New Income Recognition for Not-for-Profit Entities

- Each and every arrangement that gives rise to gross inflows of economic benefits will need to be analysed and broken down into its component parts in order to correctly determine the appropriate accounting treatment.
- A contract may end up being accounted for partially as a revenue transaction within the scope of AASB 15, and partially in another standard.
- The effort involved in accounting for revenue and income by not-for-profit entities will be much greater than before, in terms of resource allocation and level of detail. Not-for-profit entities should start early and not rush the process of developing new accounting practices to transition to the new standards.

Overview:

A common criticism of the accounting requirements for not-for-profit entities (NFPs) is the apparent 'mismatch' created by AASB 1004 *Contributions* between the recognition of income at the time of receipt, and the associated expenses that are incurred and reported in later reporting periods.

The Australian Accounting Standards Board (AASB) has sought to address this problem by introducing AASB 15 *Revenue from Contracts with Customers* and AASB 1058 *Income of Not-for-Profit Entities.*

The standards apply to all private sector NFP entities and most public sector entities, becoming mandatorily effective for years beginning on or after 1 January 2019. Early adoption is permitted, provided both standards are adopted at the same time.

Assessment:

NFP entities must not be deceived into thinking the application of the new standards will be easy.

As an initial step, each and every arrangement that gives rise to gross inflows of economic benefits will need to be analysed to clearly identify the rights and obligations embedded in the agreement. This will necessitate a certain level of interpretation when it comes to understanding contracts entered into with counterparties, a process that is often complicated by complex, legal documents or relationships that are riddled with ambiguity.

Secondly, each arrangement may need to be broken down into its component parts in order to correctly determine the appropriate accounting standard to apply to each transaction or event.

A contract may end up being accounted for partially within the scope of AASB 15, and partially in another standard, such as AASB 1058.

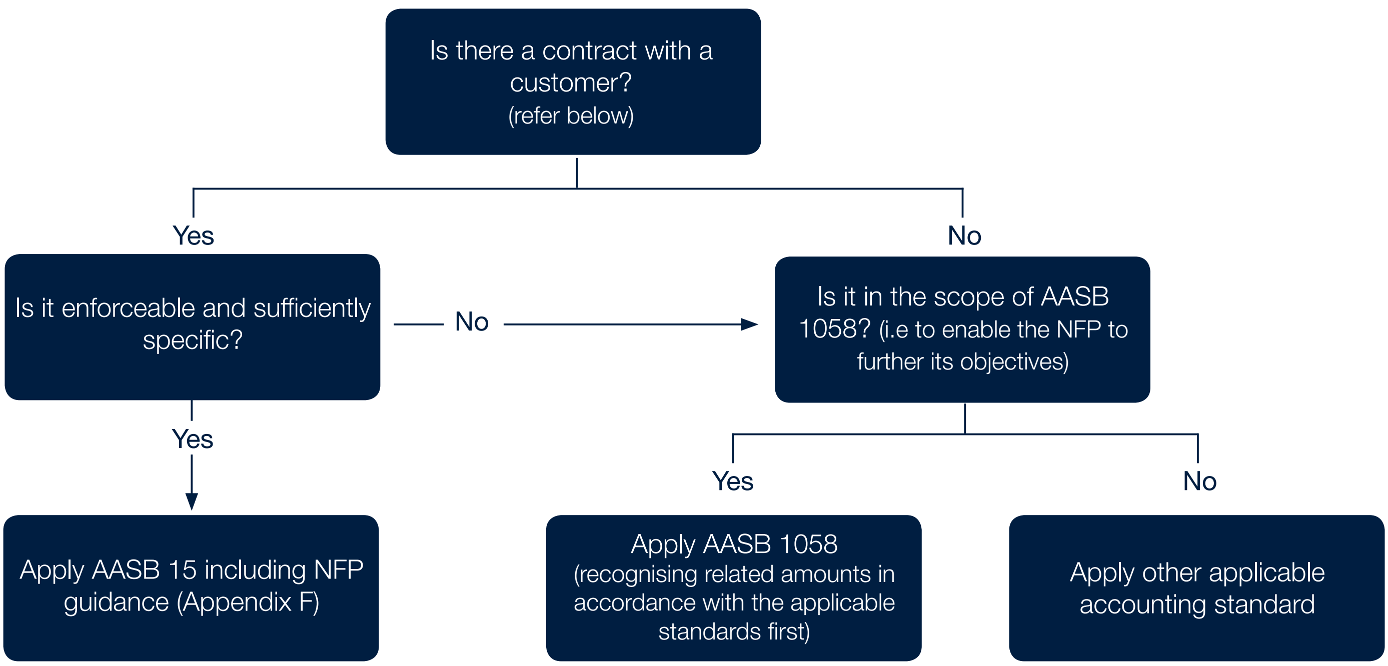
Contracts with customers:

A transaction can only give rise to revenue in accordance with AASB 15 when a 'contract with a customer' exists. A customer is the party that promises consideration in exchange for goods or services that are an output of the NFPs ordinary activities. This party is still the customer even if the goods or services are to be directed to a third party beneficiary (e.g. the community at large).

An inherent feature of a contract with a customer is that the NFP makes promises that create enforceable rights and obligations. If the arrangement is unenforceable (i.e. the customer is not able to enforce some obligations of the NFP entity through legal or equivalent means), then a contract with a customer does not exist for the purposes of AASB 15. Generic assertions regarding the intended use of the consideration received by the NFP are not, by themselves, enforceable arrangements. Enforceability is dependent upon each parties' ability to enforce the rights/obligations of the agreement.

The key features required for a contract with a customer to exist include:

- Is there a customer?
- Is it enforceable?
- Is it sufficiently specific (including term as well as goods/services to be performed)?



Even if a contract with a customer exists, there will be situations where the NFP is prevented from applying AASB 15, such as:

- Transfers to enable a NFP to acquire or construct a recognisable non-financial asset (e.g. a building),
- Volunteer services received by a NFP, and
- Promises that are not sufficiently specific in the agreement.

If AASB 15 does not apply to a contract or a transaction, the NFP considers whether AASB 1058 should be applied.

Revenue

'Revenue' for not-for-profit entities:

Revenue (AASB 15):

- Arises from the transfer of goods or services to a customer or third party beneficiary on the customer's behalf.
- Is recognised at the amount that reflects the consideration to which an entity expects to be entitled in exchange for transferring those goods or services.

Revenue is recognised by applying the 5-step model in AASB 15 as follows:

Step 1: Identify the contract(s) with the customer

A contract is an agreement between parties that creates enforceable rights and obligations. It is not necessary for each promise in the agreement to be enforceable, only that some enforceable obligations of the NFP arise.

Step 2: Identify separate performance obligations in the contract

A performance obligation is a distinct promise to transfer goods or services to the customer or third party beneficiary on behalf of the customer. Performance obligations must be sufficiently specific for the entity to apply all 5 steps in the model.

Step 3: Determine the transaction price

The transaction price is the amount of consideration the entity expects to be entitled, but only up to the amount that is highly probable with no significant reversal in the future.

Step 4: Allocate the transaction price

The transaction price is allocated to the separate performance obligations on the basis of the stand-alone selling price or other allowed approach. There is a presumption that the transaction price relates wholly to the transfer of promised goods or services, unless there is a partial refund if the NFP does not deliver on those promises.

Step 5: Recognise revenue when a performance obligation is satisfied

Revenue is recognised when the good or service is transferred to the customer and the customer or beneficiary obtains control of it. This could be at a point in time or over time.

Example – Grant revenue

A training organisation *(NFP)* receives a grant *(consideration)* from government *(customer)* to provide first-aid training *(performance obligation)* to members of a community *(third party beneficiary)*. The Government will monitor the use of the funding through an acquittal process – if it is not used as intended, it is refunded to the Government *(enforceable rights and obligations)*. The training is to be provided over a three year period *(sufficiently specific)*.

The grant is recognised as revenue as the training is delivered (over time) using the acquittal process as a measure of progress towards completion.

If the time period or nature of the service to be provided is not specified, it is unlikely that the performance obligation would be *sufficiently specific* and AASB 15 would not be applied, instead AASB 1058 should be considered.

A contract may include an obligation for goods/services and a contribution to the NFP to further its objectives. To simplify the requirements of the standard for these situations, the NFP guidance in AASB 15 includes a rebuttable presumption that the transaction price is treated as being wholly related to the transfer of promised goods or services. This presumption is rebutted when a portion of the transaction price is refundable if the goods/services are not delivered/performed.

Example – Rebuttable presumption for donation component

A museum *(NFP)* sells memberships that provide access to its facilities for a year *(performance obligation)*. In addition, the museum invites its members to donate a voluntary, non-refundable amount to assist the museum with its community education objectives. Such a donation is separately identifiable from the price of the annual membership.

If neither of the amounts are refundable, the total consideration (transaction price) is allocated to the performance obligation to provide membership access and is treated wholly within AASB 15 as a revenue transaction. The donated amount is not separately accounted for.

Where the annual membership is refundable if access is not provided for the entire year, while the donation is not, the donated amount is accounted for separately in accordance with AASB 1058.

Whether a non-refundable donation is separated is also assessed in the context of materiality to the individual contract. A donation that is not material to the individual contract need not be separated and accounted for separately. This determination does not need to be reassessed at an aggregate or portfolio level.

Income:

Income arises in accordance with AASB 1058 by applying a 'balance sheet approach'. This means that all assets, liabilities and other items are recognised in accordance with the applicable accounting standard and income is the residual credit in the accounting entry.

AASB 1058 is only applied when a NFP acquires or receives an asset (including cash) at a significant discount to its fair value, principally to further its objectives.

Example – Donated inventory

A NFP receives donated inventory and will recognise the inventory in accordance with AASB 102 *Inventories*. The entity will then consider whether the nature of the transaction gives rise to a 'related amount' in accordance with another accounting standard, such as:

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

Assuming the current replacement cost *(fair value)* of the inventory is $ 1,200, and there is no related amount to be recognised, the NFP records the following accounting entry:

Dr. Inventory	$ 1,200
Cr. Income	($ 1,200)

As a practical expedient, where a NFP receives donated inventories that are not material, the NFP can elect whether to recognise the donated goods. The assessment of materiality can be made at an individual item level or at an aggregate or portfolio level. A NFP is encouraged to disclose qualitative information regarding the inventories held but not recognised.

Example – Below market value Lease (AASB 1058 Illustrative Example 5)

A NFP enters into a lease as a lessee. The lease is significantly below-market, with payment of $100 per month for 30 years. The fair value of the right to use the asset is calculated as $ 360,000.

The NFP records the related amounts in accordance with AASB 16 Leases, resulting in the following accounting entry:

Dr. Right of use asset	$ 360,000
Cr. Lease liability (present value)	($ 1,537)
Cr. Income	($ 358,463)

Construction or acquisition of assets

When a NFP receives a grant to construct or acquire a non-financial asset, such as a building for its own use, the transaction is not a contract with a customer and therefore AASB 15 does not apply. Instead, the arrangement is accounted for by applying the specific requirements for this type of transaction in accordance with AASB 1058.

The amount received is accounted for as a financial asset, and the obligation to build the building is recognised as a liability at the time the agreement is entered into. The liability is recognised until such time when (or as) the entity satisfies its obligation to construct or acquire the non-financial asset.

In other words, income is recognised over time when the asset is constructed, or at the same time as when the asset is acquired.

Volunteer services:

Volunteer services are accounted for in accordance with AASB 1058.

Not-for-profit entities in the public sector are required to recognise income for 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. The income for the in-kind donation is recognised when the volunteer services are received and recorded as an expense.

If this doesn't apply, any NFPs, whether public or private, can elect to recognise income for the fair value of volunteer services received if the fair value of those services can be measured reliably. A NFP is encouraged to disclose qualitative information regarding the volunteer services received but not recognised.

Transition:

Entities will be required to apply the standard retrospectively using either a '*full retrospective*' or '*modified retrospective*' approach. Under the '*full retrospective*' approach, prior periods are restated, while the '*modified retrospective*' approach results in a cumulative catch-up adjustment in the year of adoption. The latter approach is intended to be the simpler option, but it is not without its challenges, including the need to provide additional disclosure.

It should be clear that the effort involved in accounting for revenue and income by NFPs will be much greater than before, in terms of resource allocation and level of detail.

Entities are advised to start early and not rush the process of developing new accounting practices to transition to the new standards. There are extensive examples in the standard for all items considered above.

About Crowe Horwath

At Crowe Horwath, we are focused on meeting the needs of businesses and the individuals within them through a collaborative approach to financial services. In conjunction with our parent company, Findex, we pride ourselves on an integrated service offering, giving you the peace of mind that comes with knowing your financial and lifestyle goals and objectives are our focus.

With over 110 offices throughout Australia and New Zealand, our vast geographical footprint provides you direct access to over 3,000 expert advisers and professionals. Located in most regional, rural and metropolitan areas, we are well positioned to assist you in building your wealth and better managing your financial future.

Tel 1300 856 065

www.crowehorwath.com.au

The relationship you can count on

Crowe Horwath (Aust) Pty Ltd ABN 84 006 466 351

October 2017