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13 February 2012

The Chairman
Australian Accounting Standards Board
PO Box 204
Collins Street
West Victoria 8007

Invitation to comment on AASB Exposure Draft Revenue from Contract with Customers (ED 222)

Dear Mr Stevenson

Ernst & Young Australia is pleased to provide comments on the AASB's Exposure Draft 222 *Revenue from Contracts with Customers* (the 'ED').

Ernst & Young Global will be providing a separate submission to the International Accounting Standards Board ('IASB') on the matters discussed in the IASB Exposure Draft. Accordingly we have only addressed the AASB Specific Matters for Comment. In particular, we have only commented on Question 1. We will forward you a copy of our letter, once it has been submitted to the IASB.

Overall, Ernst & Young Global is supportive of the Board's proposed revenue model. Our key areas of concern with the Exposure Draft, which will be detailed in our Global letter are:

- the guidance for the satisfaction of performance obligations over time;
- identification and measurement of onerous contracts at the level of a performance obligation rather than the contract level; and
- the quantum of disclosures.

As it relates to not-for-profit ('NFP') and public sector entities, our key concern relates to how the principles of performance obligations within the ED can be applied to the numerous arrangements that exist in these sectors, where the party giving the funds is different to the party that is receiving the benefit. We discuss this in further detail in Appendix A.

We would be pleased to discuss our comments further with you. Please contact Lynda Tomkins (lynda.tomkins@au.ey.com, or (02) 9276 9605) or James Scott (james.scott@au.ey.com, or (02) 8295 6271) if you wish to discuss any of the matters in this response.

Yours sincerely

Ernst & Young

APPENDIX A

SPECIFIC MATTERS FOR COMMENT

1. Whether there are any regulatory issues or other issues arising in the Australian environment that may affect the implementation of the proposals, particularly any issues relating to:
 - a) not-for-profit entities; and
 - b) public sector entities- including any implications for GAAP/GFS harmonisation

We believe that the general principles of revenue recognition and measurement proposed in the ED can be applied to the NFP and public sector entities. However, further guidance will be needed in some areas to ensure consistent application in these sectors. We also believe some modification may be needed in order that the principles provide consistent outcomes to similar activity that may be conducted by for-profit entities. We note below some specific areas that we believe will need modification. It is not, however, an exhaustive list, and therefore we recommend that a paragraph by paragraph analysis is undertaken, to understand what further guidance or modifications would be required in order to allow NFPs and public entities to apply the ED.

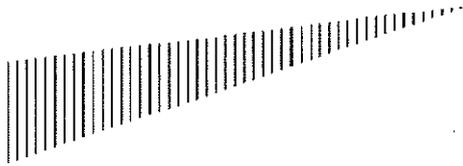
To the extent that required modifications are not excessive, we would recommend including Australian specific paragraphs or Application Guidance to the current ED. If the required modifications are excessive, we recommend that non-exchange transactions for NFP and public sector entities are scoped out of this ED and a new standard be prepared for these sectors, based on the principles as outlined in this ED. For either approach, the inclusion of Illustrative Examples or Application Guidance that provides examples of different types of grants and funding arrangements common to the NFP and public entity sector would be useful to financial statement preparers.

The biggest issue we see for NFP and public sector entities is the conceptual tension between the identification of performance obligations from the customers' perspective, and the recognition and measurement of revenue from the entity's perspective. In the NFP and government sector, very often the party paying for the service is different to those receiving the service. The ED, however, is based on the premise that this is the same party and that the transaction is performed on an arms length basis, on commercial terms. We believe that resolving this tension will require the Board to modify the ED significantly.

In the following section, we have briefly commented on a number of issues we have identified in considering how the ED would apply to NFP and public sector entities. As noted above, this is not an exhaustive list of issues, which will only be identified by undertaking a thorough standard-by-standard analysis.

a) Performance Obligations

Significant judgement is required in identifying performance obligations, requiring the entity to determine the goods and services that have been promised in the contract. In the NFP and public sector, however, the recipients of the goods and services are generally not the provider of funds to the entity. The ED, assumes that the parties are the same and bases the requirements for both the identification of performance obligations and transfer of goods and services (for satisfaction of the performance obligation), on this basis. Hence the identification of performance obligations may need to consider other factors.



The Board will also need to consider how conditions and restrictions attached to grants interact with the concept of performance obligations. Often, entities in these sectors receive funds from multiple sources, some with conditions or restrictions attached and others without. The entity then provides goods or services to customers, which bear limited (if any) relation to the conditions or restrictions applied to the sources of funds.

Grants and other sources of funds for NFP and public sector entities can have one or a combination of the following:

- Conditions on usage - eg to be used to provide specific services to specific types of individuals in the community.
- Restrictions on usage - eg detailing activities that the entity cannot undertake, such as a particular type of service, rather than detailing how the funds should be used.

Alternatively, grants can be provided having neither conditions nor restrictions attached to them. For example, a lump sum provided to a hospital, could be used for administrative tasks, capital works or direct patient care (with no conditions or restrictions attached).

The existence of conditions is likely to assist in the identification of performance obligations. However, this is not the case where restrictions apply or no conditions or restrictions exist. Guidance will therefore be needed to identify performance obligations in such cases.

In particular, if the contract contains restrictions, then we believe consideration is required as to whether;

- a) There is no performance obligation, as the entity has no intention of using the funds in a manner prohibited by the contract. As no performance obligation exists, can funds be recognised, given that the presence of performance obligations is a key principle underpinning this revenue model? Or does the absence of a performance obligation mean that revenue is recognised upon receipt?; or
- b) Is the performance obligation the acceptance of the grant with the restrictions? Under this approach, the performance obligation is satisfied on the day the funds become receivable.

b) Recognition of revenue

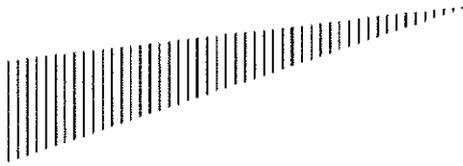
Satisfaction of performance obligations is based upon the notion of passing control of the goods or services. The disconnect between the providers of funds to an entity and those receiving the goods and services (as discussed above), also makes it difficult to reconcile the pattern of the transfer of goods and services with the funds received.

This is further complicated for the NFP and public sector entities as multiple sources of funding are often needed to provide goods or services to parties.

For example, a University receives funds from three different sources:

- i) University fees from students - which would qualify as revenue from contracts with customers.
- ii) Funds from the Government with no restrictions or conditions - a non-exchange transaction.
- iii) Donations from the public/other organisations with restrictions - a non-exchange transaction.

The University provides a course to students and has overhead costs to cover. All three sources of funds are required to provide the course, with no one source being sufficient to cover the necessary costs.



The provision of the course for the student is clearly a performance obligation for the source of funds in i) above. However, for the source of funds in ii) and iii) above, the performance obligation is not clear (as discussed in a) above.) If the performance obligation differs to the provision of the course to the student, income will be recognised in different periods, even though all sources of funds are required to provide the course to the student.

We believe that as all three sources of funds are used for the provision of that course, all three sources of funds should have a similar recognition and measurement profile for 'revenue' as the provision of the course is the University's only performance obligation.

c) Transaction price

Paragraph 71 of the ED requires that the transaction is allocated on a relative stand-alone selling price based on an observable selling price of each performance obligation. Where stand-alone selling prices are not observable, then it is estimated, using market and entity specific information. Examples of appropriate estimate methods presented in paragraph 73 include the adjusted market assessment approach.

The allocation of transaction price across performance obligations assumes that an entity either sells them separately or is able to identify a separate profit margin for each. For NFPs, stand-alone selling prices may not be observable or relevant for the services provided, as the entity may never provide goods or services independently.

An adjusted market assessment approach may also not be appropriate if the entity operates in a monopoly market as is the case with some public service entities. The second method of an expected cost plus margin approach is also likely to be inappropriate in the NFP context where goods and services are often provided at a loss. In these circumstances, would a cost plus negative margin approach be appropriate?

The Board will need to consider an alternative approach for the NFP sector. For example, one approach might be to allocate revenue on the basis of cost of providing the service, rather than based on a profit margin.

d) Objective & Scope

The ED applies to revenue arising from contracts with customers. The main source of funds for most NFP and for public sector entities is not from contracts with customers but from non-exchange transactions such as grants, donations, bequests and appropriations, which are excluded from the scope of this ED. Paragraph 14 lists four criteria that must be met for the ED to apply to a contract. Criterion (d) states that the entity must be able to identify the payment terms for goods or services to be transferred. This effectively excludes non-exchange transactions from the scope of the ED as often the person or entity paying for the services is not the recipient of the services.

As such the scope of the ED requires modification, and key terms such as *revenues*, *contracts* and *customers* must be reconsidered:

- Paragraph 10 defines a *customer* as 'a party that has contracted with an entity to obtain goods or services that are an output of the entity's ordinary activities.' The definition of customer needs to be modified to consider situations whereby the grantor holds an agreement with the grantee (the reporting entity) to provide funds, but the recipient of the output of the reporting entity is not the grantor, but a third party who is the beneficiary (for example a beneficiary of a charity). Currently, these types of arrangements are outside the scope of the ED.
- Paragraph 13 defines a *contract* as 'an agreement between two or more parties that creates enforceable rights and obligations.' In the context of NFPs, there is often not a specific agreement in place between the entity and the beneficiary of the good or service, nor is it legally enforceable. Thus, the replacement of the term 'agreement' with 'arrangement' may better allow for those circumstances where a specific agreement is not held, whilst removing the requirement for it to be enforceable.

e) Onerous Performance Obligations

Our concerns over the ED's treatment of onerous performance obligations are increased when the model is applied to NFP entities. Commonly, while overall the arrangement may be profitable or breakeven, a performance obligation alone may be loss making.

The matters noted in a) and b) above are as equally applicable when considering how the onerous performance obligation principle can be applied to NFP and public sector entities.

We suggest that NFPs income make a disclosure for loss making performance obligations that details what exchange transaction and non-exchange transaction income is matched against the costs incurred in providing the good or service.

f) Disclosures

Reduction in the detailed disclosure requirements of the ED for NFPs and public sector entities will ensure that the information presented can be prepared at a cost that does not outweigh the benefits achieved. This is particularly the case for government departments.

Under the current framework of two tier reporting, private sector NFPs may get disclosure relief from the introduction of a Reduced Disclosure Regime standard on "Revenue from Contracts with Customers", which is being considered in a separate project. The public sector and NFPs that require full IFRS will not get relief, however it is questionable how useful these extensive disclosures will be given the issues discussed above and the different user of the financial statements. We suggest the Board consider requiring a summary of the amount of income from each major source of funds to provide users an understanding of how the entity as a whole is funded.