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Online submission: www.aasb.gov.au

Dear Kris

Income for Not-for-profit Entities - Fatal flaw review

Thank you very much for the opportunity to comment on the Fatal Flaw Drafts of the Income for Not-for-Profit Entities amendments.

I have been closely following this project. I have also been following the broader topic for many years, including making contributions to submissions on ED 125 Financial Reporting by Local Governments.

I support the AASB's approach of focusing on performance obligations in funding agreements with not-for-profit (NFP) entities. I believe that as funding of many NFP entities moves from a block funding approach to a fee for service approach, NFP entities will need to deal with the issues addressed by AASB 15. These issues include those addressing what services need to be provided under the agreement, when those services are performed, and dealing with incentives and penalties.

I believe that the following matters be further clarified and harmonised:

- An entity's customary practice in performing or conducting its activities and the recognition of obligations.
- The sufficiently specific criteria, particularly with non-financial assets.
- Return obligations and accountability practices. In particular, is there a liability if accountability is not implemented, or cannot be implemented?

I do not agree with the requirements to measure leases under AASB 16 (that were formerly operating leases) that have below-market terms at fair value. The requirements of AASB 16 are to measure right-of-use asset at the lease liability. If an amount needs to be valued, it should be the market rentals for the lease, which is then used to determine a notional lease liability, that would otherwise be used as the recognition amount for the lease asset.

Regards,

David Hardidge

1 Applying the AASB 15 principles

The main elements in applying AASB 15 are the concepts of enforceability and sufficiently specific.

1.1 Enforceability

I do not believe that the draft standards have adequately applied the concept of enforceability to the NFP sector, that is referred to in paragraph F9 of an “entity’s customary practice in performing or conducting its activities”.

I interpret the concept of enforceability as being key in determining whether there is obligation. In particular, an obligation to provide future goods and services.

In the for-profit private sector, I agree that for an obligation to exist, it usually needs to be enforceable. I describe the situation as often being the nature of “so sue me” if you want to have something done.

On the other hand, I view the NFP sector as being based on a “my word is my bond” approach. This approach is not premised on someone having to go to court or similar structures to get things done. I view the NFP sector as premised on that if they say they will do it, they will do it. Particularly in the private NFP sector which is dependent on public trust for future funding.

This is similar to the application of the constructive obligation in the for-profit private sector. In particular, mining rehabilitation provisions. While these may have certain minimum legal obligations, additional amounts are recognised based on public statements and past practices. Companies tend to do as they promise in these situations, in order for them to keep their “social licence”.

While the draft standards refer to public statements and past practices, the standards do not sufficiently apply those actions in establishing an obligation (and consequently a liability).

For example, proposed AASB 15 paragraph F9 refers to “that entity’s customary practice in performing or conducting its activities”. This would include the constructive obligation approach I described above. As I stated above, the examples should further apply these concepts.

An important issue when evaluating enforceability (i.e. is there an obligation), particularly with the examples, is whether there can be enforceability if there is no mechanism for acquittal or reporting for the money spent.

I have not researched fully the implications of if the enforceability criterion not being met, so the funding arrangement is excluded from AASB 15, and whether the arrangement can be accounted for under AASB 10XX. In particular, meeting paragraphs B19 – B20 constructive obligations.

1.2 Sufficiently Specific

I do not believe that the draft standards have adequately applied the concept of sufficiently specific in the examples.

Some of the examples appear to require that for sufficiently specific, a specific number of activities to be performed (e.g. counselling services).

I believe that spending on the activities of the organisation may be able to meet the sufficiently specific criteria. For example, with one project funding arrangement (grant) I was involved with, the funding was to be used for identified expenses. We had to account for those particular expenses. Given the accountability requirements, the expenses were sufficiently specific for that task, and should meet the sufficiently specific criteria for the standards.

1.3 Acquire or construct a non-financial asset for own use.

The draft standards seem to imply that receiving funds to acquire or construct a non-financial asset does not lead to an obligation after acquisition or construction.

I do not agree.

If cash can be received by a NFP to conduct future activities to the public, and can be recognised as an obligation, then receiving a non-financial asset to be used in those same activities should also be recognised as an obligation.

Certainly it would usually be a lot easier to determine whether a non-financial asset (e.g. building) is used for the specific activities, rather than comingled cash.

2 Specific Comments – AASB 15 Application Guidance

F32 Appears to require that the magazine subscription would be refundable in full. I would expect that in practice, the subscription would only be partially refundable. For example, being reduced proportionately for the remaining time.

IE3 Example 1
I agree that the MOU could be sufficiently binding to be an obligation. The examples in the draft standards should follow this approach.

Example 3

Is the assumption of the government (who provided the funding) usually the owner of the IP? I understood that the government usually provided the funding, for the public benefit, but the university retains the IP.

I do not believe that the ownership of the IP is critical to determining whether there is an obligation for the university to expend the funds for public benefit.

I accept that the approach gets over the practical implementation for universities of trying to account for thousands of research contracts spread throughout the university.

Example 4

To make the example more realistic I suggest using a different value between the notional amount allocated to the meal and the fair value. Preferably, the reference to the \$200 fair value should be removed. Including the reference implies that NFP entities will have to make an assessment of fair values for dinners.

I think it would be very difficult to determine the fair value of a dinner easily, given the variety of meal choices, alcohol etc.

What if there is a difference between the fair value of the dinner and the amount to be refunded?

What if there is a late withdrawal fee? Does this change things? As the amount to be refunded will no longer be the same amount as the fair value of the dinner.

I agree that there is an obligation until the dinner is provided. However, the recognition of a liability in this example contrasts to other examples, particularly those with a constructed non-financial asset, where a liability is not recognised.

3 Specific Comments – 10XX Income for Not-for-profit Entities

Volunteer Services

22 Volunteer services

There should be an expansion of guidance to include situations where the volunteer services are provided by an entity's (e.g. club) members – when it would be regarded as a contribution by owners.

35 Refers to “output methods”, which is AASB 15 terminology, without linking to AASB 15.

39 Parliamentary appropriations

While these disclosures are a carry-over from AASB 1004, I question whether these are needed given AASB 1055.

B14 Refers to condition of transfer, then changes to obligation terminology. In the examples, often a condition was not sufficient to be recognised as an obligation.

Appendix C

Completed contracts do not have to be retrospectively accounted for.

Is a previous “donation” (i.e. agreement that fails the AASB 15 requirements) be regarded as a completed contract, even if there are still conditions related to the arrangement related to the use of the asset? It could be argued that the contract is completed under AASB 15, but it could also be argued that the contract is not completed in a legal sense because of the continuing conditions.

AusD7.1

D9 Onwards

Leases

I do not agree with the requirements to measure leases under AASB 16 (that were formerly operating leases) that have below-market terms at fair value. The requirements of AASB 16 are to measure right-of-use asset at the lease liability. If an amount needs to be valued, it should be the market rentals for the lease, which is then used to determine a notional lease liability, that would otherwise be used as the recognition amount for the lease asset. This is going to be a much easier figure to determine than the fair value of the right-to-use (say) 3 floors in a 10 floor building for 5 years, or the fair value of the right-to-use a tennis court for 5 years.

AASB 102 Inventories

What does “either of the individual item or of inventories at an aggregate or portfolio level” mean? For inventories of second hand clothing, does that mean each item of clothing, or the entire holding of clothing inventory?

AASB 116 Property, Plant and Equipment

Transition date provisions

Do you measure the fair value at date of transition, or original donation date and calculate subsequent depreciation?

4 Specific Comments – 10XX Income for Not-for-profit Entities – Illustrative Examples

IE 4

Example 4A

I do not agree that the condition is not sufficiently specific.

I think that it is the condition relating to the “principal” is never satisfied – until such time as the entity ceases operating, or providing those services.

Not knowing when you are going to pay a liability does not remove the need to recognise a liability. For example, the deferred tax liability on revalued land, or for brand names on a business combination may “never” be paid.

Example 4B

I do not understand the reference to AASB 9, and to a financial liability. Is this to the potential to return the funds because of not meeting the condition to provide student accommodation? If yes, then this guidance is applicable to other situations and examples with conditions for non-performance.

Also, I do not understand the reference to derecognition, when the entity gets to control the receipt of the “interest”.

I have seen accounting advice that for similar situations, when the entity is entitled to the interest but not the principal, that the financial asset was the right to the future interest. Given it was a right to the perpetual interest, this

arrived around the same amount as the “principal”. Which effectively meant recognising the “principal” as the asset anyway.

Example 4C

The recognition of a contract liability to provide future services contrasts with other examples where a non-financial asset is received to be used to provide future services.

I believe that receipt of financial assets and non-financial assets with similar conditions should be accounted for similarly,

IE 5

Example 5

As noted above, I believe that preparers should have to fair value the market lease rentals and determine a notional lease liability, rather than to have to fair value a right-to-use asset.

I believe that using the facility for providing charitable services is sufficiently specific. It should be fairly clear what the facility is being used for – does it meet the local government’s condition or doesn’t it. If the charity does not meet the condition, then I presume it is liable for eviction / return of the right-to-use asset.

Even if the requirements of AASB 15 are determined as not being met, then I believe that there is a constructive obligation to provide charitable services from the facility (which contrasts to the conclusion in the example).

I believe that the accounting for this arrangement should be the same as for Example 4C – the entity has been provided an asset to provide (sufficiently specific) services for a defined period of time. Consequently a performance obligation should be recognised.

IE 6

Example 6

I believe there is an obligation not to spend the money between receiving it (31 May 20X0) and the starting of the funding period (1 July 20X0).

This condition / obligation is sufficiently specific. None of the money is to spent. The entity therefore needs at least the amount received in its bank account between those dates.

I disagree that the entity has a discretion to spend the money before 1 July 20X0 or not – or at least no different to a private sector entity having the “discretion” not to deliver under a AASB 15 contract.

Consequently, on receipt of the money, a liability should be recognised. Whether the amount is recognised under AASB 15 or AASB 137.

At 1 July 20X0 then the amount may have to be recognised in full, depending on the assessment of other criteria in AASB 15.

IE 6

Example 7C

Is the assumption that the remaining funds not spent on wells, be spent in Kenya? If so, then I think a sufficiently specific condition exists. If donors provided money knowing that it would be used for water wells in Kenya, or if there was a surplus, still spent in Kenya, then I do not think they would mind.

I raised earlier the issue of if there is no acquittal / reporting back, can the promise be sufficiently specific.

For example, if there is no tracking of the money being spent on wells, because donors are not really fussed as the money is going to be spent in Kenya anyway, is the promise sufficiently specific?

Example 7D

Is this example realistic? Returning unspent funds for a series of \$200 donations?

I believe an example with a series of small value donations is important. I think the above example (excess funds used in the country where the wells are being built) is more realistic.

Also, is it realistic to expect that the charity account for and track the construction of wells for each donation? The example refers to each donation being a contract liability.

I do not think the example realistic. As what happens if one well is more remote than the others and requires extra funds over the \$200. Can you use the funds from another donation, even if that donation is specific to 2 wells, without causing accounting problems?

I do not think the portfolio approach could be used, as the return of surplus funds (that seems to be determined on a donation by donation basis), was a critical assumption.

IE 6

Example 8A

The example should have the funds being received before 1 July 20X1, consistent with common practice, and various comment letters.

As noted above under Example 6, I believe there is an obligation not to spend the money between receiving it (whatever date) and 1 July 20X1. I also believe that the obligation is sufficiently specific as there is an implied requirement to have a bank balance exceeding the amount provided (i.e. none spent) during that period.

Example 8B

One of the assumptions is that the State Government can enforce the repayment of the grant if it does not apply the funds to its education program. How is this achieved? The acquittal / reporting requirements do not seem to be able to distinguish between the commingled funds in providing the activities.

I do not see any substantive difference between this example, of the State Government providing funds for the education program, and other situations of providing funds for general activities, where the cash is comingled. I agree that situations like this should be able to be recognised as a performance obligation.

Accounting entries – the date of 30 June 20X2 should highlight if the entry is an aggregation of all entries for the year ended that date, or an entry processed on that date.

IE 7

Example 9 – Cash grant for construction of a building

Similar to my views above for Example 5, I believe that using the facility for providing early learning programs is sufficiently specific. It should be fairly clear what the facility is being used for – if the school does not provide the programs from the facility, then the school has a return obligation.

Consequently, I believe that either an AASB 15 obligation, or an AASB 137 obligation exists. This obligation would be satisfied over the 10 year life of the building.

Accounting entries – the date of 30 June 20X2 and 30 June 20X3 should highlight if the entry is an aggregation of all entries for the year ended that date, or an entry processed on that date.

Example 10

The example is confusing. The example states that the grantor does not control the hospital, so presumably the grant is not to one of its state controlled hospitals.

I understand that the Federal Government is the body that generally funds private sector hospitals.

Irrespective, I have assumed that the State Government is providing the funds in order to provide further services under its objectives for public health in that state.

This example is inconsistent with the approach of the standards in applying the private sector AASB 15 to the NFP sector. In particular, AASB 15 paragraph F6.

That paragraph explains that a customer (in the context of AASB 15) is the entity that directs where the goods and services are provided, and that such goods and services can be provided to third parties.

I believe that the arrangement would potentially come under AASB 15.

I believe that the use of the beds in providing services as directed by the State Government is sufficiently specific. The beds are, or are not, being used to provide public health services.

A further assessment needs to be made as to whether there are mechanisms in place to provide accountability as to what happens to the bed. Similar to my comments above, and the approach in the standards, if the bed cannot be identified in order to determine what has to be returned, then the AASB 15 requirements are not met.

On the basis that the services are sufficiently specific, and the return obligation can be identified, then I believe the arrangement should be accounted for under AASB 15.

IE 8

Example 11

The example should be clearer in highlighting that the entity (being a Local Government) is subject to the mandatory recognition of volunteer services.

I do not think that the example is realistic. It seems that basically the Local Government is using the services of volunteers instead of paying its own staff. Something I would have thought the public sector unions would have something to say about. I expect that there would also be issues with OHS.

Irrespective, I think that the example should be expanded to include the services of other volunteers who provide services to the preschool, that would not otherwise be paid for. I.e. If the volunteers did not volunteer their services, the activity would not take place. After all, the preschools are already short of full-time employees. For example, any extra reading activities.

Example 12

I agree with the recognition of a liability. Though I am not convinced that it is a contractual financial liability under AASB 9. Is the amount refundable when requested by the ratepayer, or more of a rates in advance by the ratepayer?

This example is inconsistent with other examples where there is comingling of cash received with the cash of the entity's operations.

I do not see a difference between the prepayment of rates, and the return obligation, and the receipt of grant funds before the start of the funding period. Indeed, I would expect there would be more justification for a liability for the

grant funding as the funds are not to be used before the funding start date, while the prepaid rates can be used in operations.

IE9

Example 13

I believe that it will be more common for NFP entities to have below-market rentals for the use of office space, or administrative facilities than the use of (originally) vacant land.

Similar to my comments above, I believe the accounting below-market leases is that the lease asset should be based on an assessment of the market rentals, not trying to work out the fair value of the right-to-use part of an asset.

The example is not clear of the remaining term of the lease. Was it 99 years from lease commencement, or another 99 years remaining on the lease at transition date?

In this example, assuming that the remaining lease is still for a significant period of time, the fair value of the land will probably be close to the fair value of the right-to-use land asset.

Similar to my comments above, I believe that in real life situations there will be a sufficiently specific obligation to use those facilities to provide services under the arrangement, which will be services as directed by the grantor (customer). Consequently, I believe that an obligation should be recognised.