

# ***Not-for-Profit bulletin***



## ***New income accounting requirements to apply to Not-for-Profit entities***

In this month's newsletter, as we near closer to the adoption of the new revenue and income standards for not-for-profit entities (NFPs) we consider some of the key implication for NFPs.

These standards will likely change the way NFPs currently account for such arrangements, which may have significant impacts, depending on the entity involved and the nature of their operations. To assess this impact, NFPs will need to undertake a review of all existing contractual agreements in respect of revenue/income and lease transactions. Furthermore, application of the new standards will in some cases require judgement in determining fair values and performance obligations attached to funding arrangements.

For NFPs with 31 December reporting dates, their first set of financial statements applying the new requirements will be for the year ended 31 December 2019. For those NFPs with 30 June reporting dates, their first set of financial statements applying the new requirements will be for the year ended 30 June 2020.

### **What are the new NFP income accounting requirements?**

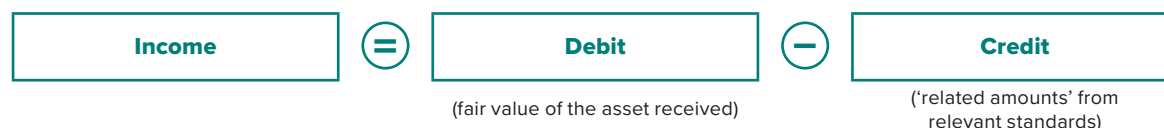
AASB 1058 Income of Not-for-Profit Entities, has replaced most of the requirements in AASB 1004 Contributions, and applies to the following:

- Transactions where the consideration paid to acquire an asset is significantly less than the fair value of that asset principally to enable the entity to further its objectives.
- Receipt of volunteer services.

Such assets can be physical (like land and buildings), intangible (like intellectual property or licenses) and/or financial (like cash or shares) that could be donated, granted or acquired.

Under the previous standard, acquisitions of assets were measured at cost, unless they were acquired at nominal or nil consideration where fair value measurement was required. This new standard will require fair value to be recognised in almost all circumstances (except inventory which is measured at current replacement cost) when the value of the asset received is significantly less than fair value and that difference is principally to enable the entity to further its objectives.

**The general principle in AASB 1058 is:**



The exception to this general principle occurs in circumstances where a transfer to a NFP is to enable the entity to acquire or construct a recognisable non-financial asset to be controlled by the NFP (discussed in more detail below).

In practical terms, 'related amounts' is the credit entry or entries the NFP would record when recognising the inflow of cash or other assets. They could include:

- contributions by owners ((revised) AASB 1004)
- a lease liability (AASB 16 Leases)
- a financial instrument (AASB 9 Financial Instruments)
- a provision (AASB 137 Provisions, Contingent Liabilities and Contingent Assets)

Therefore, for those NFP transactions where the above standards are not applicable, such as donations, bequests or grants that do not give rise to a liability, the fair value of the asset received will be recognised as income immediately once the entity obtains control of the asset (which usually occurs at the time of receipt).

AASB 1058 also notes that an NFP might identify a related amount in the form of revenue or a contract liability arising from a contract with a customer. An arrangement, or a related amount (component) thereof, that meets the criteria necessary for treatment as a contract with a customer (refer detailed discussion below) is accounted for in accordance with AASB 15 Revenue from contracts with customers. This means that the NFP would recognise income in respect to the arrangement, or component thereof, when (or as) the NFP satisfies its performance obligations by transferring promised goods and services. That is, contracts that are accounted for under AASB 15 provide an opportunity to account for revenue over time, but only in specific circumstances. Accounting for revenue over time is often preferred by NFPs as this is more akin to the 'matching' principle where income and expenses are recognised by the entity in the same reporting period.

**Revenue from contracts with customers – NFP considerations**

The five-step model contained in AASB 15 is as follows:

- 1** identify the contract with the customer
- 2** identify the separate performance obligations
- 3** determining the transaction price
- 4** allocating the transaction price to performance obligations
- 5** recognising revenue as performance obligations are satisfied

An agreement, or a component thereof, would be classified as a contract with a customer, therefore applying Steps 1 and 2 of AASB 15, in an NFP context if the agreement:

- is 'enforceable', that is, it creates enforceable rights and obligations between the parties
- includes a promise or promises by the NFP to transfer a good or service that is 'sufficiently specific' for the entity to determine when the performance obligations are satisfied



## **Enforceability**

A contract with a customer in an NFP context is enforceable when:

- the agreement can be enforced through legal or equivalent means
- at least some of the obligations under the agreement are enforceable

Examples of terms that result in enforceable agreements include, but are not limited to, the following:

- A refund in cash or kind is required when the agreed specific performance has not occurred.
- The customer, or another party acting on the customer's behalf, having a right to enforce specific performance or claim damages.
- The customer having the right to take a financial interest in assets purchased or constructed by the entity with resources provided under the agreement.
- The requirement that both parties to the arrangement need to mutually agree on any changes to which transferred funds are put.

Under the new requirements the following circumstances would not, of themselves, cause an agreement involving a promise to transfer goods and/or services to be enforceable by another party through legal or equivalent means:

- A transferor has the capacity to withhold future funding to which the entity is not presently entitled.
- An NFP publishes a statement of intent to spend money or consume assets in particular ways, particularly if the statement of intent is in the nature of a public policy statement and does not identify parties who could enforce the statement.

The new standard, unlike the previous standard, considers refund obligations specifically and acknowledges that such an obligation gives weight to a contract passing the 'enforceable' criteria under AASB 15. However, the AASB consider that a refund obligation on its own does not constitute a performance obligation and therefore a liability. This is because the entity has the discretion to avoid breaching the agreement, which would require the return of the funds. As indicated above, the identification of 'sufficiently specific' performance obligations must also be present to even consider if there is any possibility to defer revenue.

## **Sufficiently specific promises within a contract**

To be considered a contract with a customer in an NFP context an agreement must, in addition to meeting the enforceability criteria, contain a promise or promises that are 'sufficiently specific'. Promises must be 'sufficiently specific' so that the transfer of goods or services is not at the discretion of the NFP, and it can be determined when the obligation is satisfied.

Determining whether a promise is 'sufficiently specific' will require judgement, considering any conditions specified in the arrangement, whether explicit or implicit, regarding the promised goods or services, including conditions regarding the following aspects:

- the nature or type of the goods or services
- the cost or value of the goods or services
- the quantity of the goods or services
- the period over which the goods or services must be transferred

Whether a promise is 'sufficiently specific' so as to qualify as a performance obligation is assessed separately for each promise and will depend on the particular facts and circumstances. For instance, if an arrangement specified, in addition to the time frame over which the goods or services are to be provided, the nature/type and quantity of goods or services to be provided, together these features would enable the NFP recipient to determine when the goods or services have been provided.

In contrast, a promise by an NFP to transfer unspecified goods or services within a particular period does not, of itself, meet the 'sufficiently specific' criterion because the NFP is unable to determine when its obligations under the agreement are satisfied.

## **Contract with a customer that includes a donation component**

Frequently customers enter into contracts with NFPs with a dual purpose of obtaining goods and services from the NFP as well as assisting the NFP achieve its objectives by providing a donation. In such circumstances, provided that the arrangement meets both the 'enforceability' and 'sufficiently specific' criteria, the entire transaction price is treated by the NFP recipient as wholly related to the transfer of the promised goods and/or services except when the transfer is partially refundable in the event the NFP does not deliver the promised goods and/or services. In such circumstances, the transaction price is disaggregated by the NFP and:

- The component that relates to the transfer of the promised goods and/or services is accounted for as a contract with a customer in accordance with AASB 15.
- The balance of the transaction price (donation component) is accounted for in accordance with AASB 1058, which normally requires such amounts to be recognised as income immediately.

The following factors may indicate that a component of the transaction price is not related to the promised goods or services, and therefore may be in the nature of a donation component:

- The component is not refundable.
- Where the NFP has the status of a deductible gift recipient, the customer can claim part of the transaction price as a tax deduction for a donation.

### **What other transactions in an NFP context does AASB 1058 deal with?**

In addition to the accounting for any donation component arising from a transaction involving the acquisition of an asset by an NFP, AASB 1058 also establishes the accounting by NFPs for:

- transfers to an NFP to enable the entity to acquire or construct a recognisable non-financial asset to be controlled by the NFP
- below-market ('peppercorn') leases
- donated goods
- volunteer services



### **Transfers to enable acquisition or construction of a recognisable non-financial asset**

Where an NFP receives a grant to enable the entity to acquire or construct a recognisable non-financial asset (such as a building) that will be controlled by the NFP, income will be recognised as or when it satisfies its obligations to construct that asset. AASB 1058 requires the NFP to:

- apply the applicable recognition and measurement requirements of AASB 9 to the financial asset (e.g. cash and/or receivable)
- recognise a liability for the excess of the initial carrying amount of the financial asset received over any related amounts (see discussion above)

Subsequent to this initial accounting, the NFP would:

- Recognise the acquired or constructed non-financial asset in accordance with the applicable Australian Accounting Standard (for instance AASB 116 Property, Plant and Equipment).
- Release the liability amount to the profit or loss as income when (or as) the NFP satisfies its obligations under the transfer (i.e. acquires the asset or constructs the asset as applicable).

To qualify for this accounting treatment the following must exist:

- an enforceable agreement
- no requirements for the NFP to transfer the non-financial asset to any other body
- the asset must be used to acquire or construct a recognisable non-financial asset to identified specifications

As the concept of 'identified specifications' is not defined in AASB 1058, some judgement may be required to determine when these criteria are met.

Examples 9 – 11 of the Illustrative Examples to AASB 1058 demonstrate how some of these new requirements might be applied and when income would be recognised.

### **Below-market leases**

The changes in the leasing standard are contained in AASB 16 and apply to all reporting entities. Leases previously classified as 'operating leases' are required to be brought onto the statement of financial position as a right of use asset and a corresponding lease liability. The changes required can be complex, depending on the type of operating lease arrangements the entity has, the value of such arrangements and the lease terms involved.

When AASB 1058 is applied in conjunction with the requirements of the new leasing standard, the AASB has allowed NFPs a temporary accounting policy choice regarding leases that are significantly below market value principally to enable the entity to further its objectives. Such leases are often called peppercorn or concessionary leases and have payments of zero or nominal amounts. The choice available on a class of asset basis is to:

- Recognise the right of use asset at cost (determined as equivalent to the present value of the nominal or zero lease payments over the term of the lease).
- Recognise the right of use asset at the fair value of the right to use the leased property during the lease term (which will be different to the present value of the nominal or zero lease payments over the lease term).

Where the fair value option is chosen, the difference between initial measurement of the right of use lease asset and the lease liability is recognised immediately as income in accordance with AASB 1058.

Such peppercorn or concessionary lease arrangements might include the use of a building or office space for free (or a nominal amount) by an NFP that is provided by a government related entity (like a council) or even a philanthropic-minded asset owner. The reason the AASB provided the temporary accounting policy choice is because it realised that determining the fair value for such arrangements could be challenging and NFP guidance on fair value may need to be developed.



### Donated goods

Many NFPs receive donated goods and other assets that are used by the NFPs to further their own objectives, either by consuming the benefits embodied in these goods or selling them. Under

AASB 1058, donated goods that are classified as inventory in accordance with AASB 102 Inventories are accounted for in consistence with the approach outlined above in respect to assets acquired for significantly less than their fair value principally to enable the NFP to further its objectives. However, under the amendments to AASB 102 arising from AASB 1058, rather than being initially measured at their fair value, donated goods will be initially measured at their current replacement cost.

The purpose of requiring NFPs to initially measure inventory at current replacement cost rather than fair value is to avoid any losses immediately arising in instances where an item of inventory held for distribution is subsequently measured at its current replacement cost. In addition, AASB 102 will permit, as a practical expedient, NFP recipients of such donated goods to elect to recognise a donated item of inventory based on an assessment of the materiality either of the individual item or of donated inventories at an aggregate or portfolio level. Accordingly, under AASB 1058, NFPs receiving individually immaterial items of donated inventory could choose not to recognise those items in their financial statements.

### Volunteer services

Many NFPs receive services free of charge – director services, volunteer services and even some professional services.

Consistent with the previous standard, local governments, government departments, general government sectors and whole of government must recognise the fair value of those volunteer services where they can be measured reliably, and the services would have been purchased if they had not been donated.

However, this requirement has been extended to permit all NFPs to elect to recognise volunteer services as an expense or an asset, as applicable, provided the fair value can be measured reliably.



### Will NFPs be required to disclose additional information under the new income accounting requirements?

Consistent with the new income accounting requirements, AASB 1058 requires NFPs to disclose sufficient information to enable users to understand the financial effects of volunteer services and other transactions where the entity acquires an asset for consideration that is significantly less than fair value principally to enable the entity to further its objectives. Consistent with this disclosure objective, AASB 1058 requires disclosure of a range of information, including:

- Income recognised during the period, disaggregated into categories that reflect how the nature and amount of income (and the resultant cash flows) are affected by economic factors.
- The opening and closing balances of financial assets arising from transfers to enable the NFP to acquire or construct recognisable non-financial assets to be controlled by the entity.
- An explanation of when the NFP expects to recognise as income any liability for unsatisfied obligations as at the end of the reporting period.
- Judgements, and changes in judgements, made in applying AASB 1058 that significantly affect the determination of the amount and timing of income arising from transfers to enable the NFP to acquire or construct a recognisable non-financial asset to be controlled by the entity.

- For obligations that an NFP satisfies over time, the method(s) used to recognise income and an explanation of why the method(s) used provide a faithful depiction of the NFP's progress towards satisfying its obligations.
- For obligations satisfied at a point in time, the significant judgements made by the NFP in evaluating when it has satisfied its obligations.

In addition, NFPs that account for part or all of a transfer of assets as a contract with a customer under AASB 15 will be subject to the applicable disclosure requirements in AASB 15.

Note that AASB 1058 also encourages a NFP to disclose information about externally imposed restrictions that limit or direct the purpose for funds. Therefore, where income may be recognised up-front due to the lack of 'sufficiently specific' performance obligations but the income is intended for a specific purpose (perhaps a bequest is received that relates to providing an annual scholarship), the NFP is therefore encouraged to identify the asset under which the restriction exists and the nature of restriction. Further disclosures encouraged include the separate identification of equity and total comprehensive income into restricted and unrestricted amounts.



**Are there any exemptions, practical expedients or short-cuts available on transition to the new income accounting requirements?**

AASB 1058 provides NFPs with a choice between the following transitional approaches:

- Retrospectively to each prior reporting period presented in accordance with AASB 108: Accounting Policies, Changes in Accounting Estimates and Errors ('full retrospective') requiring comparatives to be restated.
- Retrospectively with the cumulative effect of initial application recognised in the opening balance of retained earnings (or another component of equity, as appropriate) at the date of initial application, involving no restatement of comparative information ('cumulative catch-up').

In addition, the transitional requirements to AASB 1058 provide a number of practical expedients, including the following:

- When applying the full retrospective approach, an NFP need not restate completed contracts or transactions (needs to be done consistently for all contracts/transactions) that:
  - begin and end in the same annual reporting period
  - are completed contracts or transactions at the beginning of the earliest period presented
- Under the cumulative catch-up approach, an NFP may elect to apply AASB 1058 retrospectively only to contracts and transactions that are not completed contracts at the date of initial application.
- With respect to an asset (other than a lease asset) that was acquired for consideration significantly less than fair value principally to enable the entity to further its objectives and initially measured at a cost that was significantly less than fair value, the NFP is not required to remeasure the asset to fair value under either the full retrospective or cumulative catch-up approaches.

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