

NSW TREASURY AEIFRS UPDATE - 2 JUNE 2005

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May you live in interesting times.....

Environment of Accounting Standards: Now and in the future

- ❑ Promised principles-based (including substance over form) -- yet rule-based continues
 - Options in standards
 - Mixed measurement models eg financial instruments and fixed assets
- ❑ A 'Framework' -- yet fundamental concepts being challenged because we live in an information era but standards are based in an industrial era
 - Unbundling rights & obligations in *AASB 139* & *AASB 117* but not in *Concession Agreements*
 - Comprehensive Income
- ❑ Promised a stable platform, but changes since and numerous changes in the pipeline
 - AASB139 fair value option
 - IFRS / FASB Convergence project by 2009
- ❑ IFRS convergence in Australia
 - yet additional Australian paragraphs
 - AASB 3 *Business Combinations* scope changed, now being reversed
- ❑ An environment of changed influence
 - I-FRS or US-FRS
 - I-IFRS private-sector, public-listed focus vs AEIFRS sector-neutral
 - Influence of major capital markets eg USA & EU
 - Influence of Big 4 international desks
 - Influence of Governments
 - Influence of SEC & ASIC
 - Changed roles of standard setters – draft MOU
 - Opportunities for National standard setters in
 - ~ Research projects (IASB staff guidance)
 - ~ Active projects (direction by IASB or FASB staff)
 - Reduced influence of National standard setters
 - IFRS going beyond interpreting eg Service Concessions
 - IASB & IFRIC agenda committees set priorities eg AASB 139

State of Play

Background: Two simultaneous issues for the Public Sector

- ❑ AEIFRS & GFS/GAAP Harmonisation are strategic directives by the Financial Reporting Council (FRC) to the AASB
- ❑ AEIFRS applies from 2005-06 financial year
- ❑ GFS/GAAP harmonisation standard
 - expected to apply for 2006-07 year but early adoption permitted; & only applies at Sector level
 - applies to financial reports. But intent is that Budget and Outcomes Reports be on the same basis.

Reasons to converge

- ❑ Convergence with IFRS because
 - High quality, comparable financial reporting that is globally accepted
 - Needed for global capital markets
- ❑ GFS/GAAP Convergence to achieve

“ a single set of Government reports in which the Outcomes Report is directly comparable with the relevant Budget Statements”

Are we there yet ????

- ❑ IFRS stable platform issued
 - IFRS 31 March 04
 - AEIFRS July 04
- ❑ GAAP/GFS ED currently being debated by AASB
 - ED expected soon
 - Proposed commencement in 2006-07 but early adoption in 2005-06 permitted
- ❑ BUT the stable platform is already being amended eg
 - AASB 139 fair value option
 - Others – see later
- ❑ AEIFRS
 - applied in 2005-06 Budget
 - will apply in 2005-06 financial reports
- ❑ GFS/GAAP harmonisation
 - 2005-06 Budget
 - Options in AEIFRS that harmonised with GFS were adopted (based on ‘indicative mandates’)
 - GFS/GAAP harmonised format not adopted
 - 2005-06 Financial Reports
 - Will apply both: ‘mandated’ options and
 - ~ GFS/GAAP
 - ~ harmonised format of (expected) standard at Sector level

Treasury's Strategies

Treasury's strategies to implement AEIFRS

- Assess implications AEIFRS & GFS/GAAP:
 - on *Budget Result and Net Financial Liabilities*
 - Data collection, systems, training needs and resources
- Communicate implications to stakeholders, especially Ministers & CEOs
- Make high level policy decisions as early as possible
- Develop agencies' understanding by:
 - Web site including *Treasury Analyses*
 - Seminar presentations
 - Developing policies & guidance
- Implement AEIFRS and GFS concurrently, *if possible*, so that change only occurs once

What have we done to date?

- ✓ Assessed major impacts of AEIFRS & GFS/GAAP
- ✓ Communicated implications to stakeholders, especially Ministers and CEOs
- ? Made high level policy decisions as early as possible – some debate
 - ✓ Issued Indicative Mandates for options
 - ✓ Issuing revised policies and guidance reflecting mandates
- ✓ Developed agencies' understanding by:
 - ✓ Website including *Treasury Analyses*
 - ✓ Seminar presentations – 2003, 2004 and today
- ✓ Commenced concurrent implementation of AEIFRS and GFS
 - ✓ 2005-06 Budget Papers
 - ✓ Estimated 1 July 05 impacts
- ✓ Avoided potential impacts ???

Treasury's Accounting Policy Role and Strategies

- Role similar to an Accounting Standard Setter, in that we determine policies, mandate options and provide guidance
- Our role is to advise the Government (Ministers & CEOs)
- Beyond that, it is the responsibility of agencies to
 - implement the standards, the policies, & mandates
 - exercise professional judgement
- But we take a more active role with significant issues, eg:
 - Issues material at State level
 - Issues generic across a number of agencies
 - Contentious issues that could lead to audit qualification
 - To advise agencies, we must be adequately briefed

Why do we mandate?

- Consistency in Consolidated Financial Statements & Budget
- Harmony with GFS
- Adopting a consistent principle i.e. fair value
- Comparability between entities

The Transition to AEIFRS

Implementation Timetable

Step	Milestone
<i>Agency - Submit changes to draft opening AEIFRS Balance Sheet at 1/7/04</i>	<i>30 June 05</i>
<i>Treasury - Issue suggested AASB 1047 30/6/05 note disclosure</i>	<i>June 05</i>
<i>Treasury issues mandates, policies and guidance, where possible</i>	<i>30 June 05</i>
<i>Audit Office audits 1/7/04 opening balance sheets</i>	<i>30 June 05</i>
<i>Agencies prepare & submit 2004/05 financial reports on AGAAP basis, including AASB 1047 disclosures</i>	<i>Jul/August 05</i>
<i>Agencies prepare & submit 2004/05 AEIFRS primary financial statements</i>	<i>August 05</i>
<i>Treasury monitors developments during 05-06 and advises on impacts, mandates and policies</i>	<i>Continuous to 30 June 06</i>
<i>Agencies prepare full 2004/05 AEIFRS financial report including additional note disclosures (for comparative purposes)</i>	<i>Dec 05</i>
<i>Agencies prepare first AEIFRS financial reports</i>	<i>Jul/August 06</i>

Major impacts of adopting AEIFRS

Introduction

- Principles of first time adoption
- Significant impacts in 2005/06
- Other future significant impacts

Principles of first time adoption (AASB 1)

- Requires full retrospective application
 - First year – 2005/06
 - Restate comparatives for 2004/05 (except AASB 132 & AASB 139)
 - Date of transition – 1 July 2004 (AASB 132 & AASB 139 – 1 July 2005)
 - Opening balance sheet at 1 July 2004
 - Same accounting policies for 2004/05 & 05/06
 - Overrides transitional provisions of individual Standards

- AASB 1 exemptions available only if entities make an explicit & unreserved statement of compliance with AEIFRS.
- Separate requirement to disclose compliance with IFRS (Para 14 AASB 101)
 - 'For-profit' entities will be able
 - 'Not-for-profit' entities will not
- Initial adjustments
 - De-recognise A&L if not permitted by AEIFRS e.g. research costs
 - Recognise new A&L not permitted under previous GAAP e.g. restoration costs
 - Reclassify previous GAAP opening balance sheet e.g. investment property & intangibles
 - Measure A&L based on AEIFRS e.g. super
- Adjustments to RE at date of transition
- There are exceptions to requirement for retrospective application from date of transition:
 - optional exemptions/elections - Treasury indicative mandates for all options:
 - e.g. financial instruments deferral option
 - mandatory exemptions i.e. require prospective application:
 - prospective hedge accounting
 - de-recognition of financial assets and liabilities
 - estimates

Significant impacts for Total State Sector

- Major impacts in 2005/06
- Deferred standards – eg grants, financial instruments & comprehensive income
- Anticipated impacts on income of future periods
- \$6 billion increase defined benefit scheme superannuation liability:
 - change in discount rate to the government bond rate
 - impacts on all agencies whose liability is not assumed by the Crown

Significant impacts – 'sectors' & Total State Sector

- \$3.6 billion increase in Crown's accrual of deferred income tax assets from PTEs:
 - income tax balance sheet approach
 - different recognised tax assets and liabilities.
- Offset by equivalent liability in PTE sector.
- Eliminated on consolidation in Total State Sector Accounts.

Significant impacts for GGS & PTEs (\$m)

Adjustments to accumulated funds	GGS	PTEs
Investment properties – write back Asset Revaluation Reserve (AASB 140)	162	263
Restoration obligations (AASB 116)	19	1
Effect of valuing assets individually rather than by class (AASB 116) – For Profit Entities	(16)	(26)
Asset Revaluation Reserve adjustments		
Derecognition & reclassification of intangible assets (AASB 138)	-	(25)

Balance sheet reclassifications	GGS	PTEs
Investment properties (AASB 140)	643	1,042
Intangibles (AASB 138)		
Easements	-	527
Software	195	247
Emission rights	-	39
Other	10	45
Total	205	858
Assets held for sale (AASB 5)	60	63

Future significant impacts for agencies:

- Grants – potential amendments to revenue recognition
- Financial instruments (e.g. derivatives) - deferred:
 - 2005-06 Budget exclude the impact
 - no impact on 2004/05 (ex post) AEIFRS comparatives
- Higher income volatility particularly for 'for-profit' entities:
 - financial instruments
 - superannuation
 - investment property

Summary

- Accounting changes for:
 - Budget
 - Ex post general purpose financial report
- Financial implications
- Potential impacts:
 - Future changes – grants & financial instruments
 - Fair value – investment property & financial instruments

Disclosure

Introduction

- AASB 1047 -- 30 June 2005 under AGAAP
- Model Financial Statements, including the Financial Reporting Code
- AEIFRS disclosure for 2005-06

AASB 1047 Note Disclosure

For year ending 30 June 2005:

- Any known or reliably estimable information about impacts had the report been prepared under AEIFRS;
or
- If impacts not known or reliably estimable, a statement to that effect.

What AASB 1047 says about the format.....

- ????? Nothing – the format is not prescribed – so Treasury has issued a Circular with an example to assist
- Agencies must provide enough information so that impacts can be understood by the user and reader
- Judgement required on presentation.....to suit agencies' individual circumstances

Reconciliation of equity from AGAAP to AEIFRS

	Notes	30/06/05 \$000	1/7/04 \$000
Total equity under AGAAP		X	X
Adjustments to accumulated funds			
Recognition of major inspection costs	1		
Recognition of restoration costs	2		
Derecognition of intangible assets	3		
Adjustments to other reserves			
Write back asset revaluation reserve for intangibles	3		
Total equity under AEIFRS		Y	Y

Reconciliation of surplus/(deficit) from AGAAP to AEIFRS

Year ended 30 June 2005	Notes	\$000
Surplus/deficit under AGAAP		X
Major inspection costs	1	
Restoration costs	2	
Research costs expensed	3	
Surplus/(deficit) under AEIFRS		Y

Importance of disclosing uncertainty

- See Treasury's suggested wording on this.....
- Amounts disclosed are best estimates
- Why the actual figures may change from the estimates:
 - Pending changes to AEIFRS (including UIGs)
 - Emerging accepted practice in interpretation and application
 - Proposed standard designed to harmonise the standards and GFS

Model Financial Statements

2004/05

- Budget dependent agencies
 - Agencies should use existing Financial Reporting Code
 - No changes – except for AASB 1047 Disclosure
- Non-budget dependent agencies
 - Existing AGAAP, including AASB 1047 Disclosure

2005/06

- That's next year.....why talk about it now?
 - Comparatives
 - Disclosure differences
 - Changes to primary statements
 - Additional disclosure
 - Totally new concepts
- Need to start preparing **NOW!**

2005/06

- Budget dependent agencies
 - ED on AAS 29 not expected to issue until 2nd Qtr 2006
 - Draft Financial Reporting Code for 2005/06 under AEIFRS available soon
- Non-budget dependent agencies
 - Refer to model statements available from accounting firms' websites

AASB 101 Disclosures for 2005/06

Primary financial statements: main differences from AGAAP

- Income statement (or operating statement for AAS 29 entities)
 - Format not as restrictive
 - No extraordinary items (AASB 101.85)
 - Offsetting gains and losses on disposals (AASB 101.34(a)) (not a change for AAS 29 entities)
- Balance Sheet
 - Mixed format permitted (both current / non-current and liquidity) only in certain circumstances, **but**
 - the Code requires current/non-current
 - GFS/GAAP harmonisation is outstanding: it may use a liquidity format
 - Current / non-current classification of liabilities
 - additional criteria for “current”
 - after balance date events are ignored
- New Statement of Changes in Equity
 - AASB 101 requires 2 statements to show performance and equity
 - But at the GGS level, comprehensive income is likely to be early adopted in 2005/06 as part of GFS/GAAP convergence
 - Recycling permitted in some circumstances

Disclosures under AEIFRS

- Cover areas not in IFRS, including:
 - Australian definitions (eg not-for-profit entities)
 - Australian disclosures (mainly retained from the past)
 - Australian-specific Standards (eg AAS 29 for government departments)

New disclosures

- Judgements (apart from estimations) made in applying accounting policies that have the **most significant effect** on financial report (AASB 101.113)

Examples:

“The agency has determined that XYZ lease is an operating lease rather than a finance lease because....”

“The agency has capitalised development expenditure on Y because.....”

- Key **assumptions** concerning the future, and other key sources of **estimation** uncertainty that may cause a material adjustment to carrying amounts of assets and liabilities (AASB 101.116).

Examples:

“Assumptions used to calculate the provision for expected warranty claims on products sold were based on current sales levels and current information available about returns.”

or....discount rates used for estimating provisions

or....estimating the useful life of assets

New disclosures in numerous other standards

- Unfunded superannuation (AASB 119.120-125)
- Investment Property (AASB 140.75-76)
- Assets held for sale or disposal (AASB 5.30-42)
- Extra disclosure by *for-profit* entities (but **not** for *not-for profit* entities) for revalued assets (AASB 116.77(e))
- Non-financial disclosures; eg financial risk management objectives and policies (AASB 132.56-59)
- Still **more** disclosure requirements! Refer to disclosure checklists

Disclosure Recap

2004/05

- AASB 1047 – refer to Treasury Circular

2005/06 - START PREPARING NOW!!

- Financial Statements format
 - Budget-dependent GGS use the Financial Reporting Code
 - other agencies may refer to model statements from private sector
- Additional disclosures – be prepared to disclose much more information than in the past

GOOD LUCK!

For-profit/Not-for profit classification

- Impact of the FP / NFP classification
- Background - definition of a not-for-profit entity
- Additional guidance – draft HOTARAC policy
- Comparison with Treasury's previous approach
- Responsibility for FP / NFP classification

Classification impacts on

- Asset valuation – Non-cash generating assets of NFP entities effectively exempted from impairment testing
- Grants – AASB 120 (FP) versus AASB 1004 (NFP)
- Investment Property – Excludes property held by NFP entities to meet service delivery objectives
- Assets received at nominal consideration measured at fair value by NFP entities (e.g. Inventories, PP&E, Intangibles, Investment Property) versus AASB 120 for FP entities
- Related party disclosures – AASB 124 applies to FP entities only
- Other disclosures – e.g. NFP entities will not be able to make an explicit and unreserved statement of compliance with IFRS under AASB 101

Background – definitions in Standards

- Not-for-profit entity is an entity *whose principal objective is not the generation of profit* – AASB 136, para Aus6.2.
- Previously (per AASB 1010), a not-for-profit entity meant an entity whose financial objectives did not include the generation of profit

Additional Guidance

- Across Australian jurisdictions differing interpretations existed
- Therefore, additional guidance required
- BUT ultimately professional judgement must be exercised
- HOTARAC policy will be endorsed shortly and issued as Treasury policy to apply from 1 July 2005, with AEIFRS

Draft HOTARAC policy – overall approach

- Classification relevant for financial reporting purposes only
- Does not overrule
 - GFS Budget classification

- Legal requirements e.g. to pay a dividend
- Social obligations of an entity
- Substance rather than legal form
- Does not replace professional judgement
- No single factor conclusively determines status of an entity. Need to assess a number of factors, considered together

Factors to consider

- Statements by owners about objectives of the entity
- Governance framework applied to the entity
- Purpose, nature and extent of funding from owners
- Targeted financial performance of the entity, agreed between owners and board/management
- Classification under Government Finance Statistics (GFS)

Statements about the objectives of the entity

- Explicit statements in legislation of “principal”, “main” or “sole” objectives, provide a strong rebuttable presumption
- Rebuttable presumption may be overturned, if other factors provide sufficient contrary evidence
- Legislation may be ambiguous e.g. there may be a number of objectives and the principal objective may be unclear
- Consider other statements about objectives in shareholder resolutions, entity’s constitution AND other factors

Governance framework – extent that private sector type frameworks apply

- Commercially sound legal and corporate capital structures
- SCI / charter referring to making of profits
- Monitoring performance against financial targets
- Provides for payment of dividends and income tax
- Separation of ownership, shareholding Ministers, Board and Management
- Contractual relationship and funding for CSOs

Purpose, nature and extent of funding from owners

- For profit entities - receive CSO payments i.e. delivery of social benefits in the form of specified outputs
- Not-for-profit entities - receive appropriations, grants & subsidies
- Substance of funding rather than legal form

- ❑ Consider:
 - Whether funding is on-going or only during early years
 - % of expenditure funded by owners on an on-going basis

Targeted financial performance of the entity

- ❑ Targeted profit or returns (e.g. appropriate for the industry) provides evidence that an entity is for-profit
- ❑ Intention rather than actual profits / returns is important
 - Losses over a number of periods is not inconsistent with having profit as the main objective
 - Profit over a number of periods does not prevent an entity from being classified as not-for-profit
- ❑ Existence of cash generating unit (CGU) does not necessarily mean entity is for-profit

Classification under GFS

- ❑ GFS classification provides evidence of an entity's status, i.e.
 - General Government Sector entities are normally NFP
 - Public Trading Entities are normally FP
- ❑ BUT the GFS classification is not conclusive because GFS uses a different definition to the FP / NFP definitions

Comparison with Treasury's previous approach

- ❑ In principle, the draft HOTARAC policy is no different to the approach taken in the 2003 Asset Valuation Guidelines (TPP 03-02)
- ❑ Therefore, the FP / NFP classification should not change, UNLESS:
 - An entity's external circumstances have changed; OR
 - There has been a reconstruction within the public sector

Agency Responsibility

- ❑ The for-profit / not-for-profit classification is ultimately an agency responsibility
- ❑ Any change in classification must be supported by a brief, in consultation with Treasury, where necessary, that considers the factors discussed

Summary

- ❑ The FP / NFP classification impacts more significantly than in the past
- ❑ Classification must consider all available evidence and the overall substance of the entity
- ❑ The FP / NFP classification is ultimately an agency responsibility; BUT Treasury should be consulted, where necessary

Asset valuation and capitalisation

Main differences / Implications

- Background - Treasury's draft Asset Valuation & Capitalisation Policies
- Two step process to fair value
- Income approach for specialised assets, in the absence of market evidence
- Expanded discussion on impairment
- What is an "asset" for offsetting asset revaluation increments / decrements – for-profit entities only
- Restoration costs
- Major inspection costs
- Capitalisation thresholds & disclosures
- Instructions to valuers

Background

Treasury's draft Asset Valuation & Capitalisation Policies (apply from 1/7/05, with AEIFRS)

- Policy incorporates guidance not provided in AASB 116 & AASB 136 including:
 - AASB Guidance to AASB 116 which accompanies but is not part of the Standard; &
 - Additional Treasury Guidance to address public sector issues, including clarified decision tree
- For most entities no material difference to previous policies, which already incorporated the principles, based on exposure drafts to the current AASB 136

Two step process to fair value

AEIFRS compared to previous AGAAP

- Previous AASB 1041 is now split into two steps
- Step 1 - AASB 116 – fair value, subject to AASB 136
 - Fair value based on market based evidence, if available
 - If not available, use either:
 - depreciated replacement cost or
 - income approach
- Step 2 Impairment per AASB 136 replicating AASB1041 RAT
 - Assess whether indication of impairment annually
 - Write down to Recoverable Amount
 - i.e. higher of fair value less selling & value-in-use

AASB 116 income approach

Why should an income approach not be used for specialised assets?

- Policy states that specialised assets must be valued at depreciated replacement cost (not an income approach)
- Because DRC is most relevant in the public sector, where:
 - there is no feasible alternative use (must be replaced); &
 - assets are specialised; ie market selling price cannot be observed
- Fair value differs from value in use. AASB 116/AASB 136 based on two-step approach
- Alternative views exist
 - price regulation provides market evidence for an incomes approach, versus
 - most say an incomes approach is most frequently used for commercial property, not specialised assets.
- Treasury thinks 'no solution fits all purposes'
 - Valuation becomes circular & price regulation may be too low, eroding economic capacity
 - Pragmatic solution – need both for valuation
 - DRC is the 'ceiling' and value in use the 'floor'

Current developments regarding fair value

- FASB – ED proposed to apply on / after 15 June 05
 - In absence of quoted prices, use *single* or *multiple relevant* valuation techniques (market, incomes & cost), emphasising relevant market inputs.
 - Where no observable markets, use hypothetical (ie input prices)
- IASB – Discussion Paper
 - Prepared by Canadian ASB
 - Some recommendations differ from FASB

Additional Impairment guidance

Impact of AASB 136 will, in part, depend on whether FP or NFP entity

- “Value in use” is defined as the present value of future net cash inflows, except as below
- All assets of a FP entity belong to one or more CGU/s
- But, for NFP entities, “value in use is depreciated replacement cost for assets that are not primarily dependent on the ability to generate net cash inflows....”
- In short, such assets of NFP are exempt from AASB 136

Extensive AASB 136 guidance is provided

- Impairment indicators – external and internal
- What constitutes a CGU
- Elements in calculating value in use
 - Determining net cash inflows of a CGU

- Discounting future cash flows
 - Treasury Policy requires the use of WACC
 - Other additional Treasury Guidance; eg pre versus post tax WACC

Accounting for asset revaluation changes

What is an “asset” for revaluation purposes – for-profit entities?

- For-profit entities must account for changes in ARR on an individual “asset” basis (NOT class basis), which may negatively impact equity at date of transition
- AASB 116 does not prescribe unit of measure of an asset. But, an “asset” (not a “part of an asset”) is the basis for changes in the ARR
- Therefore, the Policy advises that the asset is the complex asset (not its parts). This reduces any negative impact.
- Parts of assets must still be separately depreciated, where materially different useful lives
- Professional judgement is required in determining the unit of measure; ie the “asset”, not “part” of an asset
- Treasury policy provides guidance; ie to consider the following issues:
 - How the business is managed; eg how performance managed / monitored, regulatory approach
 - What is an operating asset; eg
 - Whether an item has utility by itself or in conjunction with other items;
 - What would be aggregated for purpose of disposal
- Examples
 - Water entity may have 3 assets – water delivery, sewerage and drainage
 - Electricity distributor may have only one complex asset

Restoration Costs

Where there is a legal or constructive obligation

- Recognise restoration provision as a liability if
 - Legal or constructive obligation (AASB 137)
 - Reliably measured
 - Material in NPV terms - AASB 1031 *Materiality*
- Accounting treatment
 - if a liability recognised for restoration costs
 - then capitalise to PP&E (& depreciate it) (AASB 116 para 16 (c))

Feedback from agencies

- Most agencies have not recognised a liability, arguing:
 - Liability (legal or constructive) does not exist
 - Environmentally damaged land has been sold
 - Cannot be reliably estimated
 - NPV is immaterial because of extensive life of infrastructure

- Treasury's view is that agencies should:
 - exercise judgement
 - support treatment with well developed rationale
 - consider that the land value may have been reduced whether a liability exists or not

Where there is NO legal or constructive obligation

- Where no feasible alternative use, 'existing use' valuation should:
 - reflect environmental damage in fair value
 - exclude costs necessary to prepare site for alternative use
- 'Highest & best use' valuation – where there are feasible alternative uses:
 - fair value is net of costs to achieve alternative use

Major Inspection Costs

Accounting treatment under AASB 116

- Cost of PP&E includes cost of major inspections, as a replacement, whether originally identified when acquired
- This means that major inspection costs are reallocated as a portion of the recognised value (rather than being added to the cost or fair value as restoration costs are)
- Represents only labour costs as distinct from the cost of physical parts that may be replaced

Comparison with Major Periodic Maintenance (MPM) under Capitalisation Policy

- This represents a change from the previous treatment of MPM (TPP 00-3). Previously, MPM was:
 1. Capitalised – where it represented a separately identifiable physical component asset – no change
 2. Expensed – where it could not be separately identified as a physical component asset
- Under AASB 116, labour costs associated with (2) above, can now be capitalised, where recognition criteria satisfied

Feedback from agencies

- Few agencies are recognising major inspection costs, because regarded as
 - incidental to plant overhauls or
 - not material
- Treasury is of the view that agencies should:
 - exercise professional judgement
 - support treatment by well developed rationale

Capitalisation Thresholds

Guidance Only!

- Capitalise physical non-current assets with cost > \$10,000
- Expense assets with cost < \$1,000
- Use professional judgement for those in between, based on materiality
- Assets that form part of a network should be aggregated

Guidance Only!

Instructions to Valuers

Agencies must determine basis for valuations

- The increase in number of Standards impacting on valuation treatment (AASB 116, AASB 136, AASB 138, AASB 140 & AASB 5) means that it is important to determine the correct basis for the valuation
- It is the primary responsibility of the agency to determine the basis for the valuation and adequately instruct the valuer

Agencies to provide instructions to valuers in the following areas

- Whether assets are to be valued at *highest & best use* or *existing use* (based on feasible alternative uses criteria)
- Existence of any contamination / damage to property including (but not limited to) areas where there is a legal or constructive obligation
- Different categories of assets to be valued e.g. heritage assets, assets held for sale, investment property, easements etc

Asset Valuation and Capitalisation

Summary

- For most entities there will be no material differences arising, except in limited areas i.e.
 - For-profit entities – treatment of ARR increments and decrements
 - Restoration costs & major inspection costs
 - Reclassifications and different treatment for investment property, assets held for sale and intangible assets

Financial Instruments

Introduction

- Financial instruments
- Embedded derivatives
- Interest free or non-commercial loans
- Current proposed amendments to Fair Value Option

Key Points

- Broad definition – most financial transactions unless covered by other standards; eg AASB 119 & AASB 138
- Includes FI previously off-balance sheet:
 - derivatives & embedded derivatives
 - fair value impact of interest free or non-commercial loans
- Mixed measurement model
- Current proposed amendments to Fair Value Option
 - issue of whether amendment will comply with GFS

What are derivatives and embedded derivatives:

- Characteristics of a **Derivative**:
 - value varies in response to change in variables eg CPI;
 - no/ small initial net investment; &
 - settled at a future date.
- Indicators of an **Embedded Derivative**:
 - meets derivative definition on a stand alone basis.
 - changes the nature of the transaction.
 - economic substance & risks not closely related to host contract.

Embedded derivatives – examples:

- Coal purchase contracts linked to Singapore oil prices
 - purchase price of raw material linked to a substitute
- Electricity supply contracts linked to aluminium prices
 - price of key input linked to customer's product price

- Contract price denominated in foreign currency which is not the functional currency of parties to transaction

Example where it is not an Embedded Derivative:

- Contrast to CPI indexed contract price – not embedded derivative if reflects cost of goods/services

Embedded Derivatives – accounting treatment:

- Separately accounted for as a derivative:
 - on first time adoption; or
 - when entity first becomes a party to the contract.Subsequent re-assessment prohibited (IFRIC D15)
- Option - FV entire instrument, if separate recognition would:
 - be more complex; or
 - result in less reliable measures (para 12 & AG33A IAS 39)

Existence of Identified Embedded Derivatives

- Concern raised – alleged extensive existence of embedded derivatives in an Australian jurisdiction
- Contrary to:
 - advice from the above jurisdiction
 - Treasury's experience to date
- Exercise professional judgement to support assessment – ie strategic & risk management approach

Interest free or non commercial loans

- Initial recognition:
 - interest free loans at fair value
 - foregone interest (interest free or concessional component) as a grant (para 43 & AG64 AASB 139)
- Subsequent measurement:
 - amortised cost using the effective interest method (para 46 AASB 139)
 - changes accounted for in profit or loss when impaired, derecognised or through amortisation process.

Hedge Accounting

- Accounting designation & documentation requirements before the date of transition (1 July 05)
 - contracts management & accounting system

- Hedge accounting can only be applied where:
 - AASB 139 requirements met; and
 - transactions previously designated as a hedge.
- General rule - applied prospectively
Para 28 AASB 1 & para IG60 AASB 139

Unresolved issues – near-final Draft Amendments to IAS 39: Fair Value Option

- Fair Value through profit or loss designation only available if:
 - FI managed & performance evaluated on a Fair Value basis:
 - documented risk management or investment strategy; and
 - information provided to key management (para 9); **OR**
 - Eliminates/significantly reduces accounting mismatch.
- Timing and documentation of designation requirements to adopt the fair value option
 - 'fair value through profit or loss' or 'available for sale designation' at the date of transition. (Optional exemption - para 25A AASB 1)
 - nothing to prevent this designation from occurring after 1 July 2005, but effective as at 1 July 2005 – ie:
 - no specific documentation requirements or effectiveness testing etc, required on or before the date of transition.

Summary

- Affects not just the electricity sector and TCorp
- Review contracts for embedded derivatives, even if rare
- Recognise interest free or non-commercial loans
- AASB 139 amendments

Grants

- Summary of major impacts
- NFP impacts - AAS 29, AASB 1004 & ED 125
 - Status & feedback from agencies
- FP impacts – current & proposed AASB 120
 - Status & feedback from agencies

Major Impacts

- Effect at 2005 is unclear; depends on timing of a number of projects
- Potential in future that proposals may delay revenue recognition

Grants – Not-for-Profit entities

Status

- Agencies required to apply AAS 29 & AASB 1004 – under AEIFRS, there is no change in treatment compared to the previous requirements
- However, there may be future changes based on ED 125
- There is uncertainty regarding the timing & impact of these amendments i.e. may or may not impact first AEIFRS 2005/06 financial report
- Agencies instructed by Treasury to apply the current requirements, as amendments have not yet been finalised

ED 125 proposals

- Distinction between in-substance agreements
 - For provision of goods and services
 - Revenue is recognised when good or service provided
 - That are NOT for the provision of goods or services
 - Revenue is recognised when conditions met or when grant is enforceable
- Potential for delay in revenue recognition
- Conditions versus restrictions
 - Restrictions limit the use of assets
 - do not give rise to a liability
 - Conditions are future events that trigger a right of compensation or return
 - may give rise to a liability
 - “Time” may be a restriction or a condition

When does a liability arise under ED 125?

- A liability will arise where an entity has no discretion to avoid an obligation.
- A liability may arise where an agreement has the following features:
 - Specification of what is being provided; and
 - Reliable acquittal process (or enforceable conditions); and
 - Right to refuse payment / demand repayment, if acquittal process below agreed standard

Factors to consider when assessing whether a liability exists

- Substance over form – terms must operate *in practice* i.e. right of repayment is exercised
- Probability - trivial conditions that are likely to be satisfied do not give rise to a liability
- Grant is paid in arrears or in advance – when transferred in arrears no liability arises

Feedback received from agencies

- Most agencies have concluded that no liability (or asset) arises from grants
- BUT** more work is required!!

Recent developments – AASB and IPSASB

- AASB is considering draft IPSASB ED on Non-Exchange Revenue Transactions
- The AASB is currently considering Australian Guidance to AASB 1004, based on ED 125 proposals
 - As a result, ED 125 may impact the first AEIFRS 2005/06 financial report!

Grants – For-Profit entities

Status – Current AASB 120 “Government Grants”

- Current AASB 120 may delay revenue recognition
 - Grants must be recognised as income over the period necessary to match related costs; or when receivable, where there are no related costs
 - BUT recognise as income only when there is reasonable assurance the entity will comply with conditions and the grant will be received
- Non-monetary grants recognised at fair value
- “Grants” narrowly defined to exclude fee for service type arrangements

Status – Proposed amendments to AASB 120 based on AASB 141

- Conditional grants recognised as revenue only when conditions met
- Time is a condition
- Uncertainty regarding timing and impact of these amendments – Exposure Draft due Quarter 2, 2005
- Agencies instructed by Treasury to adopt the current AASB 120, as proposed amendments are not yet available

Feedback received from agencies

- Impact of adopting AASB 120 is minimal, because the treatment of
 - Developer contributions is substantively unchanged and is covered separately in UIG 1017
 - Community service obligations is substantively unchanged as they are generally cost reimbursements

Summary

- Grants is an area of significant uncertainty
- Revenue recognition may be delayed
- Take action now!!
 - Consider “substance” rather than “form”
 - Monitor current developments

Recent Developments and What's Next?

Recent Developments

- Service concession / BOOT agreements
- Business combinations
- Unfunded superannuation – change in discount rate
- Tax effect of superannuation
- Dividends – signing of SCI / SBI
- Fraud control

What's Next - Timetable and Watch List

Recent Developments

Service Concession Arrangements (BOOTS)

HOTARAC Policy – apply from 1/7/05, with AEIFRS

- Based on UK Standard FRS 5
- During concession, asset of Government or operator based on who has a majority of the risks & benefits
- Lease component shown separately
- Upfront payments recognised over the concession period
- Emerging Interest (asset)
 - recognise in income statement over concession period, on an annuity basis
 - revaluation adjustments to ARR (per AASB 116)

IFRIC D12 Service Concession Arrangements

- Control approach (para 5) applies when the Grantor:
 - Controls or regulates what services the operator must provide, to whom it must provide & at what price; &
 - controls residual interest at end of concession period.
 - applies only to the Operator, not the Government as grantor
- HOTARAC & UIG submissions oppose
 - control is linked to risks and benefits
 - regulation does not give control
 - not applying to counterparty is unprecedented

Business Combinations

ED 139: Proposed amendments

- Revert scope of AASB 3 to IFRS 3 ie exclude common control
 - AASB 3 and IFRS 3:
 - Business combination at fair value
 - If not business combination, write down assets to value of consideration – (\$nil if no consideration)
 - AASB 3 currently wider than IFRS 3 because IFRS 3 common control exemption EXCLUDED from AASB
- Replacement of term “contribution by owners” in standards & UIG 1038:
 - Because it created inconsistencies with IFRS
 - to be replaced by the term:
“Contributions by equity participants as equity participants”
- Ability to designate in UIG 1038 retained
- Effect on NSW Public Sector when ED 139 is issued:
 - AASB 3 will no longer apply to most business combinations within the Sector due to common control
 - AAS will be silent on valuation of “contributions by equity participants as equity participants”
 - UIG Interpretation 1038 will still permit designation
 - Treasury Circular 01/11 will still designate transactions as contributions and require their valuation at fair value
- In practice, no change

Unfunded Superannuation

Change in the AASB 119 discount rate

- The discount rate as at 1 July 2004 has changed for Pooled Fund entities, as a result of recent expert advice from both the valuing actuary and from tax consultants
- For agencies whose superannuation is NOT assumed by the Crown, this means:
 - Pillar will reissue revised 1/7/04 AASB 119 Super position statements by mid June 2005
 - Opening AEIFRS 1/7/04 balance sheet must be revised & re-submitted
- EISS scheme is not affected by the change in discount rate

Note disclosure information

- Further, for agencies whose super is NOT assumed by the Crown:
 - 30 June 2005 AEIFRS Superannuation Position statements – to issue late July 2005 for the AASB 1047 note disclosure
 - More detailed AASB 119 note disclosure information will be supplied to agencies by Pillar & EISS at a later date, in time for inclusion in the 2005/06 AEIFRS financial report

Tax effect of superannuation

Do superannuation balances result in temporary differences under AASB 112?

- Preliminary view “Yes”
- Reason – applying principle of AASB 112 para 26(a)
- Represents change from practice under AAS 3 (i.e. considered a permanent difference)

Provision for Dividends

Importance of signing SCI / SBI

- Only dividends “declared” before the reporting date can be recognised (under AASB 137 Provisions)
- “Declared” means appropriately authorised and no longer at the discretion of the entity
- Signed SCI/SBI means “Declared” (as per Treasury’s Indicative Mandates)
- IMPORTANT** that the SCI/SBI must be signed, at the latest, by the end of the financial year to which it relates

Fraud Control

Follow up to Audit Office Performance Audit

- Performance audit report Fraud Control – *Current Progress and Future Directions*
 - Report found agencies’ fraud control perception improving but not adequate
- Recommended that each audit committee review:
 - adequacy of processes supporting management representations on fraud to auditors
 - fraud control strategy against 10 attributes listed in the report

Treasury will:

- Make a minor amendment to *Public Finance and Audit Act 1983* s11 regarding internal controls to explicitly refer to fraud control
- Issue a circular to all agencies as a reminder
- Encourage all Public Sector organisations to address the report's recommendations

Extensive guidance on internal control and fraud control already widely available in NSW Public Sector (see websites)

Treasury, including:

- *Risk Management and Internal Control Toolkit (1997)*
- *Statement of Best Practice on Internal control and Internal Audit (1995)*

ICAC's 82 publications, including:

- *Pitfalls or Probity (1993)*

Audit Office:

- *Fraud Control (1994)*

What's next?

Timetable

Action	When
Agency – resolve outstanding AEIFRS issues	NOW!
Audit office audits 1/7/04 opening balance sheets	By 30 June 2005
Agency – revise and submit opening 1/7/04 AEIFRS balance sheet	30 June 2005
Agency – prepare and submit AGAAP 2004-05 financial report including AASB 1047 note disclosure	July/August 2005
Agency – prepare and submit AEIFRS 2004-05 primary financial statements	August 2005
Agency – prepare full 2004-05 AEIFRS financial report including additional note disclosures (for comparative purposes)	December 2005
Agency – prepare first AEIFRS financial report	July/August 2006

Watch List – monitor likely developments

- Financial instruments
- Grants
- Service concession arrangements
- GFS/GAAP convergence & Comprehensive Income
- IASB/FASB convergence
- Treasury's website –
 - <http://www.treasury.nsw.gov.au/ias/iasindx.htm>
- Other relevant websites – AASB & IASB

GFS/GAAP and Comprehensive Income

- ❑ GFS/GAAP ED is likely to be issued soon
 - Options in standards that harmonise already adopted and applied in 2005-06 Budget
 - But Comprehensive Income format not adopted
 - As drafted, only applies at Sector level, but ...?
 - To apply from 1/7/06 but early adoption permitted
- ❑ IASB *Performance Reporting*
 - Discussed since 2001
 - IASB / FASB convergence project – 2003
 - Project segmented – 2004
 - Part A - Convergence re- whether single comprehensive income statement
 - Part B - Fundamental reconsideration - disaggregation

Comprehensive Income Matrix

	Total	Income before re-measurements	Re-measurements
Business	xx	x	x
Financing	xx	x	x
Tax	xx		
Comprehensive income	xx		