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.

A new approach to income recognition by Not-for-Profit entities

Siva Sivanantham, CA, Senior Manager - National Audit Support at Grant Thornton

February 2017

Introduction

Following a decade-long project to overhaul the income recognition requirements for Not-for-Profit (NFP) entities, the Australian Accounting Standard Board has finally issued its new income recognition requirements for NFP entities.

The new requirements are expected to result in better matching of income and related expenses as income recognition will now be deferred when there is a performance obligation or any other liability. For example, if a not-for-profit entity receives a grant or donation which comes with a sufficiently specific and enforceable performance obligation, the entity will recognise revenue when it fulfils its performance obligation. This is in contrast to the current requirements which commonly force income recognition on day one despite the fact that the entity is yet to fulfil its performance obligation. In addition, more assets will now be recorded on the balance sheet as the new requirements broaden the 'fair value on initial recognition' principle to cover all assets where NFPs pay significantly less that the fair value (not just those assets acquired at nil or nominal consideration as currently required), principally to enable the NFPs to further their objectives
(i.e. not trade discounts or distress sales).

These requirements were released in December 2016 in a package of standards, comprising:

- AASB 1058 *Income of Not-for-Profit Entities*
- AASB 2016-7 *Amendments to Australian Accounting Standards – Deferral of AASB 15 for Not-for-Profit Entities*
- AASB 2016-8 *Amendments to Australian Accounting Standards – Australian Implementation Guidance for Not-for-Profit Entities*.

These standards replace the existing requirements in AASB 1004 *Contributions*. AASB 1004

CHARTERED ACCOUNTANTS™
AUSTRALIA + NEW ZEALAND

continues to be in force, however its scope has now been reduced to only cover issues specific to government departments and contributions by owners in the public sector.

We look at some of the key aspects of the new requirements below.

The new model

Under the new income recognition model, a NFP first considers whether AASB 15 *Revenue from Contracts with Customers* applies to a transaction or part of a transaction. In order for AASB 15 to apply to a transaction, the performance obligation(s) arising from the transaction needs to be 'sufficiently specific' and 'enforceable'.

Where AASB 15 does apply to a transaction or part of a transaction, the NFP applies the general AASB 15 principles to determine the appropriate revenue recognition.

When AASB 15 does not apply to a transaction or part of a transaction, the NFP then considers whether AASB 1058 applies. AASB 1058 will apply when a NFP:

- enters into a transaction where the consideration to acquire an asset is significantly less than fair value principally to enable the NFP to further its objectives and
- receives volunteer services (recognition of volunteer services is only mandatory to entities in the public sector).

NFP application guidance in applying AASB 15

The content of AASB 15, which incorporates IFRS 15 *Revenue from Contracts with Customers* issued by the International Accounting Standards Board, is generally expressed from the perspective of for-profit entities in the private sector. To assist the NFP sector in applying AASB 15 principles, particularly in circumstances where a for-profit perspective does not readily translate to a NFP perspective, the AASB has now added NFP application guidance and illustrative examples as an appendix to AASB 15.

As noted earlier, in order for AASB 15 to apply to a NFP transaction, there are two critical elements that need to be satisfied:

- the agreement between two or more parties must create 'enforceable' rights and obligations
- the NFP entity's promise to transfer a good or service needs to be 'sufficiently specific'.

Enforceability criterion

The determination of whether the performance obligation is 'enforceable' and 'sufficiently specific' is a matter of judgement, having regard to the particular facts and circumstances.

The new application guidance clarifies that, in the NFP context, a 'contract' is an agreement between two or more parties that creates 'enforceable' rights and obligations. An agreement is typically enforceable by another party through legal or equivalent means if the agreement is in writing and includes sufficiently specific requirements of the parties. Oral agreements may also be enforceable. Enforceability depends solely on the customer's capacity to enforce its rights. The enforceability of agreements does not depend on their form. For example, documents such as memoranda of understanding, heads of agreement and letters of intent can all constitute enforceable agreements; a formal contract is not required.

Sufficiently specific criterion

Judgement will be necessary in assessing whether a promise is 'sufficiently specific', taking into account any conditions specified in the arrangement (whether explicit or implicit) regarding the promised goods or services, including conditions regarding:

- 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.

AASB 1058 Income of Not-for-Profit Entities

Under AASB 1058, the timing of income recognition will depend on whether a transaction gives rise to a performance obligation, liability or contribution by owners.

Where a NFP receives an asset for significantly less than its fair value principally to enable the NFP to further its objectives, it recognises the asset in accordance with the relevant standard (e.g. donated inventory is recognised in accordance with AASB 102 *Inventories*). The NFP then considers the relevant accounting standard that applies to the other side of the entry (called 'related amounts'). The other side of the entry could be, for example:

- contributions by owners (AASB 1004 *Contributions*)
- revenue or a contract liability (AASB 15)
- a lease liability (AASB 16 *Leases*)
- a financial instrument (AASB 9 *Financial Instruments*)
- a provision (AASB 137 *Provisions, Contingent Liabilities and Contingent Assets*)

The difference (if any) between the consideration transferred for the asset and the fair value of the asset received after recording any 'related amounts' is recognised as income.

Grants for construction or acquisition of non-financial assets

AASB 1058 includes specific requirements with respect to grants for construction or acquisition of recognisable non-financial assets.

When a NFP receives a grant to construct a building to be controlled by the NFP, the funds received are initially recognised as a financial asset (cash) with a corresponding liability (obligation to construct the building). Subsequently, the liability is derecognised as the performance obligation is satisfied (i.e. as the construction of the building is completed).

Where a NFP receives a grant to acquire specific assets, it recognises income when the relevant assets are acquired. If a NFP receives a grant to develop an asset which does not satisfy the recognition criteria in other accounting standards (e.g. a research grant to develop the NFP's intellectual property), income is recognised when the funds are obtained.

Donations

The standard includes a rebuttable presumption that the total transaction price in a contract with a customer is related to the transfer of the promised goods or services. This means that an NFP is not required to identify or recognise separately the donation component in a contract with a customer (i.e. the entity allocates the entire transaction price to the performance obligations specified in the contract).

This presumption can be rebutted and the transaction price split into its component parts when the transaction price is only partially related to the transfer of the promised goods or services. The following may be indicative of an element that is not related to the promised goods or services:

- a non-refundable component of the transaction price and
- where the entity has the status of a deductible gift recipient (DGR) – the donor can claim part of the transaction price as a tax deduction for a donation.

For example, let's assume a NFP sells subscriptions to an online database and invites subscribers to also make a donation to generally assist the NFP's mission. If both the subscription fee and the donation were refundable (either in full or in proportion) during the subscription period, the presumption cannot be rebutted. However, if the donation was non-refundable, then the NFP may be able to rebut the presumption and recognise the donation portion immediately in accordance with AASB 1058.

Peppercorn leases

Leases with significantly below market rates (i.e. peppercorn leases) are quite common in the NFP environment. Presently, NFPs account for below market leases that are finance leases by measuring the leased asset and lease liability at present value of the minimum lease payments which results in a negligible amount. Under the new requirements, such leased assets will be measured at fair value at the inception of the lease whereas the lease liability will be recognised at present value of peppercorn lease payment amounts. The difference between the lease asset and liability will be recorded as income under AASB 1058.

Effective date and transition

The new requirements become mandatory for annual period beginning on or after 1 January 2019. Early application is permitted provided AASB 15 is also adopted for the same period. There is now a one-year extension to the effective date of AASB 15 to NFPs (i.e. it applies to NFPs from 1 January 2019).

In terms of transition, NFPs are provided with a choice between two methods:

- full retrospective application – with restatement of comparative information in each prior period presented
- partial retrospective application – without restating comparatives. Under this approach, the cumulative effect of initially applying the new requirements is recognised as an adjustment to equity at the date of initial application.

Conclusion

While these new requirements do not apply mandatorily until 1 January 2019, they represent a major change for the NFP sector. Some NPFs will be interested in early adopting these new standards depending on their circumstances (for example to achieve better matching of income and expenses). Accordingly, it is paramount that NFPs fully understand these changes and start developing their implementation plans sooner rather than later.