Technical Accounting Alert
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New income recognition requirements for not-for-profit entities

Introduction

In December 2016, the AASB released AASB 1058 *Income of Not-for-Profit Entities* (AASB 1058) and AASB 2016-8 *Amendments to Australian Accounting Standards – Australian Implementation Guidance for Not-for-Profit Entities* (AASB 2016-8), providing clarity and simplification of the income recognition requirements for not-for-profit entities (NFPs). AASB 1058, together with AASB 15 *Revenue from Contracts with Customers* (AASB 15), supersedes all previously issued income recognition requirements for private sector NFPs as prescribed by AASB 1004 *Contributions* (AASB 1004). It also supersedes the majority of previously issued income recognition requirements for public sector NFPs. This alert summarises the key aspects of the changes for NFPs, focusing on the private NFP sector.

Reasons for change

Before the new standards were issued, NFPs recognised income based on whether the underlying transaction was reciprocal or non-reciprocal in nature. Reciprocal transactions were covered by AASB 118 *Revenue* and AASB 111 *Construction Contracts* while non-reciprocal transactions were covered by AASB 1004 *Contributions*. Making distinctions between the reciprocal or non-reciprocal nature of a transaction could be complex. Further, income for non-reciprocal transactions were generally recognised up front, resulting in a mismatch between income and expense recognised which did not generally reflect the economic reality of most NFP's financial circumstances. To improve upon this guidance, the AASB issued AASB 1058 and AASB 2016-8, which mainly adds Appendix F to AASB 15 containing Australian implementation guidance for NFPs, removing the concept of reciprocal and non-reciprocal transactions and providing comprehensive income recognition guidance for NFPs.

Summary of key changes

NFPs must recognise income in accordance with AASB 1058 or AASB 15. In determining which standard is applicable, an NFP must consider whether a contract with a customer exists. Appendix F to AASB 15 provides specific application and illustrative guidance related to:

- identifying whether there is a contract with a customer;
- identifying performance obligations; and
- allocating the transaction price to performance obligations.

If a contract with a customer does not exist, the NFP would then consider whether AASB 1058 is applicable. AASB 1058 applies to the receipt of volunteer services and to transactions where the consideration to acquire an asset is significantly less than fair value and the difference exists principally to enable the NFP to further its objectives. An example of the latter transaction is a cash donation, where the NFP receives cash to further its objectives but does not provide consideration to the other party in exchange for that donation.

Applying the new guidance

Applying AASB 15: specific guidance for NFPs

In order to apply AASB 15 to recognise income, NFP transactions must contain an enforceable contract with a customer that contains sufficiently specific performance obligations. The following is not an exhaustive analysis of the application of AASB 15, but rather a discussion of key elements of the standard that are specific to NFPs.

- **Identifying a contract**

  AASB 15 defines a contract as an agreement between two or more parties that creates enforceable rights and obligations. If a NFP's promise to transfer a good or service is made in an unenforceable arrangement with another party, a contract with a customer does not exist. If a NFP's promise to transfer a good or service in an arrangement with another party fails the 'sufficiently specific' criterion discussed below, a contract with a customer does not exist and the NFP shall not treat the promise as a performance obligation in a contract with a customer. Where a contract with a customer does not exist, the NFP shall consider whether AASB 1058 is applicable.

  A customer is the party that promises consideration in exchange for goods or services. The customer may direct that the goods or services be provided to third party beneficiaries on its behalf and the arrangement will still be within the scope of AASB 15. This contrasts with the current requirements where such arrangements may be considered non-reciprocal and hence are likely to fall outside of the scope of AASB 118 and within the scope of AASB 1004.

  The new guidance instructs NFPs that the definition of a contract should encompass arrangements entered into under the direction of another party (for example. a contribution that is received with a directive to provide specified services.) An agreement is considered enforceable when a separate party is able to enforce it through legal or equivalent means.

- **Identifying performance obligations**

  A performance obligation represents a promise to deliver goods or services. AASB 15 requires that such promises be individually distinct or bundled in combination with other promises. In order to identify performance obligations, the underlying promise must be sufficiently specific to be able to determine when the obligation is satisfied. Assessing whether a promise is sufficiently specific requires judgement in considering the nature, cost, and quantity of the goods or services as well as the period of which the goods or services must be transferred.

  If a NFP receives a contribution to be used over a specific period, but the agreement does not specify the services to be provided in sufficient detail, it would not meet the sufficiently specific criterion. Similarly, if a NFP receives a contribution for a specified purpose but it does not specify the period over which it is to be used, it would not meet the sufficiently specific criterion. In both cases, the NFP would not be able to determine when the promise has been satisfied.

  When determining whether a performance obligation exists, NFPs should consider the relevant details of the transaction to determine whether the promise meets the sufficiently specific criterion.

  If a contract provides a transfer of a financial asset for a NFP to acquire or construct a non-financial asset and the NFP is to retain control of the acquired or constructed asset, then there is no right or obligation to transfer that asset to other parties. In such situations, the contract is not a contract with a customer and AASB 15 does not apply. Such contracts should be accounted for in accordance with AASB 1058.

- **Allocating the transaction price to performance obligations**

  Customers may contribute to a NFP with a dual purpose of obtaining goods or services and to help the NFP achieve its objectives. In other words, the transaction may contain both a contribution that does not meet the sufficiently specific criterion under AASB 15 and performance obligations that do. NFPs shall allocate the transaction price to each performance obligation so that the amount allocated to each obligation represents the amount of consideration to which the entity expects to be entitled in exchange for transferring the promised goods or services to the customer.

  There exists a rebuttable presumption that the transaction price for a contract with a customer relates wholly to the transfer of promised goods or services. This presumption is rebutted when the transaction price is partially refundable if the NFP does not deliver. The non-refundable portion of the transaction price may be indicative that an element of the contract is not related to promised goods or services (i.e. a donation element). If the presumption is rebutted, the NFP shall disaggregate the transaction price, accounting for the component relating to the transfer of promised goods or services under AASB 15 and accounting for the remainder under AASB 1058.

Applying AASB 1058

AASB 1058 applies when a NFP enters into transactions where the consideration to acquire an asset is significantly less than the fair value of the asset principally to enable the entity to further its objectives and to the receipt of volunteer services.

If the consideration provided to acquire an asset, including cash, is significantly less than the fair value of that asset, or if no consideration was provided, and the difference is principally to enable the entity to further its objectives, such a transaction is within the scope of the standard.

The standard also covers a number of other topics that may be relevant to NFPs. The following is not an exhaustive analysis of the new guidance, but rather a discussion of key highlights.

- **Transactions where the consideration to acquire an asset is significantly less than the fair value of the asset principally to enable the entity to further its objectives**

  To meet the objective of these transactions, a NFP shall initially recognise:

  a an asset, including cash, in accordance with the applicable accounting standard;

  b any related contributions by owners, contract liabilities, financial liabilities, lease liabilities and other liabilities and revenue, measured in accordance with the applicable accounting standard (these elements are known as “related amounts”);

  c any liabilities for obligations arising from transfers to enable the entity to acquire or construct non-financial assets to be controlled by the entity; and

  d related income, representing the residual amount of resources received.

  Peppercorn leases (i.e. leases with significantly below market rates) 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. If the lease is classified as an operating lease, usually nothing is recognised in the financial statements. 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.

  Where the transaction is a transfer of a financial asset to enable an entity to acquire or construct a non-financial asset to be controlled by the NFP (i.e. a non-financial asset for the NFP’s own use), the NFP recognises a liability for the excess of the fair value transferred over any related amounts recognised. Income is then recognised over the period in which the obligations under the transfer are satisfied.

For example, a third party may make a cash donation to a NFP and specify that the cash must be used to construct a building to house the NFP's operations. The NFP would recognise:

- an asset for the cash donation, to be used in constructing the building;
- as construction progresses, an asset for the constructed building in accordance with AASB 116 *Property, plant and equipment*;
- a liability representing the obligation to construct the building, to be settled over the period in which the building is constructed; and
- income over the period in which the building is constructed.

Such a transaction is not covered by AASB 15 because there is no transfer of goods or services to the customer and the NFP must apply AASB 1058.

If the transaction does not require the NFP to acquire or construct a non-financial asset to be controlled by the NFP, then any excess of the initial carrying amount of the asset over the related amounts is recognised as income immediately.

Under a related amendment to AASB 102 *Inventories*, donated inventory is to be initially measured at current replacement cost, subject to a materiality assessment. This materiality assessment may, as an accounting policy choice, be made at the individual transaction, or aggregate level. The practical effect of this is to allow entities receiving individually immaterial donations of inventory not to recognise those donations in their financial statements.

- **Volunteer services**

Certain NFPs in the public sector shall recognise volunteer services as an asset if:

a the fair value of the services can be measured reliably; and

b the services would have been purchased if they had not been donated.

For volunteer services for which the fair value can be measured reliably but would not have been purchased if they had not been donated, NFPs in the public sector may, as an accounting policy choice, elect to recognise those services.

NFP entities in the private sector can make an accounting policy choice to recognise volunteer services if the fair value of the services can be measured reliably (irrespective of whether the services would have been purchased if they had not been donated).

Recognised volunteer services shall be measured at fair value.

- **Other transactions**

AASB 1058 provides guidance for several other specific transactions and transaction elements, including refund obligations, endowments, bequests, provisions, parliamentary appropriations and non-contractual income arising from statutory requirements.

Disclosures

The objective of disclosure requirements under AASB 1058 is for a NFP to disclose sufficient information to enable users of the financial statements to understand the effects of volunteer services and transactions where an entity acquires an asset for consideration that is significantly less than fair value principally to enable the entity to further its objectives on the financial position, financial performance and cash flows of the NFP. In satisfying the objective, NFPs should apply judgement to consider the level of detail necessary and how much emphasis to place on each of the required disclosures. NFPs should also carefully consider the disclosure requirements of AASB 15 to ensure adequate disclosure.

Specific disclosures under AASB 1058 include the disaggregation of income (e.g. grants, bequests, donations and volunteer services, if recognised) and details of capital grants.

A NFP entity is encouraged, but not required, to disclosure the nature of the entity's dependence on volunteer services and unrecognised donated inventories.

Transition

AASB 1058 applies to annual reporting periods beginning on or after 1 January 2019. Early application is permitted for NFPs provided they also apply AASB 15. The application date of AASB 15 for NFPs is deferred by 12 months to align with AASB 1058.

On transition, NFPs shall apply the guidance either:

a retrospectively including comparative information (with certain limited practical expedients being available) in accordance with AASB 108 *Accounting Policies, Changes in Accounting Estimates and Errors* (full retrospective approach)*;* or

b retrospectively with the cumulative effect of initial application recognised at the date of initial application as an adjustment to the opening balance of retained earnings (modified retrospective approach).

Key issues in implementing the new standard

Key issues in implementing AASB 1058, together with the related amendments to other standards, will include:

- determining the fair value of assets acquired where a transaction is on non-commercial terms, including below-market leases; and
- determining whether agreements for government grants contain sufficiently specific performance obligations to allow deferral of income recognition.

Further information

If you wish to discuss any of the information included in this Technical Accounting Alert, please get in touch with your Grant Thornton Relationship Partner or a member of the National Assurance Quality Team at national.assurance.quality@au.gt.com.