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.

AASB responds to criticism of income recognition by not-for-profit entities

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New income recognition requirements that are clearer and simpler for not-for-profit (NFP) entities to understand will be released by the end of this year. A ‘fatal flaw’ draft of the requirements is available on the AASB website and we encourage our NFP constituents to review and provide feedback by 21 October.

The new requirements will better reflect the substance of transactions by providing more opportunity for deferral of income where performance obligations are attached. They will also improve the usefulness and consistency of NFP entity financial statements and reduce preparation costs and audit effort.

The AASB undertook the project in response to constituent requests to review the income recognition requirements for NFP entities, including AASB 15 *Revenue from Contracts with Customers* and how it might be applied in the NFP sector. The AASB has been continuously engaging with stakeholders since the issue of ED 260 *Income of Not-for-Profit Entities* in April 2015 to seek feedback from stakeholders on the proposals, with a Project Advisory Panel providing expert input into developing the accounting requirements. The final standard will be released in December 2016.

What is changing?

In addition to the Standard itself, the AASB is also issuing implementation guidance on accounting for non-contractual receivables, and implementation guidance and illustrative examples for AASB 15.

These three outputs replace most of the income recognition guidance in AASB 1004 *Contributions*, with a key outcome being that private-sector NFP entities will no longer apply AASB 1004. The objective of the new Standard is to capture transactions where the consideration to acquire an asset is significantly less than the asset’s fair value principally to enable the NFP entity to further its objectives (e.g., donations, grants and taxes). The Standard will also capture the receipt of volunteer services.

Under AASB 1004, most common NFP transactions (such as donations, grants and contributions received) resulted in the immediate recognition of income, even when restrictions or conditions were imposed. AASB 1004 distinguishes transactions based on whether they are reciprocal or non-reciprocal, whether there is an equal exchange of value and whether the beneficiary is the transferor. Under the new requirements, the timing of income recognition will depend on whether there is any liability or other performance obligation related to the cash or grant received. This will provide a significant step forward in reflecting the substance of the income transactions of NFP entities.

For example, take a government grant of $400,000 provided to a charity to deliver three counselling sessions per week for a year to victims of violence. Such a grant is sufficiently specific to know when the service have been performed, and assuming the agreement is enforceable, revenue will be recognised as the counselling sessions are provided.

However, time-based conditions themselves are unlikely to create performance obligations. Where the entity is able to alter the use of the funds received without consequence a performance obligation will not arise and income will be recognised immediately. However, even if income is not deferred, the disclosure of externally imposed restrictions is encouraged either on the face of the statement of financial performance, in the statement of changes in equity or in the notes.

Significantly below fair value leases

NFP entities are currently faced with uncertainty as to the interaction between AASB 117 *Leases* and AASB 1004. The uncertainty has led to diversity in the accounting policies applied to leases of assets with significantly below fair value payments. This diversity has significantly reduced comparability between NFP entities, as well as the usefulness of NFP financial statements.

The new Standard addresses this issue with amendments to AASB 16 *Leases*. The right-of-use asset is required to be measured at fair value and the lease liability at the present value of the minimum lease payments, with the below-fair value component likely to be recognised as income immediately (unless there are other specific performance obligations).

Examples

Together with application guidance, the AASB has developed a wide range of examples to illustrate how an NFP entity can apply the requirements. These cover topics such as accounting treatment for grants to construct non-financial assets (e.g., buildings), bequests and endowments, research grants, recognition of a lease with significantly below fair value lease payments and multi-year cash grants.

Application guidance for AASB 15

The guidance for AASB 15 assists with the identification of a contract with a customer in an NFP entity context. It helps entities identify enforceable agreements, how to identify whether a performance obligation exists, and how to allocate the transaction price to performance obligations.

Enforceable agreements

A customer that enters into an agreement with an NFP entity for delivery of goods or services (usually to a third party beneficiary) may enforce its agreement with the entity through means that are not typical in a for-profit context. The guidance includes a broad range of examples of enforceable agreements in an NFP context. It is likely that a large number of arrangements in the NFP sector will meet the AASB 15 enforceability criteria.

Donation components in contracts with customers

Some transactions with customers for delivery of goods or services may also include donations. The guidance assists NFP entities to account for the donation element in a transaction with a customer that would otherwise be accounted for under AASB 15. There will be a rebuttable presumption that the donation element need not be accounted for separately from the performance obligations in the contract and the transaction price (including the donation element) is allocated fully to the performance obligations. This presumption is only rebutted if certain criteria are met. This simplification helps NFP entities so that they do not always have to separately account for a donation element in a contract with a customer.

What are the key changes from the proposals in ED 260?

Accounting for the credit side of transactions

ED 260 included accounting requirements for both assets (i.e. the debit amounts) and credit amounts such as liabilities and income. Essentially, the proposals for debit amounts in ED 260 intended to provide asset recognition guidance while referring to other Standards for measurement guidance. In its redeliberations the Board decided that the new Standard should focus on the requirements for credit amounts (with the exception of volunteer service assets) while other Standards provide guidance on the debit amounts (e.g. an asset). This change is intended to make it simpler for NFP entities to determine the accounting treatment for their transactions. For example, an NFP entity will apply AASB 16 to recognise and measure a right-of-use asset for a lease with significantly below-market terms and conditions and apply the new Standard to recognise any related credit amounts, such as income.

Fair value asset when consideration is significantly less than fair value

Currently, only assets acquired by NFPs at nil or nominal consideration must be fair valued. The new Standard will require assets for which the consideration is significantly below fair value to be measured at fair value in accordance with AASB 13 *Fair Value Measurement*. However, this will only apply to transactions where the difference between fair value and the consideration of the asset is principally to enable an NFP entity to further its objectives. This ensures that the new requirements do not capture the acquisition of assets in a distress sale or with bulk or trade discount. The new Standard also provides guidance on how to account for the difference between the transaction price and the fair value of the asset, which may be a contribution by owners, liability, a performance obligation under AASB 15 or income under the new income Standard.

Effective Date and Transition

The effective date for the requirements will be 1 January 2019, with early application permitted. The effective date of AASB 15 for NFP entities has also been deferred to 1 January 2019 to provide NFP entities an extra year to prepare for the transition.

The AASB recognises that implementing the new requirements may be challenging in some circumstances, and has provided significant transition relief. For example:

- an entity is only required to assess the fair value of leases with significantly below fair value payments as at the date of transition to the new requirements, rather than from the date of commencement of the lease;
- only new transactions after the effective date will need to apply the new requirements if income has already been fully recognised under AASB 1004; and
- an entity may apply the new requirements in its current year and not restate comparatives.

Next steps

Once the fatal flaw review has been completed and the new Standard finalised, the AASB will be holding a webinar to introduce the new requirements. We will also make available education materials and run education sessions with constituents.

Please contact the AASB at standard@aasb.gov.au if you have any comments or would like further information.