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Our ref ED 144 - 051205.doc

5 December 2005

Dear David

Comments on ED 144 “Proposed Australian Guidance to accompany AASB 1004 Contributions”

Thank you for the opportunity to comment on the above Exposure Draft.

Executive summary

Overall we believe that Australian Guidance to accompany AASB 1004 is required; however we have concerns over its current format, particularly in relation to the interaction of AASB 1004 *Contributions* and AASB 118 *Revenue*.

The proposed Australian Guidance currently fails to direct users to AASB 118 when application of that standard is more appropriate. As such, the Guidance in its current form is unlikely to be useful in assisting users to clearly distinguish between circumstances where AASB 118 and AASB 1004 apply and may result in non-compliance with AASB 118.

AASB 118 does not require a “return obligation” in order to have a service contract. We do not consider the guidance in G4 to be compatible with AASB 118.

(a) Whether guidance be issued at this stage to accompany AASB 1004

We agree in principle that Australian Guidance should be issued to accompany AASB 1004, however we have concerns over the guidance in its present form. Please refer to the points below for an understanding of our concerns.

(b) The usefulness of the proposed guidance on the circumstances in which a contribution is initially recognised as a liability rather than income

The usefulness of the guidance is complicated by the introduction of new terminology (e.g. stipulations, return obligations, involuntary transfers) and the distinction between when to apply AASB 118 and AASB 1004 is unclear and inconsistent with the principles of AASB 118.

Whilst we acknowledge the new terminology is consistent with that proposed by IFAC, we do not consider it is helpful in explaining the linkage with AASB 118 and is more confusing.

For example, the proposed guidance in paragraph G1 directs users to AASB 118 *Revenue* when the amounts received or receivable relate to the rendering of services provided the inflow is not a contribution. The rendering of services is defined in AASB 118.4 as "...the performance by the entity of a contractually agreed task over an agreed period of time." AASB 118 refers to a "performance" obligation but makes no reference to a "return" obligation. In our view, the introduction of this concept (and other new terminology) in the guidance to AASB 1004 is inconsistent with AASB 118, reduces the usefulness of the guidance and increases the risk of non-compliance with AASB 118.

Refer to points (d) and (e) below for examples in the guidance that we consider to be either inconsistent with AASB 118 or unclear.

(c) Whether there are any situations that would result in the guidance leading to a liability being initially recognised, when it is more appropriate for income to be recognised

None noted.

(d) Whether there are any situations that would result in the guidance leading to income being initially recognised, when it is more appropriate for a liability to be recognised

In our view, there are situations that would result in inappropriate initial recognition of revenue primarily arising from the definitions of contribution in AASB 1004 and the definition of conditions in paragraph G4.

Guidance paragraph G4 states that if a stipulation specifies the purpose for which the asset must be used by the recipient entity, but does not specify that the asset must be returned to the donor if not used as specified, then the stipulation is not a condition. As a result, the user is referred to paragraph G13 and the entire amount of the contribution is recognised initially as income.

An example of where this would lead to inappropriate initial recognition of revenue is where a club receives a grant to build a sporting facility. Assume there is no stipulation requiring return of the funds if the performance obligation is not fulfilled (or if funds remain unspent upon completion); then the entity would recognise the revenue up-front in accordance with paragraph G13. We believe it is more appropriate to recognise this arrangement in accordance with a service contract in AASB 118, as the entity has an obligation to perform a "contractually agreed task" and revenue would be more appropriately recognised on a percentage of completion basis as the sporting facility is built.

Refer to point (e) below for detail on the definition of contribution in AASB 1004 and its impact on the unclear interaction between AASB 1004 and AASB 118.

(e) Whether the distinction between applying AASB 118 and AASB 1004 is sufficiently clear

The proposed guidance in paragraph G1 directs users to AASB 118 *Revenue* when the amounts received or receivable relate to the rendering of services. The rendering of services is defined in AASB 118.4 as “..the performance by the entity of a contractually agreed task over an agreed period of time.”

The distinction between applying AASB 118 and AASB 1004 is confused by the introduction of new terminology in the guidance (e.g. condition, return obligations) that fails to clarify the circumstances in which an entity renders a service as per AASB 118. This is further complicated by Guidance paragraph G1 that refers only amounts that are not contributions to AASB 118.

For example, where an inflow specifies that the future economic benefits must be consumed, the entity has an obligation to perform a “contractually agreed task” to utilise the inflow thereby meeting the “rendering of services” definition in AASB 118. However, the flowchart in paragraph G5 suggests differently by treating the “rendering of services” and “performance obligations” (as indicated in the above example by a requirement to “consume” the benefits) in separate decision boxes. Our interpretation is that a requirement to perform any action is, by definition, rendering a service and AASB 118 applies.

Further, the definition of a contribution (and non-reciprocal transfers) in AASB 1004 contributes to the unclear interaction between AASB 118 and AASB 1004. It is our view that the definition of non-reciprocal transfer is problematic as it specifies that the transfer is “received without directly giving approximately equal value in exchange to the other party or parties to the transfer”.

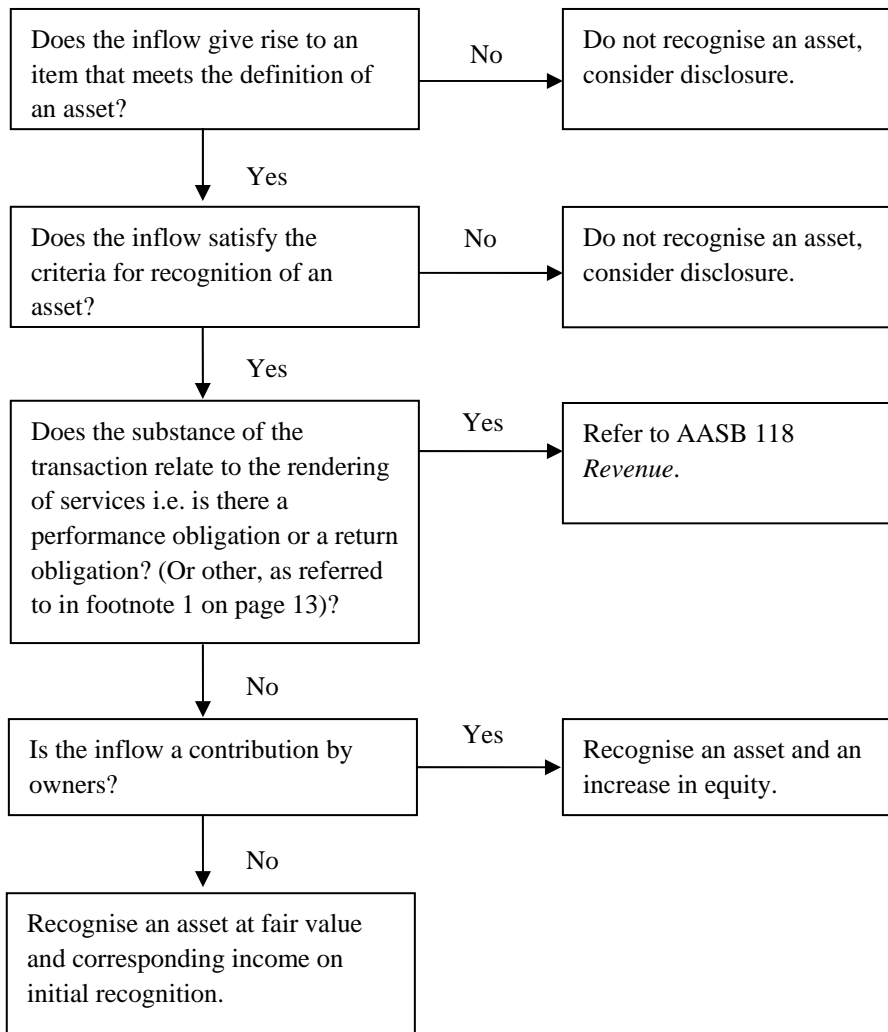
For example, where a club receives a government grant to build a sporting facility, a service contract exists as the entity has a performance obligation to fulfil. However, the entity may not give the government approximately equal value in exchange and therefore the grant could be considered a contribution and the guidance in AASB 1004 applicable rather than AASB 118. We consider this is inappropriate as all contributions to which a performance obligation is attached (whether or not the beneficiaries are a party to the contribution agreement) is in substance a service contract that should be treated in accordance with the rendering of service requirements in AASB 118.

We also note that the discussion of “service contracts” in AASB 118 does not require a “return obligation” to exist. Accordingly we do not consider the guidance in G4 to be appropriate.

Consequently, it is our view that the Australian Guidance can be simplified by referring all contributions which contain a “performance obligation” to AASB 118 and removing the discussion on conditions and stipulations, instead focussing on guidelines that assist entities to apply the “rendering of services” definition by clearly distinguishing the circumstances when AASB 118 applies. Simplified guidance should focus on two key points:

- where a performance obligation (e.g. perform a task, consume benefits etc) or a return obligation exists, the inflow requires the entity to perform a “contractually agreed task” and therefore AASB 118 applies; and
- where no performance or return obligation exists (e.g. donations), then AASB 1004 applies.

This analysis can be summarised through simplification of the flowchart at paragraph G5 as follows:



The usefulness of the guidance could be further enhanced by providing several examples of circumstances that indicate the existence of a service contract so that users are able to clearly identify when AASB 118 applies.

For example, it would be useful to provide an example of the situation when a contribution is provided where the funds are required to be used in the business of the entity for general purposes but consistent with its objectives.

(f) Whether, instead of treating contributions in relation to the rendering of services under AASB 1004 and using the proposed guidance, such amounts should be treated in accordance with the rendering of services requirements in AASB 118.

It is our view that all contributions that relate to the rendering of services should be treated in accordance with the rendering of service requirements in AASB 118. If the guidance remains in its current form, we consider an exemption from AASB 118 will be necessary for "not for profit" entities. At present they are not exempt and in our view the requirements in AASB 118 should override AASB 1004, however this could in certain circumstances lead to non-compliance with AASB 1004 and a possible qualified audit opinion.

Additional comments on specific paragraphs

Contributions with conditions

Guidance paragraph G12 discusses the treatment of revenue earned on the occurrence of a significant event. The guidance requires these amounts to be treated as a prepayment in accordance with AASB 118. The Appendix to AASB 118 suggests such revenue is recognised when the significant act has been completed, accordingly we consider, if retained, this paragraph should say that it is a service contract in accordance with AASB 118.

The guidance in G12 may also be contradictory to AASB 139, as the entity does not have an unconditional ability to refuse repayment of the funds. In this case, the liability (return obligation) arises at inception, not when it is expected that the conditions cannot be met, as some conditions are not under the entity's control.

Contributions without conditions

Guidance paragraph G14 refers to fulfilment of a performance obligation which is defined in paragraph G7 as a condition. Since paragraph G14 is under the heading "contributions without conditions" this reference to performance obligations is contradictory and misplaced.

Guidance paragraph G14 itself seems contradictory. It is not clear in this case when revenue is recognised. Our view is that it should be recognised in accordance with AASB 118 as the performance conditions are satisfied, while in the example it implies that the revenue is recognised up front, with a provision to be recognised in accordance with AASB 137.

Involuntary transfers

These paragraphs primarily relate to government entities and as such, the guidance does not match the current scope of AASB 1004 (i.e. not-for-profit entities). This is also the case with the inclusion of government examples in paragraph G3 and G12. References to governments

should be removed from the guidance until such time that AAS 27, AAS 29 and AAS 31 are withdrawn.

Additionally, paragraphs G15-G19 introduce the term "involuntary transfer". We consider the introduction of new terminology in the Australian Guidance as unnecessary. In this instance, the payment of items such as taxes may be involuntary from the viewpoint of the payer, but from the receiver's perspective (being the perspective we are accounting for), the transfer is merely a contribution. Applying our proposed simplified model and related flowchart would produce the same result. The examples presented in G15-G19 would be useful guidance in the application of the flowchart in G5, however with greater emphasis on the recipient than the donor.

Should you wish to discuss our comments, please contact me on (02) 9335 7569 or Kris Peach on (03) 9288 5297.

Yours sincerely



John F Teer
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