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ED 147 sub 4

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Professor David Boymal
The Chairman
Australian Accounting Standards Board
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15 May 2006

Dear David

Exposure Draft 147: Revenue from Non-Exchange Transactions (Including Taxes and Transfers)

We are pleased to submit our comments on Exposure Draft 147: *Revenue from Non-Exchange Transactions (Including Taxes and Transfers)* (ED 147). Our comments represent the views of the Australian firm of PricewaterhouseCoopers and are provided to assist the Australian Accounting Standards Board (AASB) formulate comments on the equivalent International Public Sector Accounting Standards Board "Exposure Draft 29: *Revenue from Non-Exchange Transactions (Including Taxes and Transfers)*" (ED 29).

We are generally supportive of the proposals in ED 147, as we understand they are broadly in line with the direction the International Accounting Standards Board (IASB) considered taking on accounting for non-exchange transactions. However, we are concerned the proposed guidance and examples in ED 147 highlight some inconsistencies and practical issues around the recognition and measurement of liabilities relating to non-exchange transactions that require further consideration.

These issues are highlighted in our responses to the specific matters for comment in ED 29 included in the attachment to this letter.

We believe the IPSASB and AASB need to consider these issues in the context of the work the IASB is doing on revenue recognition and the measurement of liabilities. The Boards should also continue to monitor this after the release of any public sector standard on the recognition of revenue from non-exchange transactions as they should try to keep the concepts and rules in line with IASB developments.

We would welcome the opportunity to discuss our views at your convenience. Please contact me on (03) 8603 3868 or Sue Whitechurch on (02) 8266 7543 if you would like to discuss this further.

Yours faithfully

Jan McCahey
Partner
Assurance

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Attachment: Specific Matters for Comment in ED 29

(a) Exclude entity combinations that are non-exchange transactions from the scope of the Standard.

We concur with this exclusion at this stage. We believe further consideration needs to be given to specific issues relating to the accounting for these types of non-exchange transactions, which are currently recognised in the separate requirements concerning restructuring of administrative arrangements in AAS 29 *Financial Reporting by Government Departments.*

(b) Include within the scope of the IPSAS compulsory contributions to social security schemes (e.g. health and disability insurance, aged pensions) which are in the nature of non-exchange transactions. In particular:

(i) Do you think that these compulsory contributions to social security schemes should be explicitly excluded from the scope?

(ii) Do you think that the ED gives enough guidance in respect of such compulsory contributions? If not, do you think the IPSAS should explicitly address these compulsory contributions and provide specific guidance to assist entities determine to what extent such contributions should be considered as exchange transactions? (See paragraph BC27)

We question whether compulsory contributions to social security schemes are non-exchange transactions if contributors are entitled to benefits such as health and disability insurance and aged pensions. However, we do not consider it appropriate for us to make specific comments on this as we do not have experience of dealing with these types of transactions in the context of whole of government reporting in Australia.

(c) Define terms as set out in paragraph 8. These definitions have been developed by the IPSASB for this IPSAS. Please identify any amendments to the definitions that you consider necessary.

We have the following observations on the proposed definitions for this IPSAS:

Non-exchange transactions
The definition of non-exchange transactions in paragraph 7 refers to receiving value from or giving value to “another entity” without directly giving or receiving approximately equal value in exchange. It is not clear whether the other entity must be a party to the non-exchange transaction and if it would include individuals. Our understanding is this would be the other party or parties to the non-exchange transaction, including individuals, so suggest the wording be amended to clarify this.

Attachment: Specific Matters for Comment in ED 29 (continued)

Exchange transactions
The definition of exchange transactions in paragraph 7 should also be amended to clarify that “another entity” is referring to the other party or parties to the transaction.

(d) Distinguish exchange and non-exchange components of non-exchange transactions. Paragraphs 11 and 12 note that these transactions may comprise two components, one of which is an exchange transaction, each component of which is recognized separately.

We concur with this proposal.

(e) Include guidance to clarify that restrictions do not give rise to the recognition of a liability on initial recognition of the transferred asset (paragraph 20). Do you agree that restrictions do not give rise to liabilities on initial recognition of the transferred asset?

We concur with this proposal.

(f) Require recognition of assets when resources are transferred or when the reporting entity has an enforceable claim to resources that are to be transferred (see paragraphs 33 – 34 and paragraph 80). The ED notes that before a claim to a resource is enforceable, the resource does not meet the definition of “control of an asset” because the recipient reporting entity cannot exclude or regulate the access of the transferor to the resource.

We concur with this proposal.

(g) Measure assets acquired in a non-exchange transaction at their fair value on initial recognition and amend IPSAS 12, “Inventories”, IPSAS 16, “Investment Property” and IPSAS 17, “Property, Plant and Equipment” to be consistent with this requirement (see paragraphs 38 – 39 and the Appendix). IPSAS 12 currently requires inventory to be initially recognized at cost, and IPSASs 16 and 17 currently require that where assets are acquired for no cost or a nominal cost, their cost is their fair value as at the date of acquisition.

We concur with this proposal.

Attachment: Specific Matters for Comment in ED 29 (continued)

(h) Require that a liability be recognized in respect of an asset transferred subject to conditions upon initial recognition of the transferred asset (paragraph 50). When the condition has been satisfied the liability is reduced, or derecognized, and revenue recognized. Alternatively, do you consider that the IPSAS should only require the recognition of a liability when it is more likely than not that the condition will not be satisfied (see paragraph BC11)? In addition, are you of the view that the requirements relating to the recognition of a liability in respect of a condition applies equally to depreciable and non-depreciable assets?

We agree with the proposal that a liability be recognised upon initial recognition of a transferred asset that is subject to conditions as this is broadly in line with the direction we understand the IASB is considering in relation to non-exchange transactions.

However, we are concerned that the guidance and examples in ED 29 do not make it clear what obligation is being recognised as a liability. Is it:

1. the obligation to comply with the specific performance obligations set out in the conditions,
2. the obligation to consume the future economic benefits or service potential embodied in the transferred asset as specified in the conditions, or return the asset to the transferor,
3. the obligation to return the transferred asset to the transferor, if the specific conditions are not met, or
4. a combination of the obligation under 1. or 2. and the obligation to stand ready to return the transferred asset, if the conditions of the transfer are not met?

The amount of the liability will vary depending on what obligation is being measured and recognised so this must be made very clear to ensure the rules in the standard can be understood and consistently applied.

Our comments on the possible alternatives are set out below. We believe the IPSASB and AASB need to consider these issues in the context of the work the IASB is doing on revenue recognition and the measurement of liabilities. The Boards should also continue to monitor this after the release of any public sector standard on the recognition of revenue from non-exchange transactions as they should try to keep the concepts and rules in line with IASB developments.

1. Obligation to comply with the specific performance obligations

We have concerns with this alternative because we do not believe this is in line with current liability recognition rules and it pre-empts the outcome of the IASB projects on liability and revenue recognition. We think it is too early for the IPSASB to adopt an approach that requires a recipient to recognise a liability for the future outflow of resources required to comply with specific performance conditions on the receipt of a transferred. The past event giving rise to these outflows is the entering into contractual arrangements to perform the undertakings specified in the

Attachment: Specific Matters for Comment in ED 29 (continued)

conditional transfer and actual performance under those contracts, and not the transfer agreement itself. The recipient's obligation under the transfer arrangement will often be to return the asset if the specific conditions of the transfer are not complied, but this may vary depending on the specific terms of the transfer.

We envisage many recipients will have difficulty determining a reliable best estimate of the amount required to settle the obligation to comply with the performance conditions. In practice, recipients may not have contracts with third parties relating to the performance conditions at the reporting date and the future outflow of economic resources required to meet specific performance obligations will not always be equal to the fair value of the asset received in a conditional transfer.

A requirement to recognise this liability on the receipt of the transferred asset could result in the recipient recognising initial revenue or expense. For example, in a situation where a recipient only expects to use part of an asset received in a conditional transfer in relation to a specified project, the difference between the fair value of the asset received and the estimated outflow of resources required to complete the project would be recognised as initial revenue – even if the recipient has not started work on the project and must return the asset if it is not completed, as specified. Similarly, if an entity receives an asset as partial funding for a specific project and the transferred asset must be returned if it is not completed, as specified, it will be required to recognise the difference between the fair value of the asset received and the estimated outflow of resources required to complete the project as an initial expense – even though it may not have started work on the project, or contracted to have work done.

2. *Obligation to consume the future economic benefits or service potential embodied in the transferred assets or return the asset to the transferor*

The comments in paragraph BC10 of the Basis for Conclusions support this alternative as this says a recipient of a conditional transfer of assets should recognise a liability on the initial recognition of the asset because it is required to consume the future economic benefits or service potential embodied in the transferred asset in the delivery of particular goods or services to third parties as specified, or else return the transferred asset.

The proposed standard requires the liabilities for these obligations to be measured using the rules in IPSAS 19. The recipient will either consume the transferred asset as specified in the conditions or return the asset and is required to recognise a liability for the most likely outcome under the recognition criteria in paragraph 45 of ED 29. The outflow of resources under the return obligation will not be probable if the recipient expects to comply with the conditions of the transfer.

Attachment: Specific Matters for Comment in ED 29 (continued)

We are concerned it is not clear how the IPSASB intends the rules in IPSAS 19 to be applied to determine a best estimate of the amount required to settle the obligation to consume the transferred asset, as specified in the conditions. This could be measured initially at the fair value of the transferred asset and in subsequent periods at the carrying amount of the transferred asset, as this represents the future economic benefits or service potential that are still to be consumed. However, we question how this is supported by IPSAS 19.

The recipient will only recognise a liability for the obligation to return the transferred asset under the rules in IPSAS 19 and proposed in ED 29 if it does not expect to comply with the conditions of the transfer, because a provision or liability is recognised when:

(a) an entity has a present obligation as a result of a past event;

(b) it is probable that an outflow of resources embodying economic benefits or service potential will be required to settle the obligation; and

(c) a reliable estimate can be made of the amount of the obligation.

If a liability is recognised for the return obligation, it will not necessarily be the fair value of the transferred asset as the risk and uncertainties of not complying with the conditions must be taken into account in measuring the liability.

Some may argue the recipient should recognise a liability for both obligations, but as noted in the comments on alternative 4 below, this is not supported by the recognition criteria in IPSAS 19 and proposed in ED 29.

3. Obligation to return the transferred asset to the transferor

A liability for the obligation to return a transferred asset to the transferor would only be recognised under the current liability recognition criteria in IPSAS 19 and proposed in ED 29 when it is probable that the conditions of the transfer will not be met. This is in line with the current Australian rules, but as noted above the amount of the liability recognised under ED 29 may not be the fair value of the transferred asset as the risk and uncertainties of not complying with the conditions must be taken into account in measuring the liability.

The comments in ED 29 indicate the IPSASB does not support this alternative because it could result in recipients recognising revenue prematurely. Paragraph BC11 of the Basis of Conclusions says it rejected a proposal that a liability should only be recognised when it is probable that conditions attaching to the inflow of resources will not be satisfied and future economic benefits or service potential will be returned to the transferor.

Attachment: Specific Matters for Comment in ED 29 (continued)

This suggests the IPSASB is intending that the initial liability required to be recognised for conditional asset transfers is for the obligation to comply with the specific conditions, rather than the obligation to return the asset, unless it is probable that the recipient will not comply with the conditions. This is in line with the proposed treatment of a return obligation for an asset transfer subject to a stipulation that it be returned if a specified future event does not occur. The comments in paragraph 25 of ED 29 state that a return obligation does not arise until such time as it is expected that the stipulation will be breached and a liability is not recognised until the recognition criteria have been satisfied.

4 Combination of the obligation under 1 or 2 and the obligation to stand ready to return the transferred asset

As noted in the comments on alternatives 2 and 3 above, a liability for the obligation to return a transferred asset would only be recognised under the current liability recognition criteria in IPSAS 19 and proposed in ED 29 when it is probable that the conditions of the transfer will not be met. The outflow of resources under the return obligation will not be probable if the recipient expects to comply with the conditions of the transfer.

We support this approach until further work is done in the liability recognition and measurement project. We are concerned that requiring the recognition of a liability for both obligations could result in an initial expense being reported on asset transfers because the liability would be greater than the fair value of the transferred asset. We question whether this is appropriate as the recipient could be required to recognise an initial expense which suggests it has taken on an onerous obligation.

(i) Require liabilities related to inflows of resources to be measured according to the requirements of IPSAS 19, "Provisions, Contingent Liabilities and Contingent Assets" (paragraph 52).

We have concerns with the proposal to require liabilities related to inflows of resources to be measured according to the requirements of IPSAS 19 because the proposals in ED 29 do not make it clear what obligations are required to be recognised in relation to conditional asset transfers – refer to our detailed comments in our response to question (h).

Attachment: Specific Matters for Comment in ED 29 (continued)

(j) Require a non-exchange transaction that gives rise to the recognition of an asset to also give rise to the recognition of revenue to the extent that a liability is not recognized (paragraph 54). Are there any non-exchange transactions in which it would be appropriate to initially recognize the gross inflow of economic benefits or service potential represented by the asset as revenue even if a liability is also recognized, with the simultaneous recognition of an expense for the liability?

We believe the requirement in paragraph 54 should make reference to the exception for transactions that are contributions from owners, as defined in paragraph 7.

(k) Require a reporting entity to recognize liabilities in respect of advance receipts related to taxes (see paragraph 67) and advance receipts related to transfers (see paragraph 105).

We concur with this proposal. The guidance should make it clear that the measurement of the liability recognised for assets received before a transfer arrangement is binding should be based on the fair value of the assets transferred.

(l) Not permit the netting of expenses paid through the tax system (see paragraphs 72 – 76) against taxation revenue. Instead such expenses must be recognized separately on a gross basis. The ED distinguishes between expenses paid through the tax system and tax expenditures, and notes that tax expenditures are foregone revenue, not expenses.

We concur with this proposal.

(m) Permit recognition of services in-kind that satisfy the recognition requirements (see paragraphs 99 – 103) and require disclosure of the nature and type of services in-kind received, whether recognized or not (paragraph 107-108).

We believe the optional recognition of services in-kind is not desirable given the conceptual uncertainties surrounding them. We recommend the use of the recognition criteria in paragraph 10.12 of AAS 29, ie. services in-kind should only be recognised where:

(a) the fair value of the services can be reliably determined; and

(b) the services would have been purchased if they had not been donated.

Attachment: Specific Matters for Comment in ED 29 (continued)

If the IPSASB adopts the approach proposed in ED 29, further guidance should be provided on when services in-kind are controlled by an entity. Paragraph 100 indicates services in kind meet the definition of an asset because the entity controls a resource from which future economic benefits or service potential are expected to flow to the entity. However, paragraph 102 goes on to say some services in-kind do not meet the definition of an asset because the entity has insufficient control over the services provided. Given many services in-kind involve voluntary contributions of services, it is unclear at what point the service in-kind can be said to be controlled by the entity and circumstances when such control may be "insufficient".

The level of detail required for disclosures of services in-kind also needs to be clarified. Paragraph 114 refers to paragraph 107(e) requiring entities to make disclosures about the nature and type of services in-kind received, whether they are recognised or not. There is no paragraph 107(e) but paragraph 107(d) requires the disclosures of the nature and type of major classes of bequests, gifts and donations, with separate disclosure of the major classes of goods in-kind received.

The example of services in-kind received by a hospital in paragraph IG48 indicates the hospital should disclose the number of hours of service provided by volunteers. We query whether this level of detail is necessary or appropriate in every case, particularly when the number of hours does not represent the benefit received because the entity did not control the amount or nature of voluntary services received.

(n) Provide entities a five year period in which to conform their accounting policies in respect of taxation revenue to the requirements of this Standard. (See paragraphs 115 – 122). Do you believe that transitional provisions should be provided in respect of other non-exchange transactions?

We believe consideration should be given to extending the transitional provisions to have broader application to non-exchange transactions. In particular, we believe consideration needs to be given to the practicality of requiring public sector entities to recognise all assets received in previous non-exchange transactions when the standard is first applied.

Some public sector entities may have difficulty complying with the requirements to recognise assets contributed in non-exchange at their fair values at the date of the contribution and the related liabilities, particularly when the transactions occurred many years ago and the conditions relating to those assets have been satisfied prior to the application of the standard.

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Attachment: Specific Matters for Comment in ED 29 (continued)

Additional comments

Illustration of the Analysis on Inflows of Resources

We believe the flowchart on page 16 of ED 29 will assist users in applying the proposed guidance on accounting for non-exchange transactions. However, we are concerned the first question in the flowchart focuses on the definition of asset, without referring to the comments in paragraphs 99 and 100 which indicate the proposed standard also applies to services in-kind and other assets that are consumed immediately.

We believe it is important to make it clear that the inflows covered by the initial step in the flowchart include services in-kind and other assets that are consumed immediately.