Staff Paper

Feb 2011, AASB Agenda Paper 10.2 / FRSB Agenda Paper B7.2

Income from Non-Exchange Transactions – Scope of the Revised ED

Purpose of this Paper

1. This paper discusses issues relating to the scope of the revised ED being developed to succeed AASB ED 180/FRSB ED 118 *Income from Non-exchange Transactions (Taxes and Transfers)*, for proposed application to public benefit entities (PBEs)/not-for-profit entities (NFPs).

Overall Staff Views

2. AASB and NZICA staff:

   (a) recommend that, ideally, the scope of the Boards' revised ED should not be limited to non-exchange transactions of PBEs/NFPs; but

   (b) consider that the Boards' choice of measurement basis for obligations to transferors will determine whether it is necessary to define 'non-exchange transactions' (and, therefore, potentially it would be necessary to limit the scope of the revised ED to non-exchange transactions). Based on the AASB staff's recommendations in AASB Agenda Paper 10.6 / FRSB Agenda Paper B7.6, AASB staff think the measurement basis for obligations to transferors should not require departure from the ideal in (a).

Background

3. Consistent with IPSAS 23 *Revenue from Non-Exchange Transactions (Taxes and Transfers)*, ED 180/ED 118 applies to non-exchange transactions (other than those giving rise to a business combination) of PBEs/NFPs.

4. AASB 1004 *Contributions* and its predecessor Standard [AASB 1004 *Revenue* (June 1998)] reflected the principles in former Statement of Accounting Concepts SAC 4

Definition and Recognition of the Elements of Financial Statements that a liability cannot arise from the receipt of an asset in a non-reciprocal transfer (non-exchange transaction). When it was originally reissued (upon adoption of IFRSs in Australia), AASB 1004 *Contributions* reflected the view that conforming to the treatment of government grants in IFRSs would be inappropriate for PBEs/NFPs because:

(a) the treatment in IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance* was inappropriate conceptually (see Appendix B); and

(b) non-exchange transactions were far more prevalent for public benefit entities (PBEs)/not-for-profit entities (NFPs) than they were for for-profit entities. Therefore, the conceptual flaws in IAS 20 should generally not have a significant adverse effect on financial statements of for-profit entities, but would be likely to have a significant adverse effect on financial statements of PBEs/NFPs.

5. At the Boards' joint meeting in March 2010, some Board members argued it would be appropriate to apply the domestic Standards incorporating IAS 18 *Revenue* to account for revenue from non-exchange transactions, in which case the distinction between exchange and non-exchange transactions would be irrelevant. This approach was not supported by a majority of Board members for various reasons. AASB and NZICA staff consider that, regardless of the conceptual arguments for and against that treatment, IAS 18 has a practical problem that would undermine its consistent application to non-exchange transactions. IAS 18 requires revenue in relation to inbound transfers of assets to be recognised when the entity either transfers to the buyer the significant risks and rewards of ownership of goods sold; renders services; or provides others with the use of the entity's assets yielding interest, royalties or dividends. When a performance obligation exists, this treatment is essentially consistent with the approach the Boards tentatively agreed to develop for the revised ED succeeding ED 180/ED 118. However, when a performance obligation does not exist (for example, a transfer of assets is received without any stipulations), applying the IAS 18 requirements would be problematic. The PBE/NFP would be required to associate the resulting revenue with particular transfers of goods, rendering of services or provision of the use of the entity's assets. This would seem likely

to be an arbitrary approach that would not foster faithful representation or comparability between entities.

6. For the reasons in paragraph 5, staff considered in March 2010 that it was necessary for non-exchange transactions to be excluded from the scope of the domestic Standards incorporating IAS 18. In other words, in the context of current IFRSs, staff considered it necessary for non-exchange transactions to be accounted for under a separate Standard, even if performance obligations and return obligations arising from non-exchange transactions were to be treated as liabilities.

7. In contrast to IAS 18, the IASB ED on Revenue from Contracts with Customers focuses explicitly on entities generating revenue by satisfying performance obligations to customers. The corollary of that approach is that if an entity receives assets without incurring a performance obligation, it recognises income immediately. Therefore, applying the IASB ED would remove a reason for separate treatment of non-exchange transactions.

Staff Analysis

Process for Modifying IFRSs for PBE/NFP

8. Appendix A considers the implications of applying the Boards' *Process for Modifying IFRSs for PBE/NFP* ('the *Process*') when determining the scope of the revised ED. The staff's conclusion is that applying the *Process* identifies a need to modify the proposed IFRS on Revenue from Contracts with Customers for application by PBEs/NFPs but does not indicate that a distinction needs to be made between the treatment of exchange transactions and non-exchange transactions.

9. As noted in paragraph A12 in Appendix A, the Boards tentatively decided that modifications to the forthcoming IFRS on Revenue from Contracts with Customers would be appropriate for PBEs/NFPs if that IFRS reflects the proposals in the IASB ED. Those modifications relate to the characteristics of PBEs/NFPs and do not relate to the non-exchange nature of transactions.

Comments by Respondents to AASB ED 180/FRSB ED 118

10. Ten respondents to the ED[1] argued it is inappropriate to distinguish the treatment of exchange transactions and non-exchange transactions, or that additional guidance on the distinction between exchange and non-exchange transactions is necessary for the Standard to be workable, because:

(a) the creation of a liability does not depend on whether the transaction giving rise to it was exchange or non-exchange [KPMG(Aust), KPMG(NZ), NZ Treasury]; and

(b) the distinction between exchange and non-exchange transactions is presently unclear and, therefore, arbitrary classifications may result [KPMG(Aust), KPMG(NZ), HoTARAC, Finance Department, Ernst & Young, Bionic Ear, PwC (Aust), NFPSAC, Auckland Uni., NZ Treasury].[2]

11. Staff agrees that the creation of a liability does not depend on whether the transaction giving rise to it was exchange or non-exchange. Even under IPSAS 23, some non-exchange transactions give rise to liabilities. Similarly, staff thinks the recognition and measurement of assets received, or of performance obligations and return obligations, ideally should not differ according to whether the transaction giving rise to those assets and liabilities was exchange or non-exchange.

12. A consideration in deciding whether the exchange/non-exchange distinction is warranted is whether the required treatment of 'non-exchange' transactions would be sufficiently clear without that distinction. If no performance obligations or return obligations arise from a transaction, the recognised inflow of assets should be recognised as giving rise to income immediately. However, the IASB ED on Revenue from Contracts with Customers assumes that the entire contract consideration ('transaction price') relates to obligations of the seller. The IASB ED does not contemplate transfers that do not give rise to obligations

[1] The collation of 31 submissions on AASB ED 180/FRSB ED 118 was Agenda Paper B4.2 for the joint AASB-FRSB meeting on 17 – 18 March 2010. Copies are available on request to either jpaul@aasb.gov.au or joanne.scott@nzica.com

[2] In addition, some respondents sought guidance on how to classify particular types of transactions as exchange or non-exchange, but did not indicate that such clarification is essential to the operation of the proposed Standard.

of the seller. Some may consider it is necessary to define a 'non-exchange' transaction and clarify that such a transaction gives rise to income immediately.

13. Staff think it is unnecessary to refer to 'non-exchange' transactions when addressing this issue. Instead, staff think the revised ED should include PBE/NFP guidance that says transfers that do not give rise to obligations of the recipient give rise to income immediately.

14. An agenda paper planned for the Boards' March 2011 meeting will discuss whether any of the disclosures in the proposed IFRSs on Revenue from Contracts from Customers are inappropriate for non-exchange transactions. The staff's tentative view is that if some disclosures are inappropriate for non-exchange transactions, this should be dealt with through differential application of disclosure requirements within the revised ED for this project. That is, such disclosure modifications would not, of themselves, be sufficient to warrant limiting the scope of the revised guidance to non-exchange transactions.

15. Therefore, staff recommends that the scope of the Boards' revised ED should not be limited to non-exchange transactions. This recommendation is conditional on consideration of the issue discussed in paragraphs 18 – 24. Adopting this recommendation would also:

    (a) address the concern of respondents to ED 180/ED 118 that the distinction between exchange and non-exchange transactions is presently unclear (and some argue that the distinction is inherently unclear because it does not represent the economic substance of the arrangements); and

    (b) assist with succinctly meeting the Boards' decision (expressed at the joint meeting in October 2010) to provide guidance on the meaning of 'customer' in relation to both exchange and non-exchange transactions. Removing the distinction would mean the guidance need only be provided once for all transactions.

16. If the recommendation in paragraph 15 were adopted, then:

    (a) the scope of the revised ED would not need to differ from that of the domestic Standard incorporating the forthcoming IFRS on Revenue from Contracts with Customers (although some scope exclusions for other IFRSs, such as IAS 20, might not need to be replicated); and

    (b) consistent with paragraph 9, the revised ED would propose adding to the text of the Standard referred to in (a) the PBE/NFP modifications agreed by the Boards.

17. The outcomes described in paragraph 16 could be reflected in a revised ED that either proposes a Standard that would apply only to not-for-profit entities, or proposes adding PBE/NFP paragraphs to a domestic Standard on Revenue from Contracts with Customers that applies to all entities. Depending on the Boards' decisions at their respective meetings in February 2011, that issue could be addressed in agenda papers for the Boards' March 2011 joint meeting.

Transactions with Exchange and Non-Exchange Components

18. Paragraphs 19 – 24 discuss whether transactions with 'exchange' and 'non-exchange' components give rise to a need to retain the distinction between 'exchange' and 'non-exchange' transactions proposed in ED 180/ED 118.

19. ED 180/ED 118 discusses transactions with 'exchange' and 'non-exchange' components. It says:

> "There is a further group of non-exchange transactions where the entity may provide some consideration directly in return for the resources received, but that consideration does not approximate the fair value of the resources received. In these cases the entity determines whether there is a combination of exchange and non-exchange transactions, each component of which is recognised separately." (paragraph 11)
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> "Where an asset is acquired by means of a transaction that has an exchange component and a non-exchange component, the entity recognises the exchange component according to the principles and requirements of other Australian Accounting Standards / NZ IFRSs. The non-exchange component is recognised according to the principles and requirements of this Standard. In determining whether a transaction has identifiable exchange and non-exchange components,

professional judgment is exercised. Where it is not possible to distinguish separate exchange and non-exchange components, the transaction is treated as a non-exchange transaction." (paragraph 42)

20. It may be argued that, in the circumstances described in paragraph 42 of ED 180/ED 118, the components of a transaction giving rise to performance obligations or return obligations should be identified as exchange components (with their treatment conforming to that under the IFRS on Revenue from Contracts with Customers), while other components should be treated as non-exchange components to be treated under specific guidance in the Standard developed from this project.

21. This approach might be considered appropriate because (as noted in paragraph 12) the IASB ED on Revenue from Contracts with Customers assumes that the entire contract consideration ('transaction price') relates to obligations of the seller. The IASB ED does not contemplate transfers that, in part, do not give rise to obligations of the seller (transactions with 'non-exchange components'). Some may consider it is necessary to define a 'non-exchange' component of a transaction and clarify that the 'non-exchange' component gives rise to income immediately.

22. Staff think it should generally be unnecessary to refer to 'non-exchange components' when dealing with this issue. The 'non-exchange component' could simply be the residual after any performance obligations and return obligations are accounted for.

23. However, taking the approach proposed in paragraph 22 would raise liability measurement issues that would not arise under the IASB ED on Revenue from Contracts with Customers. The IASB ED proposes allocating the transaction price (consideration received or receivable) across the various obligations, based on the stand-alone selling prices, because there is an unstated presumption that transactions are commercial in nature. If that approach were applied to transactions with 'non-exchange components', it would be necessary to specifically identify each component of the transaction, including the non-exchange component. Doing so would therefore require a distinction between exchange and non-exchange components, and a definition of each (regardless of the terminology used). In contrast, if each obligation were measured as an independent variable (i.e., as a direct measurement rather than an allocated amount), it would be feasible to account for a

'non-exchange' component as a residual without identifying the nature of the component. However, it would also mean that any error in measuring that residual would affect income recognised as at the date of the original transaction, which would not happen under the IASB ED on Revenue.

24. For the reasons in paragraph 23, AASB and NZICA staff think the choice of measurement basis adopted for obligations to transferors will determine whether it is necessary to define 'non-exchange transactions' (and, therefore, 'exchange transactions'). Therefore, potentially it would be necessary to limit the scope of the revised ED to non-exchange transactions. However, the AASB staff's recommendations in AASB Agenda Paper 10.6 / FRSB Agenda Paper B7.6 imply the measurement basis for obligations to transferors should not require the scope of the revised ED to be limited to non-exchange transactions.

Questions for Board members

Q1 Do you agree that the creation of a liability does not depend on whether the transaction giving rise to it was exchange or non-exchange?

Q2 Do you agree that the measurement of assets received, or of performance obligations and return obligations, ideally should not differ according to whether the transaction giving rise to those assets and liabilities was exchange or non-exchange?

Q3 Do you agree that, ideally, the scope of the Boards' revised ED should not be limited to non-exchange transactions? (See Question 4 regarding a possible impediment to applying that view.)

Q4 Do you agree that, for the reasons in paragraph 23, the Boards' choice of measurement basis for obligations to transferors will determine whether it is necessary to define 'non-exchange transactions' (and, therefore, potentially it would be necessary to limit the scope of the revised ED to non-exchange transactions)?

APPENDIX A: Applying the Process for Modifying IFRSs for PBE/NFP

A1. This Appendix considers the implications of applying the Boards' *Process for Modifying IFRSs for PBE/NFP* ('the *Process*') when determining the scope of the revised ED. The *Process* says "The purpose of modifying IFRSs for PBE/NFP is to reflect differences between the PBE/NFP and for-profit sectors, including differences in user information needs, that warrant a different accounting treatment or guidance for public benefit and not-for-profit entities" (paragraph 3).

A2. Applying the *Process*, the first question to consider is whether differences between user information needs warrant a different treatment of non-exchange transactions by PBEs/NFPs. Paragraph 12 of the *Process* says "The following factors would generally be reviewed when considering differences in user needs between the for-profit and PBE/NFP sectors:

(a) nature of transactions, events and circumstances and their impact on PBE/NFP;

(b) benefits to users of complying with the IFRS; and

(c) costs of complying with the IFRS."

A3. In respect of factor (a) described above, the *Process* says:

> "… some transactions, events and circumstances are more common among PBE/NFP than for-profit entities and may warrant a separate standard or more specific guidance. Transactions and circumstances that would generally be considered on this basis include the following:
>
> (a) *Non-exchange transactions* …" (paragraph 15).

A4. An issue that needs to be addressed is whether different prevalence of a particular transaction type in a sector indicates different user information needs. It does not necessarily follow that user information needs would differ because of different prevalence of a particular type of transaction.

A5. The *Process* notes that, for non-exchange transactions, applying the relevant IFRS (i.e., IAS 20) would result in less relevant information for users of financial statements of PBEs/NFPs than using another measurement basis (paragraph 17). However, the IFRS treatment cited in the *Process* (measuring transfers of assets at cost rather than fair value) does not apply to the proposed revenue recognition model in the IASB ED on Revenue from Contracts with Customers.

A6. In addition, the other main concerns with applying IAS 20—set out in Appendix B—do not arise with the proposed revenue recognition model in the IASB ED on Revenue from Contracts with Customers.

A7. The other examples of different user information needs in relation to PBEs/NFPs given in the *Process* relate to non-financial information (paragraph 16). Since the recognition of income from non-exchange transactions relates only to financial information, those other examples do not provide an indication that a modification of the IFRS should be based on whether a transaction is non-exchange. In addition, the submissions on ED 180/ED 118 do not identify reasons why users would have different information needs in relation to non-exchange transactions.

A8. Agenda Paper B4.4 for the joint AASB-FRSB meeting in October 2010 noted that a feature of non-exchange transactions involving PBE/NFP recipients is that:

(a) transferors 'purchase' goods or services on behalf of third party beneficiaries, such as members of the community; and

(b) consequently, the degree of specificity of a right to receive goods or services may vary considerably, sometimes calling into question whether the right is sufficiently specific to qualify as a performance obligation. For example, due to their 'remoteness' from third party beneficiaries, donors to a charity may consider that the charity is better placed than them to assess the needs of those beneficiaries, particularly as they are providing resources in concert with other donors. Therefore, they may make donations that specify the goods or services to be provided, and/or the nature or location of the beneficiaries, but also provide considerable discretion to the charity to redirect the donated assets to other charitable purposes or beneficiaries.

A9. It may be argued that non-exchange transactions of PBEs/NFPs warrant a different accounting treatment because transfers and taxes may be provided in the expectation of the recipient's 'performance' in relation to the transferred assets, but in many instances the promised performance is not specified in sufficient detail for a liability to be identified. Under that view, a liability should nonetheless be recognised to avoid 'premature' recognition of income in relation to the transfers and taxes.

A10. However, the AASB and FRSB tentatively agreed at the October 2010 meeting that such a fundamentally different approach to recognising liabilities, compared with that proposed in the IASB ED on Revenue in Contracts with Customers, is not warranted. Therefore, the feature of non-exchange transactions noted in paragraph A8 does not provide a reason for developing a Standard specifically applying to non-exchange transactions.

A11. In addition, in relation to paragraph 20 of the Process, there are no apparent reasons why the costs of compliance with the IFRS on Revenue from Contracts with Customers would be disproportionate in relation to non-exchange transactions.

A12. In contrast, the Boards have tentatively decided that modifications to the forthcoming IFRS on Revenue from Contracts with Customers *would* be appropriate for PBEs/NFPs if that IFRS reflects the proposals in the IASB ED. Those modifications are set out in the minutes of the AASB/FRSB meeting held in October 2010 (available on the AASB website) and noted briefly in the project status report (AASB Agenda Paper 10.9 / FRSB Agenda Paper B7.9). Those modifications relate to the characteristics of PBEs/NFPs and do not relate to the non-exchange nature of transactions.

A13. The *Process* says that, if a different requirement or different guidance is likely to be appropriate for a PBE/NFP, the AASB and FRSB would consider the treatment in other authoritative material such as a public sector specific IPSAS (paragraph 27). The facts that IPSAS 23 adopts a different treatment of non-exchange transactions than does IAS 20 and that the scope of IPSAS 23 is based (in part) on the non-exchange nature of transactions create a *prima facie* case for basing the scope of the revised ED on non-exchange transactions. However:

(a) IPSAS 23 was developed before the IASB ED on Revenue from Contracts with Customers. Therefore, we do not know whether the IPSASB would have developed a Standard with a scope based on non-exchange transactions if the forthcoming IFRS on Revenue from Contracts with Customers already existed; and

(b) the treatment of transactions within the scope of IPSAS 23 does not seem to depend particularly on the non-exchange nature of transactions. Liabilities are identified in respect of transactions giving rise to particular obligations, despite those transactions being non-exchange. This differs from AASB 1004, which treats all non-exchange transactions as transactions that do not, of themselves, give rise to liabilities.

A14. Based on the discussion above, the staff conclusion is that applying the *Process* identifies a need to modify the proposed IFRS on Revenue from Contracts with Customers for application by PBEs/NFPs but does not indicate that a distinction needs to be made between the treatment of exchange transactions and non-exchange transactions.

APPENDIX B: Flaws in IAS 20

B1. This Appendix summarises the main flaws in IAS 20. None of these flaws is encountered under the IASB'S Proposed Model for Contracts with Customers.

B2. IAS 20 focuses on recognition of deferred income, without specifying the nature of obligations to be recognised as liabilities. Thus, it does not distinguish performance obligations and return obligations, and therefore does not clarify when the stipulations attaching to a grant should be considered to have been met.

B3. IAS 20 requires government grants to be "recognised in profit or loss on a systematic basis over the periods in which the entity recognises as expenses the related costs for which the grants are intended to compensate" (paragraph 12). However, many stipulations attaching to government grants relate to specified outputs, rather than to costs. The ratio of costs to the value of outputs might not be consistent for all of the outputs stipulated in relation to a grant.

B4. Moreover, some stipulations attaching to grants are in no way intended to compensate for costs incurred by the grantee. In such cases, it is unclear when the government grants should be recognised as income under IAS 20.

B5. Paragraph 7 of IAS 20 specifies that:

> "Government grants, including non-monetary grants at *fair value*, shall not be recognised until there is reasonable assurance that:
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> (a) the entity will comply with the conditions attaching to them; and
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> (b) the grants will be received."

The criterion in (a) relates to the existence of a liability, not an asset.

B6. Paragraph 24 of IAS 20 says government grants related to assets may be presented in the balance sheet by deducting the grant in arriving at the carrying amount of the asset. Such treatment understates the grantee's assets and liabilities. A consequence of understating grant-funded depreciable assets is that future depreciation charges are less than they otherwise would be, to the detriment of future assessments of whether the entity is recovering its operating costs.