

The Chair  
Australian Accounting Standards Board  
PO Box 204  
Collins Street West  
Victoria 8007

14 August 2015

Dear Madam

**EXPOSURE DRAFT ED 260 *INCOME OF NOT-FOR-PROFIT ENTITIES***

Thank you for the opportunity to comment on the proposals to amend accounting for income by not-for-profit entities.

We are generally supportive of the proposals included in ED 260 (including for donations), but are looking for the standard to provide a wider application of 'substance over form' for 'funding arrangements' from governments and/or corporate entities. Please refer to Appendix 1 for our comments in this regard.

We also note the absence of paragraphs AG30-AG34 that have been referenced on several occasions in the ED.

If you have any comments regarding this request, please do not hesitate to contact Sheryl Levine at [sheryl.levine@bdo.com.au](mailto:sheryl.levine@bdo.com.au).

Yours faithfully

**BDO Australia Limited**



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## RESPONSES to QUESTION 2

Question 2 is requesting feedback on whether we agree with the AASB's proposal that, to qualify as a performance obligation, a not-for-profit (NFP) 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).

### BDO view

We agree with scrapping the concepts of reciprocal and non-reciprocal transfers. However, we are concerned that the new principles for deferral of income are still too strict, and hurdles too high for grant income/funding arrangements to be deferred and recognised as revenue at a time that is more reflective of the NFP's operations. In many cases grant income/funding may be received, with no refund clauses, prior to 30 June (year-end), and funds will only be spent in a subsequent period.

Therefore, we do not support this proposal in Question 2, and we have identified practical application issues with the whole of paragraph 8(a)(i) of Accounting Standard 10XX *Income of Not-for-Profit Entities*, namely, the requirement that in order to qualify for income deferral, the transaction must arise from:

- A contract with a customer, where that contract/agreement is enforceable, and
- The contract must include 'sufficiently specific' promises to provide goods and services.

Our discussion below focusses on both aspects of income deferral by not-for-profit entities.

### Enforceable agreement

In practice, in order to reduce costs of 'red tape', funding arrangements between grantors and NFPs often can be less formal and legalistic than what might occur in the private sector for corporates.

The funding agreement is often merely a written agreement (few pages), rather than a formal contract. These 'agreements' are silent on whether the agreement is enforceable, and may not include an explicit clause whereby non-acquittal requires repayment of unspent funds.

Sometimes, funding is received based on an application form, and there is no written agreement once the application is approved.

We also see cases of 'informal funding arrangements' between NFPs and government agencies or corporates.

In the case of NFPs' arrangements with government, we note that the core purpose of funding agreements is to set out the fundamental objectives to be achieved. Therefore these agreements can be focused at maximising service capabilities and be open-ended, depending on the goal of the NFP and government. Consequently, the 'sufficiently specific' criteria required may not be clearly communicated, and/or be vague on purpose so as to not limit the NFP's options on achieving its set goals.

We also note instances where agreements are rolled over for multiple years at the discretion of the department, and/or the terms are not strictly adhered to by the departments for budgetary

reasons. These circumstances add additional layers of judgement with respect to the application of the ‘sufficiently specific’ criteria. Given NFP’s limited finance resources, these issues can make managing them more difficult.

To force entities down a path that requires them and the funding body to write funding arrangements that meet all the requirements of IG3-IG8 would be a costly and time-consuming exercise for very little benefit. IG 5 refers to the agreement being enforceable if it contains a penalty for non-performance that is ‘sufficiently severe to compel’. The practical consequence to these entities if they do not spend funding as implied is that they do not receive ongoing funding and risk significant reputational damage to such a point that it does compel them to use the funds appropriately (substance over form).

### Sufficiently specific promises

Further to our comments on the ‘enforceable agreement’ above, in all the above cases there is often merely an implicit understanding that the funding is to be spent in line with the altruistic purpose of the entity. Arrangements often do not refer to a specific project/programme, but will be provided for the entity to meet its altruistic purposes. Without having it specifically written into an agreement, such entities will be ‘sufficiently compelled’ to meet the performance obligation or its ability to continue as a going concern could be in doubt.

We therefore expect that the requirements for an ‘enforceable agreement’ will be difficult to meet for these arrangements, and fail to take cognisance of the substance of the grant, i.e. to provide a funding arrangement rather than an ad hoc donation, where entities would have complete discretion on use of funds. Some examples are provided below.

#### **Example 1: Collaborative research centres and/or research funding**

Funding is often provided for research projects into issues with an altruistic purpose, e.g. in medical research, agriculture, automotive, innovative technology etc. The terms of the funding arrangement will often not refer to a specific project/programme but will be provided for the ‘ongoing’ research operations of the entity.

A ‘farmer’s federation’ could spend money on various research projects around soil, weather, infectious diseases, etc. The funding agreement allows them discretion as to how to best use the funds, based on priority and demand. Such funding is unlikely to meet the ‘sufficiently specific’ criteria for income deferral under the proposals because of insufficient specificity of performance obligations.

#### **Example 2: Promotion of the arts**

Certain government bodies provide funding for ‘promotion of the arts’ to theatres, production companies, galleries, etc. Funding agreements often do not specify how the funds should be spent.

An example would be where funding for the performance of Romeo and Juliet implies an enforceable agreement and performance obligation that the funds will be used to put on plays and performances. The recipient has discretion as to how they spend the money to meet these objectives.

A situation could arise, for example, where Romeo and Juliet has been overdone so the recipient chooses to put on Hamlet instead. The funder would consider that the performance obligation has still been met. Such implied performance obligations are also unlikely to meet the ‘sufficiently specific’ criteria under the proposals.

**Example 3: Corporate funding for promotion of the arts**

A performing arts not-for-profit entity has planned interstate performances in July 2015. In June 2015, Qantas and Sheraton provide funding through the provision of xx airfares and xx accommodation.

The written arrangements are general in nature and refer to the use of airfares and accommodation within the altruistic pursuits of the organisation. The implied intent behind the funding is to provide airfares and accommodation for the troupe interstate for the July 2016 performance. Balance date is 30 June 2015.

The implied intent gives rise to a performance obligation to use the airfares and accommodation in July while the interstate performances are running. As such it makes commercial sense to defer the funding on the balance sheet at 30 June 2015.

In this case, the recipient went back to Qantas and Sheraton and asked them to amend the agreement to explicitly state that the airfares and accommodation were to be used between July 2015 and June 2016 so that they could achieve deferral under the current standards. The corporate funders did so begrudgingly. In our opinion, this is a case of accounting standards dictating how businesses conduct themselves and costs and time incurred for no extra benefit (a case of the ‘tail wagging the dog’).

**Example 4: Separately identifiable donation component of a contract with a customer**

While the concept of separating the contract revenue and donation from a customer is sound, one area of concern is the requirements for NFPs

- To understand the intention of the customer (IG21(a)), and
- To separately identify the donation from the goods or service (IG21(b)).

For certain NFPs in the university and health sector, some agreements combine research and development, delivery of the NFP’s core mission, and delivery of regular goods and services. Therefore understanding the intention is not necessarily clear cut. Specific guidance is necessary to assist NFPs to apply the correct treatment under either AASB 15 or AASB 10XX.

An example where the criteria for separately identifiable goods and services could become complex is as follows:

A university hospital which is a NFP undertakes training, treatment and research into preventable diseases. During the year, the hospital signed a contract/agreement with the following terms:

- A medical imaging manufacturer supplied a revolutionary new type of medical imaging machine to the hospital at no cost.
- The core missions of the hospital is the research and development into cutting edge technology in the prevention of diseases.

- The new medical imaging machine can be utilised for treating full fee paying patients, but the hospital is also planning to use the machine to develop new types of medical procedures.
- The same manufacturer also signs a contract for the supply of servicing and consumables for the medical imaging machine for five years, and
- For new medical procedures developed by the hospital, the intellectual rights to this development will be held jointly with the medical imaging manufacturer.

It is clear from this example that the medical imaging manufacturer benefits when the university hospital develops a ground breaking medical procedure as follows:

- Commercial interest in selling consumables and servicing
- Corporate social responsibility for curing disease, and
- Investment into research and development which will enhance the company's potential further application of its machines in medicine.

As the accountant for the NFP hospital, how could you be reasonably expected to assess the intention of the manufacturer, and allocate the benefits between commercial contract and donation in this instance?

#### Capital grants

The other anomaly which we believe is in need of remedying is the treatment of capital grants for NFPs. Many NFPs receiving a capital grant to construct an asset (building) recognise income up front under AASB 1004 *Contributions*. In the majority of instances, we believe the agreement is 'sufficiently specific' around the return of funding if the building is sold or ceases to be used for its intended purpose. However, this concept is not incorporated into the accounting for the asset e.g. the NFP must repay capital grants where the asset is not utilised for the intended purpose over the life of the constructed asset.

We believe the treatment of such capital grant should be aligned with the method of accounting used by for-profit entities under AASB120 *Accounting for Government Grants and Disclosure of Government Assistance*. Under this method, capital grant revenue is deferred over the period the benefit is received e.g. in line with amortisation of the asset.

Two specific examples of this issue are:

- Non-government schools receive a block or capital grant for the construction of a building. The block grant agreement specifies that if the school ceases to use the property for its intended education purposes, then an amount is refundable to the government. The refund amount is determined using a time based formula. The generally accepted accounting for this grant is to record it as income at the completion of the building and disclose a contingent liability as a note to the financial statements for the period of the block grant agreement.
- Private NFP entities that build and operate social housing facilities. The Government agreements have similar conditions to the school grants, but the refund amount has a different formula, and the government will often take a security over the subject property to protect its position. There appears to be some diversity in practice for the accounting, with some entities choosing to record capital grant income on completion of construction, and others deferring over the life of the agreement.



We are of the view that the Implementation Guidance in the proposed standard needs to cover capital grants as these are common transactions in the sector, specifically addressing whether the 'sufficiently specific' criteria under AASB 15 are met for these types of capital grants because this would achieve a similar accounting result to AASB 120.