



Staff Paper

Feb 2011, AASB Agenda Paper 10.8 / FRSB Agenda Paper B7.8

Income from Non-Exchange Transactions – Illustrating the Measurement of Different Categories of Obligations

Purpose of this Paper

1. This paper extends Agenda Paper 8.3 for the December 2010 Board meetings to include amounts and illustrate how different categories of obligations could be measured under the AASB staff proposals in the measurement papers on income from non-exchange transactions for this meeting.
2. As this paper is a companion piece for those measurement papers, no questions are asked in it.
3. The additional information (to that provided in the December 2010 paper) and related additional discussion are marked up in the examples.

Examples

The first example is a transaction that is wholly exchange in nature and gives rise to both a performance obligation and a return obligation. This example provides a point of comparison for the following examples.

Example 1—Exchange Transaction for the Rendering of Services

Local Government A is contracted by the national government to trap and relocate crocodiles that encroach on areas of likely human contact. The contract is for twelve months, and requires the activity to be performed continuously throughout that period. The fee of \$600,000 for this service is paid in advance on 2 January 20X0, at which time a binding arrangement is created. ~~Any unearned portion is refundable.~~ If Local Government A fails to perform as promised for any part of the year, a pro rata refund of the contract fee (for the unperformed period) must be paid to the national government. The reporting date for Local Government A is 30 June each year.

Local Government A intends to make a profit on this service, which it performs to subsidise community services it provides at a loss.

Assume that:

- (a) as recommended in AASB Agenda Paper 10.6 / FRSB Agenda Paper B7.6, the performance obligation to provide the service is measured at its fulfilment value (IAS 37-

based measure). Local Government A’s best estimate of the fulfilment value as at 2 January 20X0 is \$550,000. The fulfilment value reduces in a straight line each month; and

- (b) as recommended in AASB Agenda Paper 10.7 / FRSB Agenda Paper B7.7, the stand-ready obligation of Local Government A to make a pro rata refund of the fee for any non-performance of the service is measured at the probability-weighted amount of fee that it expects to refund. The probability of needing to make a pro rata refund is assessed as 5 per cent throughout the twelve month period. At any given time, therefore, the return obligation is measured as 5 per cent of the amount contingently refundable.

Event and timing	Return obligation?	Performance obligation?
Fee for service paid in advance on 2 January 20X0	Return obligation for unearned portion of the fee (not an advance receipt obligation), <u>measured at \$30,000¹</u>	Performance obligation to provide the service, <u>measured at \$550,000</u>
During the period from 2 January 20X0 to 30 June 20X0, six months’ fee income is earned by Local Government A	Return obligation for unearned portion of the fee	Performance obligation to provide the service
Reporting date of 30 June 20X0	Return obligation for unearned portion of the fee, <u>measured at \$15,000</u>	Performance obligation to provide the service, <u>measured at \$275,000</u>
During the period from 1 July 20X0 to 31 December 20X0, six months’ fee income is earned by Local Government A	Return obligation for unearned portion of the fee	Performance obligation to provide the service
31 December 20X0	No return obligation	No performance obligation

Thus, on entering the contract and receiving the fee (on 2 January 20X0), Local Government A would recognise liabilities to the national government totalling \$580,000 and income of \$20,000 (a ‘day one’ gain). This contrasts with the treatment proposed in the IASB ED on Revenue from Contracts with Customers, under which the liabilities to the national government would be measured at \$600,000 (and therefore no ‘day one’ income would be recognised).

¹ 5% × \$600,000

Example 2—Transfer to a PBE/NFP University with Stipulations

This Example is based on Example 11 in the Illustrative Guidance in ED 180/ED 118, which is modified to add pertinent details (including amounts) and reflect the Boards’ decision in March 2010 that an accompanying return obligation is not essential for a performance obligation to qualify as a liability.

On 2 January 20X0, the national government (transferor) transfers 200 hectares of land in a major city to a university (reporting entity) for the establishment of a university campus. The transfer agreement specifies that university campus buildings with a capacity for 10,000 students and ~~1,500-800~~ academic staff are to be built on the land. The estimated fulfilment value (IAS 37-based measure) of constructing the campus buildings is \$140 million. ~~, but~~ However, the transfer agreement does not specify that the land is or other assets are to be returned if the campus buildings are not constructed. Nevertheless, the government can enforce the construction of the campus buildings through legal or equivalent means (a right to enforce specific performance). There are no other stipulations attached to the transfer.

The university recognises the land as an asset in the statement of financial position of the reporting period in which it obtains control of that land. The land should be recognised at its fair value in accordance with AASB 116 / NZ IAS 16 *Property, Plant and Equipment*. Its fair value is \$800 million. Because the government can enforce the construction of the campus buildings through legal or equivalent means, the university recognises a liability for its enforceable performance obligation when the land is recognised as an asset. The binding transfer agreement is entered into simultaneously with the transfer of control of the land. Therefore, there is no advance receipt.

This example and its treatment are set out below in a similar format to the other examples in this paper. It is also assumed that construction of the buildings is completed in November 20X0, and that the reporting date for the university is 31 December each year.

Event and timing	Return obligation?	Performance obligation?
On 2 January 20X0, land with a fair value of \$800 million is transferred to the university	There is no advance receipt and no other return obligation	Performance obligation to construct the campus buildings, measured at <u>\$140 million under IAS 37²</u>
Construction of campus buildings is performed from 2 January 20X0 to 30 November 20X0	No return obligation	Performance obligation to construct the campus buildings
Reporting date of 31 December 20X0	No return obligation	No performance obligation

² This measurement basis is recommended in AASB Agenda Paper 10.6 / FRSB Agenda Paper B7.6.

Measuring the university's performance obligation at \$140 million using the measurement basis in IAS 37 reveals that the PBE/NFP university received a donation as a component of the transfer from the national government. As at 2 January 20X0, the university would recognise income of \$660 million (being \$800 million [fair value of land] minus the performance obligation of \$140 million). A further \$140 million would be recognised as construction income during the year ending 31 December 20X0, representing the satisfaction of the performance obligation.

Example 3—Advance Receipts of Income Tax (Example 8 in ED 180/ED 118)

Example 8 in the Illustrative Guidance in ED 180/ED 118 provides the following fact pattern and proposed treatment:

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.

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).

This example and its treatment are set out below in a similar format to the other examples in this paper. The example is modified to focus on payments by a particular taxpayer, to assume that the first instalment of 'provisional tax' paid is \$100,000, and that additional instalments of provisional tax totalling \$300,000 are received from the taxpayer by Government A during the tax period. When the taxpayer's tax assessment is issued, it is determined that there is no amount refundable to the taxpayer.

Assume that:

- (a) Government A does not incur an enforceable performance obligation in return for income taxes it recognises as an asset;
- (b) the stand-ready obligations of Government A are measured using the basis recommended in AASB Agenda Paper 10.7 / FRSB Agenda Paper B7.7;
- (c) as at 24 December 20X0, the weighted average probability of the \$100,000 advance receipt needing to be refunded (due to insufficient taxable income being earned by the taxpayer) is 4 per cent. Therefore, Government A's obligation to stand ready to return taxes paid in advance by the taxpayer is \$4,000; and

(d) as at 31 December 20X1, which is prior to lodgement of the taxpayer’s tax return, the weighted average probability of a repayment of the \$400,000 taxes received for the year ending on that date (due to insufficient taxable income being earned by the taxpayer) is 0.5 per cent. Therefore, Government A’s obligation to stand ready to return taxes paid by the taxpayer (a return obligation that is not an advance receipt) is \$2,000.

Event and timing	Return obligation?	Performance obligation?
First instalment of provisional taxation paid 24 December 20X0	Advance receipt liability (return obligation) <u>measured at \$4,000</u>	No performance obligation ³
During the period from 1 January 20X1 to 31 December 20X1, taxable income is earned by the taxpayer and further provisional tax instalments are paid to Government A.	<p>To the extent that tax instalments precede the earning of taxable income during the period, an advance receipt liability exists.</p> <p>To the extent that Government A estimates that the taxpayer has incurred income tax by earning taxable income, the advance receipt liability ceases to exist.</p> <p>The advance receipt liability is increased by each tax instalment paid, and is progressively extinguished throughout the tax period because the taxable event is the taxpayer’s earning of taxable income during the tax period. Any estimated balance of the advance receipt liability remaining at the end of the tax period would be replaced with an unconditional obligation to make a refund (return obligation).</p> <p>The estimated extinguishment of advance receipt obligations gives rise to a return obligation.</p>	No performance obligation

³ ED 180/ED 118 (paragraph 65) notes that specific purpose tax levies may give rise to conditions on transferred assets, which include performance obligations. For the purposes of this example, it is assumed that the income tax is a general purpose tax.

	This return obligation is the obligation to stand ready to make a refund if, contrary to estimates, the tax instalments exceed the tax assessed.	
At Government A's reporting date of 31 December 20X1, all taxable income relating to the taxpayer's tax instalments has been earned, but a tax return has not been received.	The advance receipt obligation has been fully extinguished. Government A has a stand-ready obligation to refund tax instalments if they exceed the tax assessed (return obligation), measured at \$2,000.	No performance obligation
Income tax assessment issued 28 February 20X2	No return obligation	No performance obligation

The events relating to the receipt and assessment of the taxpayer's income taxes for the tax year ending 31 December 20X1 span three financial periods, beginning with the payment of the first instalment and ending with the issuance of the income tax assessment. The amount and timing of income tax recognised as income by Government A in relation to that taxpayer and tax year are set out below.

<u>Annual reporting period ending</u>	<u>Income recognised</u>	<u>Calculation</u>
<u>31 December 20X0</u>	<u>\$96,000</u>	<u>\$100,000 instalment minus advance receipt liability of \$4,000</u>
<u>31 December 20X1</u>	<u>\$302,000</u>	<u>\$400,000 total estimated tax for the tax period minus \$96,000 income already recognised, minus return obligation of \$2,000</u>
<u>31 December 20X2</u>	<u>\$2,000</u>	<u>Expiry of \$2,000 return obligation without a refund being paid</u>

ED 180/ED 118 specifies when an asset is recognised for taxes but does not specify when resulting income is recognised. Paragraph 60 of the ED states that "An entity shall recognise an asset in respect of taxes when the taxable event occurs and the asset recognition criteria are met". Paragraph 66(a) of the ED says it is likely that the taxable event for income tax is the earning of taxable income during the taxation period by the taxpayer. In addition, Example 1 in the Implementation Guidance accompanying the ED says "At the end of the reporting period, the government recognises assets **and income** in respect of personal income tax on the taxable income earned during the reporting period to the extent that it can reliably measure it" (paragraph IG2, emphasis added). This example illustrates that, under the measurement basis proposed in AASB

Agenda Paper 10.7 / FRSB Agenda Paper B7.7, income tax would not necessarily be recognised as income solely as taxable income is earned by the taxpayer.

Example 4—Matching Grants for the Construction ~~and Maintenance~~ of a New Bridge

Local Government B receives a grant of \$80 million from the national government on 15 May 20X0 as a contribution of half the estimated cost of constructing a new bridge. The grant is provided on the condition that a matching grant is provided by the relevant state government, to enable the bridge to be built without Local Government B financing the bridge's construction with debt or increased rates. If a matching grant is not obtained, the national government grant must be returned.

The grant and its deployment are the subject of an agreement, which is not entered into by Local Government B until its council completes its due diligence on the construction project and the likelihood of obtaining a matching grant from the state government. Local Government B's reporting date is 30 June each year. The agreement becomes binding on 15 July 20X0. Under the terms of that agreement, the national government grant is refundable in full if the bridge is not constructed to an adequate standard within two years of entry into the agreement (i.e., by 14 July 20X2).

Local Government B obtains a matching grant of \$80 million from the state government on 31 July 20X0. On the same day, a binding agreement between Local Government B and the state government is entered into. Under the terms of that agreement:

- (a) the state government grant is refundable in full if the bridge is not constructed to an adequate standard within two years of entry into the agreement (i.e., by 30 July 20X2); and
- ~~(b) Local Government B must maintain the bridge for twenty years after its completion. The state government has the capacity to enforce this promise by legal or equivalent means. However, there are no refund provisions attaching to this promise. [deleted to limit the complexity of the example]~~

On 28 February 20X2, Local Government B completes construction of the bridge to an adequate standard, and representatives of both the national and state governments sign off on adequate completion.

Assume that:

- (a) as recommended in AASB Agenda Paper 10.7 / FRSB Agenda Paper B7.7, Local Government B identifies the following stand-ready obligations and measures each of them as the product of the probability of occurrence and the amount of the outflow:
 - Until the grant agreement with the national government becomes binding on 15 July 20X0 [an advance receipt exists]
 - (i) the obligation to stand ready to return the \$80 million grant to the national government if the grant agreement does not become binding (i.e., Local Government B declines the grant);

- (ii) the obligation to stand ready to undertake an enforceable obligation to construct a new bridge (this is measured at fulfilment value, which takes into account the probability of completing the construction);
 - (iii) the obligation to stand ready to undertake an obligation to return the grant in full if the bridge is not constructed to an adequate standard by the specified date;
 - *After the grant agreement with the national government becomes binding (15 July 20X0) [an advance receipt no longer exists] but before a matching grant is obtained from the state government (31 July 20X0)*
 - (iv) the obligation to stand ready to return the \$80 million grant to the national government if Local Government B is unable to obtain a matching grant;
 - (v) the obligation to stand ready to return the \$80 million grant to the national government if the bridge is not constructed to an adequate standard by the specified date; and
 - *After the binding grant agreement with the state government is entered into (31 July 20X0)*
 - (vi) the obligation to stand ready to return both \$80 million grants to the national and state governments if the bridge is not constructed to an adequate standard by the respective specified dates (in relation to the national government, this is a continuation of the stand-ready obligation referred to in (v));
- (b) as recommended in AASB Agenda Paper 10.6 / FRSB Agenda Paper B7.6, Local Government B measures its performance obligations to construct the bridge at their fulfilment value. Its estimated cost to construct the bridge (i.e., assuming that completion of construction is certain) is \$150 million. The amount of the grants sought (and ultimately obtained) includes a margin on cost to compensate Local Government B for the risk of being obliged to refund the grants after work is commenced;
- (c) Local Government B estimates that, as at 15 May 20X0, the probability of declining the grant of \$80 million is 20 per cent. This assessment remains unchanged as at 30 June 20X0. As at each of those dates, the related stand-ready obligation is measured as \$16 million;
- (d) Local Government B estimates that, until the matching grant is obtained, the probability of being unable to obtain a matching grant of \$80 million is 10 per cent; and
- (e) Local Government B estimates that, if the project proceeds, the probability of performing to an adequate standard is 95 per cent and the probability of needing to refund the grants in full is 5 per cent. This assessment remains unchanged throughout the project.

Based on these assumptions:

(a) on 15 May 20X0 and 30 June 20X0:

(i) as noted above, the probability of the grant agreement with the national government not becoming binding, and a refund of \$80 million consequently occurring, is 20%. Thus, all other possible outcomes described below are estimated to have, in aggregate, an 80% probability of occurring. The stand ready obligation is measured at \$16 million;

(ii) there is a 10% probability that if the grant agreement becomes binding, a refund of \$80 million will be required due to an inability to obtain a matching grant. This outcome represents a 10% × 80% probability out of all possible outcomes. The stand ready obligation to make a refund for this reason is measured at 8% × \$80 million, i.e., \$6.4 million;

(iii) based on (i) and (ii), there is a 72% probability of the project proceeding;

(iv) therefore, the probability of adequate completion of the project is 72% × 95% = 68.4%. The stand ready obligation to undertake a performance obligation is measured at 68.4% × \$75 million (half of the estimated project completion cost), i.e., \$51.3 million;

(v) the probability of a return of the grant due to non-performance or unsatisfactory performance is 72% × 5% = 3.6%. The stand ready obligation to undertake a promise to potentially make this return is measured at 3.6% × \$80 million, i.e., \$2.88 million; and

(vi) the excess of the grant over the sum of the above-mentioned stand ready obligations = \$80 million minus \$76.58 million. As at 15 May 20X0, Local Government B would recognise income of \$3.42 million.

(b) on 15 July 20X0, the agreement with the national government becomes binding and the probabilities need recalculating as follows:

(i) there is a 10% probability that a refund of \$80 million will be required due to an inability to obtain a matching grant. The stand ready obligation to make a refund for this reason is measured at \$8 million;

(ii) based on (i), there is a 90% probability of the project proceeding;

(iii) therefore, the probability of adequate completion of the project is 90% × 95% = 85.5%. The performance obligation is measured at 85.5% × \$75 million, i.e., \$64.125 million;

(iv) the probability of a return of the grant due to non-performance or unsatisfactory performance is 90% × 5% = 4.5%. The stand ready obligation to make a return is measured at 4.5% × \$80 million, i.e., \$3.6 million; and

- (v) therefore, the total amount of the liability to the national government is remeasured from \$76.58 million as at 30 June 20X0 to \$75.725 million as at 15 July 20X0; and
- (c) on 31 July 20X0, the matching grant is obtained and the obligations to both governments are measured as follows:
- (i) the performance obligation is measured at 95% × \$150 million, i.e., \$142.5 million;
- (ii) the stand ready obligation to make a return is measured at 5% × \$160 million, i.e., \$8 million; and
- (iii) therefore, the total amount of the liability to both governments is measured at \$150.5 million (compared with total grants received of \$160 million).

Note that the bases for measuring the performance-related and refund-related components of the liability do not change when an advance receipt ceases to exist and is substituted by other related obligations. This example seems to indicate that advance receipts are not a special category of obligation, if the staff’s measurement proposals in the related papers are agreed with.

Event and timing	Return obligation?	Performance obligation?
Local Government B receives national government grant, without a binding agreement, on 15 May 20X0	Advance receipt liability, <u>measured at \$76.58 million</u>	No performance obligation (no binding agreement)
Reporting date of 30 June 20X0	Advance receipt liability, <u>measured at \$76.58 million</u>	No performance obligation (no binding agreement)
Agreement with national government becomes binding on 15 July 20X0	Return obligation exists (obligation to stand ready to return national government grant if bridge not built by 14 July 20X2), <u>measured at \$11.6 million</u> . This is no longer an advance receipt obligation.	Performance obligation arises to build the bridge by 14 July 20X2, <u>measured at \$64.125 million</u>
Local Government B receives state government grant, upon entering a binding agreement, on 31 July 20X0	Return obligation arises (obligation to stand ready to return state government grant if bridge not built by 30 July 20X2). This is not an advance receipt obligation.	Performance obligation arises to build the bridge by 30 July 20X2. Performance obligation arises to maintain the bridge for twenty years.
<u>Total liability at 31 July 20X0</u>	<u>\$8 million</u>	<u>\$142.5 million</u>

Event and timing	Return obligation?	Performance obligation?
Period from 31 July 20X0 until 28 February 20X2	Obligations exist to stand ready to return grants to both the national government and state government if the bridge is not built by the specified dates.	Performance obligations to both the national government and state government to build the bridge. Performance obligation to maintain the bridge for twenty years is owed to the state government.
Construction of the bridge is completed on 28 February 20X2	Both return obligations are extinguished.	Performance obligations to build the bridge are extinguished. Performance obligation to maintain the bridge for another twenty years is owed to the state government.
Reporting date of 30 June 20X2	No return obligation	No performance obligation to maintain bridge for another 19 years and 8 months.