



Project:	Termination for Convenience Clauses	Meeting:	November 2020 (M178)
Topic:	Staff analysis and recommendations	Date of this paper:	28 October 2020
Contact(s):	Shachini Dassanayake sdassanayake@asb.gov.au (03) 9617 7633 Fridrich Housa fhousa@asb.gov.au (03) 9617 7618	Agenda Item:	5.1
		Project Priority:	Medium
		Decision-Making:	Medium
		Project Status:	Consider staff analysis and decide next steps

Objective of this agenda item

1. The objective of this agenda item is for the Board:
 - a) to **consider** implementation issues raised by stakeholders regarding AASB 15 *Revenue from Contracts with Customers* and AASB 1058 *Income of Not-for-Profit Entities* in respect of termination for convenience clauses; and
 - b) to **decide** on the next steps.

Reasons for bringing this agenda item to the Board at this meeting

2. At its June 2020 meeting, the Board received an update from staff about a request from stakeholders for the AASB to provide clarification or guidance on accounting for “termination of convenience clauses”. Staff agreed to assess the request further and consider the requirements of the AASB *Due Process Framework* before bringing recommendations to the Board.
3. Staff provided further update on the preliminary analysis of the issues and the engagement with stakeholders to the Board at its September 2020 meeting.
4. Staff continued to engage with stakeholders to obtain further feedback and now ask the Board to consider the staff analysis and decide on the next steps at this meeting.

Summary of staff recommendations

5. Staff recommend that no further work be undertaken by the AASB as the requirements of Australian Accounting Standards that may be relevant (including AASB 15, AASB 1058, AASB 9 *Financial Instruments*, AASB 132 *Financial Instruments: Presentation* and AASB 13 *Fair Value Measurement*) provide an adequate basis to determine the accounting for termination for convenience clauses.

Structure

6. This paper is structured as follows:
 - a) Background (paragraphs 7-15)
 - b) Summary of accounting views presented by the submitters (paragraphs 16-17)
 - c) Staff analysis and recommendation (paragraphs 18-39)

Attachments

- Agenda Paper 5.1.1 Letter from submitter A dated 25 May 2020 (Board only) [included in the supplementary folder]
- Agenda Paper 5.1.2 Letter from submitter B dated 25 June 2020 (Board only) [included in the supplementary folder]

Background

7. Two stakeholders sent letters to the AASB Chair requesting the AASB to provide clarification or guidance related to accounting for termination for convenience clauses (TFC).
8. In these letters, the submitters stated that such clauses are common in government contracts and agreements (including but not limited to research grant agreements) and there are divergent views on the accounting required by the accounting Standards. As a result, the submitters considered this issue to have possible wider public sector implications. Some other stakeholders mentioned that these clauses have become common in private sector contracts as well, for example where customers receive prepayments to carry out development work.
9. TFC is a clause in a contract that allows one or both parties to terminate the agreement without having to show cause, such as default or breach of the contract. For example the grantor may, at any time, terminate the contract for the grantor's convenience and without cause.
10. One submitter stated that such termination rights as described in paragraph 9 are commonly seen in government agreements, have been there for many years, but have never regularly been exercised by the funding bodies in the past.
11. The other submitter stated that these clauses provide the government with a unilateral right to terminate an agreement at any time and are usually drafted into agreements as a protective mechanism to safeguard and provide an option to government, to enable it to preserve public policy, flexibility or on account of other government exigencies/emergencies.¹
12. Based on our further discussion with stakeholders, termination might occur if the government decides that its resources are best put elsewhere because of needs that have arisen. This might not necessarily reflect a change in government policy but presumably a change in priorities. For example, change in government or moving funds from one project to another due to an emergency such as moving funds to COVID-19 research from another research project.
13. While TFCs give flexibility rights, they need to be clearly drafted, exercised in good faith, and complied with.²

¹ <https://www.ags.gov.au/sites/default/files/CN40.pdf>

² <https://www.claytonutz.com/knowledge/2014/october/giving-government-some-flexibility-making-your-termination-for-convenience-clause-work>

- 14. In the event the clause is exercised by the government, the grantee will only be liable to pay back funds received that have not been spent in accordance with the agreement.
- 15. The submitters pointed out that when assessing accounting for some contracts, divergent views exist whether a termination clause gives rise to a financial liability and if so, how such financial liability is initially measured.

Summary of accounting views presented by the submitters

- 16. The stakeholders presented two views as to when a termination for convenience clause gives rise to a financial liability:
 - a) View 1: at contract inception; and
 - b) View 2: only once there is a request for repayment.
- 17. The table below explains the views presented by the two stakeholders in more detail:

Views presented	Details of the argument
<p>View 1: The termination for convenience clause gives rise to a financial liability at inception of a contract.</p>	<p>This view is primarily based on the fact that ‘the receiving entity does not have an unconditional right to avoid delivering cash to settle a contractual obligation’ in the instance where the agreement is terminated by the government exercising the TFC and demanding repayment of funds. Therefore, the total amount of funding (or the amount of funding provided at inception) should be treated as a financial liability at inception by the recipient entity (applying requirements of AASB 132 paragraph 19).</p>
<p>View 2: The termination for convenience clause does not give rise to a financial liability until there is a request for repayment.</p>	<p>This view is primarily based on the fact that the termination for convenience clauses are common within funding agreements entered into with the government and are protective in nature so as to provide flexibility to the government where required.</p> <p>Therefore accounting for these clauses should be based on the substance of the arrangement as required by paragraph 15 of AASB 132. According to this view, the substance of most of the funding arrangements is non-financial in nature i.e. requiring the recipient entity to fulfil obligations under the funding arrangements rather than requiring them to repay the funds granted. Further, there is no obligation on the part of the recipient entity to repay or right for government to collect until the government serves a written notice. Also, until the government requests repayment, the recipient entity will not know what amounts, if any, will be required to be paid back to the government.</p> <p>In addition, proponents of this view believe that there is a recognition and measurement uncertainty at contract inception because the amount that may be ultimately repaid is affected by various factors such as timing of the notice, progress of the project, possible compensation and re-scoping of the project. It is the submitter’s view that the measurement uncertainty fails the “measure reliably” requirement to recognise a liability applying paragraph 83 of the <i>Framework for the Preparation and</i></p>

Views presented	Details of the argument
	<p><i>Presentation of Financial Statements</i> currently applicable to Australian NFP entities.</p> <p><u>Both stakeholders (A and B) support this view, i.e. no financial liability should be recognised by the recipient entity until there is a specific request for repayment.</u></p>

Staff analysis and recommendation

18. Staff have assessed the requirements of the Australian Accounting Standards (AAS) to evaluate whether there is sufficient guidance available to determine applicable AAS and recognition and measurement requirements for contracts and agreements containing termination for convenience clauses.
19. Staff have structured the analysis as follows:
- (a) Scope and definitions; and
 - (b) Recognition and measurement.

Scope and definitions

20. Staff considered definitions and scope requirements specified by AASB 15 and AASB 1058 as the agreements which were subject to the stakeholders' discussion are research grant agreements. Staff then considered relevant definitions and scope requirements of AASB 9 and AASB 132. These are summarised in the table below.

Accounting Standard	Scope and definitions
AASB 15	<p>AASB 15 paragraph 5(c) specifies that AASB 15 does not apply to financial instruments and other contractual rights or obligations within the scope of AASB 9.</p> <p>Paragraph 7 of AASB 15 also states that a contract may be partially in its scope and partially in the scope of another Standard, such as AASB 9. In such cases, AASB 15 states that if the other Standard specifies how to separate and/or initially measure one or more parts of the contract, then an entity first applies the separation and/or measurement requirements of that other Standard.</p> <p>For example, if a contract contains a financial instrument in the scope of AASB 9, then the entity separates and measures that financial instrument using the guidance in AASB 9 and excludes from the transaction price determined for the purposes of AASB 15 the amount initially measured in accordance with AASB 9.</p> <p>Further, AASB 15, paragraph Aus9.1 specifies that if a contract that would otherwise be within the scope of AASB 15 does not meet the criteria in paragraph 9 of AASB 15 as it is unenforceable or not sufficiently specific, it is not a contract with a customer within the scope of AASB 15 in respect of not-for-profit entities and an entity</p>

Accounting Standard	Scope and definitions
	shall consider the requirements of AASB 1058 <i>Income of Not-for-Profit Entities</i> in accounting for such contracts.
AASB 1058	<p>AASB 1058 paragraph 9 requires, on initial recognition of an asset subject to the Standard, recognition of any related contributions by owners, increases in liabilities, decreases in assets, and revenue ('related amounts') in accordance with other Australian Accounting Standards, for example a financial instrument, in accordance with AASB 9.</p> <p>AASB 1058, paragraph 10 then requires the NFP entity to recognise income immediately for any excess of the initial carrying amount of an asset over the related amounts. Further paragraph 12 of AASB 1058 specifies that an entity applies judgement in determining the extent to which the acquisition of an asset gives rise to income as specified by AASB 1058 or to revenue, a liability or a contribution by owners recognised in accordance with another Australian Accounting Standard.</p>
AASB 132	<p>AASB 132 paragraph 11 defines a financial instrument as any contract that gives rise to both a financial asset of one entity and a financial liability or equity instrument of another entity. Further, financial liability is defined basically as a contractual obligation to deliver cash or another financial asset to another entity.</p> <p>AASB 132 paragraph 13 specifies that 'contract' and 'contractual' refer to an agreement between two or more parties that has clear economic consequences that the parties have little, if any, discretion to avoid, usually because the agreement is enforceable by law. Contracts, and thus financial instruments, may take a variety of forms and need not be in writing.</p> <p>AASB 132 paragraph 15 specifies that classification of any instrument as a financial asset, financial liability or equity is determined in accordance with the substance of the contractual arrangement and the underlying definitions.</p> <p>AASB 132 paragraph 20 states a financial instrument that does not explicitly establish a contractual obligation to deliver cash or another financial asset may establish an obligation indirectly through its terms and conditions.</p>
AASB 9	AASB 9 paragraph 2.1(j) scopes out rights and obligations within the scope of AASB 15 that are financial instruments, except for those that AASB 15 specifies are accounted for in accordance with AASB 9.

21. Scope requirements and related definitions specified in AASB 9, AASB 15, AASB 132 and AASB 1058 listed in the table in the preceding paragraph provide guidance to assess whether a termination for convenience clause contained in a contract or agreement gives rise to a financial liability.

22. Staff specifically note as crucial the requirements of AASB 15 paragraph 7 in respect of contracts that are partially in scope of other Standard and requirements of AASB 1058 paragraph 9 to recognise related amounts in accordance with other AAS.
23. Staff noted that the proponents of View 2 primarily based their conclusions on their assessment that TFCs are not substantive and referred to AASB 132 paragraph 15 in particular. They argued:
 - a) the grant is not a financial instrument at inception as the rights for the grantor to recall the funds has never regularly been exercised and have never previously been considered substantive to warrant recognition of a liability by their mere existence;
 - b) the grantor has a legal right to receive cash from the grantee only when it has served a written notice of termination entailing the course of action that it proposes to take.
24. Staff noted that judgement needs to be applied to determine whether the termination clause is substantive (in line with an IFRS Interpretations Committee (IFRS IC, Committee) agenda decision summarised in paragraph 26 below), noting that the reference to substance of the contractual agreement in AASB 132 relates to the presentation requirements.
25. However, staff noted the references to “clear economic consequences”, “little if any discretion to avoid” and “enforceable by law” in the definition of terms “contract” and “contractual” in AASB 132 paragraph 13 and similarity to characteristics referred to in the *Conceptual Framework for Financial Reporting* (paragraphs 4.59 - 4.62) in respect of the substance of contractual rights and obligations discussed in paragraph 29 below.
26. Further, staff noted the IFRS IC agenda decision from [January 2014](#) in respect of a AASB 132-related submission.
 - a) The Committee noted that the definitions of financial asset, financial liability and equity instrument in IAS 32 are based on the financial instrument’s contractual rights and contractual obligations. However, paragraph 15 of IAS 32 requires the issuer of a financial instrument to classify the instrument in accordance with the substance of the contractual arrangement. Consequently, the Committee noted that if a contractual term of a financial instrument lacks substance, that contractual term would be excluded from the classification assessment of the instrument.
 - b) The agenda decision states that to determine whether the clause is substantive, the issuer will need to understand whether there are actual economic or other business reasons that the clause would be exercised and that judgement will be required.
 - c) IFRS IC staff paper³ discussed in relation to this agenda decision asserted that non-substantive is about “why?” – i.e. whether there are actual economic or business reasons as to why the grantor would choose to exercise the option. The discussion on substance does not focus on probability but whether there would be reasons to exercise and that these reasons do not have to be purely economic.
 - d) The staff paper also noted that it is also important to distinguish between “non-substantive” and “non-genuine”. The latter can be defined as extremely rare, highly abnormal, and very unlikely to occur (i.e. how likely or “when?”), as per paragraph AG 28 of AASB 132.⁴

³ See IFRS IC January 2014 [Agenda paper 8](#)

⁴ However, staff note that paragraph AG28 of AASB 132 refers to contingent settlement provisions.

27. Staff acknowledge that the IFRS IC agenda decision discusses different contractual clauses than TFCs and while it may provide further guidance when assessing the substance of a contractual clause, an entity must consider its particular fact patterns and apply professional judgement.
28. Some stakeholders pointed out that the above IFRS IC agenda decision relates to classification assessment of the financial instrument and questioned its relevance for assessing whether an arrangement gives rise to a financial liability. Staff noted, however, another IFRS IC agenda decision from [May 2016](#) that refers to the Presentation section of AASB 132, when assessing whether the arrangement subject to the clarification request satisfies the definition of a financial liability or otherwise.
29. In addition, note that in some circumstances an entity may need to apply AASB 108 *Accounting Policies, Changes in Accounting Estimates and Errors* paragraphs 10 and 11. Staff note below examples of few references to terms “substance” or “substantive” in other AAS and applicable Conceptual Framework, such as:
 - a) AASB 10 *Consolidated Financial Statements* paragraphs B22 and B26 stipulate that the rights are substantive if there is a practical ability to exercise and also rights are not protective simply because they are contingent on events or circumstances or because they apply in exceptional circumstances.
 - b) *Conceptual Framework for Financial Reporting* (which is currently not applicable to NFP entities) paragraph 4.61 specifies that contract terms without substance are to be disregarded and a term has no substance if it has no discernible effect on the economics of the contract (e.g. a term that binds neither party or a right, including an option, that the holder will not have the practical ability to exercise in any circumstances).
 - c) *Framework for the Preparation and Presentation of Financial Statements* (framework currently applicable to NFP entities) paragraph 51 stipulates that in assessing whether an item meets the definition of an asset, liability or equity, attention needs to be given to its underlying substance and economic reality. Further, paragraph 61 refers to economic consequences and little, if any, discretion to avoid the outflow of resources when considering when an obligation arises.

Recognition and measurement

30. If an entity determines that TFC gives rise to a financial liability, it should be recognised and initially measured as per AASB 9. AASB 9 paragraph 3.1.1 requires an entity to recognise a financial asset or a financial liability in its statement of financial position when it becomes party to the contractual provisions of the instrument.
31. At initial recognition, an entity measures a financial asset or a financial liability at its fair value plus or minus, in the case of a financial asset or a financial liability not at fair value through profit or loss, transaction costs that are directly attributable to the acquisition or issue of the financial asset or the financial liability (AASB 9 paragraph 5.1.1). The fair value of a financial liability with a demand feature (e.g. a demand deposit) is not less than the amount payable on demand, discounted from the first date that the amount could be required to be paid (AASB 13 paragraph 47).
32. After initial recognition, a financial liability generally is subsequently measured at amortised cost, except for liabilities that are measured at fair value with subsequent changes recognised in profit or loss.
33. In accordance with AASB 15 paragraph 7, if a contract with customer that is within the scope of AASB 15 contains a financial instrument in the scope of AASB 9, then the entity separates and

measures that financial instrument using the guidance in AASB 9 and excludes from the transaction price under AASB 15 the amount initially measured in accordance with AASB 9.

34. Subsequently, the entity would consider the applicable requirements of AASB 9 for the subsequent measurement and derecognition of the financial liabilities. As per paragraph 3.3.1 of AASB 9, an entity shall derecognise a financial liability (or part of it) when and only when it is extinguished (e.g. in relation to the funds that have been spent by the recipient in accordance with agreement).
35. Staff also noted that for a contract with a customer in the scope of AASB 15, further requirements of AASB 15 in respect of identification of the contract such as in paragraphs 9 to 16 may be relevant to determine the appropriate accounting for the contract after the financial liability has been extinguished (wholly or partially).
36. On the other hand, if a contract that would otherwise be within the scope of AASB 15 does not meet the criteria in paragraph 9 of AASB 15 as it is unenforceable or not sufficiently specific, an NFP entity shall consider the requirements of AASB 1058 in accounting for such contracts. In accordance with AASB 1058 paragraph 14, which requires the entity to subsequently apply the requirements of other Australian Accounting Standards applicable to the related amounts, the entity would consider the applicable requirements of AASB 9 in respect of the subsequent measurement and derecognition of financial liabilities.

Staff assessment

37. Based on the analysis above, staff consider that the requirements of AAS and available guidance provide an adequate basis to enable an entity to account for termination for convenience clauses and to address the alternative views expressed by the submitters.

Staff recommendation on the next steps

38. Staff have also considered requirements of the [AASB Due Process Framework for Setting Standards](#) (September 2019) and outlined in the table below three possible options for the Board's consideration of the next steps:

Option	Staff recommendation
Option 1: Refer to IFRS IC	<p>As per AASB Due Process Framework paragraph 8.2, the AASB provides guidance to Australian stakeholders on interpretation issues by informing the IFRS IC of issues raised by Australian stakeholders for it to consider for inclusion on its work program. On the other hand, as per paragraph 8.3 of the framework, before issuing a domestic Interpretation of an IFRS Standard, the AASB should refer the issue to the IFRS IC.</p> <p>If the IFRS IC declines to address it, and the agenda decision does not provide adequate guidance, the AASB proceeds with a domestic Interpretation if and only if the issue is widespread, with diversity in practice and relates to Australian-specific legislation or circumstances.</p> <p>Staff do not recommend referring this matter to the IFRS IC as the requirements of applicable Standards provide an adequate basis as explained in the staff analysis and assessment (see paragraphs 18-37).</p>
Option 2: Provide additional guidance to the stakeholders by way of a Staff FAQ	<p>As per section 9 of the <i>AASB Due Process Framework</i>, the AASB may issue material to support consistent application.</p> <p>The AASB may publish educational material related to pronouncements on the website, including Agenda Decisions and Staff Frequently Asked</p>

Option	Staff recommendation
	<p>Questions (Staff FAQs). These materials do not have authoritative status and cannot add or change requirements in the pronouncements.</p> <p>AASB Staff FAQs: AASB 15 Revenue from Contracts with Customers, AASB 1058 Income of Not-for-Profit Entities and AASB 16 Leases, which are published on the AASB website, could be updated to include additional guidance on TFCs if required.</p> <p>However, staff do not recommend issuing staff FAQs or any other educational material on this matter due to the following reasons:</p> <ul style="list-style-type: none"> • this issue is also relevant to for-profit entities reporting under AAS and seeking compliance with IFRS Standards; • staff have already discussed the analysis provided in this paper with the two submitters and other stakeholders and a staff FAQ would not add anything further to the discussion in this paper; and • the requirements of applicable Standards provide an adequate basis as explained in the staff analysis and assessment (see paragraphs 18-37).
<p>Option 3: No further work to be undertaken by the AASB at this point in time</p>	<p>As explained in paragraphs 18-37, staff consider that the requirements of AAS and available guidance provide an adequate basis to enable an entity to account appropriately for termination for convenience clauses.</p> <p>Hence staff do not recommend undertaking further work.</p>

39. Based on the assessment summarised in paragraph 38 and the analysis of the available options in the table above, staff recommend Option 3.

Question for Board members

Q1: Do Board members agree with the staff recommendation in paragraph 39?