Australian Government
Australian Accounting Standards Board

Staff Paper

Project:	**Income of Not-for-Profit Entities**	**Meeting**	AASB November 2016 (M154)
Topic:	**Transition of recognised assets**	**Agenda Item:**	1.2
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Introduction and objective of this paper

1 The objective of this paper is to obtain Board decisions in relation to transition requirements for assets recognised prior to the date of initial application of AASB 10XX *Income of Not-for-Profit Entities* which were acquired for more than no, or nominal, consideration but still for an amount significantly less than fair value.

Link to project summary

http://www.aasb.gov.au/admin/file/content102/c3/Income_of_Not_for_Profit_Entities_Project_Summary.pdf

Summary of staff recommendations

2 The staff recommend that entities are required to remeasure assets acquired for amounts significantly less than fair value but greater than a no or nominal amount at fair value as at:

(a) the date of initial application of AASB 10XX; or

(b) the beginning of the earliest period presented

depending on the transition option an entity choses to apply.

Background

3 As part of the Board's drafting of the fatal-flaw draft of AASB 10XX *Income of not-for-profit entities*, the Board revised the objective of the Standard to 'apply to transactions where the consideration to acquire an asset is significantly less than fair value principally to enable a not-for-profit entities to further its objectives…'.

4 This change in objective was then reflected, as consequential amendments, in the asset measurement requirements of Australian Accounting Standards relating to assets (for

example, AASB 138 *Intangible Assets*) to require that not-for-profit entities initially measure the cost of the asset at fair value where the consideration for the asset is significantly less than fair value principally to enable the entity to further its objectives.

5 This objective is broader than the current requirements of AASB 1004 *Contributions*, and will, consequently, include more assets within the requirements to fair value on initial recognition than is currently the case.

6 Noting the broad application of the Standard the Board inserted transition relief into AASB 10XX for 'completed contracts'.[1] The relief permits entities to transition to AASB 10XX without retrospectively applying the Standard to transactions already accounted for under AASB 1004 *Contributions*[2]. The Board inserted this relief to replicate a similar provision in AASB 15 *Revenue from Contracts with Customers* because the Board was concerned that without it transitioning to AASB 10XX would be more burdensome for not-for-profit entities than for for-profit entities transitioning to AASB 15.

7 Importantly, a completed contract is one in which the contributed asset was measured at fair value on initial recognition. Entities would then have applied the applicable Accounting Standard for the subsequent measurement of that asset. Therefore, this transition relief provides entities with the option not to retrospectively apply AASB 10XX to the original transaction and identify, recognise and measure any related amounts.

8 This approach was exposed during the Board's public fatal flaw review process in September/October 2016. Feedback from that process indicated concern for transitioning transactions where an asset was acquired for an amount greater than a no, or nominal, amount but nevertheless was significantly less than fair value. The respondent noted significant transition costs would be imposed if entities did not receive additional transition relief.

9 In the diagram below, transactions for no, or nominal, consideration would have been accounted for in accordance with AASB 1004 and therefore receive the 'completed contracts' relief. Transactions where the consideration represents the fair value of the asset, or not significantly less than fair value, are not within the scope of AASB 10XX. However, transactions that fall between these two areas, being those where the consideration was greater than a no, or nominal amount, but still significantly less than fair value do not receive any transitional relief, these are referred to as the 'gap transactions' in this paper.

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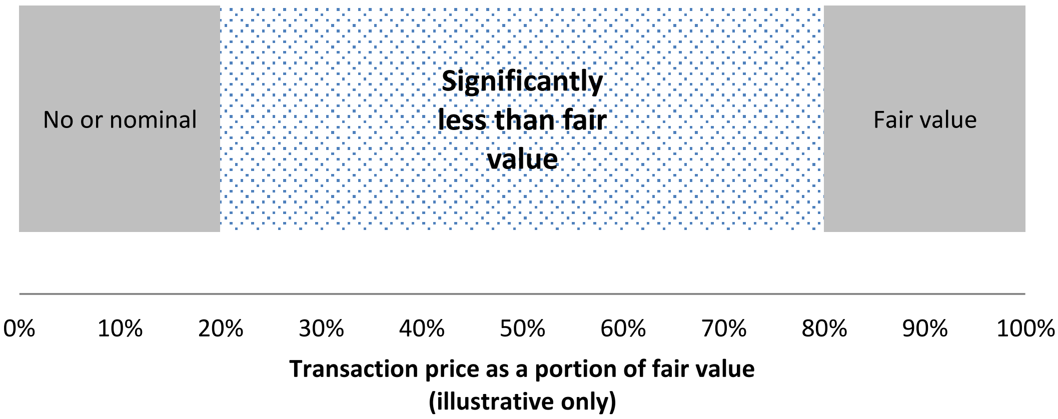
1 Paragraph C2:
For the purposes of the transition requirements in paragraphs C3–C12:
(a) …
(b) a completed contract is a contract or transaction for which the entity has recognised all of the income in accordance with AASB 1004 *Contributions.*

2 Transactions accounted for under AASB 1004 are those where an asset was acquired for no, or nominal, consideration.



	No or nominal	Significantly less than fair value	Fair value
Current accounting	Fair value and recognise income (except for leases) (AASB 1004)	Apply applicable Accounting Standard (likely measured at cost (eg. AASB 138 and AASB 116))	Apply relevant Standard
AASB 10XX accounting	Fair value the asset and recognise any related amounts – including leases (AASB 10XX)	Fair value asset and recognise any related amounts (AASB 10XX)	Apply relevant Standard (not in scope of AASB 10XX)
Transition relief	'Completed contract' See paras 6–7	Not currently addressed	No change (not in scope of AASB 10XX)

Staff analysis

10 Absent any specific transition requirements, 'gap transactions' are transitioned in accordance with the general transition provisions of AASB 10XX. Under those requirements an entity would retrospectively apply the amended measurement requirements of the Standard applicable to its historic 'gap transactions'. That process would require an entity to measure the asset at fair value on acquisition, recognise and measure any related amounts at acquisition and recognise any cumulative effect in retained earnings, or another component of equity (as appropriate), per the transition option chosen. This is in contrast to 'completed contracts', which are effectively 'grandfathered' for transition purposes.

<u>Possible transition options</u>

11 Staff have identified three transition options for the Board to consider:

(a) Option 1: consistent with assets acquired for no or nominal amounts, relieve entities from the requirement to determine fair value on the date of acquisition of an asset, instead **requiring fair value** as at:

   (i) the date of initial application of AASB 10XX; or

   (ii) the beginning of the earliest period presented

   depending on which transition relief option the entity chooses;

(b) Option 2: extend the ‘completed contracts’ relief to all historic ‘gap transactions’. That is, **no requirement to fair value** the assets on transition to AASB 10XX; or

(c) Option 3: maintain the current transition requirements (no additional transition relief). Entities would be required to **fair value the asset as at the date of acquisition**.

Option 1: Fair value depending on transition option applied

12 The objective of the Standard is to more accurately reflect the underlying economics of transactions that not-for-profit entities enter into. Those transactions that fall within the scope of the ‘completed contracts’ relief have already been subject to fair value measurement and income recognition. Therefore, it is arguable that the economic substance of those transactions has been captured and no further effort is necessary.

13 The historic ‘gap transactions’, on the other hand, have not been subject to fair value measurement. Consequently, any income component arising from the receipt of assets under those transactions has not been recorded. Therefore, it is arguable that the economic substance of these transactions has not already been captured.

14 Under this option, it is necessary to measure at fair value any asset recognised in a transaction where the consideration for the asset was significantly less than fair value. However, it is acknowledged that performing this task on a fully retrospective basis would impose an undue cost burden on not-for-profit entities. Accordingly, as a form of transition relief, entities would need only determine the fair value of the asset as at the date of transition to AASB 10XX or as at the beginning of the earliest period presented, depending on the transition option applied.

15 Under this approach the financial statements following transition to AASB 10XX will be aligned with the objective of the Standard. Assets acquired for consideration significantly less than fair value would be carried at amounts based on fair value and any related obligations would be recognised.

16 However, not-for-profit entities might have entered into countless transactions that could be considered ‘gap transactions’. Requiring those entities to remeasure assets arising from those transactions to their fair value, either on transition or as at the date of acquisition, would impose significant costs on those entities. Arguably, the benefit to users of the financial statements of such a transition requirement would not outweigh the costs to not-for-profit entities.

17 Requiring not-for-profit entities to remeasure assets arising from those transactions to their fair value, either on transition or as at the date of acquisition, would impose significant costs on those entities. Arguably, the benefit to users of the financial statements of such a transition requirement would not outweigh the costs to not-for-profit entities.

Option 2: Extend 'completed contracts' transition relief to 'gap transactions'

18 The Board could extend the 'completed contracts' transition relief to 'gap transactions'. This would mean that the cost of assets acquired for significantly less than fair value at acquisition is carried forward ('grandfathered') on application of AASB 10XX.

19 While Option 1 has the benefit of a consistent fair value measurement approach to all assets acquired for consideration that is significantly less than fair value, staff acknowledge that the costs of that approach could outweigh the potential benefits. This is particularly the case for entities that have many assets currently recognised at cost but which would ordinarily be measured at fair value under AASB 10XX.

20 However, this option would introduce a mixed measurement outcome for assets acquired for consideration that is significantly less than fair value. Those acquired prior to the application of AASB 10XX (for more than a nominal amount) would continue to be measured at cost. Other assets acquired under similar circumstances after transition to AASB 10XX would be initially measured at fair value. Furthermore, any ongoing obligations that might exist for assets recognised prior to transition would not be recognised. This is similar to the outcome of the concession for 'completed contracts'.

Option 3: Provide no relief

21 The rationale for this option is similar to that in option 1. However, entities would be required to determine the fair value of the assets arising from 'gap transactions' as at the date of acquisition of the asset.

22 This approach would impose significant additional costs on transition for only marginal benefits. Accordingly, staff do not recommend providing no transition relief for 'gap transactions'.

Staff recommendations

23 Staff recommend transition option 1, requiring entities to remeasure assets arising from 'gap transactions' to their fair value on the date required by the transition option the entity applies. In the staff view, this approach would be most consistent going forward with the objective of the Standard. Proposed transitional requirements have been drafted in paragraphs C8–C9 of the pre-ballot draft of AASB 10XX on this basis.

24 Extending the 'completed contracts' relief to 'gap transactions' would create mixed measurement environment in an entity's financial statements for transactions that share the same economic substance. Moreover, any unrecognised obligations (such as performance obligations, provisions, etc) would remain unrecognised after transition to AASB 10XX.

Question to Board members

Do Board members agree with the staff recommendation to require entities to measure the fair value of assets arising from 'gap transactions' on transition to AASB 10XX either at the date of transition or as at the beginning of the earliest period presented, depending on the transition option chosen?

Appendix A: Example

A not-for-profit entity acquires an item of property, plant and equipment (PPE) in 2013 for $10,000 (a 50% discount on the fair value of $20,000 for the asset on the date of purchase) on condition that the entity utilise the asset in accordance with a sufficiently specific performance obligation. At the time it acquires the asset the entity determines that the acquisition is not a contribution within the scope of AASB 1004 because it transferred consideration that was greater than a nominal amount. Therefore, the entity recognises the item of PPE in accordance with AASB 116 *Property, Plant and Equipment* at cost, being $10,000. The entity's policy is to depreciate the asset on a straight-line basis over 20 years.

In 2019 the entity transitions to AASB 10XX and elects to apply the transition option provided in paragraph C3(b). For the purpose of this example assume that the performance obligation satisfies the requirements for a contract with a customer under AASB 15 *Revenue from Contracts with Customers* and has a value of $5,000 on the date of initial application of AASB 10XX. In the 6 years since acquisition the fair value of the asset rose to $35,000.

Under **Option 1** the entity must:

(a) remeasure the item of PPE to its fair value as at the date of initial application of the Standard ($35,000);

(b) review the terms and conditions of the contract and recognise and measure the performance obligation;

(c) determine if any other related amounts exist in the remaining difference between the consideration paid for the asset and the asset's fair value after recognising the performance obligation;

(d) recognise any remaining difference as income;

(e) calculate the journal entries required to recognise the relevant carrying amounts of the above elements on transition with any cumulative difference recognised as an adjustment to the opening balance of retained earnings (or other component of equity, as appropriate) at the date of initial application of the Standard.

Under **Option 2** the entity would not remeasure the asset on transition and would not recognise any ongoing obligations related to the asset. Essentially the asset would be 'grandfathered'.

Under **Option 3** the entity would apply the same process as described for Option 1 above with the exception that the fair value of the asset would be determined as at the acquisition date of the asset and the entity's depreciation policy applied to the restated value from that date.

The table below summarises the key carrying amounts arising after the application of the three transition options identified in this paper. Immediately prior to transition the carrying amount of the asset, taking depreciation into consideration, is $7,000.

Element	**Option 1 (fair value at date of application) $**	**Option 2 (no requirement to fair value) $**	**Option 3 (fair value at acquisition date) $**
Carrying amount of asset on transition	35,000	7,000[(1)]	14,000[(2)]
Performance obligation	5,000	–	5,000
Opening retained earnings adjustment	23,000[(3)]	–	2,000[(4)]

(1) $10,000 – [6 × ($10,000 ÷ 20)] = $7,000

(2) $20,000 – [6 × ($20,000 ÷ 20)] = $14,000

Note, the formulas below determine the amount to increase the value of the asset on transition (given a carrying amount of $7,000 immediately prior) and subtract the value of the recognised performance obligation to arrive at the adjustment to opening retained earnings.

(3) ($35,000 – $7,000) – $5,000 = $23,000

(4) ($14,000 – $7,000) – $5,000 = $2,000