

# **PROPOSED ACCOUNTING STANDARD**

## **FINANCIAL REPORTING BY LOCAL GOVERNMENTS**

**Submission by**

**DG & AB MAXWELL  
Consulting Accountants**



## **INTRODUCTION**

Our firm provides specialist financial and administration consulting services solely to Local Government throughout Australia, but principally within New South Wales. Our senior principal, David Maxwell is a Fellow of the Institute of Chartered Accountants and an Associate of Local Government Managers Australia with over 25 years experience as Local Government Auditor, Principal Accounting Officer, Chief Executive Officer and Consultant.

We have also developed a range of spreadsheet templates designed taking advantage of common features in computer mainframes to assist Council officers in the preparation of the Annual Financial Statements, and these are marketed under the name of Coalface Software Solutions. Our templates complying with the NSW Local Government Code of Accounting Practice and Financial Reporting are used by over 50% of the Councils in that State.

Coalface Software Solutions sponsors the NSW Annual Financial Statements Award presented by the NSW LGMA Financial Professionals Group, judges by nominees of the NSW Local Government Auditors Association, Finance Professionals Group and Coalface Software Solutions. We have recently forwarded a copy of the judges remarks for the 2002 Statements Award to staff of the Board.

## **RELIANCE ON REQUIREMENTS IN OTHER STANDARDS**

We support the proposal to rely on requirements in other Standards. Notwithstanding the “override” in the second clause of paragraph AAS27.13, this has been the practice generally adopted in NSW as new and revised Standards have issued.

## **CONFORMITY WITH OTHER ENTITIES**

We support the proposal to bring local government requirements into line with those for other entities. We submit that local government requirements should only differ in the rare instances where the nature of local government is such that compliance with general standards would result in disclosures that are actively misleading.

## **LOCAL GOVERNMENT AS A REPORTING ENTITY**

We support this proposal, provided the Standard continues to make explicit that the parent entity is not deemed to be a reporting entity<sup>1</sup>.

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1. In NSW, certain types of rates and charges are permitted to be utilised only for the purposes for which they were raised. Ledgers are therefore subdivided into individual “funds”, each “fund” levying charges where appropriate on other “funds” as if they were independent third parties. While separate financial reports are prepared for each fund for management purposes, the general purpose reports should combine all activities of the legal entity.



## ADDITIONAL LEGISLATIVE REQUIREMENTS

State governments have a penchant for requiring additional information to be disclosed in the Annual Financial Statements. In Victoria, the Minister has issued regulations which require compliance with AAS 22 “Related Party Disclosures”. In NSW, Environment Protection Authority interpretation of the EP&A Act require a particular form of disclosure of unexpended developer contributions, which is reported at Note 17 in the standard NSW reporting format.

We can envisage circumstances where a State government may legislate<sup>2</sup> that a certain disclosure or method of calculation be utilised in the preparation of the general purpose reports in conflict with the Standards. It would then be ludicrous to prepare two sets of “general purpose reports”, one complying with legislation and the other with the Standards. We submit that the Standard should stipulate that any conflicting information required by legislation be included in an Appendix to the general purpose reports prepared in accordance with the Standards.

## RESTRUCTURE OF LOCAL GOVERNMENTS

This is a particularly hot topic in NSW local government at the moment, and we attach a copy of the format we developed for inclusion in our NSW 2003 software package.

We concur with the proposal that the change in net assets be made by direct adjustment to equity. Most commonly such restructures are carried out by State Government decree against the expressed wishes of the local governments involved, and it therefore is inappropriate that the amounts be recognised as part of the local government’s *net result for the year*.

However, in relation to ED7.1(c), we submit that, where the acquiring entity adopts the transferor’s carrying amounts and those carrying amounts include assets to which AAS 38 applies, the Asset Revaluation Reserve should be adjusted to reflect the revaluation component of carrying values.

In the various restructures that have occurred in NSW local government in recent years, it has been characteristic that there is less than 60 days between gazettal of the restructure and the date of its effect. Except by chance, such a time frame is unlikely to permit a comprehensive assessment of the condition of all acquired assets, and the preparation of properly considered fair values, within the time available to comply with reporting deadlines. We submit that the Standard should permit the finalisation of these amounts within two reporting periods, or alternatively the proposal in ED17.1 would be acceptable.

We note that in 2002 Victorian local governments reported very substantial amounts as fundamental errors arising from the initial recognition of assets<sup>3</sup>.

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2. In this submission, “legislate” refers to all forms of compulsion, including Act of Parliament, regulation, Codes and compulsory guidelines.
  3. Our tabulation of these errors is incomplete, but the total exceeds \$60 million.



## Disclosure - Statement of Cash Flows

Where a restructure involves a transfer of cash assets, we submit that this should be disclosed as an adjustment to cash balances “below the line” as shown in our attached example template.

### **“GRANTS” RECEIVED BY LOCAL GOVERNMENT**

To our knowledge, this is the area of AAS 27 that has sustained the greatest - and most continuous - criticism. It is complicated by the fact that all governments tend to describe almost all payments to local governments as “grants”<sup>4</sup>. We identify four types of “grants”.

*Purchase of goods and services contracts*, also known as “single price contracts”, where a State Government Department contracts with a local government for (e.g.) the construction of a certain length of road for a fixed price (which may be subject to rise and fall clauses). The constructed asset may be owned by either the State or the local government. We suggest that these contracts should be accounted for in accordance with AAS 11 during the construction phase, and the asset (and revenue in relation to the granted asset) recognised by the local government (if applicable) only on completion of construction.

*“Non Local Government Grants”* (An ugly term, but we can think of no better term.) Many local governments operate child and aged care facilities and receive “grants” on exactly the same terms and conditions as private industry operators. Should the operator be able to provide the service for less than the amount of the payment, they are entitled to retain the surplus as profit on that operation. (The amounts of the payments are such that this never happens.) Although these are special purpose grants, the question of timing differences does not arise. We suggest that these amounts are revenue when received.

*“Reimbursement Grants”* In terms of numbers, but not necessarily in terms of amounts, these are the most common types of “grants” paid to local governments. Local government is reimbursed all or part of its costs in undertaking certain specified activities in accordance with the terms and conditions of the “grant”<sup>5</sup>. In all cases, the grant programs are designed to meet the other government’s aims and objectives, and local government is merely the delivery agent that ensures that these services are delivered within the local government area because the other government itself does not have the capacity or capability of delivering those services to that area.

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4. Immediately following release of a State or Federal Budget, local parliamentarians are supplied with lists of all payments included within those budgets that are proposed to be paid to or through local governments, and those lists are headed “grants”. In the case of State Budgets, the lists include funds sourced from Federal Government that are administered by the State.
  5. Depending on the individual “grant”, and the normal practice of the department involved, there may be an advance payment.



Most commonly the local government is required to execute an agreement (often under seal) that sets out specific items that are eligible for reimbursement, and their basis of calculation. A range of such agreements that we have recently inspected average over 20 pages, and the method of calculation of the reimbursement amounts varies significantly between agreements even for a single sponsoring department. For example, in some agreements Councils may claim wages paid plus full oncosts, or wages paid plus labour oncosts only, or actual wages paid plus the payment of specific oncosts only at the time of payment<sup>6</sup>.

It is not uncommon for a department to make an advance payment (subject to its own budgetary position) shortly before 30 June. All such agreements include a requirement that any advance funds not utilised in accordance with the particular agreement must be refunded to the Department concerned.

**In our opinion, these payments are utilised to meet the objectives of the other government, and the fact that the local government's own objectives coincide or are similar merely influences the choice of vehicle for delivery of the other government's service.** We submit that reimbursements in advance of expenditure should be recognised as a liability and expenditure in advance of reimbursement should be recognised as an asset (subject to certainty of recovery).

**We also submit that differentiation on the basis of which government's objectives are primarily being achieved could provide an appropriate conceptual basis for establishing appropriate accounting procedures.**

*Discretionary Grants* Some "grants" made to local government may be utilised by the local government at its own discretion, either as to purpose, or according to local priorities within a stated purpose. The *Financial Assistance Grant* sourced from Federal funds but administered by States is an example of the first, being expended completely at the local government's discretion. The *Roads to Recovery Grant*, also sourced from Federal funds, is an example of the second, where a local government is required to expend the funds on *local roads* for construction works, but has a discretion as to the individual roads on which the works are carried out.

In contrast to *reimbursement grants*, these payments are utilised to meet the objectives of the local government, and we consider disclosure as revenue is appropriate.

We have found that much of the discussion in paragraph 8.1 rather confusing and somewhat difficult to apply to specific examples.

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6. Including, in one instance, a requirement that the Council take out a separate workers compensation policy to cover the one employee subject to the grant.



## “GRANTS” - SPECIFIC PARAGRAPHS

Paragraph 8.1.29 - To use Financial Assistance Grant as an example of an unconditional “grant agreement” could be misleading. No agreement is signed (other than between Federal & State governments in relation to their administration) and the legislation relates to multiple years. To suggest that FAG revenue should be recognised only once every three years, as a three year total, is absurd.<sup>7</sup>

Paragraph 8.1.30 - When the Federal Government announced the Roads to Recovery program it announced total amounts payable to Councils over the triennium of the program, which was structured in such a way that it includes portions of *four* local government reporting periods<sup>8</sup>. Actual funding is being made available on a staged basis, and again we consider it inappropriate to recognise the whole of the triennium revenue in a single reporting period. We submit that recognition of revenue should match allocations made each year.

## “GRANTS” - THE DISCLOSURE PROBLEM

### Description

The range of payments made to local government by other governments is extremely broad, and the descriptions of “grant” or “subsidy” or other seems to depend more on the requirements of program acronyms than on the terms and conditions of the payment. We submit that all such payments (including goods and services contracts) should be described as *payments from other governments*<sup>9</sup>.

### Statement of Financial Performance

There are a number of different treatments in use. In NSW & Queensland these are split between *grants for operating purposes* and *grants for the acquisition of assets* - a split that often cannot be made accurately. There are a number of different treatments in use in Victoria, some of which include *grants for the acquisition of assets* and some include all *grants* as “non-operating revenues”.

We suggest that information relating to the likelihood of future funding would be far more valuable to a user of the Annual Financial Statements than the existing range of variable interpretations. Accordingly, all amounts received from other levels of government should be disclosed as *amounts received from other governments*, with further disclosure (by way of note or otherwise) of *recurrent*<sup>10</sup> and *non-recurrent* amounts.

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7. FAGs payments to Councils each year comprise a base amount plus the estimated CPI increase for that year; an adjustment to actual CPI is added to or deducted from the following year’s payments. We submit that FAGs grants should be accounted for on a receipts basis.
  8. The form of the announcement was obviously dictated by political imperatives.
  9. We include in the term “governments” all government authorities, including “qangos”.
  10. We would define *recurrent* amounts as those for which the Council has a reasonable expectation that a payment, of broadly similar amount and for similar purposes, will be made in each of the 3 succeeding reporting periods (i.e.. the life of the Management Plans required by all States).



### Statement of Cash Flows

Appendix 1 in AAS 27 discloses amounts from other governments separately from operating, investing and financing cash flows<sup>11</sup>. Because generally the largest portion of *payments from other governments* relate to operating expenses, this usually results in a very substantial consumption of cash in operating activities.

Our research indicates that when *payments from other governments* are included in operating activities, the cash generated from operating activities usually represents 20% - 30% of total operating inwards cash flows. Although our research is incomplete, this range applies to in excess of 75% of all NSW and Victorian Councils (with the possible exception of Melbourne metropolitan Councils which tend to the lower end of the range). Our research is not yet to the point where we are prepared to recommend this as a performance indicator, but we will continue the research as opportunity offers.

We do not support the differentiation between *recurrent* and *non-recurrent* in this statement as it does not provide any information that is not effectively available from the statement of financial performance and the usual note relating to receivables.

### **RATES IN ADVANCE**

A ratepayer who overpays his rates is entitled to request refund of the overpayment at any time until the next rate is made and levied, and the Council is required to make the refund. If a ratepayer overpays on (say) 29 June and requests a refund on 2 July, before Council has completed the statutory procedures involved in making and levying the next year's rate on (say) 15 July, then Council is required to make the refund payment. We therefore disagree with the proposed interpretation.

Rates are levied on the valuation (plus base or minimum amounts if applicable) irrespective of the amounts, if any, paid in advance. The payment of amounts in advance does not in any way alter Council's entitlement to revenue in any subsequent year. For any particular property, a Council is only entitled to receive rates that are levied in accordance with the Act, irrespective of the time of payment. We suggest that the correct amount of revenue to be recognised is the rates revenue actually levied by Council.

Rates records are designed to identify the rate levy for each property and the discharge of that liability by the ratepayer: some rates ledger systems have difficulty in isolating amounts in advance as a separate subtotal, although it can do so for individual properties. For NSW Councils, it would further complicate the existing accounting and acquittal procedures required by rate-pegging legislation.

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11. A practice not adopted by the NSW Code of Accounting Practice.



### Disclosures

We submit that the Standard should require disclosure of total rates levied, amounts written off by way of pensioner concessions and other amounts written off as separate amounts. Information relating to the valuation basis on which rates are assessed<sup>12</sup> are inappropriate as they relate merely to the incidence of the rates levy between individual properties, not to the total rates levy of the Council as a whole.

## **LAND UNDER ROADS**

We support this proposal.

## **DISCLOSURE BY FUNCTION**

In practice, we find the requirement to report all transactions both by type and by function to be the single factor that most complicates local government accounting procedures, as few commercial accounting systems have this capability. However, the range and complexity of local government activities is so great that this provision is necessary.

## **RESTRICTIONS ON DISPOSAL OF ASSETS**

Many jurisdictions require that all reserves other than Asset Revaluation Reserve be “cash-backed” and in NSW this has led to the development of a concept of “internal restrictions” on the basis that although Council may change its reserves structure at any time, those reserves once created are restricted by legislation.

We submit that *reserves* should be disclosed as part of *equity* and the extent to which they are “cash-backed” disclosed by way of note or otherwise.<sup>13</sup> We also submit that the wording in ED11.1 should be amended to exclude the NSW interpretation.

### Definition of Current Assets

Part (c) of the definition of *current asset* in AAS 36 excludes a “cash or a cash-equivalent asset which is not restricted in its use beyond twelve months or the length of the operating cycle whichever is greater”. While most States interpret this as referring only to a *restriction in time*, in NSW this has been interpreted to include *restrictions of purpose* where the current Management Plan does not provide for the funds to be expended within 12 months. This has resulted in some very significant consequential effects of performance indicators such as the current ratio.

We submit that clarification here would be appropriate.

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12. As, for example, in the Victorian 2003 Annual Financial Statements guidelines.

13. The City of South Perth disclosed *Accumulated Surplus, Cash-Backed Reserves* and *Asset Revaluation Reserve* in its 2002 Annual Statements. we felt that this was a particularly effective presentation.



## CONDITIONS ON CONTRIBUTIONS

As indicated above we believe that prepaid rates constitute amounts to which the local government has no legal entitlement, and should be recognised as liabilities. We have no objections to the disclosures in relation to prepaid amounts from other governments, determined on the basis set out above.

We submit that contributions recognised as revenues, where there is a legislative requirement that they be spent for a particular purpose and the moneys have not been expended<sup>14</sup>, should also be disclosed. In our opinion, a requirement to disclose anticipated future expenditure<sup>15</sup> would not be unreasonable.

## AUTHORITY FOR REPORTS

We suggest that this is an inappropriate importation from AAS 29. AAS 37.5.1 (a) requires the disclosure of the legal form of the entity, which is “incorporation pursuant to the Local Government Act” of the relevant State or Territory. In **every** instance, the authority pursuant to which the general purpose financial report has been prepared will be “the (State) Local Government Act xxxx, as amended, and the regulations thereunder”.

## PERFORMANCE INDICATORS

We point out that there is a vast amount of research required before reliable financial performance indicators are developed, and generally accepted by all States.

A number of States require specific non-financial performance indicators to be disclosed in other parts of Council Annual Reports. The nature of these other indicators in many instances makes them unsuitable for inclusion in the financial statements, and would require exclusion clauses in audit reports. We consider that **all** performance indicators should be co-located but that the financial statements should be cross-referenced to the other section of the Annual Report in which they appear.

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14. Principally developer contributions. A sample of 40 NSW Councils showed that they held a total of \$260,000,000 at 30 June 2003.

15. In time bands of *within 12 months, 12 months to 36 months and more than 36 months*. These time bands have been selected to match required management plan cycles.



## BUDGETARY INFORMATION

Our research indicates that approximately 20% - 25% of local governments' total cash expenditure is for the acquisition of assets (approximately 0% - 5% for debt servicing)<sup>16</sup>. The information included in the Statement of Financial Performance represents a sub-set of probably only 50% of the information in the budget which lends itself to misinterpretation. We prefer the use of a comparison in the form of the "Rates Setting Statement" used by many local governments in WA<sup>17</sup> and Victoria whereby the whole of the budget is compared with actual results. On this basis, disclosure of budget information on the face of the Statement of Financial Performance is inappropriate.

## MEASUREMENT OF PREVIOUSLY ACQUIRED ASSETS

From a technical point of view, we oppose this proposal, but having had extensive experience of the process of recognition of assets in the circumstances described we strongly support it as an appropriate response to a practical problem.

## COUNCIL SUBDIVISIONS

We have identified a problem in relation to subdivisions of land undertaken by Councils<sup>18</sup> where planning laws require that the Council "pay" contribution to public infrastructure to itself (in NSW, in accordance with section 94 of the Environmental Planning & Assessment Act). Even if the transaction is made by journal entry, that action places a *restriction of purpose* on an equivalent sum of cash assets, which in our opinion should be reported.

If the transaction (Cr. revenue, Dr. land development asset) is eliminated for reporting purposes, the eventual profit on sale of the land is significantly overstated. The disclosure relating to unexpended contributions (currently in AAS 27, and see our comments above) refers to third parties. While it may take some years, the contributions will fund the acquisition of assets, and these will be correctly recorded at the cost of acquisition.

It should be noted that these types of circumstances only arise for local government - private land developers pay their contributions to the local government; State land development contributions are either paid to local government or transferred from the developing authority to the EPA. It is only local government that can be placed in the situation where it both the consent authority and the land developer.

We submit that the Standards do not adequately cater for situations where the actions of a local government, by virtue of externally imposed legislation, create additional obligations to expend future funds for its own "benefit".

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16. The statistics are based on analysis of an extensive sample of NSW local governments for the years 2000 -2002 and Victorian local governments for 2002, and random selections for WA, NT and Queensland for 2002.

17. In our opinion, that of the City of Canning was particularly effective.

18. As at 30 June 2002, approximately \$130 million in NSW.



We shall be pleased to supply any further information that you may require.



# COALFACE COUNCIL

## STATEMENT OF CASH FLOWS for the year ended 30th June 2003

	Notes	Actual 2003 \$'000	Actual 2002 \$'000
<b>CASH FLOWS FROM OPERATING ACTIVITIES</b>			
<u>Receipts</u>			
Rates & Annual Charges		-	-
User Charges & Fees		-	-
Interest Received		-	-
Grants & Contributions		-	-
Other operating receipts		-	-
<u>Payments</u>			
Employee Costs		-	-
Materials & Contracts		-	-
Interest Paid		-	-
Other operating payments		-	-
<b>Net Cash provided by (or used in) Operating Activities</b>	11	-	-
<b>CASH FLOWS FROM INVESTING ACTIVITIES</b>			
<u>Receipts</u>			
Proceeds from sale of Property, Plant & Equipment		-	-
Proceeds from sale of Real Estate for resale	5, 8	-	-
Proceeds from sale of Investment Securities		-	-
Repayments from Deferred Debtors		-	-
Contributions to joint ventures by minority interests	19	-	-
Distribution received from associated entities	19	-	-
<u>Payments</u>			
Purchase of Property, Plant & Equipment		-	-
Purchase of Real Estate for resale	8	-	-
Purchase of Investment Securities		-	-
Loans to Deferred Debtors		-	-
Distributions from joint ventures to minority interests	19	-	-
Capital contributed to associated entities	19	-	-
<b>Net Cash provided by (or used in) Investing Activities</b>		-	-
<b>CASH FLOWS FROM FINANCING ACTIVITIES</b>			
<u>Receipts</u>			
Proceeds from Borrowings & Advances		-	-
Proceeds from Retirement Home Contributions		-	-
<u>Payments</u>			
Repayments of Borrowings & Advances		-	-
Repayment of Finance Lease Liabilities		-	-
Repayment of Retirement Home Contributions		-	-
<b>Net Cash provided by (or used in) Financing Activities</b>		-	-
<b>Net Increase (Decrease) in cash held</b>		-	-
Cash Assets at beginning of reporting period	11	-	-
Adjustment to opening cash due to adoption of revised Accounting Standards		-	-
Adjustment to Cash arising from Council restructure		-	-
<b>Cash Assets at end of reporting period</b>	11	-	-

This Statement is to be read in conjunction with the attached Notes

# COALFACE COUNCIL

## NOTES TO AND FORMING PART OF THE FINANCIAL STATEMENTS for the year ended 30th June 2003

### Note 24 - RESTRUCTURE OF THE COUNCIL

By an Order by the Governor in Council published in the Government Gazette of *day month year*, the boundaries of the Council were amended with the effect of excluding an area of *xx* sq. km., being part of the suburb of *Bullamakanka*, which was transferred to the *Woop Woop Shire Council*. The Order took effect on *day month year*.

In accordance with the Order, the following assets and liabilities were transferred to the *Woop Woop Shire Council* as at the date of effect of the Order

<b>ASSETS</b>	\$'000
<i>Current Assets</i>	
Cash Assets	-
Investment Securities	-
Receivables	-
Inventories	-
Other	-
	-
<i>Non-Current Assets</i>	
Cash Assets	-
Investment Securities	-
Receivables	-
Inventories	-
Other	-
Property, Plant & Equipment	-
	-
	-
	-
<b>LIABILITIES</b>	
<i>Current Liabilities</i>	
Other Payables	-
Borrowings	-
Provisions	-
	-
<i>Non-Current Liabilities</i>	
Other Payables	-
Borrowings	-
Provisions	-
	-
	-
	-
<b>LOSS ON RESTRUCTURE OF COUNCIL</b>	-