



## Staff Paper

March 2011, Agenda Paper J3.6

### **IFRS on *Revenue from Contracts with Customers* – PBE/NFP issue regarding Onerous Contracts**

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

1. This paper discusses a public benefit entity (PBE) /not-for-profit entity (NFP) issue that might arise in applying the IASB's and FASB's tentative decision in their draft Standard on *Revenue from Contracts with Customers* that liabilities should be recognised for onerous contracts. This issue is a consideration in determining whether to exclude PBEs/NFPs from the scope of the domestic Standards incorporating the IFRS on *Revenue from Contracts with Customers* when those domestic Standards are first issued—which is discussed in Agenda Paper J3.3.

#### **Summary of Staff Views**

2. AASB and NZICA staff:
  - (a) note that PBEs/NFPs sometimes receive transfers accompanied by enforceable obligations to provide goods or services that will cost more to fulfil than the amount of the transfer, because the cost of those goods or services is expected to be recovered from other sources such as user charges; and
  - (b) consider that:
    - (i) the Boards should explore whether the requirements in the IFRS on *Revenue from Contracts with Customers* to recognise liabilities for onerous contracts in respect of these transfers are suitable for PBEs/NFPs;
    - (ii) exploring this issue is likely to take longer than the period before the Boards issue domestic Standards incorporating the IFRS on *Revenue from Contracts with Customers*;
    - (iii) it would be difficult to define a temporary scope exclusion for these transfers without the risk of unintended consequences; and, therefore

- (iv) these transfers are a reason to exclude PBEs/NFPs from the scope of the domestic Standards incorporating the IFRS on *Revenue from Contracts with Customers* until this issue is explored fully.<sup>1</sup>

### Background

3. IASB ED/2010/6 *Revenue from Contracts with Customers* proposed that, if a performance obligation is onerous, the entity shall recognise a liability and a corresponding expense (paragraph 54). It described a performance obligation as onerous “if the present value of the probability-weighted costs that relate directly to satisfying the performance obligation ... exceeds the amount of the transaction price allocated to that performance obligation” (paragraph 55).
4. The *IASB Update* for the IASB-FASB meeting in February 2011 indicates that the IASB and FASB have tentatively decided to require an entity to account separately for onerous contracts rather than for each onerous performance obligation. The *IASB Update* states:
- “The boards began discussing issues in applying the test to assess whether performance obligations are onerous. The boards tentatively decided that the unit of account for the onerous test should be the contract, specifically the remaining performance obligations in the contract.”
5. This change in thinking does not affect the principles involved in the PBE/NFP-specific issue discussed below.

### PBE/NFP-Specific Issue

6. At its February 2011 meeting, in its discussion of Income from Non-Exchange Transactions, the AASB requested staff to prepare a paper discussing transfers accompanied by enforceable obligations to provide services that will cost more to fulfil than the amount of the transfer (e.g., the transfer partially funds the entity to perform a service it already intended to perform). The Board noted concerns that, unless the amount of a performance obligation is limited to the amount of consideration received in return for

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<sup>1</sup> It should be noted that some staff disagree with this conclusion because they think the arrangement described in paragraph 2(a) is not a ‘contract with customers’. This viewpoint is discussed in paragraph 9.

incurring the obligation (the transaction price), an entity might customarily recognise losses upon recognising such transfers.

7. This issue was also 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)*. The 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.”

8. Staff think this issue is not restricted to the project on Income from Non-Exchange Transactions and, consistent with the view of New Zealand Treasury, potentially affects application of the IFRS on *Revenue from Contracts with Customers* by PBEs/NFPs.

### ***Alternative Approaches to Dealing with this Issue in the Longer Term***

9. Some staff think there is no issue to address in the context of the IFRS on *Revenue from Contracts with Customers*, because they consider the arrangements described in paragraphs 6 – 7 are not ‘contracts with customers’. For example, they regard the example in paragraph 7 as a set of assets (railway) used to provide a service, with a small component of ‘user pays’. This is consistent with the view expressed by the FRSB in its submission on IASB ED/2010/6 that ‘contracts with customers’ are primarily exchange transactions (quoted in paragraph 16 of Agenda Paper J3.3).
10. Other staff think that, in the light of the Boards’ tentative decision in October 2010 to explore developing an approach in which the notion of ‘customer’ is applied to non-exchange transactions as well as exchange transactions, the arrangements described in

paragraphs 6 – 7 do give rise to a potential issue regarding recognising liabilities for onerous contracts. However, these staff have yet to develop a recommended approach for this issue in the longer term. They note that the following alternative approaches to the abovementioned transfers could be explored by the Boards in due course:

- (a) Applying the ‘onerous contract’ requirements of the IFRS on *Revenue from Contracts with Customers* and interpreting that Standard as requiring expenses to be recognised when the entity makes an enforceable promise to provide goods or services (whether ‘social benefits’ or otherwise) to others. Some argue that recognising such expenses reflects the nature of arrangements entered into by PBEs/NFPs, and that the significance of any resulting loss should be viewed differently from a loss recognised by a for-profit entity. Others express concern that this treatment can cause the expenses associated with providing the promised goods or services to be recognised in a different period from when the goods or services are provided, and that this outcome would hinder comparisons of service performance in a period with the cost of the services performed;
- (b) Concluding that making an enforceable promise to provide goods or services to others without commensurate consideration would give rise to a liability only to the extent of the consideration (i.e., an onerous contract liability would not be recognised in addition to the performance obligation measured at the allocated transaction price). For example, it may be argued that a PBE/NFP that is obliged to provide particular goods or services has only a conditional obligation to provide those goods or services until it obtains control of the resources necessary for providing those goods or services. (The tentative thinking of the IASB and FASB is that conditional obligations are not liabilities.) Under that view, the PBE/NFP incurs an unconditional obligation (liability) when it obtains control of the resources (e.g., grant), and only to the extent of the consideration received. This has a parallel of sorts with the IASB-FASB analysis of the difference between promises to provide goods or services before and after the customer consideration for those goods or services is received. However, from a transaction neutrality viewpoint, it could create a worrying precedent for arguing that contracts of for-

profit entities could never be onerous (e.g., if a for-profit entity underestimates the cost of fulfilling obligations for which it has been paid in full);

- (c) Focusing on the nature of the promised items and concluding that social benefit ‘obligations’ do not constitute liabilities unless they are for obligations to transfer cash or other benefits to individuals, and such transfers are outstanding (i.e., the individual recipients have an unconditional entitlement to receive the transfer). This would apply even if the entity has made an enforceable promise to another entity (e.g., a grantor) to provide other social benefits, such as transport or education services. Some argue that, in substance, a promise to provide social benefits other than transfers to qualifying individuals is not enforceable even if a grant agreement stipulates that particular goods or services must be provided in return for the grant. The IPSASB’s consideration of when liabilities arise in respect of social benefits has been deferred pending the development of concepts for the elements of financial statements in the IPSASB’s Conceptual Framework project; and
  - (d) Concluding that the estimated cost of fulfilling the enforceable promise to provide goods or services should be compared with the estimated consideration receivable from all parties as a result of fulfilling the promise (as opposed to comparing it with the transaction price for the particular contract or other enforceable arrangement). Some argue that determining whether a contractual or other enforceable promise is onerous on this basis more faithfully represents the economic substance of the arrangement. Others express concern that taking this broader view of the economic benefits may effectively recognise economic benefits the entity does not presently control (e.g., future user charges).
11. The initial thoughts of the staff referred to in paragraph 10 are that the approach in paragraph 10(d) seems the most promising. If the Boards agree that this is an issue worth exploring, staff intend to explore whether there are precedents for the approach in paragraph 10(d) in other IASB projects, for example, on Insurance (in relation to contracts for which the insurer cannot refuse renewal but is not presently entitled to receive the renewal premiums).

12. The staff’s key point is that (if this is an issue) exploring this issue is likely to take longer than the period before the Boards issue domestic Standards incorporating the IFRS on *Revenue from Contracts with Customers*.

**Questions for Board members**

- Q1** Do you think the Boards should explore whether it is suitable for PBEs/NFPs to apply the requirements in the IFRS on *Revenue from Contracts with Customers* to recognise liabilities for onerous contracts in respect of the transfers referred to in paragraphs 6 – 7?
- Q2** Do you agree that exploring this issue would be likely to take longer than the period before the Boards issue domestic Standards incorporating the IFRS on *Revenue from Contracts with Customers*?

13. Paragraphs 14 – 18 discuss the possible effect of existing PBE/NFP-specific modifications in other Standards on how ‘onerous contracts’ might be recognised by PBEs/NFPs if no PBE/NFP-specific amendment for this issue were made in the domestic Standards incorporating the IFRS.

***Short-Term Implications of this Issue***

14. IASB ED/2010/6 did not include a proposal to amend the requirements in IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* for the recognition of provisions for onerous contracts. Those requirements are similar to the latest tentative decisions of the IASB and FASB regarding onerous contracts in their Revenue project. IAS 37 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).
15. Paragraphs 16 – 17 discuss whether PBE/NFP-specific modifications to IAS 37 in AASB 137 and NZ IAS 37 would overcome the concern with the proposed IFRS on *Revenue from Contracts with Customers* noted in paragraphs 6 – 7.

16. AASB 137 *Provisions, Contingent Liabilities and Contingent Assets* includes PBE/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 (see Appendix A). This guidance does not address grant agreements creating enforceable obligations of the grantee to provide goods and services (such as grants for a lesser amount than the estimated cost of providing the goods or services). Therefore, the PBE/NFP-specific modification to IAS 37 in AASB 137 does not avoid the concern noted in paragraphs 6 – 7.
17. NZ IAS 37 includes a PBE/NFP-specific modification excluding the Crown from applying the Standard to obligations expressed in legislation that have characteristics similar to an executory contract (see Appendix B). This scope exclusion does not appear to apply to grant agreements creating enforceable obligations of the grantee to provide goods and services (such as grants for a lesser amount than the estimated cost of providing the goods or services). In addition, it applies only to the Crown, and therefore would not affect other New Zealand PBEs/NFPs potentially affected by the concern noted in paragraphs 6 – 7.
18. For the reasons in paragraphs 14 – 17, some staff think the potential concern noted in paragraphs 6 – 7 would affect PBEs/NFPs applying domestic Standards that incorporate the IFRS on *Revenue from Contracts with Customers*. At this stage, the IASB and FASB have yet to decide the mandatory application date for that forthcoming IFRS. Therefore, it is unclear how long the AASB and FRSB would have to develop a PBE/NFP-modification to the IFRS to overcome this concern.

### ***Alternatives for Dealing with this Issue in the Short Term***

19. If the Boards' answers to both Questions 1 and 2 above are "yes", alternative approaches for dealing with this issue in the short term include:
  - (a) giving these obligations arising from these transfers to PBEs/NFPs a temporary exclusion from the scope of the requirement in the IFRS on *Revenue from Contracts with Customers* to recognise a liability for onerous contracts; and

- (b) temporarily excluding PBEs/NFPs from the scope of domestic Standards incorporating the IFRS on *Revenue from Contracts with Customers*.
20. Regarding the alternative in paragraph 19(a), it would be difficult to define a temporary scope exclusion for these transfers without the risk of unintended consequences. This is because PBEs/NFPs may also make enforceable promises to provide goods or services at an expected cost exceeding the transaction price but without an expectation of consideration from other sources for those goods or services. Presently, under AASB 137 and NZ IAS 37, those entities would be required to recognise a provision for an onerous contract. Staff think it would be inappropriate to permit non-recognition of a provision in these circumstances. Whilst staff think it may be possible to develop an appropriate scope exclusion, this could take some time, in which case it would seem more efficient to deal with the issue thoroughly in a longer-term analysis of PBE/NFP-specific issues.
21. Accordingly, the staff referred to in paragraph 10 think the transfers described in paragraphs 6 – 7 are a reason to temporarily exclude PBEs/NFPs from the scope of domestic Standards incorporating the IFRS on *Revenue from Contracts with Customers*.

### Question for Board members

- Q3** Do you think the transfers described in paragraphs 6 – 7 are a reason to exclude PBEs/NFPs from the scope of the domestic Standards incorporating the IFRS on *Revenue from Contracts with Customers* until this issue is explored fully?

## APPENDIX A

## Text of paragraphs Aus26.1 and Aus26.2 of AASB 137

**Obligations arising from local government or government existing public policies, budget policies, election promises or statements of intent**

- Aus26.1 This paragraph and paragraph Aus26.2 relate to the recognition by a local government, government department or government of a liability arising from a local government or government existing public policy, budget policy, election promise or statement of intent. The intention 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 present obligation which is binding. A liability would be recognised only when the entity is committed in the sense that it has little or no discretion to avoid the sacrifice of future economic benefits. For example, a government does not have a present obligation to sacrifice future economic benefits for social welfare payments that might arise in future reporting periods. A present obligation for social welfare payments arises only when entitlement conditions are satisfied for payment during a particular payment period. Similarly, a government does not have a present obligation to sacrifice future economic benefits under multi-year public policy agreements until the grantee meets conditions such as grant eligibility criteria, or has provided the services or facilities required under the grant agreement. In such cases, only amounts outstanding in relation to current or previous periods satisfy the definition of liabilities.
- Aus26.2 Some such transactions or events may give rise to legal, social, political or economic consequences which leave little, if any, discretion to avoid a sacrifice of future economic benefits. In such circumstances, the definition of a liability is satisfied. An example of such an event is the occurrence of a disaster, where a government has a clear and formal policy to provide financial aid to victims of such disasters. In this circumstance, the government has little discretion to avoid the sacrifice of future economic benefits. However, the liability is recognised only when the amount of financial aid to be provided can be measured reliably.

## APPENDIX B

**Current New Zealand PBE/NFP-specific modification in NZ IAS 37**

**NZ 1.1. This Standard shall be applied by all entities in accounting for provisions, contingent liabilities and contingent assets except in the case of the Crown. In the case of the Crown this Standard shall not be applied in accounting for obligations expressed in legislation that have characteristics similar to an executory contract.**

NZ 3.1. Obligations of the Crown expressed in legislation that have characteristics similar to an executory contract are those where:

- (a) the Crown is obligated to provide goods, services or transfers to the community in future periods using funding to be obtained from the community substantially in those future periods; and
- (b) the intended third party recipients of the goods, services or transfers have not yet satisfied the criteria for entitlement to those goods, services or transfers.

NZ 3.2. These obligations of the Crown have characteristics similar to executory contracts in that the community will, collectively, provide funds to the Crown in the future under tax legislation, and the Crown will, in return, provide goods, services or transfers to the community in the future. Such obligations of the Crown include obligations to make future social welfare payments (such as to pay unemployment, domestic purposes and national superannuation benefits) and to deliver future health and education services, to the extent that the substantial funding of those benefits will be met through future taxation and other revenues and the intended recipients have not already satisfied the criteria for entitlement to those benefits. However, such obligations exclude the obligation of the Crown to fund future payments by the Government Superannuation Fund since the recipients of those future payments have already performed services giving rise to obligations.

NZ 3.3. The exclusion from the application of this Standard of obligations of the Crown that have characteristics similar to an executory contract is not intended to achieve a different result, in terms of the Crown's recognition of liabilities, from the practice followed at the date of introduction of this Standard to recognise liabilities only where the recipients of benefits to be provided in the future have already satisfied the criteria for entitlement to those benefits. These obligations raise issues for financial reporting that require further study. Therefore, until further progress has been made in this regard, such obligations of the Crown are excluded from the scope of this Standard.