Perspective

This is one of a series of articles where experts in assurance, reporting and regulatory matters discuss recent technical and policy developments in these areas

Not-for-profits – Are you ready?

Melissa Alexander CA – Partner, Pitcher Partners

Kerry Hicks FCA – Director, Technical Standards – Pitcher Partners

November 2019

Ready, set, go – we are now at the 'go' stage in applying the new accounting standards relevant for not-for-profit entities (NFPs) for December 2019 year ends. Those June year ends have an extra six months to 'go' but should be pretty 'set' in understanding and starting to assess the impacts of the new accounting standards for NFPs. If this is all news to you, read on to discover how you can get 'ready, set, go' regarding the new standards and determining their impact.

The new standards impacting NFPs for years commencing on or after 1 January 2019 are:

- AASB 1058: Income of Not-for-Profit Entities
- AASB 15: Revenue from Contracts with Customers
- AASB 16: Leases

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 arrangements/agreements in respect of both revenue/income and lease transactions.

NFPs will need to exercise judgement in applying the new standards in determining fair values, lease terms, incremental borrowing rates for leases, and performance obligations attached to funding arrangements. Such judgements should be disclosed appropriately.

Income of not-for-profit entities – the principle

AASB 1058, 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; and the
- 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 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 regarding income recognition is that the entity recognises income immediately, being the difference between the above fair value of the asset received and amounts recognised in the relevant related standards, which include:

- An equity contribution by owners
- Revenue or a contract liability arising from a contract with a customer (AASB 15)
- A lease liability (AASB 16)
- A financial instrument (AASB 9)
- A provision (AASB 137).

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).

Example 1

Assume a NFP that is an educational institution receives $2million cash from a previous student as a bequest with the following terms:

- *Amount to be invested at the institution's discretion*
- *Income generated from investing the principal to be applied towards an annual scholarship.*

The $2 million cash is an asset which is controlled upon receipt and within the scope of AASB 9. As the arrangement is not enforceable (for example, it does not contain a refund obligation) it is not a contract with a customer or a financial liability. Further, the consideration paid for the asset is NIL, so considerably less than the fair value of the asset principally to enable the entity to further its objectives – so it is within the scope of AASB 1058. The bequest does not give rise to a contribution by owner, a lease liability, a provision or a further liability under AASB 9.

Therefore, the journals are:

DR Cash $2 million

    CR Income $2 million

Note that AASB 1058 encourages a NFP to disclose information about externally imposed restrictions that limit or direct the purpose for funds. Therefore, in relation to Example 1 above, the NFP is therefore encouraged to identify the asset under which the restriction exists and the nature of restriction (i.e. for applying funds towards an annual scholarship). Further disclosures encouraged include the separate identification of equity and total comprehensive income into restricted and unrestricted amounts.

Is it revenue?

A contractual arrangement will be classified as a contract with a customer if the agreement is with a customer and:

- Is ‘enforceable’, that is, it creates enforceable rights and obligations between the parties; and
- 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.

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.

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.

To complete the steps involved in recognising revenue under AASB 15, in addition to the two steps outlined above, an additional three steps need to be considered, as follows:

- Determining the transaction price
- Allocating the transaction price to performance obligations; and
- Recognising revenue as performance obligations are satisfied.

Example 2

Assume a charity receives a government grant of $5 million to provides counselling services to alcoholics. The services are to be provided in regional Australia, with the objective of reducing alcoholism in those areas by 25% in the next 3 years. The grant is refundable to the extent that monies are unspent at the end of the three-year period or if funds are not spent in accordance with the terms of the agreement.

The contract is enforceable due to the refund condition within the contract. The performance obligations in the contract are not sufficiently specific as the contract does not specifically identify the activities that must be performed by the charity to satisfy the agreement, the determination of such activities being completely in the hands of the charity. The inclusion of a particular period over which to transfer the services does not ‘of itself’ meet the ‘sufficiently specific’ criterion.

Therefore, the journals are:

DR Cash $5 million

CR Income $5 million

To meet the ‘sufficiently specific’ criterion and therefore be accounted for under AASB 15 we would expect the contract to identify the number of counselling sessions to be provided and identify the specific regions that the services will be available in, along with an appropriate accountability mechanism to government.

If such information was included in the terms of this contact, performance obligations could be assessed ‘sufficiently specific’. The NFP then reviews these performance obligations and determines there is a single performance obligation to provide a certain number of consulting services to specific areas over a three-year period and to report to the government on their progress. The entity would allocate the transaction price of $5million to the single performance obligation and determine when it is appropriate to recognise revenue – at a point in time or over time. Given that services are provided over time, and the charity can determine how many consulting hours are performed in each period at each location, it determines that it is appropriate to recognise revenue over time. Therefore, the journals are:

Day 1

DR Cash $5 million

CR Contract liability $5 million

At the end of the first reporting period

Assuming 100 hours of a 500-hour consulting agreement is performed,

DR Contract liability $1 million

CR Revenue $1 million

What about leases?

The changes in the leasing standard 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); or
- 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.

What about capital grants?

AASB 1058 contains specific requirements relating to capital grants. Where a NFP receives a grant to enable the entity to acquire or construct a recognisable non-financial asset that will be controlled by the NFP, income will be recognised as or when it satisfies its obligations to construct that asset. 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; and
- The asset must be used to acquire or construct a recognisable non-financial asset to identified specifications.

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.

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.

Further guidance

Revenue

Appendix F of AASB 15 provides general guidance on assessing 'enforceability', 'sufficiently specific' and the allocation of the transaction price to performance obligations in the context of a NFP entity. Appendix G provides guidance on assessing the criteria for NFP public sector licensors. Illustrative examples are also included relevant to NFP.

Income of not-for-profit entities

Appendix B of AASB 1058 contains application guide to help the entity assess what standards will apply in their particular circumstances. It contains flowcharts that can be easily followed for transactions other than volunteer services and volunteer services. The standard also contains various implementation examples to illustrate the application of the requirements.

CA ANZ

CA ANZ has released its updated Enhancing Not-for-Profit Reporting Guide. In addition to providing guidance to NFPs in preparing their annual reporting, it also contains updated illustrative financial statements for financial years ended 31 December 2019. These financial statements have been updated for the disclosures relating to the new accounting standards referred to in this article and contain an additional appendix showing the transitional disclosures that should be added to the financial statements in the first year of adoption of the new standards.