Accounting for funding arrangements under the PBE Standards

In 2016, the Public Benefit Entity (PBE) Standards saw the introduction of an accounting framework that distinguished between revenue from exchange transactions and revenue from non-exchange transactions for the first time.

In this article, we look at some of the key implications regarding accounting for revenue for not-for-profit ("NFP") entities receiving funding from government or other agencies.

Given the diversity of funding arrangements in the NFP and public sectors, a separate standard exists to distinguish between:

- transactions in which an entity receives value, and directly gives approximately equal value in exchange (PBE IPSAS 9 *Revenue from exchange transactions*); and
- an entity receiving value, without directly giving approximately equal value in exchange. (PBE IPSAS 23 *Revenue from Non-Exchange Transactions)*

The classification of revenue into revenue from non-exchange transactions will drive the timing of revenue recognition - and although revenue is revenue, timing is everything!
The impact of this is that NFP entities now need to carefully consider the terms of their funding arrangements to ensure their accounting and disclosure is appropriate.

Traditionally under legacy accounting standards, where the revenue was considered to relate to services provided, the timing of revenue was dependent on the stage of completion of the transaction at the reporting date. As funding is often provided in advance of delivery in the NFP sector, the revenue was often recognised over a period time after the receipt of the funds.

Under the PBE Standards, non-exchange revenue is a class of revenue which is recognised when any performance obligations relating to the funding have been satisfied. Practically, this means that for many NFP entities, revenue from funding arrangements will be recognised earlier than traditionally.

In implementing the standards, we identified that preparers of financial statements encountered challenges at two key stages:

- Considering if the funding arrangement represented an exchange or non-exchange transaction;
- Determining if the funding arrangement contained performance obligations sufficient to defer revenue as a liability at the time of receipt.

Distinguishing between exchange and non-exchange transactions

The judgement as to whether a revenue transaction represents a non-exchange transaction may impact the accounting treatment. Unfortunately, there is no bright-line test to distinguish a non-exchange transaction from an exchange transaction, and in some cases, the assessment may be quite subjective.

The requirement for classification as non-exchange is triggered if both of the following exists:

- Firstly: if the recipients of the services provided by the entity are not the funding body.
- Secondly: if the benefit received by the funder is not approximately equal in value to the services provided. Often, funding is only provided that partially covers the cost of the services provided – or may be provided from multiple sources.

The accounting standard provides limited guidance in making this distinction, and as such we provide some additional considerations when making your assessment as to who is the recipient of the services:

- Is your organisation relieving the funder of a requirement in return for the funding, or would your organisation procure funding elsewhere to provide the same services should the specific funder not provide the funds?
- Who determines the recipients of your services? Does your organisation determine the recipients they will serve, or are the recipients referred by the funder or other contracted agencies?
- Do other providers who perform the same service to the funder?
- How does the service link to your organisation's goals and objectives?

In instances where the decision reached is finely balanced, disclosure should be provided in your financial statements of the factors weighting the judgement applied in the financial statements.

Performance obligations sufficient to defer revenue at time of receipt

Some funding contracts have stipulations within the arrangement which require funds to be returned if certain performance obligations are not met. These are commonly referred to as **"claw-back clauses".** This type of stipulation is known as a condition.

Conversely, stipulations within funding arrangements that do not specify that the funds must be returned are known as restrictions.

On receipt of non-exchange revenue that is subject to a condition, a liability is incurred which represents:

- either a future outflow of resources being applied to satisfy the condition; or
- the repayment of the funding.

However - conditions must be enforceable. Where a condition is not enforceable, the substance of the stipulation is really to that of a restriction – and so a liability is not recognised on receipt of the funds.

In distinguishing between conditions and restrictions, consideration beyond just the legal form is necessary.

- Both contractual terms and past dealings with the funder need to be considered to assess whether the funder has demonstrated that it has the ability and intent to enforce the terms of the contract or not. Where there is no past behaviour to suggest that the funder will enforce the terms of the contract, it is assumed that the condition will be enforced.
- Where a contract imposes a term that requires the entity to perform an action that the entity has no alternative but to perform (even without the contract), or return the funds, then this neither the substance of a condition nor a restriction.

Example: How stringent do funding conditions need to be?

As an example, let's consider funding is made under a contract by a government department to a social housing entity, specifying that it:

- increases the stock of social housing by an additional 1000 units over and above any other planned increases; or
- uses the funding in other ways to support its social housing objectives.

If neither of these stipulations are met, the entity is required to return the funding to the government department.

The stipulations in this contract are stated so broadly so as not to impose on the entity a performance obligation. Instead, the performance obligation is imposed by the operating mandate of the entity and not by the terms of the funding. Therefore, the stipulations have the form, but not the substance of a condition.

Conclusion

The accounting for different types of revenue that PBEs receive is a significant change from previous accounting rules in this area. Care needs to be taken to ensure the judgments made in applying these still relatively unfamiliar standards.

The impact for many organisations that receive funding in advance has been that there is now a perceived “mismatch” between the timing of revenue recognition and related expenditure. Where this is the case we encourage disclosure within your financial statements to ensure the extent of non-exchange funds received in advance but without “conditions” is clear to the readers.

As always, the RSM technical team is available to assist with any queries and expert advice required.

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