At a glance

- The release of a new standard, together with guidance and revisions to existing standards will impact income recognition in the NFP sector
- The requirements will delay the recognition of some types of income by NFP entities and may result in a better matching of income and expenses compared to current practice
- The new requirements apply to annual reporting periods beginning on or after1 January 2019 with earlier application permitted

New income recognition requirements for Not-for-Profits

The Australian Accounting Standards Board (AASB) has released AASB 1058 *Income of Not-for-Profit Entities* and AASB 2016-8 *Amendments to Australian Accounting Standards – Australian Implementation Guidance for Not-for-Profit Entities* that may change when Not-for-Profit (NFP) entities recognise certain types of income. The AASB has also amended AASB 1004 *Contributions*, with many of its requirements being revised and relocated to the new AASB 1058, thereby effectively limiting the scope of AASB 1004 to address issues specific to government entities and contributions by owners in a public sector entity context.

The standards will defer income recognition in some circumstances for NFP entities, particularly where there is a performance obligation or any other liability. In addition, certain components in an arrangement, such as donations, may be separated from other types of income and recognised immediately. The Standard also expands the circumstances in which NFP entities are required to recognise income for goods and services received for consideration that is significantly less than the fair value of the asset principally to enable the entity to further its objectives (discounted goods and services), including for example, peppercorn leases.

Background – reasons for issuing the Standard

Drawbacks of AASB 1004

By requiring non-reciprocal transfers of assets (including cash) to be recognised as income when received by a NFP entity, AASB 1004 fails to account for any obligations that may arise for the NFP entity to provide specific goods or services in exchange for the transfer. This is a common criticism of AASB 1004. Income can potentially be recognised too early, while associated expenses may be recognised in later reporting periods when the goods or services are provided to third parties. This leads to a mismatch between income and expenses and volatility in reported results. For example, a university receiving a grant related to specific services to be provided to students over a certain period may, under AASB 1004, be required to account for income when the grant is received, despite the university having obligations to provide future services.

Issuance of AASB 15

AASB 15 *Revenue from Contracts with Customers* (AASB 15), which replaces AASB 118 *Revenue*, AASB 111 *Construction Contracts* and related Interpretations, outlines the principles an entity must apply to recognise and measure revenue. However, as it was written with a focus on for-profit entities in the private sector, it raises many questions as to how to apply the principles in the NFP sector. For example, is there a contract when a donation is made during a general fundraising drive? Who is the customer of a NFP entity? Is the customer the beneficiary of the goods or services provided by the NFP entity (which could be an individual, a group or the public at large) even if they do not directly pay for the goods or services? Or is the customer the party that contributed the funds to the NFP entity for the provision of the goods and services? And how do the answers to these questions impact income recognition?

New standards issued

The AASB has issued:

1. AASB 1058 *Income of Not-for-Profit Entities ("AASB 1058")*, which provides a more comprehensive model for accounting for income of NFP entities.
2. AASB 2016-8 *Amendments to Australian Accounting Standards– Australian Implementation Guidance for Not-for-Profit Entities* ("AASB 2016-8") which provides authoritative implementation guidance when applying AASB 15 to those arrangements of a NFP which are identified as contracts with customers. The amendments to AASB 9 *Financial Instruments* provide guidance on the recognition and initial measurement of non-contractual receivables arising from statutory requirements. Such receivables include taxes, rates and fines.
3. An amended AASB 1004 *Contributions* ("AASB 1004"), which, given the requirements of AASB 1058 and AASB 2016-8, has a much narrower scope and now applies only to government entities, and contributions by owners. The AASB has stated that it will revisit this standard at a future date.

A new approach

Following comments received on its Exposure Draft ED260 *Income of Not-for-Profit Entities*, the AASB reworked the proposals to produce a more comprehensive model for accounting for income of NFP entities.

The model is essentially Balance Sheet based. When a NFP entity acquires an asset at a discount to its fair value (principally to enable the NFP to further its objectives) the NFP entity will recognise the asset in accordance with the applicable Australian Accounting Standard and then consider which accounting standard applies to the other side of the entry – the "related amounts".

For example, when a NFP receives donated inventory, the entity will recognise the inventory in accordance with AASB 102 *Inventories*, and then consider whether the nature of the transaction gives rise to a "related amount" in accordance with another standard, such as:

- Revenue or a contract liability (AASB 15)
- A financial instrument (AASB 9)
- A contribution by owners (AASB 1004)
- A lease liability (AASB 16 *Leases*)

Any difference between the consideration given for the inventory (in this example, of nil) and its fair value, after recognising any related amounts such as whether the NFP recognises a performance obligation in accordance with AASB 15, is income.

In addition, acknowledging that guidance would assist NFP entities in assessing whether an arrangement falls within AASB 15 and applying the principles in the standard, the AASB issued a new appendix to AASB 15, AASB 2016-8, which provides guidance as well as several examples of typical NFP revenue arrangements.

Under AASB 2016-8, a NFP entity is required to first consider whether a transaction is a contract with a customer that has performance obligations to transfer goods or services to another party. If this is the case, the NFP entity would account for the transaction under AASB 15, including the new Australian Implementation Guidance. Otherwise, the transaction would be accounted for in accordance with another Standard, for example AASB 1058.

Key items for consideration

One of the most significant changes is for NFP entities to use the principles of AASB 15 when accounting for revenue from all of their contracts with customers. This includes contracts that are currently considered to be non-reciprocal in nature. Of particular note is the requirement to use the concept of performance obligations as the basis for determining when a NFP entity recognises revenue in relation to grants and other funding arrangements. For arrangements which fall within scope, the principles would result in revenue being recognised when the performance obligation is satisfied, regardless of whether the ultimate beneficiary of the goods or services transferred is the grantor of the funds or another party. In contrast, where the beneficiary of the goods and services is not the grantor, the current requirements are often interpreted as requiring income to be recognised when the funds are received.

Basic principles of revenue recognition under AASB 15

The core principle under AASB 15 is that an entity recognises revenue at an amount that reflects the consideration to which the entity expects to be entitled in exchange for transferring goods or services to a customer.

The principles are applied using the following five steps:

1. Identify the contract(s) with a customer
2. Identify the performance obligations in the contract
3. Determine the transaction price
4. Allocate the transaction price to the performance obligations in the contract
5. Recognise revenue when (or as) the entity satisfies a performance obligation

Identifying whether a contract with a customer exists

There are two critical elements that must exist for an agreement with a NFP to fall within scope of AASB 15:

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

The following table outlines some of the factors that need to be considered in determining whether a NFP entity has a contract with a customer.

Factor to consider	Explanation
Customer	A customer is the party that promises consideration in exchange for goods or services. However, for some contracts in the private sector and for most contracts in the NFP sector, the customer may direct that the goods and services be provided to third party beneficiaries (including individuals or the community at large) on its behalf. Such arrangements may still be within the scope of AASB 15. This contrasts to the current requirements whereby such arrangements might be considered non-reciprocal and hence would fall outside the scope of AASB 118 and, therefore, be within the scope of AASB 1004.
Contract	Contracts / agreements do not need to be written, but can be oral or implied by the NFP entity's customary practices in performing or conducting its activities.
Enforceable agreement	The term 'contract' refers to an agreement with another party that creates *enforceable* rights and obligations. An agreement with a NFP entity may be enforceable "through legal or equivalent means". Examples of terms that result in enforceable agreements include: a. A refund in cash or kind is required when the agreed specific performance has not occurred b. The customer, or another party acting on its behalf, can enforce specific performance or claim damages c. The customer has the right to take a financial interest in assets purchased or constructed d. The parties are required to agree on alternative uses of the resources provided under the agreement and e. An administrative process exists to enforce agreements between sovereign States or between a State and another party A contract would still be enforceable despite a lack of history of enforcement and despite the customer's intention not to enforce. Enforceability depends on the party's *capacity* to enforce. The ability of a party to withhold future funding, or general statements by the NFP entity around its intended use of funds are not, of themselves, sufficient to create enforceable arrangements.

Identifying whether a performance obligation exists

Once a NFP entity has identified a contract, it would then assess if it has promised to transfer any goods or services to the customer (or to a beneficiary on the customer's behalf). In accordance with AASB 15, a promise to transfer a distinct good or service to a customer is a performance obligation. If a contract includes a performance obligation(s), revenue will be recognised only when the performance obligation is satisfied by transferring the promised goods and services.

For a performance obligation to exist in respect of a NFP entity, the promise to transfer a good or service must be sufficiently specific to be able to determine when the obligation is satisfied.

In determining whether the promise is sufficiently specific, judgment would be required taking into account any conditions specified regarding the promised goods or services, including the following conditions:

- The nature or type of goods or services
- The cost or value of the goods or services
- The quantity of the goods or services
- The period over which goods or services must be transferred

A promise to transfer goods or services over a particular time period does not, of itself, meet the sufficiently specific criterion. Accordingly, a condition for a grant to be used by a NFP entity during a particular year to provide unspecified goods or services would not, of itself, meet the sufficiently specific criterion. Similarly, the existence of an acquittal process would not, of itself, give rise to a performance obligation.

Consequently, if a NFP entity either:

- Promises goods or services, but not as part of an enforceable arrangement or
- Makes promises that are not stipulated in sufficient detail to be able to determine when they are satisfied

then any inflows related to that arrangement would not give rise to revenue from a contract with a customer, and would not be in scope of AASB 15. Instead, such inflows would be accounted for in accordance with AASB 1058.

How we see it

A NFP entity will need to consider its funding arrangements and assess whether they fall within the scope of AASB 2016-8 or AASB 1058, or both. This will require determining whether each arrangement is enforceable and includes promises that are sufficiently specific to qualify as performance obligations. This assessment will involve analysing arrangements at a level of detail previously not required.

Research Grant Income

AASB 2016-8 includes examples to illustrate how NFP entities might apply some of the requirements of AASB 15 in practice. For research grant arrangements, universities and other research organisations will need to make judgements around contract enforceability, the specificity of the promised services, and whether goods or services are transferred.

The examples in the standard illustrate several common grant scenarios and terms. In many cases, we expect that research funding will be within scope of AASB 15. The following are examples of grant document terms that are likely to give rise to contracts that fall within scope of AASB 15:

- Requirement to transfer or licence intellectual property (IP) to the grantor
- Rights to receive payment for the service of conducting specified research
- Detailed requirements around publication of findings

NFP entities will need to consider carefully the requirements of AASB 15 around timing of income recognition, in particular the requirements to assess the pattern of transfer of goods and services. For example, a contract in which IP is licensed for use by a grantor during the period in which it is developed by the NFP would result in income recognised over the period of use, whereas a contract in which the IP licence is only granted at the end of development will result in income recognition at the end of development.

The requirement to provide budgets and progress reports do not represent a transfer of benefits to the grantor, but merely provide an indication of how the NFP entity has used funds.

Grants for the Construction of Assets

When a NFP entity receives a grant to construct a non financial asset for its own use, the arrangement does not represent a contract with a customer and is not subject to AASB 15. For example, when a grant is received to enable a NFP entity to construct a building, the entity receives cash and is required to construct the building, which will then remain in the control of the NFP entity. The cash received is accounted for as a financial asset in accordance with AASB 9, and the obligation to build the building is recognised as a liability at the time the agreement is entered into. The related income is recognised as the obligation to construct the building is fulfilled i.e., over time, and the asset is recognised in accordance with the relevant accounting standard e.g., AASB 116.

In other situations, the agreement may be the granting of cash to purchase specific assets. Under such arrangements the income would be recognised at the point in time that the specified assets are purchased. If grant income is received in relation to the development of an asset which does not meet the recognition requirements of any other standards, for example, a grant to conduct research which develops an entity's own Intellectual Property, the entity recognises income when it obtains the funds.

Donations

During development of the new standard, the AASB proposed a two part qualitative assessment as a means to determine whether a contract contained a donation component. Following feedback, the AASB decided to simplify the requirements, and the final standard contains a rebuttable presumption that the consideration promised in a contract relates wholly to the identified performance obligations. This means that it is not necessary for a NFP entity to identify or recognise separately the donation component of a contract, but instead allocates all of the transaction price to the performance obligations in the contract.

Should a NFP wish to identify and recognise a donation component, it will need to rebut the presumption that the transaction price relates wholly to the performance obligations. It can do this in relation to that part of the consideration which is:

- Not refundable and
- Where the NFP entity has Deductible Gift Recipient (DGR) status- the donor can claim a tax deduction for part of the transaction price

For example, if a NFP entity sells online subscriptions to a magazine, and also invites subscribers to make a non refundable donation when paying for the subscription, the NFP may, if it chooses, recognise the donation portion of the transaction immediately in accordance with AASB 1058, and the subscription portion in accordance with AASB 2016-8. Alternatively, it may recognise the entire amount under AASB 2016-8.

Donations which are not part of a contract with a customer will be accounted for in accordance with AASB 1058. This includes donations implicit in 'peppercorn' (or below market) leases (see below) and assets acquired by NFP entities at a discount to their fair value.

Donated Goods

Some NFP entities receive donations of goods and other assets e.g., property, which may then be used by the entity in its activities. Currently, we see mixed approaches to accounting for these items. Under the new standard, NFP entities will be required to recognise donated inventory at their current replacement cost, subject to a materiality assessment. This materiality assessment may, as an accounting policy choice, be made at the individual transaction, or portfolio of transactions level. The practical effect of this is to allow entities receiving individually immaterial donations of inventory not to recognise those donations in their accounts.

The standard encourages entities to disclose the nature of donated goods held at reporting date but not recognised in the accounts.

'Peppercorn' leases

AASB 1058 incorporates consequential amendments to other standards which will lead to changes in income recognition. For example, it is common in the NFP sector for leases to be entered into at significantly below market rates (i.e., a peppercorn lease).

Under current requirements, if a NFP entity is granted a

below-market lease that is classified as a finance lease, the application of AASB 117 enables the NFP entity to measure the lease asset and liability at the present value of the minimum lease payments, which in the case of a peppercorn lease is a negligible amount. This accounting understates the NFP entity's lease asset and, consequently, fails to recognise the donation component.

To address this, the Standard amends AASB 16 such that NFP entities will be required to measure the lease asset, including right of use assets under AASB 16, at the fair value of the leased property at inception of the lease. Consequently, the difference between the lease liability measured at the present value of the 'peppercorn' lease rental and the fair value of the lease asset would be recognised as income in accordance with AASB 1058.

Similar amendments have been made for other non-financial assets that are acquired at a discount to their fair value.

The transition rules of AASB 2016-8 essentially grandfather existing below market leases until the new leases standard applies. The practical implication of this is that NFP entities with peppercorn lease arrangements will not be required to change their current lease accounting until AASB 16 becomes effective (periods beginning on or after 1 January 2019). Leases recognised on transition to AASB 16, and new leases entered into thereafter, will result in the off-market component of the lease arrangement being recognised immediately in the income statement.

How we see it

NFP entities will need to reassess their lease contracts, assess fair value of those assets and recognise any implied off-market amount as income immediately (subject to the transition relief). This will impact a NFP entity's results both initially and on an ongoing basis (for example, due to higher depreciation expense on leased assets).

Volunteer services

AASB 1004 currently requires certain NFP entities in the public sector to recognise as income the fair value of services provided by volunteers if the fair value of those services can be reliably determined and the services would have been purchased if they had not been donated. Those requirements are moved to AASB 1058 and extended such that all NFP entities, whether public or private, can elect to recognise as income the fair value of volunteer services received if the fair value of those services can be measured reliably.

The standard also encourages, but does not require, disclosure where NFP entities are dependent on volunteers.

AASB 1004 Contributions

AASB 1004 remains in force, albeit in much reduced form. The scope of the standard has been reduced and now covers

- Government Departments
- Other Government controlled NFP
- Local Government and Whole of Government

The standard provides guidance, largely unchanged from previously, on

- Parliamentary appropriations
- Restructure of administrative arrangements
- Liabilities of government department assumed by other
- Contributions by owners

For these items, the timing of the recognition of income continues to be determined by an assessment of when control of the funds passes to the NFP entity (voluntary transfers) or when the entity has an enforceable right to receive funds (compulsory transfers). Therefore, voluntary transfers would usually be recognised on receipt of funds, and compulsory transfers would usually be recognised when the underlying 'taxable event' occurs.

Contributions by owners

The AASB considered whether a public-sector specific definition of 'contributions by owners' is still necessary in Australian Accounting Standards and also whether AASB Interpretation 1038 *Contributions by Owners Made to Wholly-Owned Public Sector Entities* should be withdrawn or retained. Concerns were raised that the current definition is too narrow because it requires NFP entities to determine whether the contributor had specifically designated the transfer as a contribution by an owner before classifying it as such. As a result, in some cases, NFP entities have been required to classify as income items which are in substance contributions by owners.

In the interests of time, the AASB has carried forward the Contributions by owners requirements and will revisit this issue as part of a later project dealing with public sector reporting,

Transition

The new standards are applicable from 1 January 2019 with earlier application permitted.

On transition, NFP entities will be required to apply AASB 1058 using one of two methods:

- Full retrospective approach: retrospectively to each prior reporting period presented or
- Modified retrospective approach: retrospectively with the cumulative effect recognised as an adjustment to the opening retained earnings at the date of initial application (i.e., start of the reporting period in which the entity first applies the standard)

AASB 1058 encourages but does not require restatement of comparatives.

Next steps

NFP entities are encouraged to assess their income arrangements and consider the detailed requirements of the new standards.

If you would like any assistance in understanding the potential implications of this Standard please contact your EY adviser.

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