Nexia Australia

# Accounting Update

## Income of Not-for-Profit Entities

January 2019

This publication replaces the previous version dated March 2017 to incorporate amendments introduced by AASB 2018-8 *Amendments to Australian Accounting Standards – Right-of-Use Assets of Not-for-Profit Entities.*

The accounting for donations, grants and contract revenue by not-for-profit ("NFP") entities are affected by:

- AASB 1058 *Income of Not-for-Profit Entities*;
- AASB 15 *Revenue from Contracts with Customers*; and
- AASB 2016-8 *Australian Implementation Guidance for Not-for-Profit Entities* – Revenue from Contracts with Customers (AASB 15).

Not-for-profit entities are required to apply these standards to reporting periods beginning on or after 1 January 2019.

**Key features:**

- An asset received by a NFP entity will be initially recognised at its fair value where the consideration paid for the asset is significantly less than fair value and that difference is principally to enable the entity to further its objectives.
- Such assets include physical, intangible and financial assets - whether acquired, donated or granted.
- Donation elements in below-market loans are recognised as income at inception.
- Income recognition will more closely match recognition of related expenses.
- Capital grants will generally be recognised as income as and when the asset is constructed or acquired.

### Recognising the asset received

An asset received by a NFP entity can take the form of cash; other financial assets such as bonds or shares; physical assets such as land & buildings; intangible assets such as intellectual property; and includes the right to use an asset under a lease.

Before the changes, a NFP entity was only required to recognise acquisitions of assets at fair value when they were acquired for no or nominal consideration. Otherwise, those assets were recognised at their cost of acquisition. The new standards require that an asset is initially measured at fair value when the consideration paid for the asset is significantly less than fair value and that difference is principally to enable the entity to further its objectives.

The purpose of this change is to recognise the donation element in a transaction where the reduced consideration enables the entity to further its objectives. Consequently, it is not necessary to recognise a donation element in a transaction where the reduced consideration in not principally related to furthering the entity's objectives as may arise from distressed sales, trade discounts or volume rebates. Similarly, discounts available to all not-for-profit entities, but not to for-profit entities, are not considered principally to further the specific not-for-profit entity's objectives.

By referring to consideration 'significantly less than fair value' the AASB does not intend the requirement to apply to transactions where the consideration is marginally less than fair value. Further, by providing a link between the significantly reduced purchase price (compared to fair value) and the purpose of that reduction being to enable a NFP entity to further its objectives narrows the types of transactions that would be in scope of AASB 1058.

The AASB believes that it has struck an appropriate balance between the costs and benefits of identifying and recognising significant donation elements in transactions. Nevertheless, the widening of the requirement to recognise more transactions at fair value compared to current accounting standard requirements will add complexity for NFP entities as they consider whether there is a significant donation element embedded in a transaction. In many cases, this will involve significant judgement.

## Recognising income

The general principle in AASB 1058 is that the entity recognises, as income immediately, the difference between the fair value of the asset received and any amount separately recognised as either:

a. an equity contribution;

b. revenue or a contract liability arising from a contract with a customer, in accordance with AASB 15;

c. a lease liability arising in a lease contract under AASB 16 *Leases*;

d. a financial instrument, in accordance with AASB 9 *Financial Instruments*; or

e. a provision, in accordance with AASB 137 *Provisions, Contingent Liabilities and Contingent Assets*.

General gifts, donations and bequests or grants that do not impose specific stipulations on their use are not expected to give rise to a liability within the scope of AASB 9, AASB 15 or AASB 137. Hence, such amounts are recognised immediately as income when the entity obtains control of the asset.

## Application of AASB 15

AASB 2016-8 introduces guidance to assist not-for-profit entities determine whether, in relation to identifying a contract and identifying performance obligations, a transaction is within the scope of AASB 15 *Revenue from Contracts with Customers*. In a NFP context, a customer can direct that goods or services be provided to third-party beneficiaries (including individuals or the community at large) on the customer's behalf. For example, a NFP entity may receive government funding for the purpose of providing youth crisis counselling services to the public. In this arrangement, the customer is the government, notwithstanding the government specifies that those services are to be provided to members of the community. Hence, provided the arrangement is enforceable and contains sufficiently specific performance obligations, it would be considered a contract with a customer.

### Enforceability

An inherent feature of a contract with a customer is that the entity makes promises in an agreement that creates enforceable rights and obligations. An agreement typically is enforceable by another party if it includes sufficiently specific requirements that enable the parties to determine whether the entity has satisfied its obligations under the agreement.

Examples of terms that result in enforceable agreements include:

- the right to enforce specific performance or claim damages for non-performance;
- the customer's right to take a financial interest in assets purchased or constructed by the entity with the resources provided by the customer; and
- the right to a refund if the agreed specific performance has not occurred.

In each of the above examples we would presume that the arrangement is enforceable (that is, the customer can legally enforce its rights) and that it contains sufficiently specific performance obligations that enable the parties to determine whether the customer is satisfied its obligations. Consequently, arrangements with such features would represent a customer contract within the scope of AASB 15.

### Identifying performance obligations

AASB 15 requires an entity to identify its performance obligations that exist in a contract with a customer. A necessary condition for identifying a performance obligation is that the promise is sufficiently specific to enable determination of when the obligation is satisfied. Such requirements can relate to the nature, type, cost, value or quantity of the goods or services and the period over which those goods or services are to be transferred.

A condition that a NFP entity must transfer unspecified goods or services within a particular period does not, of itself, meet the 'sufficiently specific' criterion. Although not a necessary pre-condition, an acquittal process may provide evidence of a promise to transfer goods or services that is sufficiently specific.

**Example**

Aassume ABC Research Inc. receives a $2 million grant to fund research for the next two years that aims to identify and validate biomarkers to distinguish malignant cancers from benign tumours. Any funds that are either unspent after two years or not spent for the purpose stipulated in the agreement must be returned to the donor.

The arrangement is enforceable as the grant is refundable if the research is not undertaken. However, the arrangement with the donor is not a contract with a customer as defined in AASB 15. This is because there is no specific requirement relating to the nature, type or quantity of deliverable to be provided to the customer and therefore the conditions relating to the use of the funds is not sufficiently specific to enable the entity to identify when it satisfies its obligations. Consequently, ABC Research Inc. recognises an asset for the $2 million received and income in accordance with AASB 1058.

If, however, the terms of the above grant also required the transfer of intellectual property rights arising from the research activity to the donor or there was a requirement to produce a specified number of research publications, the arrangement would be a contract with a customer as defined in AASB 15.

### Refund obligations

Some grant agreements may require the funds provided to an entity to be spent only in a particular period or for a particular purpose, failing which repayment to the grantor will be required.

In most cases, a NFP has the ability, through its own actions, to avoid the circumstances that would result in a breach of the grant conditions that would necessitate a return of funds. In such cases, refund obligations that only arise in the event of a breach are not liabilities recognised in accordance with other accounting standards such as AASB 137, AASB 139 or AASB 9, unless the breach has occurred or is expected to occur and the outflow of funds is probable. Nevertheless, the existence of a refund obligation may be indicative that the arrangement is enforceable by the grantor.

As a result, the existence of a refund obligation should the NFP entity not satisfy the grant conditions is not, by itself, sufficient grounds for the deferral of income under AASB 1058. That said, a grant agreement that is enforceable and contains sufficiently specific performance obligations and is refundable if those performance obligations are not satisfied may give rise to a contract liability under AASB 15 until those performance obligations have been satisfied.

### Restrictions on use

Under the new standards it is necessary to differentiate between those arrangements that are within the scope of AASB 15 because they contain sufficiently specific performance obligations and those arrangements that only impose restrictions on the use of funds.

**Example**

School A receives a bequest that includes a condition that the funds be used by the school to provide scholarships to disadvantaged students. The arrangement is not a contract with a customer because the arrangement contains neither a refund obligation nor sufficiently specific performance obligations relating to the use of the bequest. School A recognises the bequest as income upon control of the funds in accordance with AASB 1058. School A considers disclosing the nature and terms of the restrictions in its financial statements.

AASB 1058 does not require or specify particular disclosures relating to restricted funds. Nevertheless, disclosing information regarding those funds that an entity considers are committed or to be used for a specific purpose may be useful to a user of those financial statements and is encouraged.

### Non-refundable upfront fees

An entity may charge a customer a non-refundable upfront fee.

Where the transaction represents a contract with a customer in the scope of AASB 15 it will be necessary to assess whether the upfront fee relates to the transfer of a promised good or service (ie, the satisfaction of a separate performance obligation). In some cases, a non-refundable upfront fee relates to an activity that the entity undertakes but that activity does not result in the transfer of a promised good or service to the customer. Instead, the upfront fee is an advance payment for future goods or services which, therefore, would be recognised as revenue when those future goods or services are provided.

Consequently, a NFP entity will need to identify and evaluate the separate performance obligations in an arrangement.

If the transaction does not represent a contract with a customer in the scope of AASB 15 the fee will be accounted for as income in accordance with AASB 1058.

### Below-market leases

Under AASB 117 *Leases*, a NFP lessee that pays either nominal or below-market lease payments in an operating lease would generally only recognise a lease expense based on those actual lease payments. Consequently, a NFP lessee would recognise neither an asset nor a lease expense in respect of leases where the payments were zero, nominal or 'peppercorn'.

When AASB 1058 is applied in conjunction with the new leases standard AASB 16, the NFP entity will be required to recognise:

a. the lease asset either at cost (determined in accordance with AASB 16), or at fair value (that is, the fair value of the right to use the leased property during the lease term). This accounting policy choice is made on a class-by-class basis;

b. the lease liability measured at the present value of the lease payments in accordance with AASB 16; and

c. the difference between the initial measurements of the lease asset and lease liability immediately as income. Such a gain will only arise on below-market leases where the lease asset is initially recognised at fair value.

This accounting choice to recognise the effects of below-market leases at fair value is a significant change from current practice and will require NFPs to assess their current lease arrangements. The new leases standard, AASB 16, applies to NFP entities for reporting periods beginning on or after 1 January 2019 - that is, for the same reporting period as the new income recognition requirements.

### Capital grants

AASB 1058 contains specific requirements relating to capital grants. Where an entity receives a grant for the purpose of acquiring or constructing a non-financial asset to particular specifications or conditions (for example, a grant to construct low income community housing to government specifications), income is recognised as or when it satisfies its obligations to construct that asset.

## Volunteer services

Some NFP entities receive services received free of charge such as professional services, contributed labour and other volunteer services.

Local governments, government departments, general government sectors and whole of governments 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.

Other NFP entities are not required, but may as an accounting policy choice elect, to recognise volunteer services, or a class of volunteer services, on the same basis as the above.

## Application

The suite of new revenue standards AASB 15 *Revenue from Contracts with Customers*, AASB 2016-8 *Australian Implementation Guidance for Not-for-Profit Entities* (amendments to AASB 15) and AASB 1058 *Income of Not-for-Profit Entities* will apply to not-for-profit entities for reporting periods beginning on or after 1 January 2019.

On transition to the new standards, a NFP entity can elect to apply the standards either:

a. fully retrospectively; or

b. on a modified retrospective basis from the beginning of the first year of adoption. Under this method there would be no restatement of comparative financial information.

## Next steps

The introduction of the new requirements is likely to impact income recognition of many NFP entities. The introduction of the new income recognition requirements at the same time as the new leases standard, AASB 16, will magnify this effect on many more. To find out how we can assist you analyse the effects of the new standards on your organisation, please contact a Nexia Financial Reporting Advisory specialist.



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