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Warren Allen
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Dear Warren

IPSASB Consultation Paper *Accounting for Revenue and Non-Exchange Expenses*

We appreciate the opportunity to comment to the NZASB on the IPSASB's Consultation Paper *Accounting for Revenue and Non-Exchange Expenses* (the CP). We also appreciated the opportunity to participate at the NZASB Working Group meetings on the CP.

The accounting for revenue and non-exchange expenses is a challenging and important area in public sector accounting. We are pleased the IPSASB is progressing the development of improved revenue standards and a standard on public sector expenses.

We are concerned that moving away from the "condition" accounting approach of IPSAS 23 to a "performance obligation" approach as proposed under the PSPOA could result in revenue being recognised earlier, despite an expectation from the funder that the entity perform an enforceable task or deliverable. We consider the performance obligation notion of the PSPOA needs to be broadened further than proposed by the IPSASB to capture those transactions that do not transfer a good or service but there is an enforceable obligation on the grant recipient to perform a specific task or deliverable.

If the PSPOA is not broadened further, we expect it would give rise to issues similar to time-requirement issues experienced under IPSAS 23. If the IPSASB decides not to broaden the PSPOA, then it should consider broadening the time-requirement options to also cover arrangements with deliverables imposed by the funder that are enforceable but don't involve the transfer of a good or service.

A number of the issues identified by the CP for grant recipients are also relevant to grant providers. We recommend the IPSASB also consider the accounting for capital grants and time-requirements from the grant provider's perspective.

Our responses to the IPSASB's Preliminary Views and Specific Matters for Comment are attached.

We plan to provide a separate submission to the IPSASB on the CP.

If you would like to discuss any of our comments, please phone me on 021 222 6247 or email me at brett.story@auditnz.govt.nz.

Yours sincerely

A handwritten signature in black ink that reads "Brett Story". The signature is written in a cursive style with a large, looping 'S' at the end.

Brett Story
Associate Director, Technical

Our comments on the Consultation Paper

Preliminary View 1

The IPSASB considers that it is appropriate to replace IPSAS 9, Revenue from Exchange Transactions, and IPSAS 11, Construction Contracts with an IPSAS primarily based on IFRS 15, Revenue from Contracts with Customers. Such an IPSAS will address Category C transactions that:

- (a) Involve the delivery of promised goods or services to customers as defined in IFRS 15; and***
- (b) Arise from a contract (or equivalent binding arrangement) with a customer which establishes performance obligations.***

Do you agree with the IPSASB's Preliminary View 1? If not, please give your reasons.

We generally agree. However, our preference is that transactions within the scope of the PSPOA are addressed in an IFRS 15-equivalent standard that is amended for the PSPOA, rather than as a separate standard or part of an amended IPSAS 23.

Preliminary View 2

Because Category A revenue transactions do not contain any performance obligations or stipulations, the IPSASB considers that these transactions will need to be addressed in an updated IPSAS 23.

Do you agree with the IPSASB's Preliminary View 2? If not, please give your reasons.

Yes, we agree.

Specific Matter for Comment 1

Please provide details of the issues that you have encountered in applying IPSAS 23, together with an indication of the additional guidance you believe is needed in an updated IPSAS 23 for:

- (a) Social contributions; and/or***
- (b) Taxes with long collection periods.***

If you believe that there are further areas where the IPSASB should consider providing additional guidance in an updated IPSAS 23, please identify these and provide details of the issues that you have encountered, together with an indication of the additional guidance you believe is needed.

An issue encountered with IPSAS 23 is determining when a receivable asset arises under a grant arrangement.

IPSAS 23 provides limited guidance on asset recognition and measurement for grant arrangements. Determining the asset recognition and measurement accounting for grant arrangements can be challenging when grant funds are paid over time and future payments are conditional on the grantee performing an action or reaching a specified milestone. In such examples, the grantee's performance may or may not be wholly within their control.

It would be helpful if further guidance was provided on when the funding under a grant arrangement meets the asset recognition criteria and the measurement of that asset.

Further application issues in the context of related SMC and PVs questions are addressed in the relevant sections of this comment letter.

Preliminary View 3

The IPSASB considers that Category B transactions should be accounted for using the Public Sector Performance Obligation Approach.

Do you agree with the IPSASB's Preliminary View 3? If not, please give your reasons.

We generally agree with the IPSASB developing a PSPOA approach. However, we consider a broader notion of "performance obligation" needs to be developed. This is discussed further in our comments in SMC 2 below.

For those transactions with "time-based" stipulations that would not qualify for the PSPOA, the IPSASB needs to consider the accounting options included in SMC 3 below. Under the CP, the IPSASB proposes only to consider time-based stipulations under Approach 1 of enhancing IPSAS 23. The IPSASB should also consider time-based stipulations under Approach 2 of the PSPOA as the issue is relevant under both approaches.

Specific Matter for Comment 2

The IPSASB has proposed broadening the requirements in the IFRS 15 five-step approach to facilitate applying a performance obligation approach to Category B transactions for the public sector. These five steps are as follows:

Step 1 – Identify the binding arrangement (paragraphs 4.29 – 4.35);

Step 2 – Identify the performance obligation (paragraphs 4.36 – 4.46);

Step 3 – Determine the consideration (paragraphs 4.47 – 4.50);

Step 4 – Allocate the consideration (paragraphs 4.51 – 4.54); and

Step 5 – Recognise revenue (paragraphs 4.55 – 4.58).

Do you agree with the proposals on how each of the IFRS 15 five-steps could be broadened? If not, please explain your reasons.

We have a significant concern with step 2 – identify the performance obligation.

Paragraph 4.46 of the CP explains that a performance obligation only includes activities that an entity must undertake to fulfil a contract and where those activities transfer a good or service to a customer. The IPSASB considers this principle would need to be preserved in developing a broadened PSPOA.

We are concerned that the IPSASB intends to develop a broadened PSPOA with a performance obligation notion that is too narrow and would apply only where a funding contract results in a good or service being transferred to a funder or beneficiary. This may result in some transactions that include conditions (and therefore revenue deferrals may be recognised under IPSAS 23) no longer being eligible for revenue deferral under a broadened PSPOA.

We consider a contract that includes specific deliverables and is enforceable by the funder that does not involve the transfer of a distinct good or service to the funder/beneficiary should be eligible for accounting under the PSPOA. This is because in substance it is sufficiently similar to an enforceable obligation imposed by a funder to transfer a good or service.

For example, a District Health Board (DHB) enters into a 2 year multi-year grant agreement totalling \$800k to fund the salary costs for a project manager and support staff to review the DHBs systems and processes to improve cancer treatment times and then implement system improvements. The DHB is required to report quarterly to the funder on progress on the project deliverables and salary costs incurred. Funds are provided quarterly in advance subsequent to the receipt of the prior quarter's quarterly report and unspent funds are refundable to the funder at the end of the arrangement. The funder has the ability to cancel the contract or cease future payments in the event of non-performance under the contract.

This example raises the issue of when an asset arises under the contract and the amount of that asset, and when revenue is recognised following recognition of the asset.

In this example, the DHB is required to perform a specific task, which is monitored by the funder and is enforceable. Satisfying the performance expected in the funding arrangement also requires an economic outflow in the form of future salary costs.

This example also illustrates that while there may not be an immediate directly observable output to a beneficiary, the expenditure is contributing to an outcome of improving treatment times. This would be of general benefit to users of the public health system.

We therefore consider this type of arrangement should be accounted for following the PSPOA framework because in substance it is sufficiently similar to an obligation imposed by the funder to transfer a good or service.

We urge the IPSASB to develop a broadened PSPOA that is broad enough to capture those contracts with clear deliverables imposed by the funder that are enforceable but don't involve the transfer of a distinct good or service to a funder/beneficiary.

If the PSPOA is not broadened further, we expect issues will emerge similar to time-requirement issues experienced under IPSAS 23. If the IPSASB does not broaden the PSPOA as recommended, the time-requirement options in SMC 3 below should be broadened to apply to contracts with deliverables imposed by the funder that are enforceable but don't involve the transfer of a distinct good or service to a funder/beneficiary.

Specific Matter for Comment 3

If the IPSASB were to implement Approach 1 and update IPSAS 23 for Category B transactions, which option do you favour for modifying IPSAS 23 for transactions with time requirements (but no other stipulations)?:

(a) Option (b) – Require enhanced display/disclosure:

(b) Option (c) – Classify time requirements as a condition;

(c) Option (d) – Classify transfers with time requirements as other obligations; or

(d) Option (e) – Recognise transfers with time requirements in net assets/equity and recycle through the statement of financial performance.

Please explain your reasons.

The options to address concerns around time-requirements should also be considered by the IPSASB in implementing Approach 2, the PSPOA.

The accounting for funding that includes time-requirements is an important issue for affected entities due to the significant distortions that can arise in the reported financial performance. Distortions can arise when an entity is required to recognise the following year's operating funding grant when it is unconditionally agreed prior to that period, or where an entity receives a multi-year grant and is required to record revenue upfront for the full amount of the grant in advance of the costs incurred.

An example of such an issue in New Zealand is the Waikato River Clean-Up Trust where the Trust will receive \$7 million each year for 22 years. The Trust intends to disburse the funding annually on river clean-up related grants. Because the funding arrangement is unconditional, the funding to be received over the 22-year period is recognised as a receivable and revenue upfront when the agreement was executed. The funds received will then be expensed over the 22-year period as grant arrangements are entered into by the Trust. In this example, the Trust also reports a significant amount of interest revenue to unwind the discounted value of the receivable over the 22-year period, which further distorts the Trust's financial performance.

If the IPSASB decides on a recognition solution for time-requirements, we prefer option (e) of transferring the credit entry to net assets and recycling to the surplus/deficit in the period the funding relates to. Sufficient guidance would need to be provided under this option on the timing of the recycling of the credit entry to the statement of financial performance to mitigate manipulation of performance. We note there is precedent for this accounting approach in IPSAS 29 under cash flow hedge accounting where derivative gains and losses are deferred in equity and recycled to the surplus/deficit to match the revenue or expense arising from the risk managed.

Specific Matter for Comment 4

Do you consider that the option that you have identified in SMC 3 should be used in combination with Approach 1 Option (a) – Provide additional guidance on making the exchange/non-exchange distinction?

(a) Yes

(b) No

Please explain your reasons.

Yes. If the IPSASB decides to progress Approach 1, then we consider further guidance is necessary in distinguishing between exchange and non-exchange transactions. The most difficult and time consuming aspect of the transition to the new PBE Accounting Standards was assessing whether a revenue transaction was exchange or non-exchange due to the lack of guidance in this area. Further guidance on the exchange/non-exchange distinction would therefore be welcomed under Approach 1.

Preliminary View 4

The IPSASB considers that accounting for capital grants should be explicitly addressed within IPSAS.

Do you agree with the IPSASB's Preliminary View 4? If not, please give your reasons.

Yes, we agree that the accounting for capital grants should be explicitly addressed within IPSAS.

We have encountered significant issues and challenges in accounting for capital grants received by entities in applying IPSAS 23.

The IPSASB should also address capital grants from the funder's perspective.

Specific Matter for Comment 5

(a) Has the IPSASB identified the main issues with capital grants?

If you think that there are other issues with capital grants, please identify them.

(b) Do you have any proposals for accounting for capital grants that the IPSASB should consider?

Please explain your issues and proposals.

(a) Yes, the main issues we are aware of have been identified.

(b) We are disappointed the IPSASB has not identified proposals for constituents to comment on.

Our preference is for the IPSASB to develop proposed requirements and guidance for capital grant transactions based on application of the PSPOA. The proposals would need to address difficult capital grant issues, such as:

- Where an entity has a use condition on an asset, and, if it breaches this condition, the grantor can request the return of the physical asset or refund all or part of the grant monies provided. For example, a capital grant provided that must be used to construct social housing and the asset must be used for social housing purposes for 20 years, and, if breached, all or part of the grant monies are repayable to the transferor.
- A use condition is attached to an asset with an indefinite life and the asset must be returned to the transferor if that condition is breached. For example, land held that must be used indefinitely for agricultural use.

We encourage the IPSASB to consider the capital grant requirements and guidance developed by the Australian Accounting Standards Board in AASB 1058 *Income of Not-for-Profit Entities*, in particular paragraphs 15 to 17, and illustrative examples 9 and 10.

Requirements and guidance for entities that **provide** capital grants should also be considered by the IPSASB as it develops the non-exchange expense accounting proposals as providers of capital grants are faced with similar accounting issues as grant recipients.

Specific Matter for Comment 6

Do you consider that the IPSASB should:

- (a) Retain the existing requirements for services-in kind, which permit, but do not require recognition of services in-kind; or**
- (b) Modify requirements to require services in-kind that meet the definition of an asset to be recognised in the financial statements provided that they can be measured in a way that achieves the qualitative characteristics and takes account of the constraints on information; or**
- (c) An alternative approach.**

Please explain your reasons. If you favour an alternative approach please identify that approach and explain it.

We support retaining the existing requirements that permit entities to make an accounting policy choice for the recognition of services-in-kind.

In the public sector, most entities do not recognise services-in kind received. We are not aware of any concerns by public sector entities about the existing service-in kind accounting requirements.

We expect, in most cases, the cost of obtaining information on the value of services-in kind received would outweigh the benefits received from reporting this information. Mandating the recognition of services-in kind would require entities to establish systems and processes to gather reliable information, such as establishing time sheeting systems, systems to estimate the value of the services received, and internal controls over these to ensure the information is reliable and auditable.

Preparers are also unlikely to see any significant benefits associated with the time and cost of establishing and maintaining service-in kind systems. For example, mandating the recognition of services-in kind may require schools to estimate a monetary value for members of the community who “donate” their time to various school activities, such as coaching, fundraising, working-bee activities, and other activities of the school.

Additionally, we anticipate there could be difficulty in determining whether an entity has sufficient control for accounting purposes over an individual in assessing whether an asset arises from the services-in kind received.

Preliminary View 5

The IPSASB is of the view that non-exchange transactions related to universally accessible services and collective services impose no performance obligations on the resource recipient. These non-exchange transactions should therefore be accounted for under The Extended Obligating Event Approach.

Do you agree with the IPSASB’s Preliminary View 5? If not, please give your reasons.

The CP acknowledges that universally accessible services and collective services contain no performance obligations or stipulations that the resource recipient is required to fulfil as a result of receiving these services.

Given there are no performance obligations on service recipients, there appears to be little merit in considering application of an extended obligating event approach.

We consider the important issue for the IPSASB to address is the liability recognition point for universally accessible and collective services as this drives the expense recognition.

Preliminary View 6

The IPSASB is of the view that, because there is no obligating event related to non-exchange transactions for universally accessible services and collective services, resources applied for these types of non-exchange transactions should be expensed as services are delivered.

Do you agree with the IPSASB's Preliminary View 6? If not, please give your reasons.

While we are comfortable with the accounting outcome of universally accessible services and collective services liabilities and expenses being recognised when incurred, the IPSASB needs to provide further reasons and analysis to support this conclusion.

The CP justifies there is no obligating event in relation to universally accessible services and collective services because governments can vary the level of such services so that the availability of those services may be limited. We don't think this fact is persuasive in its own right to support the conclusion reached. We note that adjusting the levels of services provided by a government is unlikely to occur swiftly and may require legislative change for rights to services established through legislation.

The IPSASB should consider the work in the Social Benefits project to strengthen the support for the PV.

Preliminary View 7

The IPSASB is of the view that where grants, contributions and other transfers contain either performance obligations or stipulations they should be accounted for using the PSPOA which is the counterpart to the IPSASB's preferred approach for revenue.

Do you agree with the IPSASB's Preliminary View 7? If not, please give your reasons.

We generally agree with this PV. However, we consider:

- The performance obligation definition needs to be broader than proposed by the IPSASB, for the same reasons as explained in SMC 2 above.
- The IPSASB also considers time-requirements and capital grant accounting for grant providers, as noted in PV 4 and SMC 3 above.

We also consider that sufficient guidance needs to be provided on the liability recognition point for all grants, contributions, and other transfers (regardless of the approach applied to expense recognition). An issue often encountered in practice with these arrangements is when a present obligation to provide funding arises. Particularly, when grant funds are paid over time and future payments are conditional on the grantee performing an action or reaching a specified milestone.

Preliminary view 8

The Board considers that at initial recognition, non-contractual receivables should be measured at face value (legislated amount) of the transaction(s) with any amount expected to be uncollectible identified as an impairment.

Do you agree with the IPSASB's Preliminary View 8? If not, please give your reasons.

Yes, we agree.

The initial measurement of statutory receivables, such as taxes and fines, at fair value was subject to significant debate between some preparers and auditors on transition to IPSAS 23. In particular, there was tension between the requirements of IPSAS 23 and concerns over the loss of important information on statutory imposed revenue amounts by applying a fair value measurement approach at initial recognition.

Initially recognising non-contractual receivables at face value with a separate impairment amount would help provide greater transparency and accountability for statutory-based revenues.

Preliminary View 9

The IPSASB considers that subsequent measurement of non-contractual receivables should use the fair value approach.

Do you agree with the IPSASB's Preliminary View 9? If not, please give your reasons.

Yes, we agree. We favour this approach over amortised cost and cost as it should generally be the simplest of the 3 proposed methods to apply in practice.

Entities that hold non-contractual receivables often have a large number of debtors with small amounts in the context of the overall portfolio balance. These portfolios are not managed based on credit risks and therefore have different characteristics to commercial receivable portfolios.

We anticipate it would be unduly complex and costly to apply the amortised cost approach to large statutory receivables portfolios where discounting is required. It may also be unworkable to apply the IFRS 9 expected credit loss impairment model without practical expedients given the large volume and the nature of statutory receivables.

The cost approach also seems problematic as it would be difficult to determine when a debtor is impaired or when a past impairment is reversed within a large portfolio.

While there could be more volatility in the statement of financial performance arising from discount rate changes under a fair value approach, this doesn't seem to have been a significant issue for those New Zealand entities that have applied a subsequent measurement model that is similar to fair value.

Specific Matter for Comment 7

For subsequent measurement of non-contractual payables do you support:

(a) Cost of Fulfilment Approach:

(b) Amortised Cost Approach;

(c) Hybrid Approach; or

(d) IPSAS 19 requirements?

Please explain your reasons.

We prefer the IPSAS 19 approach as that approach appears to more closely align to the fair value approach for non-contractual receivables.

The CP is unclear on what the practical difference is between the cost of fulfilment approach and the IPSAS 19 approach above as both approaches are based on discounted cash outflows. If the IPSASB considers there is a practical difference between approaches (a) and (d) above, it would be helpful for that to be explained in the future exposure draft if different options are being considered.

Our preference is to follow an approach that closely aligns with the subsequent measurement requirements of non-contractual receivables. Different subsequent measurement approaches between receivables and payables is likely to be confusing for preparers and users of financial statements and could require different systems. This is likely to be a concern for entities that report both non-contractual receivables and payables for the same tax. For example, the Inland Revenue Department and Financial Statements of Government report both tax related receivables and payables in the statement of financial position as the Government can owe and be owed amounts related to income tax and GST (and the position of the respective taxpayers could change year-on-year).

We think there would need to be a compelling reason to apply different subsequent measurement bases for non-contractual receivables and payables.