

Project on Income of Not-For-Profit Entities

Staff Issues Paper: Recognising Liabilities for Onerous Contracts

Introduction

- 1 In its project to develop an IFRS on *Revenue from Contracts with Customers*, the IASB tentatively decided (in its redeliberations of IASB ED/2010/6 *Revenue from Contracts with Customers*) to require recognition of a liability and an expense for an ‘onerous’ long-term service contract when the transaction price for that contract is exceeded by the lower of:
 - (a) the present value of the probability-weighted costs that relate directly to satisfying the performance obligations in that contract (hereinafter ‘fulfilment cost’); and
 - (b) any amounts the entity would have to pay to cancel the contract (‘cancellation price’).
- 2 The IASB has yet to define ‘long-term’ in this context. For the purposes of this staff paper, it is assumed that all contracts or other arrangements discussed are long-term.
- 3 A qualifier to paragraph 1 is that the IASB tentatively decided that a liability and corresponding expense should be recognised if a loss remains to be recognised after recognising any impairment loss on assets related to the contract.

Issues

- 4 Some have expressed concern that, if the requirement in paragraph 1 were specified in the Australian Accounting Standard on Income of Not-for-Profit Entities, NFPs might customarily recognise onerous contract losses upon receiving transfers accompanied by enforceable obligations to provide services that will cost more to fulfil than the amount of the transfer.
- 5 This paper discusses:
 - (a) whether this concern is justified;

- (b) whether it would be appropriate for NFPs to recognise liabilities for onerous long-term service contracts; and
- (c) whether some NFP contracts should be excluded from the scope of the ‘onerous contract’ test.

6 This paper also covers arrangements, other than contracts, that give rise to performance obligations. For the sake of simplicity, only ‘contracts’ are referred to below, but they should be read as including other arrangements.

Summary of Staff Recommendations

7 Staff recommend that the ED of an Australian Accounting Standard on Income of NFPs should reflect the following views:

- (a) a NFP-specific modification should be made to the expected IFRS on *Revenue from Contracts with Customers* to indicate that, when determining whether a long-term contract with a transferor to provide specified services is onerous, user charges should be included in the transaction price (consideration) that is compared with the lower of fulfilment cost and cancellation price;
- (b) the practical difficulties associated with NFPs applying an ‘onerous contract’ test at a high (e.g. entity-wide) level are unlikely to be so significant that NFPs should be exempted from the test;
- (c) the different measurement bases for impairment losses and liabilities for onerous contracts of NFPs do not, of themselves, warrant exempting NFPs from the ‘onerous contract’ test; and
- (d) long-term contracts entered into by NFPs for a social benefit or charitable purpose should not be excluded from the scope of the ‘onerous contract’ test.

Is the Concern in Paragraph 4 Justified?

8 The concern in paragraph 4 was raised by New Zealand Treasury in its submission to the IASB on IASB ED/2010/6, and by some respondents to AASB ED 180/FRSB ED 118 *Income from Non-exchange Transactions (Taxes and Transfers)*. New Zealand Treasury argued:

“We think the [onerous contract] requirements should be scoped out for not-for-profit entities, which intentionally provide goods and services at less than cost for social benefit objectives. In a lot of cases a not-for-profit entity will receive a government grant to fund a revenue shortfall. If the customer and government grants were considered together, the entity’s costs would not exceed its revenues.

Consider an example of a railway entity that only recovers 60% of its costs from its customers and the remaining 40% from government grants. The ED would view both the customer contract and the government grant as onerous, as neither party pays for the full cost of the railway services. Therefore, the railway would be required to recognise an expense and a liability for each, even though on a total contract basis there is no loss on the services it provides. This does not appear to be a sensible outcome when considering all of the facts and circumstances of the transaction.”

- 9 New Zealand Treasury’s comments (quoted above) imply the main problem is a ‘unit of account’ issue. That is, the IFRS arguably would require the grant to be considered separately from the user charges to determine the consideration to compare with the costs to determine whether a contract is onerous. New Zealand Treasury contends that in a lot of cases a contract would not be considered onerous if revenues included the transfer and the user charges. [Paragraphs 19 – 43 consider how an entity should account for a contract if indeed the total consideration is exceeded by the lower of fulfilment cost and cancellation price.]
- 10 The interpretation by New Zealand Treasury seems consistent with the IASB’s tentative decision that, for contracts to be combined as a single of account, they must be entered into at or near the same time with the same customer or related entities. (Full details of the IASB’s proposed criteria for combining contracts to determine the unit of account for a contract are set out in Appendix A.)
- 11 The FASB has reached a similar conclusion to that of New Zealand Treasury. In its joint project with the IASB on Revenue from Contracts with Customers, the FASB tentatively decided that applying the ‘onerous contract’ test to contracts entered between NFPs and customers for a social benefit or charitable purpose would require those NFPs to identify the contracts as onerous and recognise a loss when the contracts are entered into, instead of when the benefits are provided. The related staff paper considered by the FASB did not discuss the possibility of avoiding the above-mentioned problem by defining the unit of account more broadly, as alluded to by New Zealand Treasury.

- 12 Arguably, present practice in applying AASB 137 *Provisions, Contingent Liabilities and Contingent Assets* provides a pointer to whether applying the tentatively decided ‘onerous contract’ test for the IFRS on *Revenue from Contracts with Customers* should result in recognition of liabilities for onerous contracts in the circumstances that troubled New Zealand Treasury. This is because the requirements in AASB 137 for the recognition of provisions for onerous contracts are similar to the latest tentative decisions of the IASB and FASB regarding onerous contracts in their Revenue project (see paragraph 13 below).
- 13 AASB 137 defines an ‘onerous contract’ as “a contract in which the unavoidable costs of meeting the obligations expected under the contract exceed the economic benefits expected to be received **under it**” (paragraph 10, emphasis added).¹ Arguably, the economic benefits to be considered when assessing whether a contract with a transferor is onerous under AASB 137 would exclude inflows from user charges. However, Board members have previously indicated that current practice of public sector NFPs is generally not to recognise provisions for onerous contracts. This suggests that entities, in applying the definition of an ‘onerous contract’ in AASB 137, are interpreting the economic benefits received under a contract broadly (to include economic benefits to be received from other parties as a consequence of the contract). This treatment makes sense because it reflects the economic substance of the contract. It reflects the general requirements of AASB 137 and is not dependent on the NFP-specific guidance in that Standard (that NFP-specific guidance does not affect the potential for onerous contracts to be identified in respect of the service-delivery contracts referred to in paragraph 8²).
- 14 Nevertheless, staff think a literal reading of the proposed IASB requirement to recognise liabilities for onerous contracts would give rise to the potential concern noted in paragraph 8 in respect of NFPs if they applied that requirement. At the very least, staff think the IASB’s tentative decisions give rise to the potential for the

¹ The IASB’s and FASB’s tentative decision in the Revenue project is more explicitly restrictive, because it limits contracts that may be combined to those entered into with the same customer or related entities.

² AASB 137 includes NFP-specific guidance that an intention of a local government, government department or government to make payments to other parties, whether advised in the form of a local government or government budget policy, election promise or statement of intent, does not of itself create a binding present obligation. This guidance does not address grant agreements creating enforceable obligations of the grantee to provide services (such as grants for a lesser amount than the estimated fulfilment cost). Therefore, the NFP-specific modification to IAS 37 in AASB 137 does not avoid the concern noted in paragraph 8.

‘onerous contract’ test to be interpreted in the way that New Zealand Treasury has done. Therefore, staff think the concern in paragraph 8 is justified.

Question for Board members

Q1 Do you agree that the ‘onerous contract’ test tentatively decided by the IASB could potentially be interpreted to exclude user charges from the transaction price (consideration) that is compared with the lower of fulfilment cost and cancellation price of an obligation to a transferor to provide specified services?

If Liabilities for Onerous Contracts are Recognised, What Unit of Account Should be Used to Identify Them?

- 15 This section of the paper sets aside for the time being the fundamental question of whether application of the ‘onerous contract’ test by NFPs is appropriate. It seeks Board members’ views on the appropriate unit of account for determining whether contracts of NFPs are onerous, assuming that recognition of liabilities for onerous contracts by NFPs is appropriate. This is to eliminate potential ‘noise’ regarding the appropriateness of the ‘onerous contract’ test that may stem from mis-specifying the unit of account for that test.
- 16 Staff propose that long-term contracts for the sale of services subsidised by a transfer should be combined with the contract with the transferor in order to calculate the transaction price. For example, if a transfer is a subsidy for the cost of health or transport services that will also be recovered through user charges, the subsidy and estimated user charges should be summed in order to determine the transaction price. This view is largely consistent, in substance, with the following criteria tentatively decided by the IASB for combining contracts: namely, that the contracts are negotiated as a package with a single objective; the contract amounts are interdependent; and the services have the same function (however, see paragraph 17). Staff think combining the contracts in these circumstances would faithfully reflect their economic substance. It would be consistent with current practice regarding how AASB 137 is generally interpreted (as mentioned in paragraph 13).
- 17 As implied in paragraph 10, this approach to defining the unit of account for a contract would be inconsistent with the IASB’s tentative decision that, for contracts to be

combined, they must be entered into at or near the same time with the same customer or related entities. Staff propose making a NFP-specific modification to the expected IFRS on *Revenue from Contracts with Customers* to exclude this IASB criterion from the NFP guidance on combining contracts for the purposes of identifying whether contracts are onerous.³ This is because the substance of integrally related promises—and funding thereof—in the NFP sector does not necessarily involve that feature.

- 18 Some argue that applying a broader notion of a contract for the purpose of applying the ‘onerous contract’ test would be inconsistent with the IASB’s tentative decision not to exempt a contract from that test if it is intentionally priced at a loss in the expectation of generating profits on subsequent contracts with the customer (a ‘loss-leader’ contract). However, staff think the types of NFP contracts described in paragraph 8 are substantially different from loss-leader contracts of for-profit entities. In a loss-leader contract, only the customer pays for the services provided under the terms of the contract. In the types of NFP contracts described in paragraph 8, the transferor and payers of user charges jointly pay for the services provided. Therefore, staff think the IASB tentative decision mentioned in the first sentence of this paragraph should not be a significant consideration in identifying the boundaries of a contract for the purpose of applying the ‘onerous contract’ test.

Question for Board members

- Q2** Do you agree that a NFP-specific modification should be made to the expected IFRS on *Revenue from Contracts with Customers* to indicate that, when determining whether a contract with a transferor for the provision of specified services is onerous, user charges should be included in the transaction price (consideration) that is compared with the lower of fulfilment cost and cancellation price?

Whether NFPs Should Recognise Liabilities for Onerous Contracts

- 19 For the purposes of the following discussion, it is assumed that:
- (a) under a contract, the entity has an unconditional obligation to provide services additional to those funded by the transferor (the IASB tentatively decided in its Revenue project that only unconditional obligations are liabilities);

³ Staff are not proposing to make a NFP-specific modification to the IASB’s criteria for combining contracts for other purposes covered by the expected IFRS on *Revenue from Contracts with Customers*.

- (b) for simplicity, the NFP cannot cancel the contract and thus avoid incurring a fulfilment cost that exceeds the consideration received from the transferor; and
 - (c) the unit of account for assessing whether a contract is onerous reflects the staff's proposal in Question 2.
- 20 The objective of the requirement to recognise liabilities for onerous contracts under the expected IFRS on *Revenue from Contracts with Customers* is to overcome the problem that applying the general measurement basis for an entity's obligations to customers [namely, the transaction price (customer consideration amount)] would understate those obligations if their estimated lowest cost of extinguishment exceeds the transaction price. AASB staff think this objective is appropriate for for-profit entities and NFPs alike.
- 21 Some argue that expenses arising from a NFP's contractual promises to provide services should be recognised only as the services are rendered. Staff expect that, if the appropriate unit of account is adopted for identifying whether long-term service contracts are onerous, most of those contracts would not be identified as onerous. Therefore, in those cases, expenses would be recognised as services are rendered. However, staff think it would be inappropriate to assume that no long-term service contracts of NFPs would be onerous, or to delay the recognition of losses in order to 'match' all expenses with the rendering of services.
- 22 Concerns have been raised that application of the 'onerous contract' test by NFPs might be unworkable. In addition, concerns have been expressed that the interaction of that test with the impairment test for NFPs would result in inappropriate outcomes. These concerns are discussed in paragraphs 23 – 37.

Is the test workable?

- 23 At the June 2011 AASB meeting, some Board members noted that an 'onerous contract' test might apply at a whole-of-entity level for some NFPs. This is because some transfers to NFPs are tied to the provision of all services the entity provides, such as subsidised public transport. Some Board members expressed concern that it might be unworkable to apply the 'onerous contract' test (estimating future cash flows) at a whole-of-entity level.

- 24 Staff observe that impairment testing of assets under AASB 136 *Impairment of Assets* may also involve estimating cash flows at a whole-of-entity level.⁴ However, an additional complication may arise for NFPs when they estimate cash flows at a whole-of-entity level. Particularly for NFPs in the public sector, a shortfall of cash flows needed to fund required services may prompt the government to provide additional funds to the entity. The possibility of such a government decision can create additional uncertainty in estimating future cash flows, particularly if political considerations are a factor.
- 25 There are two arguments why this additional complication does not necessarily indicate that estimating cash flows at a whole-of-entity level should be unworkable. These are outlined in paragraphs 26 and 27.
- 26 In some cases, despite the additional complication described in paragraph 24, it might be relatively straightforward to apply the ‘onerous contract’ test at a whole-of-entity level for a NFP. For example, consider Example 1 below.

Example 1

Fact pattern

Assume that Railways Department A received a grant of \$200 million on 30 June 20X0 as an explicit subsidy for the cost of providing rail services for the year ending 30 June 20X1. Railways Department A estimates that it will receive user charges of \$400 million for the year, and that the fulfilment cost of its obligation to provide rail services will be \$700 million. Assume for simplicity that user charges cannot be increased by raising ticket prices, because of a consequential reduction in patronage that would occur.

Analysis

Based on the assumed facts, Railways Department A would recognise a liability of \$200 million for the consideration received in advance of performance. In applying the ‘onerous contract’ test and treating user charges as part of the contract consideration, Railways Department A would assess whether a ‘top-up subsidy’ would be likely to be received. For example, if experience indicates that top-up payments are almost invariably received in the event of a shortfall, in the absence of contrary indications, it would seem reasonable to conclude that the contract is not onerous.

⁴ This is made explicit in Example 1C, Case 2, of the Illustrative Examples accompanying IAS 36 *Impairment of Assets*.

27 The uncertainty created by possible additional government funding affects application of AASB 136 in addition to application of an ‘onerous contract’ test. Despite this, NFPs are not exempt from impairment testing under AASB 136.

28 However, the argument in paragraph 27 is undermined by the following point. Under AASB 136, the value in use of an NFP’s asset tested for potential impairment is often not based on future cash flows. AASB 136 states that for NFPs, “value in use is depreciated replacement cost of an asset when the future economic benefits of the asset are not primarily dependent on the asset’s ability to generate net cash inflows and where the entity would, if deprived of the asset, replace its remaining future economic benefits” (paragraph Aus6.1). Determining value in use as depreciated replacement cost requires an assumption about whether the entity would, if deprived of the asset, replace its future economic benefits. This may be affected by:

- (a) assessments of whether future use of the replaced asset (e.g., patronage by the public) would justify replacement (this should correlate strongly with future cash flows from user charges and/or from transfers from government); and
- (b) political considerations.

Arguably, measuring value in use as depreciated replacement cost would be simpler than estimating whether a contract is onerous.

29 Staff observe that, nevertheless, a key aspect of a NFP’s budgeting should involve estimating the cost to provide services, and therefore estimating whether a contract is onerous should be supported by the NFP’s management information systems.

30 On balance, staff think the practical difficulties associated with NFPs applying an ‘onerous contract’ test at a high (e.g. entity-wide) level are unlikely to be so significant that NFPs should be exempted from the test.

Question for Board members

Q3 Do you agree that the practical difficulties associated with NFPs applying an ‘onerous contract’ test at a high (e.g. entity-wide) level are unlikely to be so significant that NFPs should be exempted from the test?

Interaction with impairment test for NFPs

- 31 At the June 2011 AASB meeting, some Board members expressed concern about the implications of NFPs applying an ‘onerous contract’ test based on fulfilment cost in conjunction with applying an impairment test based on depreciated replacement cost (AASB 136 *Impairment of Assets* requires NFPs to measure the value in use of some assets at depreciated replacement cost). They questioned the appropriateness of NFPs measuring a liability for an onerous contract by reference to net cash outflows when potentially measuring related impairments of assets on another basis.
- 32 This issue is illustrated by the following example, which uses the same basic fact pattern as Example 1 above, except for a different likelihood of a ‘top-up subsidy’. The full fact pattern is set out below for ease of reference. Two variations of the fact pattern (additional facts) are then added to the basic fact pattern, to illustrate different ways in which the impairment test might interact with the ‘onerous contract’ test.

Example 2

Basic fact pattern

Assume that Railways Department A received a grant of \$200 million on 30 June 20X0 as an explicit subsidy for the cost of providing rail services for the year ending 30 June 20X1. Railways Department A estimates that it will receive user charges of \$400 million for the year, and that the fulfilment cost of its obligation to provide rail services will be \$700 million.

Additional assumed facts: Variation A

The transferor government advises Railways Department A that, due to financial difficulties, there will be no additional funding for service delivery for the year ending 30 June 20X1. Railways Department A needs to identify cost savings while meeting its service charter, which provides some flexibility regarding the amount of services to be provided and the manner in which they are to be provided. However, any closures of rail lines (replaced with bus services) and sales of related assets would require Ministerial approval. Railways Department A identifies various railway lines that would need closing. Consequently, the fulfilment cost of the obligation to provide rail services would be limited to the aggregate transaction price (\$600 million), but the depreciated replacement cost of railway infrastructure assets that would be replaced if the Department were deprived of them is reduced to such an extent that an impairment loss of \$120 million is estimated.

Analysis: Variation A

Based on the assumed facts, Railways Department A would recognise: (1) a liability of \$200 million for the consideration received in advance of performance; (2) an impairment loss of \$120 million; and (3) no liability/loss for an onerous contract.

Additional assumed facts: Variation B

These additional assumed facts are the same as for Variation A, except that Railways Department A has less discretion to close rail lines and assesses that it will only be able to reduce the fulfilment cost of the obligation to provide rail services to \$660 million. The depreciated replacement cost of railway infrastructure assets that would be replaced if the Department were deprived of them is reduced to such an extent that an impairment loss of \$80 million is estimated.

Analysis: Variation B

Based on the assumed facts, Railways Department A would recognise: (1) a liability of \$200 million for the consideration received in advance of performance; (2) an impairment loss of \$80 million; and (3) a liability/loss for an onerous contract of \$60 million.

In applying the IASB's view that a liability and corresponding expense should be recognised if a loss remains to be recognised after recognising any impairment loss on assets related to a contract, the liability for the onerous contract is measured separately from the impairment loss on related assets. The impairment loss and loss on the onerous contract are separate economic phenomena arising from the same contract, and their measurement is determined independently.

- 33 Variations A and B of Example 2 illustrate that a liability for an onerous contract (and corresponding loss) would not be a hybrid measure, because it is not a residual after deducting the amount of any related impairment loss. Therefore, there should not be a problem of impracticability of measurement of a NFP's liability for an onerous contract.
- 34 Staff acknowledge that the bases for measuring the impairment loss on some NFP assets and for measuring an onerous contract liability arising from the same event would be inconsistent. However, measurement inconsistencies arise for for-profit entities from the IASB's tentative decisions regarding an IFRS on *Revenue from Contracts with Customers* (namely, liabilities to customers would be measured on the basis of consideration received, except where they are onerous, in which case they would be measured on the basis of estimated fulfilment cost). Moreover, the inconsistency mentioned in the first sentence of this paragraph presently exists between the measurement by NFPs of impairments of some assets (under AASB 136) and of provisions for onerous contracts (under AASB 137).
- 35 Staff also observe that, in some cases, either an impairment loss or a liability for an onerous contract would arise, but not both (in those cases, the issue of inconsistent measurement of loss-generating phenomena would not arise).

- 36 For the reasons in paragraphs 33 – 35, AASB staff think the different measurement bases for impairment losses and liabilities for onerous contracts of NFPs do not, of themselves, warrant excluding NFPs from the ‘onerous contract’ test.
- 37 Staff also observe that Example 2, Variation B illustrates the relevance of liabilities for onerous contracts. If an entity expects not to receive a top-up subsidy necessary to cover the fulfilment cost of an obligation to provide services, recognition of a loss should be of considerable interest to parliamentarians, members of the community and other users of the entity’s GPFRs.

Question for Board members

- Q4** Do you agree that the different measurement bases for impairment losses and liabilities for onerous contracts of NFPs do not, of themselves, warrant exempting NFPs from the ‘onerous contract’ test?

Should Some NFP Contracts be Excluded from the Scope of the ‘Onerous Contract’ Test?

- 38 The FASB tentatively decided to exclude from the scope of the ‘onerous contract’ test NFPs that contract with a customer for a social benefit or charitable purpose. The IASB-FASB staff paper for the joint meeting of those Boards on 17 – 19 May 2011 argued that:

“recognis[ing] a loss when the contract is entered into, instead of when the benefit is provided ... does not provide meaningful information and seems inconsistent with the objective of financial reporting in FASB Statement of Financial Reporting Concepts No. 4 *Objectives of Financial Reporting by Nonbusiness Organizations* ... [which] seems to indicate that costs for services should be recognised when the service is provided (instead of when the contract is entered into). [It would also] conflict with the ... information needs of donors, grantors, and other resource providers of not-for-profit entities.”

- 39 These comments imply the FASB considers contracts entered into for a social benefit or charitable purpose would routinely be identified as onerous. Staff think this concern would be largely addressed by adopting the unit of account for a contract proposed in Question 2. In addition, staff think that if a contract is identified as onerous after considering all sources of consideration for the services required to be rendered, it is appropriate to recognise a liability and related loss.

40 In addition, AASB staff observe that the scope exclusion tentatively decided by the FASB is potentially very broad. At this stage, information is not available on how the FASB might define ‘a social benefit or charitable purpose’. The IASB-FASB staff paper mentioned above gives examples of “some contracts in health care or education”. If the definition used were similar to the IPSASB’s proposed definition of social benefits, it would be very broad. IPSASB Consultation Paper *Social Benefits: Issues in Recognition and Measurement* (March 2008) defines ‘social benefits’ as:

“(a) Cash transfers; and

(b) Collective and individual goods and services

that are provided by an entity to individuals or households in non-exchange transactions to protect the entire population, or a particular segment of the population, against certain social risks.” (paragraph 16)

41 Examples of non-cash social benefits identified in that IPSASB CP are health care and education services and national defence. Arguably, subsidised public transport services would also be regarded as social benefits.

42 Because of the potential breadth of the scope exclusion tentatively decided by the FASB, adopting a similar scope exclusion in an Australian Accounting Standard on Income of NFPs would seem incompatible with a view that it is appropriate for NFPs to recognise liabilities for onerous long-term service contracts.

43 As mentioned in paragraph 20, staff think that if a contract is onerous, a liability and loss should be recognised. This is regardless of the nature of the service being provided or the objective of providing that service.

Question for Board members

Q5 Do you agree that long-term contracts entered into by NFPs for a social benefit or charitable purpose should not be excluded from the scope of the ‘onerous contract’ test?

APPENDIX A

IASB's Tentatively Decided Criteria for Combining Contracts

The IASB tentatively decided that contracts should be combined and accounted for as a single contract when they are entered into at or near the same time with the same customer (or related entities), if at least one of the following criteria is met:

- (a) the contracts are negotiated as a package with a single commercial objective;
- (b) the amount of consideration in one contract depends on the other contract; and
- (c) the goods and services in the contracts are inter-related in terms of design, technology or function.