



ED260 – Income of NFP Entities



August 2015

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The Local Government Finance Professionals

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Local Government Finance Professionals

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ED260 – Income for Not-for-profit Entities

The Local Government Finance Professional Inc (LGFP) welcomes the opportunity to comment on Exposure Draft 260, Income for NFP Entities.

The LGFP Inc (the Association) represents Queensland Local Government practitioners in the fields of accounting and financial management, and has members across the full Local Government spectrum and from most Queensland Councils.

The Association considers that ED260 is a vast improvement on the current standards, which effectively apply cash accounting concepts to some of the main Local Government revenue items, and is counter to the AASB's matching principle.

However, the new proposals do not go far enough in fully applying the matching principle, particularly in relation to unconditional government grants which are labelled for a particular year but received at the end of the prior year.

Please find below our detailed response to the exposure draft and ED questions. Also attached is a letter from the Mayor of Goondiwindi Regional Council who has expressed strong views on the matter in a number of forums.

This submission has been authorised by the Association's Executive, and myself as President. We would welcome the opportunity to discuss the issues raised with AASB so as to achieve a framework which enhances Local Government financial reporting. For LGFP policy matters, please contact me on 07 5462 0318 or dlewis@lvrc.qld.gov.au For technical matters, please contact the Association's Technical Advisor, Mr David Spearritt on 07 3113 3644 or david@orionco.net.

Yours faithfully

David Lewis,
President

1. Introduction and Overview

1.1 Overview

The LGFP Inc (the Association) represents Queensland Local Government practitioners in the fields of accounting and financial management, and has members across the full Local Government spectrum and from most Queensland Councils.

The Association welcomes the opportunity to provide input to ED260, Income of Not-for-Profit Entities.

The Association has been actively supporting Local Government Councils in implementing accrual accounting and then using the accrual financial information to enable Councils to become financially sustainable.

The basic concepts of accrual accounting are a vast improvement on the former cash accounting method in supporting efforts to monitor and improve financial sustainability of Councils. However, many aspects of the current standards effectively apply cash accounting to the recognition of Local Government revenue. This results in a mismatch between significant revenue and expenditure items.

The key issue to Local Government is the concept of 'matching' costs and revenues. AASB's Framework for the Preparation and Presentation of Financial Statements (2009) outlines the concept of matching in paragraph 95:

*Expenses are recognised in the income statement on the basis of a direct association between the costs incurred and the earning of specific items of income. **This process, commonly referred to as the matching of costs with revenues, involves the simultaneous or combined recognition of revenues and expenses that result directly and jointly from the same transactions or other events.** For example, the various components of expense making up the cost of goods sold are recognised at the same time as the income derived from the sale of the goods. However, the application of the matching concept under this Framework does not allow the recognition of items in the balance sheet which do not meet the definition of assets or liabilities.*

Our primary concern with the current (and some proposed) accounting standards occurs where the detailed requirements of the standards result in a divergence from the matching principle. The problem usually arises through the application of assumptions in the standards which may be relevant to the private sector, but not necessarily to Local Government. In particular, many of the standards assume that revenue is raised within a contract, whereas Local Governments receive taxation revenue (Rates) which are not under a contract, and unconditional grants from other levels of Government.

ED260 appears to make a substantial improvement by overcoming the premature recognition of revenue such as conditional but non-reciprocal grants. However, it does not address problems with the premature recognition of non-conditional grants.

The key areas we have experienced serious mismatches between the recognition of associated revenue and expenditures are in relation to:

1. Disaster Funding payments received in advance,
2. Rate receipts received in advance, and
3. Financial Assistance Grants, received in advance

2. Specific Revenue Items

2.1 Disaster Funding payments received in advance

In recent years almost all Queensland Local Governments experienced substantial cyclone or flood damage to their infrastructure. Funding for Councils is available under the National Disaster Relief and Recovery Arrangements (NDRRA) which is an Agreement between the Commonwealth and State Government. In some recent cases after massive natural disaster, the areas have been visited by the Prime Minister and/or Premier who made public undertaking to provide whatever funding was required to restore the area.

Local Governments are not signatories to the NDRRA arrangements, and there are no formal contracts. The whole area is highly complex and fluid, with some funds received without any paperwork, and some after applying and receiving approval.

The concepts in ED260 that revenue should be recognised when a performance obligation has been met is sound, however this should apply whether or not the moneys have been received under an enforceable agreement or otherwise.

2.2 Rate Receipts received in Advance

Councils have the legislated power to levy Rates and Charges for a specified financial year. Rate levy notices are issued to the ratepayers. However, it is quite common for ratepayers to pay rates in advance of any rate levy. Current accounting standards require these receipts to be recognised as revenue immediately on receipt. However, if a ratepayer requested a refund of the pre-paid rates, the Council would be obliged to refund the advance rates if requested prior to the levying of those rates.

As the Rates are a tax and not a contract, there is no performance obligation. However, Council is only legally entitled to the moneys once the rates have been levied, and must refund advance rates on request.

The accounting standards need to be clarified to ensure that non-contractual receipts such as rates received in advance of being levied, are not recognised as revenue until the rates have been levied. This will treat rate revenue on an accrual basis rather than the current cash basis, and will match the associated revenues and expenditures.

2.3 Financial Assistance Grants in Advance

Councils receive funds from the Commonwealth Government for Financial Assistance Grants (FAGS). Councils do not apply for these grants, but provide financial and statistical information from which state-based Grants Commissions determine the allocation for each Council. One of the principles in the commonwealth legislation governing these grants, is that the grants should be calculated on an "Effort Neutral" basis – the grant is not influenced by the level of effort a Council makes in providing any specific activity. These grants are untied, and can be utilised for any purpose.

The grants are allocated in the Commonwealth budget on an annual basis, and the state-based Grants Commissions determine the grant for each Council for each financial year. The following is a link to the Queensland Commission's 2014-15 Grant.

<http://www.qlggc.qld.gov.au/docs/grant-allocation-2014-2015.pdf>

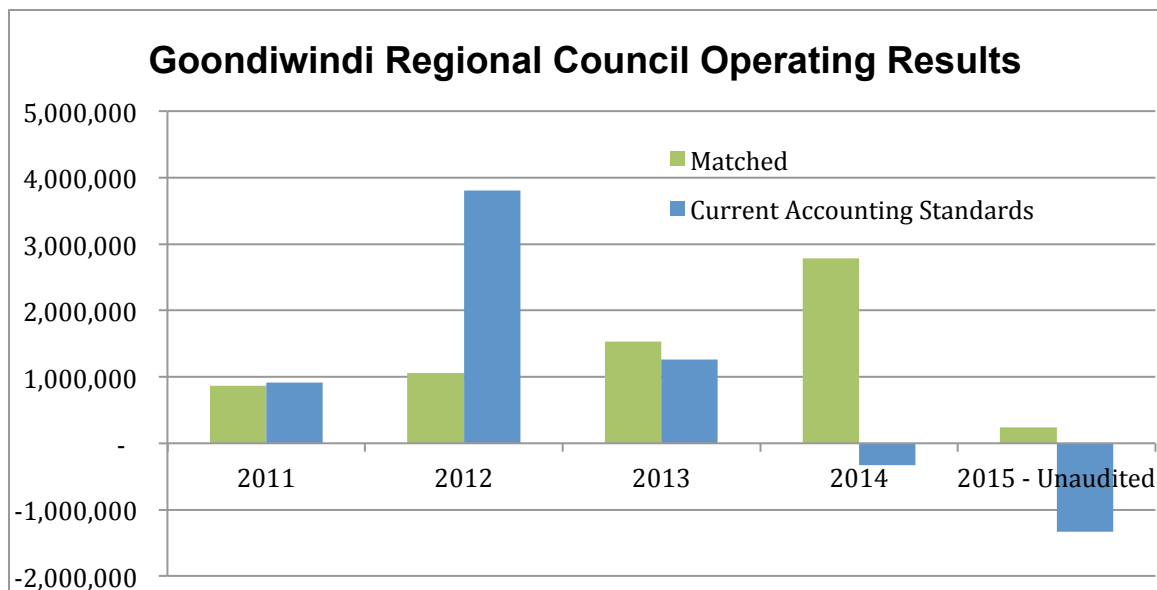
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A few years ago, one of the payments to Local Government was made on 30 June in the prior year, but this was unwound in the 2014-15 financial year. Under the current accounting standards, these moneys were recognised in the financial year in which they were received, effectively on a cash basis. Under the matching principle, the grants should have been allocated to the year for which they were applicable. However, under the existing and proposed accounting standards five payments are recognised in the year in which the first advance payment was made, and three payments in the year in which this was unwound. If the matching principle had been applied, four payments would be recognised each year.

These grants have no conditions attached, and are non-refundable. Theoretically, there is also nothing stopping a Council spending the money paid in advance in the year it was received, but when the moneys are deposited into bank accounts at 4.00pm on 30 June this is impractical.

The problems with the cash treatment of these FAG moneys is that it throws the Council operating results around considerably. Councils face ratepayer hostility for increasing rates when their financial statements artificially show a large operating surplus for the prior year, rather than reflecting the economic reality. Our Association has made considerable efforts to encourage Councils to improve their financial sustainability, and for elected Councillors to understand their financial statements.

In effect, the premature recognition of these revenues makes a mockery of the financial statements and the accounting profession. The following graph illustrates the dramatic difference between the reported operating result of a Council over time, using the current accounting standards versus application of full matching of revenue and expenses.



The Mayor of that Council has provided the following commentary about this:

Local government represents the community. As the closest level of government to the community, it is in a unique position to identify community needs and make sure that those needs are met in the most appropriate way.

Financial and annual reports play a considerable role in helping Councils communicate their achievements, demonstrate where they have made a difference and let their ratepayers know how their monies have been utilised. The financial

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disclosures made in the financial statements help form an opinion as to the ongoing sustainability of a Council.

One issue that distorts these results is the recognition and timeliness of revenue for the Federal Assistance Grant (FAGS). The current Accounting Standards mandate that NFP's i.e. Councils record this amount as revenue upon receipt as the monies are considered non-reciprocal in nature. (AASB 1004 – Contributions). In the Private Sector which most people are familiar with, a matching principle is applied whereby the revenue is recognised in the year that expenditure is to be incurred.

With the exception of the 30 June 2014 and 2015 financial years, Councils have been regularly receiving advance FAGS payments in the week before the 30 June balance date which inflates the current year results and undermines the results for subsequent years. The impact upon a Council's financial results is so difficult to explain to the community that already struggle with the interpretation of financial statements.

I challenge this approach and wholeheartedly believe that advance FAGS grants should have the "matching principle" applied and as such the revenue should be applied on systematic basis over the periods in which the entity recognises as expenses the related costs for which the grants are intended to compensate. This approach will ensure in ensuring that financial statements remain relevant for the community and more accurately reflect the state of play within Council.

I support and applaud that the relevant authorities make a submission to the Australian Accounting Standards Review Board, to amalgamate Accounting Standards AASB 1004 Contributions and AASB 120 Accounting for Government Grants and Disclosure of Government Assistance, to include that the recognition of grant revenue is deferred until earned.

Mayor Graeme Scheu

Goondiwindi Regional Council

22 July 2015.

3. Exposure Draft Questions

3.1 Replacing the Reciprocal/Non-reciprocal Transfer Distinction

- . *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.*

Response: The Association supports this change. A performance obligation approach is preferable to the reciprocity approach, since it better applies the matching principle.

3.2 Sufficiently Specific Test

- . *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 para IG13 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.*
- .

Response: The Association supports this change.

3.3 Donation requirements

- . *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?*
- .

Response: The Association supports this change. However, this is more relevant to charitable organisations than Local Governments.

3.4 Volunteer Services

- . *In relation to the AASB's proposals to:*
- . *(a) permit any not-for-profit entity to recognise volunteer services as income if the fair value of those services can be measured reliably; and*
- . *(b) 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:*

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- . (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.)

Response: The Association supports this change. However, this is more relevant to charitable organisations than Local Governments.

3.5 Inventory Donations

- . 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?

Response: The Association supports this change. However, this is more relevant to charitable organisations than Local Governments.

3.6 Contributions by Owners

- . 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.)

Response: The definition of 'ownership contributions' in the Public Sector Conceptual Framework issued by the International Public Sector Accounting Standards Board is preferable.

3.7 Contributions by Owners

- . 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

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Conclusions.)

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

Response: The Association supports the proposed changes in ED260.

3.8 Government Department Appropriations

- . *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 (ie 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.)*

Response: This is more relevant to Government Departments than Local Governments.

3.9 Transition Provisions

- . *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.)*

. **Response:** The Association supports this change.

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3.10 Other Regulatory Circumstances

- . *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).*

Response: The Association reiterates the need for a revenues to be matched with expenses for non-contract matters, such as untied Financial Assistance Grants labelled for a particular financial year.

3.11 Usefulness of Financial Statements

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

Response: Our main concern is with ensuring that the financial statements reflect the economic reality of a Council's financial situation. This requires full application of the matching principle, even where there are no conditions attached to the income, no contractual obligation, but where it is clear that the financial year applicable to the income is not necessarily when the moneys are received.

4. Our Suggestion

Overall, ED260 is a vast improvement on the current standards, which effectively apply cash accounting concepts to some of the main Local Government revenue items, and is counter to the AASB's matching principle.

However, the new proposals do not go far enough in fully applying the matching principle, particularly in relation to unconditional government grants which are labelled for a particular year but received at the end of the prior year.



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Recognition of Revenue by Council's

Local government represents the community. As the closest level of government to the community, it is in a unique position to identify community needs and make sure that those needs are met in the most appropriate way.

Financial and annual reports play a considerable role in helping Councils communicate their achievements, demonstrate where they have made a difference and let their ratepayers know how their monies have been utilised. The financial disclosures made in the financial statements help form an opinion as to the ongoing sustainability of a Council.

One issue that distorts these results is the recognition and timeliness of revenue for programs such as the Federal Assistance Grant (FAGS). The current Accounting Standards mandate that Councils record this amount as revenue upon receipt of the funds as the monies are considered non-reciprocal in nature. (AASB 1004 – Contributions). In the private sector which most people are familiar with, a matching principle is applied whereby the revenue is recognised in the year that expenditure is to be incurred.

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Mayor Graeme Scheu

Dated 22 July 2015.