

Ms Kris Peach
Chair
Australian Accounting Standards Board
PO Box 204
Collins Street
West Victoria 8007

14 August 2015

Invitation to comment - AASB Exposure Draft ED 260 *Income of Not-for-Profit Entities*

Dear Ms Peach

Ernst & Young Australia ('EY', 'we', 'us') is pleased to provide comments on the Australian Accounting Standards Board's ('AASB's') Exposure Draft ED 260 *Income of Not-for-Profit Entities* ('ED 260' or 'ED').

We support the proposal to remove the reciprocal/non-reciprocal distinction that AASB 1004 *Contributions* ('AASB 1004') has created, and replace it with income recognition requirements which are linked to the satisfaction of performance obligations. We note that there is currently diversity in income recognition practices among not-for-profit ('NFP') entities and we consider that ED 260 would provide a more robust basis for determining the timing of income recognition and, therefore, assessing a NFP entity's performance. We also believe that this proposal will lead to greater consistency in revenue and income recognition between the for-profit and NFP sectors, consistent with the AASB's aim of transaction neutrality.

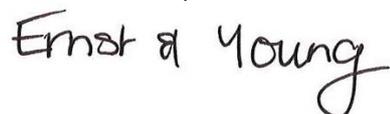
While we support the AASB's proposal, we believe that some revisions and additional application guidance is needed in specific areas so that the proposed requirements can be effectively applied in practice. In particular, we recommend:

- ▶ providing additional application guidance and illustrative examples on the assessment of whether a promise is sufficiently specific (especially for specified-purpose grants);
- ▶ simplifying the identification of a donation component; and
- ▶ providing some transition relief associated with the retrospective application of the proposed requirements.

We also believe it is important to distinguish the circumstances under which a NFP would either recognise revenue or income from a transaction that is in the scope of the draft Standard. It would also be important to clarify how the terms 'revenue' and 'income' are to be interpreted and applied to avoid confusion when these terms are used for other purposes (such as applying the Australian Charities and Not-for-profits Commission ('ACNC') reporting thresholds or for other contractual or regulatory purposes).

We provide more detail on the areas outlined above, and various other relevant matters, in the Appendix as responses to the specific questions asked in the ED. Should you wish to discuss the contents of this letter further with us, please contact Georgina Dellaportas (georgina.dellaportas@au.ey.com or (03) 9288 8621) or Anne-Marie Johnson (anne-marie.johnson@au.ey.com or (02) 9248 5537).

Yours sincerely



Ernst & Young

Appendix

Question 1

In relation to the AASB's proposal to replace the reciprocal/non-reciprocal transfer distinction in AASB 1004 with income recognition requirements based on whether a not-for-profit entity needs to satisfy a performance obligation:

- a) do you agree that this proposal would provide a faithful depiction of a not-for-profit entity's financial performance?
- b) if not, what alternative approach to income recognition would you recommend for not-for-profit entities? Please provide your reasons.

We agree with the proposal to base income recognition for NFP entities on the performance obligation concept as set out in AASB 15 *Revenue from Contracts with Customers* ('AASB 15'). For the reasons outlined below, this approach provides a more suitable basis for income recognition than that which is based on whether the transaction is reciprocal or non-reciprocal in nature.

Faithfully depicting financial performance

Revenue and income are, and should continue to be, important measures for assessing the financial performance of an entity, regardless of whether the entity is a for-profit entity or a NFP entity. AASB 15 specifies that revenue is recognised only when an entity transfers a promised good or service to a customer, thereby satisfying a performance obligation in the contract. Accordingly, the amount of revenue recognised in a period generally will be a measure of the entity's performance in transferring goods or services to the customer during that period (subject to AASB 15's constraint on revenue recognition). In our view, income recognition, and therefore assessment of a NFP entity's financial performance, should be based on the entity's performance in transferring goods or services to the parties identified in the arrangement (such as the customer/grantor or to a beneficiary identified by the customer). Consequently, in our view, a NFP entity should recognise income 'upfront' only when the NFP entity is not required to transfer any goods or services to other parties.

In contrast, the income recognition requirements in AASB 1004 have two main shortcomings:

- ▶ Firstly, AASB 1004 can inappropriately skew the depiction of a NFP entity's financial performance. This is because, as noted in paragraph BC6 of ED 260, a NFP entity may be required to recognise income prematurely on receipt of a grant arising from a non-reciprocal transaction even though the entity may have remaining obligations to transfer goods or services to other parties. In other words, AASB 1004 can result in the timing of income recognition failing to correspond with a NFP entity's performance in the transaction to which the income relates.
- ▶ Secondly, as also noted in paragraph BC6, there are differing views on the meaning of a 'non reciprocal' transfer. Some professionals read the definition broadly; others narrowly. As a result, there is diversity in the income recognition practices of NFP entities that have economically similar transactions.

In our view, the income recognition requirements of AASB 1004 need to be replaced because these shortcomings risk adversely affecting the perception of financial reporting in the NFP sector.

Alternative income recognition approaches

We recommend that the AASB's focus should be to further develop and refine the proposed requirements in ED 260 based on the feedback received in response to this exposure process. Requiring NFP entities to use the same basis for recognition of income arising from contracts with customers as for-profit entities, represents a positive alignment of requirements between these two types of entities and accords with the concept of transaction neutrality.

We do not envisage there would be any additional benefit from further elongating the project by pursuing alternative income recognition models. As noted in paragraphs BC7-BC14 of ED 260, the AASB has long been considering the appropriate income recognition requirements for NFP entities and, in each case, concluded that those other models would be unsuitable. We acknowledge that the 'performance obligation' approach proposed in ED 260 will not produce the level of income and expense 'matching' that many NFP entities, particularly in the private sector, are seeking. But to deliver on that perceived ideal would appear to require the AASB to develop an income recognition model that would conflict with the Conceptual Framework. We would not support such an approach. (For further comments on matching, please refer to the additional comments section of this comment letter).

More than for a for-profit entity, the performance of a NFP entity is also assessed based on non-financial measures and outcomes. Regardless of whether the proposal in ED 260 would achieve a matching or a mismatch of, say, funding and the costs of service delivery or related activities, we believe that it is important for a NFP entity to communicate sufficient information about the timing, frequency and persistence of its income streams (as sources of funding) and its associated outputs and outcomes achieved as part of its service performance. In other words, the solution for addressing concerns about income recognition by NFP entities is not necessarily in an accounting standard but in how they 'tell their story'. We recommend that the AASB further consider the interaction between its projects on income recognition for NFP entities and service performance reporting.

Question 2

In relation to the AASB's proposal that, to qualify as a performance obligation, a not-for-profit entity's promise to transfer a good or service to a counterparty in a contract must be sufficiently specific to be able to determine when the obligation is satisfied (see paragraph IG13 of Part A):

- a) do you agree with this proposal?
- b) if not, what factor or criteria should apply to determine whether a not-for-profit entity has a performance obligation? Please provide your reasons.

We agree with this proposal and consider that the requirement for a promise to transfer a good or service to have to be sufficiently specific will be an effective way to operationalise AASB 15's 'performance obligation' concept in a NFP entity environment. That said, we expect that assessing whether a promise is sufficiently specific will be challenging in practice for many transactions.

For relatively simple contracts, the judgement will likely be fairly straightforward. For example, a grant to be used for any purpose in an entity's operation clearly is not sufficiently specific to enable performance obligations to be identified. Equally, a written agreement that specifies the nature of the goods to be supplied, prices and quantities, clearly will be sufficiently specific to enable performance obligations to be identified. However, these are simple examples at either end of a continuum. The complexity, and need for significant judgement, resides in the many types of arrangements entered into by NFP entities that fall somewhere between these two examples.

As an example, consider a charity which receives three grants and each is to be used as follows:

- a) For payroll expenses in the health department
- b) For health related activities
- c) To provide dental check-ups twice yearly for primary school age children in the district of X

It is likely to be considered that a) does not meet the sufficiently specific requirement to be considered a performance obligation, while for b) and c), there is clearly more judgement involved. While we acknowledge the risk of providing examples may mean that practice is defined by those examples, we would anticipate that this 'sufficiently specific' requirement may prove to be challenging for many NFP entities. We note that the table contained in the materials sent to roundtable participants (page 4 of 12) relating to "Identifying whether a performance obligation exists" provides helpful additional guidance. We encourage the AASB to incorporate this table in the Illustrative Examples that will accompany AASB 15 and AASB 10XX.

We explain below some specific areas where we believe there may be potential issues in interpreting and applying the proposal in practice.

Refund obligations

Many transactions in the NFP sector may require a NFP entity to refund the cash (or other assets granted) if that consideration is unspent or other conditions are not met. The existence of such a requirement does not necessarily mean that the NFP entity should recognise a liability (either as a performance obligation or a refund obligation) when the consideration is received from a customer/grantor. As per paragraph 55 of AASB 15, an entity recognises a refund liability if it expects to refund some or all of the consideration received to the customer. However, at least in some cases, the existence of a refund obligation may indicate that the entity has made a sufficiently specific promise to

transfer goods or services to other parties. This is because if the promises in the transaction are not sufficiently specific, it is unlikely to be possible to objectively determine whether the NFP entity would be entitled to retain the consideration or obligated to refund the consideration.

Specificity of research grants

There is a wide spectrum of research grants that exist in the NFP sector, some of which may include promises that are sufficiently specific and others that are not. Part of the challenge is whether the nature and extent of research to be performed is, or can be, defined with sufficient specificity to be able to be identified as a performance obligation.

For example, a university obtains a research grant from a government health department, which could be structured in various ways. These may include “to investigate the health benefits of participating in marathons by monitoring the blood chemistry of 300 athletes running six marathons per year over five years”. In this case it may be considered that there is enough specificity in the arrangement to identify a performance obligation. On the other hand if the research was defined as “to undertake research into the health benefits of endurance sport”, this may be less clear as to whether there is sufficient specificity.

We recommend the AASB considers providing additional guidance on factors that may assist with the assessment of specificity of a research service. Such factors could include:

- ▶ The results of the research are provided to the grantor and in doing so, the grantor receives a benefit.
- ▶ The scope of the research is subsequently modified based on a request from the customer i.e. the fact that changes to the research can be made by the grantor, or require grantor approval, may provide evidence of specificity.
- ▶ The intellectual property arising from the research transfers to the grantor.

In some cases, it may be possible for a NFP entity to more clearly define in the grant agreement the research services that it will perform. However, this may create performance risks for a NFP entity if the NFP entity is subsequently unable to provide the services (or outcomes) specified and therefore it does not have an entitlement to that consideration.

Capital Grants

We also recommend that the AASB should clarify the accounting for capital grants. For example, a university may receive a grant to build a research facility that will take 3 years to construct and must be used for a specific research purpose. As such, the grant agreement may contain specific promises that the NFP entity must meet, being to construct a specified facility within a specified timeframe and to utilise that facility for a specified purpose. However, because the grant will be used to create or enhance an asset of the NFP entity rather than to directly provide a good or service to other parties, it is unclear whether these promises would be identified as performance obligations. Clarification on this issue is welcomed.

Question 3

Do you agree with the proposal in paragraphs IG19-IG30 of Part A that a not-for-profit entity would recognise a donation component in a contract with a customer as immediate income only if:

- (a) A qualitative assessment of available evidence indicates that the customer intended to make a donation to the not-for-profit entity; and***
- (b) The donation component is separately identifiable from the goods or services promised in the contract? (See also paragraphs BC36-BC49 of the Basis for Conclusions.)***

If not, under what circumstances should a not for profit entity identify and account separately for a donation that is provided as part of a contract with a customer?

We believe there is scope to simplify the assessment of whether a contract with a customer includes a donation component by converting the proposed 2-step assessment into a single step assessment. While we understand that the AASB intended for the 'Step 1' qualitative assessment (as set out in question 3(a) above) to act as a filter to restrict identification of a donation component to those cases where an entity has reason to conclude a donor intended to make a donation, we are concerned that the application of this step may be misunderstood in practice as requiring a NFP entity to make extensive customer inquiries to establish the customer's intent in each contract. (Note: If the AASB decides to retain the 2-step assessment, we recommend that the intent of the 1st step in the assessment should be clarified within the implementation guidance (rather than in the Basis for Conclusions). However, without changing the intended outcomes, we believe these concerns could be addressed and the assessment of whether a contract includes a donation component could be simplified. This could be achieved by requiring a NFP entity to account for a donation separately if the entity's entitlement to retain that donation was not conditional on that entity transferring a good or service to the customer (donor). That is, regardless of whether donor intent can be observed, the main determinant of whether a donation component exists will be the refund status. Therefore, we believe only criterion IG24(b) needs to be satisfied for a contract to have a separately identifiable donation component

We do however note that using a refund policy as a determinative factor is not without challenge. For example, it is common practice in both the for-profit and NFP sectors to offer refunds on goods and/or services net of a processing or administration fee. We suggest the AASB should consider clarifying that a customer's entitlement to a net refund does not automatically imply that the contract includes a donation component for the non-refundable amount. Because the identification of a donation component is made at inception of the transaction, we recommend that a NFP entity should assess the transaction and its customary practices to identify the circumstances in which it may withhold a portion of the consideration if the promised goods or services are not transferred and evaluate whether the reason for withholding an amount would be consistent with the amount being a donation.

Question 4

In relation to the AASB's proposals to:

- (a) permit any not-for-profit entity to recognise volunteer services as income if the fair value of those services can be measured reliably; and*
- (b) carry forward the requirement in paragraph 44 of AASB 1004 that particular public sector entities must recognise volunteer services if those services would have been purchased if they had not been donated,*

the AASB seeks views on:

- (a) whether the requirements (if any) for the recognition of volunteer services should be the same for all not-for-profit entities regardless of whether they operate in the public or private sector; and*
- (b) if your answer to a) is 'yes', whether the recognition of volunteer services should be:
 - (i) optional, provided that the fair value of those services can be measured reliably; or*
 - (ii) required if those services would also have been purchased if they had not been donated.**

In our view, the requirements for recognition of volunteer services should be the same for public and private sector NFP entities. That is, if the donated services would have otherwise been purchased, then it is equivalent to a cash donation and the cash is used to purchase those services. This would therefore make it mandatory for all NFP entities to recognise the fair value of those volunteer services (subject to reliable measurement).

Our view is that it provides useful information about the resources under the control of the NFP and that the benefits to users of having consistent information across the sector outweigh any additional costs associated with compiling the information. For example, a charity receiving pro bono legal services and one paying for legal services would be required to recognise similar costs. Also, from the perspective of raising awareness, this would assist in highlighting that these volunteer services are critical to operations, for example, volunteers for Country Fire Association Brigades and Surf Lifesaving Clubs providing weekend lifesaving services.

We note that there currently is diversity in practice, and that NFP entities may wish to broaden the scope of reporting in this area beyond financial reporting. For example, volunteer hours and the related financial impacts may provide useful information on the ability of a NFP entity to attract support for its cause, and may be used as a key performance indicator in management reporting.

Question 5

Do you agree with the proposal in paragraph 38(sic) of [draft] AASB 10XX that, when inventories are donated to a not-for-profit entity other than as part of a contract with a customer, assessments of whether the donations are material should be made on an individual transaction basis without reassessment at a portfolio or other aggregate level? (See also paragraphs BC50-BC51 of the Basis for Conclusions.)

We agree that consistent with current guidance, individually immaterial items should not be recognised. We do not believe it is necessary to explicitly refer to materiality judgements with respect to the unit of account within the proposed Standard. Current practice in this area varies, with some charities setting, as a matter of accounting policy, a de minimis threshold value for recognition of donated items, while others apply a dollar value per unit of weight of donated items. Paragraph BC52 of the ED uses the word 'elect' which could be interpreted as suggesting that entities have an accounting policy choice in relation to the recognition of individually immaterial items. However, paragraph 31 of the ED would seem to preclude an entity electing to recognise donated items on an aggregated basis. We would recommend the AASB provides additional clarity in this area.

Question 6

Australian Accounting Standards applicable to for-profit entities do not include a definition of 'contributions by owners'. Further, concerns have been expressed by some that the definition of 'contributions by owners' in AASB 1004 is too narrow. Do you consider that a definition of 'contributions by owners' is still necessary, or appropriate, in Australian Accounting Standards? If so, would you prefer using:

- (a) the definition of 'contributions by owners' presently in AASB 1004; or*
- (b) the definition of 'ownership contributions' in the Public Sector Conceptual Framework issued by the International Public Sector Accounting Standards Board (IPSASB)? (See also paragraphs BC84-BC91 of the Basis for Conclusions.)*

We consider that a definition of 'contributions by owners' is not necessary. As noted in BC86 of the ED, there is currently no definition of contribution by owners in IFRS. Currently, entities in the for-profit sector identify equity transfers without reference to a definition in the standards, and in our view, removing the definition in AASB 1004 will not create problems in the NFP sector. In practice, public sector NFP entities look to instructions issued by the Department of Treasury and Finance (or equivalent) of their jurisdiction to determine whether a transaction is designated as an equity transfer. In our view, we believe the relevant treasury issued requirements in each jurisdiction are well placed to promulgate accounting policy guidance in accounting for contributions by owners, that is consistent with Australian Accounting Standards without requiring specific requirements to be included in this Standard.

Question 7

The AASB also seeks views on the following issues related to contributions by owners:

- (a) whether, in view of concerns expressed by some that using AASB 1004's definition of 'contributions by owners' in AASB interpretation 1038 Contributions by Owners Made to Wholly -Owned Public Sector Entities (which includes for-profit public sector entities in its scope) might prevent a for-profit entity in the public sector from making an unreserved statement of compliance with IFRSs, AASB Interpretation 1038 should be:
 - (i) withdrawn;*
 - (ii) retained but with narrower application [that is, limited to not-for-profit entities in the public sector, and possibly also confined to identifying which not-for-profit public sector entities should account for transfers between them when they are controlled by the same parent (government)]; or*
 - (iii) retained without amendment (See also paragraphs BC84-BC94 of the Basis for Conclusions)**
- (b) whether requirements for restructures of administrative arrangements (presently set out as paragraphs 54-59 of AASB 1004) should still be included in Australian Accounting Standards (see also paragraph BC90(b) of the Basis for Conclusions);*
- (c) whether requirements for distribution to owners (presently set out as paragraphs 49 and 53 of AASB 1004) should still be included in Australian Accounting Standards (see also paragraphs BC94-BC96 of the Basis for Conclusions);*
- (d) whether requirements for liabilities of government departments assumed by other entities (presently set out as paragraphs 39-43 of AASB 1004) should still be included in Australian Accounting Standards (see also paragraphs BC97-BC98 of the Basis for Conclusions); and*
- (e) the practical implications if the definition 'contributions by owners' and AASB Interpretation 1038 were to be withdrawn?*

We believe Interpretation 1038 should be withdrawn. We do not believe its withdrawal would result in any significant change in practice in this area, as we consider that the relevant existing treasury requirements provide adequate guidance.

Question 8

In relation to disclosure requirements regarding compliance by government departments with appropriations, do you agree with:

- (a) omitting the requirement in paragraph 64(e) of AASB 1004 to disclose the nature and probable financial effect of any non-compliance by the government department with externally-imposed requirements for the period, other than any non-compliance reflected in material variances between amounts appropriated and amounts expended? (See paragraphs BC99-BC103 of the Basis for Conclusions.)*
- (b) extending the scope of the retained disclosure requirements for government departments (ie those regarding any non-compliance reflected in material variances between amounts appropriated and amounts expended) to also apply to any other public sector entities that obtain part or all of their spending authority from parliamentary appropriations? (See also paragraphs BC99-BC103 of the Basis for Conclusions.)*

We have no comments in relation to question 8.

Question 9

Do you agree with the proposed transitional provisions in Appendix C of [draft] AASB 10XX? In particular:

- (a) Do you agree with the transitional provisions for non-financial assets and finance lease assets and liabilities, the cost of which was not measured at fair value on initial recognition; and***
(b) Do any other issues warrant additional transitional provisions and, if so, which transitional provisions do you suggest? (See also paragraphs BC104-BC109 of the Basis for Conclusions.)

We consider the proposed transition requirements to be unduly onerous and believe that the cost of gathering data will, for many entities, outweigh the benefits realised. We would encourage the AASB to consider less onerous requirements and would support, for example, an approach similar to that adopted on transition to IFRS, i.e., an ability to use a deemed cost approach in certain circumstances.

This is particularly the case for finance leases with peppercorn lease payments where fair value should be determined at the beginning or end of either the initial period of application or the comparative period rather than fully retrospectively.

Other matters

Revenue/income distinction

We would recommend the AASB provide further clarification as to whether donation components identified are to be presented as income or revenue. There is concern in the sector as to how the presentation of these amounts may impact the application of the thresholds for various reporting requirements and the potential impact of recognising additional donations under the proposal in the ED.

Matching concept and NFP income recognition

NFPs (particularly in the charities sector) have a mission or objective that they set out to achieve. They may obtain various sources of funding to achieve their mission/objective. This might include:

- ▶ fee-for-service contracts – these may be commercial in nature but are undertaken because providing these services would be consistent with the NFP's mission/objective
- ▶ specified-purpose grants – these grants may require the NFP to perform specific actions that could be regarded as a performance obligation under the application guidance
- ▶ general-purpose grants – these grants may be provided routinely, such as annually, and without substantive conditions/restrictions attached
- ▶ donations – these are discretionary inflows that may not be received routinely and without substantive conditions/restrictions attached.

Because the risk, predictability and persistence of each of these transactions / cash flow streams are different, accounting for each them in the same way risks denying a user of an NFP entity's financial statements of sufficient information to assess an NFP's financial performance and financial position. As also noted earlier in the comment letter, we believe that introducing a matching concept in those cases where an entity does not have a performance obligation or a present obligation to refund monies would result in the income statement treating very different transactions in a similar manner, and would not be helpful for users.