Not-for-profit

Director's Guide for Financial Reporting

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Are you challenged by the accounting in a Not-for-profit context?

Not-for-profit entities (NFPs) are values and purpose driven. Many are entering into increasingly complex agreements often involving collaborations with a broad range of organisations, including governments and corporates. The purpose driven focus of NFPs presents some challenges for financial reporting. Generally, accounting standards are based upon entities having commercial motivations and market-based transactions. To assist, the Australian Accounting Standards Board (AASB) has modified Australian Accounting Standards (AAS) for NFPs.

This publication covers the peculiarities of NFP financial reporting that will be useful to directors, audit and risk committee members and others with oversight responsibilities.

NFPs often enter arrangements which are unique to the sector. They can be non-market-based transactions and often without commercial objectives:

- Grants of money, with or without attached conditions
- Leases at below market rentals (or peppercorn rates)
- Donations of property, inventory and intangible assets, or
- NFPs having a similar purpose that choose to combine together for efficiency purposes, without purchase consideration exchanged

The AASB has modified AAS using "Aus" paragraphs and also issued Australian specific standards and guidance to address such transactions.[1]

Revenue or income

When a grant is provided, NFPs need to assess whether its terms are enforceable and contain sufficiently specific performance obligations (SPPO) for the recipient to undertake. The SPPO could involve the delivery of goods or services to third-party beneficiaries. If the grant is enforceable and contains SPPO, then revenue is recognised as and when the specified goods or services are provided[2], like for-profit entities (FPs). Otherwise, the grant is generally recognised as income immediately upon receipt under NFP specific rules[3].

This assessment is important as it will affect the timing for recognising the grant in profit and loss.

Enforceability

An agreement with an NFP can be enforceable "through legal or equivalent" means such as having a contractual clause that provides for a refund or penalty, or a process to enforce fulfillment of the agreement.

[1] EY Australia publications "New Income Recognition for Not-For-Profits" & "Not for profit groups – when to consolidate"

[2] *AASB 15 Revenue from Contracts with Customers (AASB 15)*

[3] *AASB 1058 Income of Not-for-Profit Entities (AASB 1058)*

Sufficiently specific performance obligations

A promise to perform certain activities over a particular time period does not, of itself, meet the sufficiently specific performance obligation requirement. In determining whether performance obligations exist (i.e. whether there would be a transfer of goods or services) and whether they are sufficiently specific, NFPs should consider the nature, timing and amount of the promised goods or services.

An NFP may have to undertake an acquittal process to demonstrate progress toward delivering its outputs/outcomes under a contract or arrangement with the grantor. This might indicate that the arrangement contains SSPOs if progress towards fulfilment of the POs can be tracked. However, if no specific outputs/outcomes are determined upfront (for example a general undertaking to secure homes for the homeless), and there is only a self-imposed administrative goal to report on the activities performed by the entity, this would not provide evidence of SSPOs.

Example 1: Government grants

An NFP receives two government grants of $10,000 each in July 2020 that must be spent within the period 1 July 2020 - 30 June 2021. The government can demand a refund if the NFP breaches any conditions of the contract.

- **Grant 1 -** funds must be used in accordance with the NFP's overall objectives.
- **Grant 2 -** funds must be used for crisis counselling services for a specified number of hours per week.

Analysis

The agreement is enforceable, as the government can enforce its rights by requiring a refund in the event of any breach of conditions.

For grant 1, the conditions are not sufficiently specific as the nature and amount of goods or services to be transferred have not been sufficiently specified. Only the timeframe has been specified. Hence, the grant is accounted for as income immediately[4].

For grant 2, the nature of the services and the number of hours are outlined in a sufficiently specific manner. Therefore, the grant is recognised as revenue as and when the counselling services are provided[5].

Other obligations & conditions

Before recognising income, an NFP also need to consider whether other obligations and conditions exist in an arrangement that could result in recognition of a financial liability, provision or lease liability. For example, receipts of money where the donor has a right at any time to demand repayment of any unspent monies' should be assessed for whether a financial liability arises.[6]

Typical NFP arrangements

The table below summarises typical NFP arrangements and the related income recognition considerations.

Arrangement	Income recognition considerations
Capital grants	A grant to construct or acquire a tangible asset for own use is accounted for as a liability (representing the promise to build or acquire the asset) and released to profit or loss when the asset is acquired or over the period it is constructed.
Agreement to provide a good or service, as well as a donation received E.g. tickets to an event, with part of the proceeds to be refunded if the event does not go ahead	When an agreement contains SPPO and a donation element, the rebuttable presumption is that the entire amount received (including the donation) is for the transfer of goods or services. However, if it is clear that a donation is included, such as the NFP offers a partial refund if the SPPO is not met, then the money received is treated partly as compensation for goods or services (accounted as revenue) and partly as a donation (generally recognised as income immediately).
An asset is acquired for below its fair value	When a significant discount is provided to help the NFP to achieve its objectives, the asset is generally recorded at its fair value. The related gain is accounted as income immediately.[7]

Resource: New Income Recognition for Not-For-Profits

Leases

In line with FPs, an NFP entity that enters into a lease arrangement recognises an asset, reflecting its right to use the underlying asset for a period of time and a liability to make lease payments.[8]

Concessionary leases

NFPs often enter into leases with concessionary terms. The lessor is, in effect, making a donation to assist the NFP in achieving its goals.

[4] Under *AASB 1058*
[5] Under *AASB 15*
[6] Under *AASB 1058*
[7] Under *AASB 1058*
[8] *AASB 16 Leases*

Estimating the fair value of right-of-use (ROU) assets arising from such concessionary leases can be difficult due to unique circumstances such as significant lessor restrictions or the specialised nature of the leased asset.

The AASB has offered a temporary relief for NFPs to measure right-of-use (ROU) assets either at cost or at fair value on initial recognition. If "fair value" is chosen, the difference between the cost (ie. future lease payments) and the fair value is recognised as income immediately (unless there is something further in the relationship that needs to be considered and separately brought to accounted).

Incremental Borrowing Rate (IBR)

In calculating the lease liability (i.e. the present value of future lease payments), the entity uses its incremental borrowing rate (IBR) when the interest rate implicit in the lease is not readily determinable. NFPs with no borrowing history can determine the IBR by considering IBRs used by other NFPs of similar operations and size. This involves a significant level of judgment.

Free space in a building

An NFP entity may be provided with the right to use some floors in a building, which on the face of it, may appear to be for no (or only peppercorn) rent. Care however should be taken to consider all other information, because a government grant could have also been received that needs to be accounted for separately. These types of arrangements are very common in collaborative arrangements between universities, hospitals and research organisations.

Example 2: Research organisation occupying part of a hospital

A research organisation receives a government grant to fund the lease of two floors in a building that is to be constructed by a hospital.

The research organisation is required to provide these funds to the hospital to fund some of its costs in constructing the new building, with the agreement that the hospital will allow the research organisation to use two floors for a period of time for free.

Analysis

The research organisation treats the payment to the hospital effectively as a prepaid lease, and a right of use asset once the floors are available for use. The research organisation also separately accounts for the grant as income either immediately or over time (depending on the conditions attached to the grant).

Other NFP specific accounting matters

Consolidation

The purpose and the design of NFP group structures are different to FP group structures. However, like FPs, NFPs assess whether they control another entity by evaluating power, exposure to variable returns and the ability to exercise the power to influence the returns. Additional guidance[9] is provided that helps when performing this evaluation in a NFP context. NFP specific considerations include:

- Power over the entity will often arise through administrative rights rather than ownership of equity, and
- Exposure to variable returns can include non-financial returns, such as having similar activities that primarily support the NFP's objectives

Resource: *Not for profit groups – when to consolidate (February 2021)*

Inventory

Inventories acquired at less than market value[10] (e.g. donated inventories) are initially recognised at current replacement cost. This can be determined for each item individually or for the aggregate inventories held.

The requirement to carry inventories at lower of cost and net realisable value does not apply to inventories held for distribution (rather than sale). For example, a charitable organisation that has clothes for distribution to less privileged people, measures these at cost adjusted for any loss of service potential. A loss of service potential could arise, for example, when the current replacement cost is lower than the original acquisition cost, or there is a loss of operating capacity due to obsolescence.

Impairment of assets

Assets accounted for under the cost model (tangible and intangible assets) are subject to impairment considerations.

Where an impairment indicator exists

- An asset held primarily for its ability to generate net cash inflows will be tested for impairment by considering the discounted value of those future net cash inflows (i.e. value in use), and
- An asset NOT held primarily for its ability to generate net cash inflows will be tested for impairment by considering its fair value

When a class of assets is recorded at revalued amount, any impairment loss of an individual asset is

[9] *AASB 10- Appendix E -Australian Implementation Guidance for Not-for-Profit Entities – Control and Structured Entities*

[10] Principally to enable the NFP to further its objectives

offset against the revaluation surplus of assets in the same class before charging the excess loss in profit or loss.

Property, plant and equipment, Intangible assets and Biological assets

Unlike FPs, NFPs must recognise physical assets, intangible assets and biological assets obtained for no or minimal consideration[11] at their fair value. The difference between the asset's fair value and the consideration given is recognised as income immediately in profit or loss.

If choosing a policy to revalue PPE and intangibles to fair value, NFPs account for revaluations on a class of asset basis, unlike FPs where revaluations are accounted for separately on an asset by asset basis. This means increments on one asset are offset against decrements on another asset in the same class, before any net increment (decrement) of the asset class is recognised.

The AASB's approach to NFP Financial reporting

GPFS vs. SPFS

NFPs currently self-determine if they are a "reporting entity" and consequently whether they must prepare General Purpose Financial Statements (GPFS) or can prepare Special Purpose Financial Statements (SPFS):

- GPFS are prepared in compliance with the requirements in AAS
- SPFS can be prepared by choosing the accounting standards to apply[12]. However, NFPs governed by the Corporations Act or ACNC must apply certain accounting standards[13], and disclose whether their material accounting policies comply with the recognition and measurement requirements of AAS

Simplified disclosure standards

Private sector NFPs that prepare GPFS can, unless publicly accountable, choose whether to provide all disclosures in AAS (known as Tier 1) or reduced disclosures (known as Tier 2).

A Tier 2 approach results in significant disclosure relief compared to Tier 1. The current Tier 2 framework (Reduced Disclosure Requirements (RDR)) will be replaced with the Simplified Disclosures Standard (SDS) effective from 1 July 2021, but NFPs can early adopt SDS[14].

Key features of SDS:

- A single standard containing all disclosures
- New Australian specific disclosures
- Overall, less disclosures compared to RDR

To discuss further, please contact your local EY adviser.

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[11] Principally to enable the NFP to further its objectives

[12] ASIC's RG 85 requires non-reporting entities that are preparing financial statements under Corporations Act to comply with all recognition and measurements requirements of AASs

[13] Includes AASB 101, AASB 107, AASB 108, AASB 1048, AASB 1054

[14] ED 306 proposes that NFPs preparing GPFS (Tier 2) and early adopting SDS, can do so without the need to produce comparative information in the notes to the financial statements when their most recent GPFS (Tier 2) does not contain that comparable information