



Project:	Income of Not-for-Profit Entities	Meeting	AASB November 2016 (M154)
Topic:	Sweep issue: Transfers made to enable an entity to develop an unrecognisable non-financial asset for its own use	Agenda Item:	1.1
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		Decision-Making:	High
		Project Status:	Project finalisation

Introduction

- 1 The objective of this paper is to seek the Board’s decision on whether a non-financial asset must qualify for recognition under another Australian Accounting Standard (e.g. AASB 116, AASB 138) to be able to access the ‘capital grant’ accounting set out in draft AASB 10XX.15-17.
- 2 This sweep issue was identified by both staff and constituents when considering the public ‘fatal flaw’ draft AASB 10XX *Income of Not-for-Profit Entities* and AASB 2016-X *Amendments to Australian Accounting Standards – Australian Implementation Guidance for Not-for-Profit Entities*.

Issue: Access to accounting as a ‘capital grant’

- 3 Several respondents¹ to the ‘fatal flaw’ draft Standards queried the relationship between a grant to conduct specified research activity for which Intellectual Property rights are controlled by the recipient (Example 2B in fatal flaw draft AASB 2016-X) and the accounting specified in AASB 10XX.15-17 for transfers made to enable an entity to acquire or construct a non-financial asset for its own use.^{2,3}

1 Australian Council of Auditors-General, PwC, University of Melbourne, University of Sydney, Nexia Australia, staff from Ernst & Young

2 Respondents to the ‘fatal flaw’ draft Standards did not object to the accounting or the location of AASB 10XX.15-17. However, some sought clarification as to the Board’s rationale, including explanation of why these transactions were excluded from AASB 15 (to be included in a Basis for Conclusions accompanying AASB 10XX), whether the Board intends for users applying these paragraphs to refer to the principles in AASB 15, and queried the transactions to which the ‘capital grants’ paragraphs could apply. This agenda paper only addresses the last point.

- 4 In summary, these respondents have questioned whether the Board intended to:
- (a) limit the application of AASB 10XX.15-17 to grants (and other transfers) to develop a non-financial asset that qualifies for recognition under another Australian Accounting Standard; or
 - (b) extend the application of AASB 10XX.15-17 to also include grants (and other transfers) to develop a non-financial asset for which recognition is prohibited by another Australian Accounting Standard (e.g. AASB 138).
- 5 In commenting, several of these respondents observed that AASB 2016-X.F21 implies that the conduct of research activities is always a transfer of services back to the grantor (or to the public on the grantor's behalf). Accordingly, these respondents noted it was unclear how the conditions in AASB 10XX.15 could be said to be met in respect of grants to conduct research activity as they observed these grants to be in the nature of a contract with a customer within the scope of AASB 15. The staff view is that the transaction could include both a contract with a customer and an aspect to be accounted for in accordance with AASB 10XX (the drafting in the draft Standards have been updated to make this clear), and so this observation is not relevant to responding to the question in paragraph 4 above.
- 6 Staff note that the accounting for grants where an asset is not permitted to be recognised, for example a grant to conduct specific research activity, could significantly differ depending on whether a not-for-profit recipient is able to access the accounting set out in AASB 10XX.15-17 (that is, deferral of income recognition). Having regard to this, and acknowledging that the issues in paragraph 4 above were not specifically discussed by the Board in developing the fatal-flaw draft, staff think this issue is sufficiently significant for the Board to consider at its November 2016 meeting.

Summary of staff recommendation and approach taken in fatal-flaw draft

- 7 Staff have mixed views as to whether the application of AASB 10XX.15-17 should be limited to only grants (and other transfers) to develop a non-financial asset that qualifies for recognition under another Australian Accounting Standard.

The marked up versions of pre-ballot draft AASB 10XX (agenda paper 1.4) and AASB 2016-X (agenda paper 1.6) has been marked up to clearly articulate that the application of AASB 10XX.15-17 includes grants (and other transfers) to develop a non-financial asset for which recognition is prohibited by another Australian Accounting Standard (e.g. AASB 138).⁴

3 Refer to the Appendix for the relevant extracts from the draft 'fatal flaw' Standards. These paragraphs have been edited since the 'fatal flaw' version exposed for public comment to improve clarity.

4 Paragraphs and illustrative examples relevant to 'capital grants' are: AASB 10XX.15-17, 31-36, B15-B17, Examples 9-10, BC84-BC93 and AASB 2016-X.F27 and Example 2C (formerly identified as Example 2B). It has not been necessary to amend every paragraph or illustrative example to address the issue in this paper.

Background

- 8 ED 260 *Income of Not-for-Profit Entities* did not specify whether transfers of financial assets to be used for the acquisition or construction of specified property, plant and equipment (that is, an in-substance transfer of a non-financial asset) were to be accounted for as a contract with a customer within the scope of AASB 15, or recognised as income in accordance with requirements set out in AASB 10XX. Consequently, some respondents to the Exposure Draft sought clarification whether a transfer of cash made for such purposes would be recognised as income immediately, or whether a contract liability determined in accordance with AASB 15 arises. Some were concerned that immediate income recognition would not appropriately reflect the relationship between the amounts transferred and the related expenditure when construction expenses are incurred in periods subsequent to income recognition.
- 9 In its redeliberations, the Board discussed the (property, plant and equipment) examples raised by constituents, and acknowledged that in the absence of clarification in this regard, different interpretations were likely to arise and impair consistency in application as different positions may be taken on whether there is a transfer of a good or service to the customer. The Board tentatively decided to specify requirements in AASB 10XX to mirror, to the extent appropriate, the accounting that would be achieved had the transaction been accounted for had it been incontestably a contract with a customer within the scope of AASB 15. The Board's rationale for doing so was that an in-substance transfer of a good for use by the entity itself should not result in revenue until the recipient has satisfied its obligation to construct or acquire the asset (ie recognise revenue on basis as though the entity had received the asset directly rather than the cash to produce/acquire the asset).
- 10 In developing the 'fatal flaw' draft Standards subsequent to its August 2016 meeting, the Board decided to develop draft Example 2B (now renumbered as Example 2C) in AASB 2016-X. The example implies that the 'capital grants' accounting set out in AASB 10XX.15-17 applies to certain research grants, despite AASB 138 not permitting the capitalisation of the research output (the Intellectual Property) as an asset. The 'fatal flaw' Standards did not include any accompanying discussion in this regard.

Alternatives available to the Board

- 11 In response to the concern identified, the Board could decide to:
- (a) **Alternative 1:** limit the application of AASB 10XX.15-17 to only grants (and other transfers) to develop a non-financial asset that qualifies for recognition under another Australian Accounting Standard; or
 - (b) **Alternative 2:** clearly articulate in the Standard, or the accompanying Basis for Conclusions, that the application of AASB 10XX.15-17 includes grants (and other transfers) to develop a non-financial asset for which recognition is prohibited by another Australian Accounting Standard (e.g. AASB 138). The pre-ballot draft of AASB 10XX has been marked up to reflect this view.
- 12 A further related avenue is for the Board to extend the application of AASB 10XX.15-17 even further to include grants (and other transfers) provided on

condition that the grant monies are used to render specified services, rather than goods (**Alternative 3**). Staff note that the rendering of services will, in many instances, be recognised as expense, rather than capitalised as/into an asset.

Discussion

Project Advisory Panel member feedback

- 13 Staff sought feedback from Panel members on this issue. Panel members were generally supportive of the scope of the ‘capital grants’ paragraphs including non-financial assets that were not permitted to be recognised because of a requirement in another Australian Accounting Standard (Alternative 2). Panel members were not supportive of extending the accounting set out in these paragraphs to transfers to render specified services (Alternative 3).
- 14 Panel members also made the following observations:
- (a) identification of whether there is an in-substance transfer of a non-financial asset may not be straightforward. Panel members noted that a transfer may give rise to related capacity-building activity; however, this does not necessarily mean that there has been an in-substance transfer of a non-financial asset to the entity. (For example, an entity may receive a grant to help defray the costs of running a number of extra train services. The entity may expend monies on increasing the ability of rail tracks to service a larger number of train services to enable it to meet the grant conditions; however, this does not necessarily mean that there has been an in-substance transfer of a non-financial asset to the entity as part of that transfer);
 - (b) the Board’s rationale for including the ‘capital grants’ paragraphs should be explained in the Standards (or Basis for Conclusions). Panel members observed that the lack of clarity as to whether and why grants (and other transfers) to develop a non-financial asset for which recognition is prohibited by another Australian Accounting Standard can be partly ascribed to the absence of a draft Basis for Conclusions in the fatal flaw versions; and
 - (c) it is important a user reading the various Illustrative Examples will arrive the same outcome as reading the body of AASB 10XX and AASB 2016-X, and vice versa.

Staff analysis and recommendation

- 15 Staff have mixed views whether Alternative 1 or Alternative 2 should be supported.
- 16 Some staff support Alternative 2. These staff contend that the underlying principle is that the grantor intended to transfer a good (rather than a financial asset) to the not-for-profit recipient, regardless whether the accounting standards permit this good to be recognised.⁵ Accordingly, staff think the accounting should extend to both recognised

5 Extracts from AASB 138 *Intangible Assets*: “No intangible asset arising from research (or from the research phase of an internal project) shall be recognised.” [AASB 138.54] “Expenditure on internally generated

and unrecognisable non-financial assets; the key feature being whether the definition of an asset has been met (i.e. whether the not-for-profit recipient will control a resource as a result of past events and from which future economic benefits are expected to flow to the entity), rather than whether recognition of that asset is permitted by a specific Accounting Standard.⁶

- 17 Alternative 2 has the benefit of allowing the income deferral of many research grants to universities, with income recognition as the obligation to conduct the research (or return monies to the grant) is met. Feedback from a university constituent is that this will save costs in not having to identify whether the majority of grants received are within the scope of AASB 15 (as the same accounting outcome is achieved).
- 18 Other staff support Alternative 1, noting that:
- (a) the Board’s discussions in developing the ‘capital grants’ paragraphs have been focussed on creating a limited exception to the general principle in AASB 10XX for contracts to construct tangible recognisable assets, for which it is arguable whether there has been a transfer of goods or services to the customer (grantor) in exchange for the monies received;
 - (b) Alternative 1 is more consistent with the Board’s reasons for developing the ‘capital grants’ paragraphs as an intangible asset may be developed as part of that transfer, but is incidental to the grant. For example, a grantor may prioritise the progress of specified research activity in a field without necessarily being overly concerned that the IP is owned by the researchers. Another grantor may provide a grant in order for the recipient to develop an intangible asset (for example, a licence) that may be commercialised. In the first scenario, some may argue that the ‘good transferred’ is the conduct of research activity; in the latter, the ‘good transferred’ is arguably a licence. Staff note that AASB 10XX.15 as currently drafted would not distinguish between the two scenarios. However, others would argue that all research is about the IP generated regardless of whether outcomes are “successful” or not and that the IP generated from the research is the in-substance asset being transferred, similar to the relationship construction services have to the in-substance physical building. It is merely an accounting construct that prevents the IP from being recognised; and
 - (c) AASB 138 explains why an asset shall not be recognised in respect of research activity and certain intangible assets. AASB 138.55 states “In the research phase of an internal project, an entity cannot demonstrate that an intangible asset exists that will generate probable future economic benefits”. Staff consider applying the higher threshold of ‘probable’ (rather than merely ‘expected’) to be appropriate to identifying grants of a capital investment nature. AASB 138.64 states “Expenditure on internally generated brands,

brands, mastheads, publishing titles, customer lists and items similar in substance shall not be recognised as intangible assets.” [AASB 138.63]

6 AASB 138.10 observes that the following three features must exist before the definition of an intangible asset is met: identifiability, control, and the existence of future economic benefits.

mastheads, publishing titles, customer lists and items similar in substance cannot be distinguished from the cost of developing the business as a whole”. Some staff think that it would be difficult for the identifiability criteria (to meet the definition of an intangible asset) to be demonstrated as project expenditure is not necessarily representative of “identifiability”.

- 19 In addition, staff supporting Alternative 1 observed:
- (a) Alternative 2 understandably would have more public support, as it is likely to result in more ‘matching’ of income with expenses;
 - (b) Alternative 2 may confuse users of the Standard, as ‘asset’ is generally associated with a recognised asset in Australian Accounting Standards; and
 - (c) Alternative 2 is likely to result in entities being required to account for a research grant under both AASB 15 and AASB 10XX. (However, staff note that there are possibly practical manners of doing this).
- 20 The consequences of Alternative 1 would be that the requirement to conduct research where the resulting IP does not reside with the grantor or the general public (ie researchers do not control the IP) would likely fall outside AASB 15 and would be within the scope of the general requirements of AASB 10XX and would be recognised immediately as income when funding is controlled.
- 21 Staff do not support Alternative 3. Staff note that extending the ‘capital grants’ paragraphs to further grants that fail to be a ‘contract with a customer’ is inconsistent with the Board’s tentative decisions for AASB 10XX to operate as a residual Standard.
- 22 In addition, staff note some grants may include both a ‘goods’ component and a ‘service’ component (for example, a grant to build a building that must be used to deliver particular services). Staff think the deferral of income recognition in such instances should not extend beyond the construction period for a grant accounted for in accordance with AASB 10XX.16, unless there are clearly identified additional sufficiently specific criteria as contemplated by the current proposed wording. (Panel members agreed.)

Question to Board members

- Q1 Do Board members support:
- (a) Alternative 1: limiting the application of AASB 10XX.15-17 to only grants (and other transfers) to develop a non-financial asset that qualifies for recognition under another Australian Accounting Standard; or
 - (b) Alternative 2 (as marked up in the pre-ballot draft): clearly articulating in the Standard, or the accompanying Basis for Conclusions, that the application of AASB 10XX.15-17 includes grants (and other transfers) to develop a non-financial asset for which recognition is prohibited by another Australian Accounting Standard (e.g. AASB 138)?