



## Staff Paper

Dec 2010, Agenda Paper 8.2

### **‘Advance Receipts’ Liabilities – Redeliberation of Proposals in AASB ED 180/FRSB ED 118**

#### **Purpose of this Paper**

1. This paper discusses the proposed treatment of ‘advance receipts’ liabilities in AASB ED 180/FRSB ED 118 *Income from Non-exchange Transactions (Taxes and Transfers)* in the light of:
  - (a) the comments in the submissions received on that ED; and
  - (b) the Boards’ tentative decisions to date in their redeliberation of the proposals in that ED regarding performance obligations and return obligations.
2. In respect of advance receipts, this paper and Agenda Paper 8.3 discuss:
  - (a) the definition of ‘advance receipts’;
  - (b) the nature of advance receipts and, therefore:
    - (i) whether advance receipts give rise to a liability and, if so,
    - (ii) when such liabilities are either extinguished or transformed into other liabilities; and
  - (c) what, if any, additional guidance on advance receipts might be needed in a Standard on income from non-exchange transactions.

These discussions are structured around the issues raised in the submissions on the ED.

3. Agenda Paper 8.3 illustrates the different categories of obligations that can arise under transactions addressed within this project. Among other things, it illustrates the circumstances in which advance receipts obligations arise and are replaced with other obligations.

### **Overall Staff Recommendation**

4. AASB and NZICA staff recommend that the proposed treatment of advance receipts in AASB ED 180/FRSB ED 118 should be confirmed, subject to future consideration of measurement and disclosure issues.

### **Background**

5. AASB ED 180/FRSB ED 118 proposes that 'advance receipts' should be recognised as liabilities. Paragraph 26 of ED 180/ED 118 says: "In this Standard 'advance receipt' refers to resources received prior to a taxable event or a transfer arrangement becoming binding." Extracts from that ED are set out in Appendix A to this paper.
6. The Basis for Conclusions on ED 180/ED 118 notes that, in the event that the taxable event did not occur, or the transfer arrangement did not become enforceable, the entity may need to return part or all of the resources (paragraph BC20). That is, the entity has a return obligation at least until the taxable event occurs or the transfer arrangement becomes binding.

### **Comments by Respondents to AASB ED 180/FRSB ED 118**

#### *General*

7. Respondents who commented on the proposed treatment of advance receipts were strongly supportive. Of those expressing a clear view, twelve agreed and two disagreed.

#### *Specific issues*

8. The issues noted below relate to the definition or recognition of advance receipts liabilities. Issues regarding the measurement and disclosure of advance receipts liabilities are not included. These issues will be discussed when the staff prepares agenda papers on the measurement of all liabilities within the scope of this project and on disclosures.

### Nature of ‘advance receipts’ liabilities

9. Two respondents argued that the rationale for treating advance receipts as liabilities should be clarified. Ernst & Young said a liability for advance receipts is a financial liability. KPMG (NZ) argued it would be beneficial to focus on the existence of an implied return obligation if the transfer arrangement did not become binding or the taxable event did not occur.
10. AASB and NZICA staff agree with those comments, if ‘advance receipts’ is retained as a separate notion in a Standard on Income from Non-Exchange Transactions.<sup>1</sup> Whilst the Basis for Conclusions notes that, in the event that the taxable event did not occur, or the transfer arrangement did not become enforceable, the entity may need to return part or all of the resources, it does not specifically identify the nature of the liability.
11. Staff regard ‘advance receipts’ liabilities as stand-ready obligations to return assets that were provided in the expectation of the taxable event occurring or the transfer arrangement becoming binding (the ‘specified future event’).<sup>2</sup> Such obligations exist until:
- (a) the specified future event occurs [at which time they are either extinguished—e.g., when the taxable event occurs—or replaced with other obligations (such as performance obligations), e.g., when a grant agreement becomes binding]; or
  - (b) the specified future event fails to occur and the transferee becomes unconditionally obligated to return the transferred asset or an asset of equivalent value (i.e., the return becomes due and payable).
12. Advance receipt obligations are stand-ready obligations because the entity is not unconditionally obligated to return the transferred asset, but has an unconditional obligation to stand ready to return the asset if the specified future event fails to occur. If such an obligation is enforceable, it is a liability. If the asset to be returned is a financial

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<sup>1</sup> Whether ‘advance receipts’ should be retained as a separate notion is discussed in paragraphs 17 – 19.

<sup>2</sup> Staff also consider that, for a liability to arise from advance receipts, it must be necessary that a future sacrifice of economic benefits is required if the specified future event does not occur. This issue is discussed separately in paragraphs 26 – 27.

asset (as would often be the case), the ‘advance receipt’ liability would be a financial liability.

13. Advance receipts obligations essentially arise from resources held on deposit. A specified uncertain future event must occur before the transferee (i.e., obligor) obtains a right to retain the transferred assets. This key feature of advance receipts obligations seems no different from the key feature of return obligations generally (which are discussed in paragraph 25 of ED 180/ED 118). This is because other return obligations may involve the transferee needing to return the transferred assets if an agreement has become binding but the transferee either fails to perform its promises or is unable to obtain transfers from other parties (e.g., ‘matching grants’). In summary, it is difficult to discern a fundamental difference, at an element level, between advance receipts obligations and other return obligations.
14. Staff think the nature of advance receipts obligations should be clarified as part of an outline of the various types of obligations considered within the scope of this project. Those obligations are illustrated in Agenda Paper 8.3.

### **‘Binding’ arrangements**

15. In relation to advance receipts of transfers, six respondents requested clarification of the meaning of ‘binding’ in paragraph 106 of the ED (FinPro, WA Dep’t of Local Gov’t, UHY Haines Norton, HoTARAC, Aust. Dep’t Finance and Deregulation, Grant Thornton).
16. AASB ED 180/FRSB ED 118 neither defines, nor provides guidance on the meaning of, ‘binding’. This is consistent with IPSAS 23 *Revenue from Non-Exchange Transactions (Taxes and Transfers)*.
17. In responding to this concern, the first issue to consider is whether ‘advance receipts’ should be retained as a separate notion in a Standard on Income from Non-Exchange Transactions. As noted in paragraphs 11 – 13, AASB and NZICA staff think an advance receipt is a type of return obligation that, if enforceable, would qualify as a liability. Thus, staff think the recognition principles for advance receipts should be the same as those for

any other return obligation. Therefore, whether a separate notion of ‘advance receipts’ should be retained seems to depend on:

- (a) whether advance receipt obligations should be measured differently from other return obligations; and
  - (b) whether advance receipt obligations should be disclosed separately from other return obligations.
18. If the answer to both questions in (a) and (b) of paragraph 17 is no, there is no need to clarify the meaning of advance receipts. In every respect, advance receipts would merely be an example of return obligations. However, if the answer to one of those questions is yes, further consideration would need to be given to whether clarification or additional guidance on ‘advance receipts’ is necessary and appropriate.
19. Answering the questions in paragraph 17 requires consideration of issues to be considered at future Board meetings. It would be necessary to determine the general measurement principles for obligations covered by this project before deciding whether different measurement principles are appropriate for advance receipts. Given the Boards’ application of the *Process for Modifying IFRSs for PBE/NFP*, proposed disclosures for advance receipts (either separately or as a component of return obligations) would need to be developed by reference to the domestic Standards that presently or will ultimately incorporate IFRS 7 *Financial Instruments: Disclosures* and the IFRS on *Revenue from Contracts with Customers*. Therefore, a firm decision on disclosures in this project should not be made until the IFRS on Revenue is finalised.
20. Therefore, staff propose that the issue of whether the meaning of ‘binding’ should be clarified should be carried forward for consideration at a future Board meeting.

### **Inconsistency with treatment of transfers with time-based restrictions**

21. Paragraph BC23 of the AASB/FRSB Basis for Conclusions on ED 180/ED 118 says “A stipulation that transferred assets should be utilised over a stated period (such as the next financial year) is not a condition as defined. Such time requirements would represent only a restriction on transferred assets.” Under the proposals in ED 180/ED 118, a restriction

on transferred assets would not be treated as a liability. In March 2010, the AASB and FRSB reaffirmed their position on time period designations of the use of transferred assets. They decided that, “unless a performance obligation exists in relation to transferred assets, the designation of a transfer as relating to a particular time period does not give rise to a present obligation”.<sup>3</sup>

22. Four respondents argued that treating advance receipts as liabilities is inconsistent with the proposal in ED 180/ED 118 that transfers of assets with time-based restrictions do not give rise to liabilities (FinPro, UHY Haines Norton, HoTARAC, Aust. Dep’t Finance and Deregulation). For example, UHY Haines Norton argued that “If a time stipulation is not a condition and merely a restriction, the circumstances in which a grant transfer could be recognised as an advance receipt liability are difficult to envisage.”
23. AASB and NZICA staff think there is an important difference between an advance receipt and a stipulation that transferred assets should be utilised over a stated period (time-based stipulation). With a time-based stipulation that does not have an accompanying performance obligation<sup>4</sup>, nothing other than the passage of time is needed for the stipulation to expire. That is, there is no prospect of a return of the transferred assets because there is no stipulation that might be breached. And, in the absence of a performance obligation, there is no other stipulation requiring a sacrifice of future economic benefits. However, with advance receipts, an uncertain future event (whether the taxable event occurring or the transfer agreement becoming binding) must occur before the stipulation expires. Therefore, with an advance receipt, there is an obligation to stand ready to potentially return the transferred asset or an asset of equivalent value.<sup>5</sup>
24. Staff think it is important to note that the Boards have adopted a broader notion of a liability arising from a non-exchange transaction than that proposed in ED 180/ED 118. There was, arguably, an inconsistency between the ED’s proposal that a return obligation in the form of an advance receipt is a liability and its proposal that other return obligations

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<sup>3</sup> Quoted from minutes of the Boards’ joint meeting, page 6.

<sup>4</sup> An example of such a performance obligation is an obligation to stand ready for a stated period to compensate third parties if specified uncertain future events occur.

<sup>5</sup> This is also true of any other return obligation. Therefore, staff think the above-mentioned important difference exists between time-based stipulations and any return obligation.

must be accompanied by a performance obligation if they are to qualify as a liability (a ‘condition on transferred assets’). With the Boards’ decision in March 2010 to abandon the latter proposal, the apparent inconsistency is removed.

25. Accordingly, staff do not think the comment by these four respondents noted in paragraph 22 identifies a flaw in:
- (a) the proposed treatment of advance receipts as liabilities; or
  - (b) the Boards’ decision that, unless a performance obligation exists in relation to transferred assets, the designation of a transfer as relating to a particular time period does not give rise to a present obligation.

### **Other issue: financial consequences of specified future event not occurring<sup>6</sup>**

26. AASB and NZICA staff also consider that, for a liability to arise from advance receipts, it must be necessary that a future sacrifice of economic benefits is required if the specified future event (the taxable event occurring or the agreement becoming binding) does not occur (i.e., if the specified future event does not occur, the entity would need to return the transferred assets or sacrifice other assets). Otherwise, the transferor has effectively made a donation. ED 180/ED 118 implicitly assumes that a sacrifice or transfer of future economic benefits would be required if the specified future event does not occur. However, this would not necessarily be the case.
27. Staff recommend including this point in the guidance on advance receipts in a Standard on Income from Non-Exchange Transactions.

### **Questions for Board members**

- Q1** Do you agree that, until a decision is made on whether advance receipts need to be identified as a separate category of obligations, advance receipts should continue to be defined as “resources received prior to a taxable event or a transfer arrangement becoming binding”?

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<sup>6</sup> This issue was not raised by respondents to ED 180/ED 118.

**Q2** Do you agree that guidance on advance receipts obligations should clarify that:

- (a) they are unconditional obligations to stand ready to return assets provided in the expectation of the taxable event occurring or the transfer arrangement becoming binding;
- (b) therefore, they are liabilities<sup>7</sup>;
- (c) if the asset to be returned is a financial asset, the advance receipt obligation is a financial liability; and
- (d) for a liability to arise from advance receipts, it must be necessary that a future sacrifice of economic benefits is required if the specified future event (the taxable event occurring or the agreement becoming binding) does not occur?

**Q3** Do you agree that the issue of whether the meaning of ‘binding’ should be clarified should be carried forward for consideration at a future Board meeting?

**Q4** Do you agree that treating advance receipts as liabilities is consistent with the Boards’ tentative decision that designating a transfer as relating to a particular time period does not of itself give rise to a liability?

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<sup>7</sup> But see Q2(d) below also.

## APPENDIX A

**Extracts from AASB ED 180/FRSB ED 118 *Income from Non-exchange Transactions (Taxes and Transfers)*—Advance Receipts**

- 26 ... In this Standard “advance receipt” refers to resources received prior to a taxable event or a transfer arrangement becoming binding. Advance receipts give rise to an asset and a present obligation because the transfer arrangement has not yet become binding. Where such transfers are in the nature of an exchange transaction, they will be dealt with in accordance with AASB 118 / NZ IAS 18.  
[Based on IPSAS 23, paragraph 25]

**Advance Receipts of Taxes**

- 67 Consistent with the definitions of “assets,” “liabilities” and the requirements of paragraph 60, resources for taxes received prior to the occurrence of the taxable event are recognised as an asset and a liability (advance receipts) because the event that gives rise to the entity’s entitlement to the taxes has not occurred and the criteria for recognition of taxation income have not been satisfied (see paragraph 60), notwithstanding that the entity has already received an inflow of resources. Advance receipts in respect of taxes are not fundamentally different from other advance receipts, so a liability is recognised until the taxable event occurs. When the taxable event occurs, the liability is discharged and income is recognised.  
[Based on IPSAS 23, paragraph 66]

**Example 8: Advance Receipts of Income Tax (Paragraph 67)**

- IG16 Government A (reporting entity) levies income tax on all residents within its jurisdiction. The tax period and the reporting period are January 1 to December 31. Self-employed taxpayers are required to pay an estimate of their income tax for the year by December 24 of the year immediately preceding the commencement of the tax year. The tax law sets the estimate as the amount due for the most recently completed assessment, plus one tenth, unless the taxpayer provides an explanation prior to December 24 of a lower amount (penalties apply if the taxpayer’s assessment proves to be materially lower than the final amount owed). After the end of the tax period, self-employed taxpayers file their tax returns and receive refunds, or pay additional tax to the government.  
[Based on IPSAS 23, paragraph IG16]
- IG17 The resources received from self-employed taxpayers by December 24 are advance receipts against taxes due for the following year. The taxable event is the earning of income during the taxation period, which has not commenced. The reporting entity recognises an increase in an asset (cash in bank) and an increase in a liability (advance receipts).  
[Based on IPSAS 23, paragraph IG17]

### Advance Receipts of Transfers

106 Where an entity receives resources before a transfer arrangement becomes binding, the resources are recognised as an asset when they meet the definition of an asset and satisfy the criteria for recognition as an asset. The entity will also recognise an advance receipt liability if the transfer arrangement is not yet binding. Advance receipts in respect of transfers are not fundamentally different from other advance receipts, so a liability is recognised until the event which makes the transfer arrangement binding occurs and all other conditions under the agreement are fulfilled. When that event occurs and all other conditions under the agreement are fulfilled, the liability is discharged and income is recognised.

[Based on IPSAS 23, paragraph 105]

### Advance Receipts (IPSASB Basis for Conclusions)

BC20 This Standard requires an entity that receives resources in advance of the taxable event, or of a transfer arrangement becoming enforceable, to recognize an asset and a liability of an equivalent amount. This is consistent with the principles of accrual accounting to recognize revenue in the period in which the underlying event that gives rise to the revenue occurs. In the event that the taxable event did not occur, or the transfer arrangement did not become enforceable, the entity may need to return part or all of the resources. Some are of the view that, where resources are received in advance of the taxable event an entity should only recognize a liability where it considers it probable that there will be a subsequent outflow of resources. The IPSASB supports the view that revenue should not be recognized until the taxable event occurs and extends the principle to transfers, so that where resources are received prior to a transfer arrangement becoming binding, the entity recognizes an asset and a liability for the advance receipt.