled to repay the funding, for example if a project is not completed (or is completed for much less than the original expected cost and amount of the grant received). Not repaying the cash could mean future projects will not be approved, and in extreme cases may mean the entity can no longer operate. Even though there is no explicit return obligation, many would argue that in these circumstances there is an implicit return obligation. We believe this is likely to be a common issue arising in practice when the standard is implemented. <u>We therefore believe that guidance is needed on whether or not, in this situation, there is a present obligation of the entity to either perform or return the funding</u>.

Paragraph 51 states that a present obligation shall be recognised as a liability and paragraph 52 states that a present obligation is a duty to act or perform in a certain way. If this is the case, then the existence of a performance condition without a return obligation could also give rise to a liability. However, we believe that the intention of the ED is that a return obligation is required to ensure the enforceability of the performance obligation, that is, neither the performance obligation nor the return obligation on their own are sufficient to give rise to the liability. We recommend that the Board make this requirement clear by including commentary to this effect.

Paragraph 25 of the ED discusses situations when a return obligation exists only after the entity fails to perform a stipulation (the example given is the entity is required to raise an equal matching contribution). The ED states that the timing of the return obligation arises only once the stipulation is breached (i.e. funding is not raised). We believe that there needs to be further explanation provided to highlight that the entity has no liability on receipt of the funds or the entering into of a binding agreement because there is no 'performance obligation' (or no significant outflow of resources) from the act of raising matching funding. A liability only arises when the outflow of resources is probable and the funds are required to be returned, and not on the initial recognition of the asset arising from the non-exchange transaction. The example should also clarify that the triggering of a return obligation in this case, being cash, gives rise to a <u>financial</u> liability. We discuss financial liabilities further in point (h) below.

(e) the treatment of advance receipts

We agree that an entity should recognise an asset and a liability if they receive funding prior to a binding agreement. However, we believe that it should be made clear that there is an unstated assumption that an advance receipt can give rise to control over the asset <u>prior to a binding arrangement occurring</u>. Further, paragraph 106 states that "a liability is recognised until the event which makes the transfer agreement binding occurs and <u>all other conditions under the agreement are fulfilled</u>". This second part of the sentence which has been underlined is not necessary. A liability for advance receipts is recognised only until it becomes binding. This liability would be a financial liability. Once it becomes binding then the recipient needs to consider whether conditions are attached and either recognise as income if no conditions or recognise a new liability (performance obligation) if conditions are attached. This treatment needs to be made clearer.

(f) permitting, but not requiring, the recognition of contributions of services

We agree with this requirement.

(g) requiring disclosure of the nature and type of major classes of services in-kind received (paragraph 108) – IPSAS 23 encourages but does not require such disclosure

We agree with this requirement.

(h) the implications of recognising financial assets and financial liabilities that fall within the scope of this ED in accordance with the proposals rather than AASB 139 / NZ IAS 39

We have some concerns in relation to how the proposed standard interacts with the accounting for financial instruments in accordance with AASB 139 and NZ IAS 39. Because IPSAS does not yet have an equivalent to IAS 39 the ED proposes further guidance on the accounting for financial instruments arising from non-exchange transactions. However, we believe that this guidance is not clear.

In particular, the ED does not provide sufficient guidance around when a condition, which includes an obligation to return cash to the grantor, specifically gives rise to a financial liability. Based on the examples it would appear that the requirement to return cash is not a financial liability (see example 12). If the Boards do not believe that this is a financial liability, this should be stated in the final standard.

Our understanding of the requirements is that if there is a condition (performance and return obligation) in a non-exchange transaction, the liability which is recognised is a performance obligation in accordance with paragraph 51.

Paragraph 51 states that a present obligation shall be recognised as a liability. A present obligation is a duty to act or perform in a certain way (paragraph 52). If a liability under the ED is a present obligation to perform or act in a certain way, then a condition attached to a non-exchange transaction cannot give rise to the initial recognition of a financial liability. It must always be a non-financial liability. However, to the extent that the performance conditions are not met and the return obligation becomes probable then the recipient will no longer have a performance obligation under paragraph 51 but rather has a financial liability (i.e. a contractual obligation to repay the funding). That is, at the point in time when it is probable a condition will be breached, the non-financial liability will be required to be replaced by a financial liability.

We believe that more clarity is needed about the nature of the liabilities recognised under the ED – whether they are financial or non-financial liabilities - and at what point financial assets and financial liabilities arising from non-exchange transactions fall within the scope of AASB 139/NZ IAS 39. The consequential amendments to AASB 139/NZ IAS 39 specify that the initial recognition requirements in the ED override the initial recognition requirements in AASB 139/NZ IAS 39. However, based upon the discussion in the Basis for Conclusions, that amendment appears aimed at ensuring that a financial liability is *not* recognised when it otherwise might have been under AASB 139/NZ IAS 39. There are no amendments to the scope paragraphs in AASB 139/NZ IAS 39. It therefore appears that once financial assets and financial liabilities are recognised under the ED, they would then be accounted for in accordance with AASB 139/NZ IAS 39. However, this is unclear and, in some cases, inconsistent with the requirements in the ED. For example, it is unclear when to apply the requirements in AASB 139/NZ IAS 39 on the classification of financial assets and financial liabilities, and their subsequent measurement, rather than the requirements in the ED. This issue arises when:

- a financial asset or financial liability is recognised upon initial recognition. For instance, in Example 16, are the financial assets and financial liabilities accounted for under AASB 139/NZ IAS 39 after initial recognition?

- a financial liability arises subsequent to initial recognition, for example, when the entity fails to satisfy a performance obligation and this creates an unconditional liability to return cash, or when a specified future event does not occur (as discussed in paragraph 25) and cash must be returned. Once the financial liability has been recognised, is it accounted for in accordance with the requirements of AASB 139/NZ IAS 39?

- a financial liability arises on initial recognition because of an advance receipt. It appears that these financial liabilities are intended to be dealt with under the ED, but are not scoped out of AASB 139/NZ IAS 39.

Another consideration is that once a return obligation is triggered, the entity would be required to reverse the performance obligation (a non-financial liability) and recognise the return obligation (a financial liability). Differences in measurement may arise upon such occurrence. This is not addressed in the ED.

In addition, paragraphs 85 - 89 deal with debt forgiveness. However, AASB 139 / NZ IAS 39 contain requirements for when a financial liability should be de-recognised, and how to account for any difference between the amount de-recognised and the consideration paid. Given that the financial liability would have been within the scope of AASB 139 / NZ IAS 39 at the time it was forgiven, and there are no amendments to the scope of AASB 139 / NZ IAS 39, it is unclear whether and how the requirements in paragraphs 85 - 89 would apply.

In summary, more clarity is required about the interaction between the ED and AASB 139 / NZ IAS 39. That includes providing more clarity on when a financial liability would be recognised in relation to a non-exchange transaction under paragraph 58. While example 16 purports to provide guidance on a situation where a financial liability arises, the financial liability is only recognised in respect of the exchange component of the transaction and not in respect of the non-exchange transaction which is recognised entirely as income. Hence this example is not providing an example of a financial liability arising from a non-exchange transaction but rather an example of bifurcating a transaction into the two components - an exchange transaction involving a financial liability and a non-exchange transaction.

We also note that the IPSASB has proposed amendments to IPSAS 23 as a result of its adoption of an IAS 39 equivalent as a standard under IPSASB ED 38. The Boards should amend AASB ED 180/NZ FRSB ED118 to take into account any such amendments to IPSAS 23.

(i) the measurement requirements, particularly in respect of financial assets and financial liabilities

- Measurement of non financial assets - Paragraph 44 appears to contradict paragraph 84 and example 11. Paragraph 44 states that assets within the scope of AASB 116 or NZ IAS 16 are measured in accordance with this standard (i.e. the ED). On the other hand, paragraph 84 refers to the initial measurement requirements in other standards, although it then states that those other standards refer to the ED. Similarly, example 11 states that the land asset is recognised at its fair value in accordance with AASB 116 or NZ IAS 16, and it is only after referring to those standards that the reader is referred back to the ED. This is unnecessarily confusing, and we recommend that wording similar to that in paragraph 44 also be used in paragraph 84 and Example 11, so that it is clear that the ED specifies the measurement requirements, not the other standards. In addition, we encourage the Boards to clarify the treatment of transaction costs.

- Measurement of financial assets/financial liabilities

  Refer to our earlier comments on point (h).

(j) prospective application per the transitional provisions

Paragraph 117 states that the Standard will apply prospectively from the beginning of the earliest comparative period. However, paragraph 117 is not consistent with BC 18 which refers to <u>transactions</u> occurring after the start of that earliest period.

The Boards need to clarify what is meant by prospective application - i.e. whether the proposed requirements will apply to non-exchange transactions occurring on or after the beginning of the comparative period or whether it applies to recognised assets/liabilities as at the start of the earliest comparative period arising from earlier non-exchange transactions. There also could be unrecognised assets and liabilities, which were not recognised in accordance with previous accounting policies, but which would have been recognised under the requirements in the ED.

We would recommend that any Standard should be applied to the opening statement of financial position of the earliest comparative period.

Australian-specific Questions

(k) the exclusion of for-profit government departments from the scope of the ED – are requirements for such entities still required?

On the basis of transaction neutrality, we believe that for-profit government departments and agencies should be applying the same accounting requirements as private sector for-profit entities. Hence the exclusion of such entities from the scope of the ED is supported.

(l) the retention of requirements for restructures of administrative arrangements

We agree that these requirements should be retained until the Board addresses this topic more comprehensively.

(m) whether recognition requirements are needed in respect of contributions from owners and distributions to owners generally

Contributions by owners are examples of non-exchange transactions. As such, the requirements as per AASB 1004 should be retained in AASB ED 118/NZ FRSB ED 180 and expanded to apply to all not-for-profit entities.

(n) the role of AASB Interpretation 1038 once a Standard based on the ED is issued

We recommend that this Interpretation be considered separately from the ED to determine whether it is still relevant for the public sector.

(o) the proposed amendments to other Australian Accounting Standards, as set out in Appendix A

We support these amendments.

(p) whether, overall, the proposals would result in financial statements that would be useful to users

While AASB ED 118/NZ FRSB ED 180 is an improvement on the current requirements, as noted in our covering letter, we believe that there is a need for a more fundamental review of the type of financial reporting that should apply to private sector NFPs and PBEs having particular regard to the needs of users. We therefore encourage the Boards to move forward with and look at the conceptual issues relating to this sector and the user needs to be met by financial reporting for entities in this sector.

(q) whether the proposals are in the best interests of the Australian economy.

Yes, the proposals are in the best interests of the Australian economy.

New Zealand-specific Questions

(r) the proposed amendments to other New Zealand financial reporting standards, as set out in Appendix B;

We support these amendments.

(s) whether the proposals are in the best interests of users of general purpose financial statements of public benefit entities in New Zealand; and

Yes, the proposals are in the best interests of users of general purpose financial statements of public benefit entities in New Zealand (subject to our comments in the covering letter about further work to be undertaken).

(t) whether there are any regulatory issues or other issues arising in the New Zealand environment that may affect the implementation of the proposed requirements, particularly any issues relating to:

(i) public benefit entities; or

(ii) the Privacy Act 1993.

We are not aware of any issues.

Other comments for the joint Boards:

In addition to our comments on the specific questions required by the Boards, we make the following comments:

- Paragraph 43 - refers to "asset acquired" - suggest change to "asset transferred" or "asset obtained".
- Paragraph 68 relating to taxes, requires assets arising from taxation transactions to be measured at fair value as at date of acquisition. We suggest this should refer to "date of transfer". It further states that fair value is the best estimate of the inflow of resources to the entity. This is not fair value as defined in accordance with existing Standards in Australia and New Zealand. Therefore, we believe that the final Standard should not define fair value.
- Paragraphs 60 and 77 provide black letter requirements for the recognition of assets in respect of taxes and transfers. However, paragraphs 31-36 already cover these requirements. Therefore, when accounting for non-exchange transactions it would be unclear as to whether an entity should apply paragraphs 31-36 or 60 and 77 in the first instance. To avoid confusion, we recommend that the Boards amend paragraphs 60 and 77 to refer to paragraphs 31-36.
- Paragraph 98 states that an appraisal of the value of an asset is normally undertaken by a member of the valuation profession who holds a recognised and relevant professional qualification. As this is not always the case (e.g. when inventories are received) and it could be implied that the ED would require such valuations in order for fair value to be acceptable, we recommend that this paragraph be deleted or clarified.
- The treatment of multi-year grants which is very common in the PBE/NFP sector is not addressed by the ED. Under AASB ED 118/NZ FRSB ED 180, once an entity becomes eligible for a multi-year grant, (i.e. a binding agreement is in place specifying the amounts to be received each year under the funding agreement) the entity would appear to be required to recognise a receivable for the full amount of the

funding to be received over the number of years covered by the agreement, on the basis that it meets the criteria in paragraphs 31 and 32 of the ED. This will significantly bring forward the recognition of income for multi-year grants as it is not common practice under the existing literature in either Australia or New Zealand to recognise a receivable for the full amount to be received under such grants. The accounting for such grants is however not clearly explained in the ED. We recommend that the Boards consider inclusion of additional guidance together with an example of how such grants would be accounted for. Such guidance should include situations in which the receipts of future years' grants are conditional in some way. Conditions could range from reporting to the grantor at the end of each year on funds spent to situations in which there are substantial requirements that, if not satisfied, could result in the entity losing its entitlement to receive that future funding.

- Disclosures
    - Paragraph 107(c) - we recommend that disclosures are also extended to the nature of conditions
    - Paragraph 107(d) - include words "in respect of transferred assets" for consistency with paragraph 107(c)
    - Paragraph 108(d) - this requirements appears to duplicate the requirement in paragraph 107(a). We believe that bequests, gifts and donations are a class of revenue and would be disclosed as part of paragraph 107(a). However, if the Boards believe that disclosure at a level lower than these classes is required, this should be stated more clearly.
    - Paragraph 112 - it is recommended that the disclosure is expanded to require the nature of restrictions and conditions as we consider such information to be of relevance to users of the financial report of NFPs and PBEs.