THE BOTTOM LINE

Issue 4

Welcome to the latest edition of our financial reporting publication that aims to keep you in the loop with all the latest accounting and financial reporting developments, and the potential impact they may have on your business.

It's going to be another big year of accounting standards, especially for not-for-profit entities as they implement three significant standards for the first time. With that in mind, we look at the new income standards for these entities, AASB 1058 and AASB 15, and when to apply which standard. We also highlight recent developments affecting both for-profit and not-for-profit entities.

IN THIS ISSUE

Which standard am I in: AASB 1058 or AASB 15?

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1 January 2019 signalled the effective date of two brand new revenue accounting standards for not-for-profit (NFP) entities: AASB 15 *Revenue from Contracts with Customers and AASB 1058 Income of Not-for-Profit Entities*. NFPs have to consider both standards when accounting for revenue transactions. However, they are not necessarily easy to apply and NFP entities can be forgiven for being unsure about which standard to apply and when.

AASB 15 and AASB 1058 replace the NFP income recognition requirements contained in AASB 1004 *Contributions,* AASB 118 *Revenue* and AASB 111 *Construction Contracts*. Many NFPs are likely to be affected by the more prescriptive guidance provided in these new standards that could impact the amount and timing of income recognition.

Both standards apply to annual reporting periods beginning on or after 1 January 2019. That is, NFP entities with June balance dates will apply these standards for the first time in their 30 June 2020 reporting periods – which end in a mere five months.

When does AASB 1058 apply?

AASB 1058 applies where the consideration paid for an asset by a NFP is **significantly less than the fair value of the asset** and the difference is **principally to enable the entity to further its objectives.** Such assets can be in the form of cash, physical assets (a building), intangible assets (intellectual property), and include right-of-use assets arising under leases.

The assessment of what qualifies as 'significantly' less than fair value will be a matter of judgement as the standard does not define this. It would be sensible for entities to develop an accounting policy in this regard.

In assessing whether the difference between the consideration paid and the fair value of the asset acquired is principally to enable the NFP entity to further its objectives, thought should be given as to whether another entity could obtain the asset under the same terms and conditions. Where this is the case, it is more likely the difference is not principally for aiding the entity in advancing its objectives, in which case AASB 1058 would **not** apply.

Common examples of transactions which would be accounted for under AASB 1058 include donations of cash or other assets, as well as bequests and grants that do not enforce specific conditions as to their use. Such income would generally be recognised upfront in profit or loss.

Volunteer services

AASB 1058 also provides guidance on how to account for volunteer services such as professional services and contributed labour that some NFPs receive free of charge.

Local governments, government departments, general government sectors and whole of governments must recognise the fair value of those volunteer services where they can be measured reliably, and the services would have been purchased had they not been donated.

Other NFP entities are not required, but may as an accounting policy choice elect, to recognise volunteer services, or a class of volunteer services, on the same basis as the above.

Capital grants

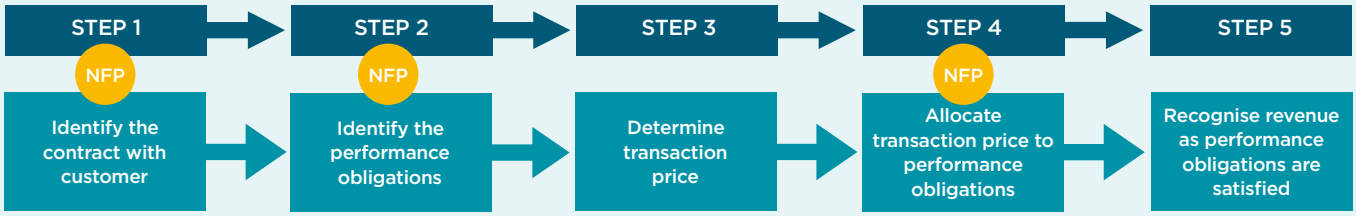
AASB 1058 contains specific requirements relating to capital grants.

Where a NFP receives a grant to acquire or construct a non-financial asset (such as property, plant or equipment) that the NFP will control, income is recognised as or when the NFP satisfies its obligations to acquire or construct that asset.

When does AASB 15 apply?

The new revenue standard introduces a five-step revenue recognition model that determines the amount and timing of revenue to be recognised. For a NFP entity to account for income under this model (and potentially defer income recognition), specific requirements must be met otherwise the income will be accounted for under AASB 1058.

AASB 15 was written from the perspective of for-profit entities. With this in mind, the Australian Accounting Standards Board (AASB) added Appendix F to AASB 15 which contains guidance to assist entities in applying the principles of AASB 15 in a NFP context. This additional guidance focuses on steps 1, 2 and 4 of the five-step revenue recognition model and the NFP-specific considerations that need to be considered at each of these steps:



NFP-specific guidance relating to steps 1,2 and 4 of the revenue recognition model is contained in Appendix F of AASB 15

For a NFPs income to be within the scope of AASB 15, two things are needed: an enforceable contract with a customer and sufficiently specific performance obligations.

Enforceability

The first criteria to consider is whether a written, verbal or implied contract between a NFP entity and a customer creates enforceable rights and obligations. For example, where the NFP has a refund obligation to the customer in the event of non-performance, the contract would be enforceable. Other terms that would render a contract enforceable include:

- The right to enforce specific performance or claim damages for non-performance;
- The right to impose a sufficiently-severe penalty for non-performance; or
- The customer's right to take a financial interest in assets purchased or acquired with the funds provided under the agreement.

Importantly, enforceability depends solely on the customer's ability to enforce its rights. Accordingly, a history of enforcement of similar agreements by the customer is not required, nor is it required that the customer have the intention to enforce its rights.

An agreement is not enforceable through a mere statement of intent, or the withholding of future funds to which the NFP is not yet entitled.

In a NFP context, the customer can direct that the goods or services be provided to third party beneficiaries (including individuals or the community at large) on the customer's behalf. For example, a NFP may receive funding from the government to provide stress management services for free to the general public. In this case, the customer is the government even though the government specifies that the services be provided to members of the community.

Sufficiently specific performance obligations

A performance obligation is a promise to transfer goods or services to a customer.

For such a promise to be accounted for separately, it needs to be distinct, either individually or when bundled with other promises in the contract. Identifying performance obligations under step 2 of the revenue recognition model in AASB 15 requires judgement.

The specificity of promises to transfer goods or services can be quite different for-profit and NFP entities. As such, the AASB provided an additional level of consideration that is specific to NFPs when assessing performance obligations.

A necessary condition for identifying a performance obligation for NFPs is that the promise is 'sufficiently specific' to be able to determine when the obligation is satisfied. Judgement will be necessary to assess whether a promise is sufficiently specific having regard to the conditions specified in any document that forms part of the enforceable arrangement. Such conditions could relate to the nature, type, cost, value or quantity of the goods and services, as well as the time frame in which the goods or services are to be transferred.

Notably, a stipulated time frame alone does not itself make a promise to transfer unspecified goods or services sufficiently specific, but a time frame is needed to be able to determine when the performance obligations have been met.

Concluding thoughts

It is a brave new world for NFP entities as they tackle the new income standards. NFPs will have to analyse contracts in a level of detail not required in the past to ensure income is correctly recognised, keeping in mind contracts may be partially within the scope of AASB 15 and partially within the scope of AASB 1058. If either the enforceability requirement or the sufficiently specific performance obligations requirement is not met, income will be accounted for under AASB 1058, generally immediately. That it not to say income is automatically deferred under AASB 15 - NFPs will have to take their contracts through steps 1 to 5 of the revenue recognition model to determine the appropriate timing of revenue recognition.

ASIC focus areas for 31 December 2019

On 6 December 2019, ASIC announced its focus areas for 31 December 2019 financial reports of listed entities and other public interest entities. In its media release, ASIC indicated that it will be reviewing more than 80 full-year 31 December 2019 financial reports to promote quality financial reporting, and useful and meaningful information for investors.

Impact of new accounting standards

The areas to be scrutinised remain the same as the 30 June 2019 reporting period. The impact of new accounting standards holds steady at the top of the list as AASB 16 *Leases* applies for the first time in 31 December 2019 reporting periods. Also, ASIC will be monitoring if companies fare better in applying and disclosing AASB 9 *Financial Instruments* and AASB 15 *Revenue from Contracts with Customers* in their second year of application.

Public disclosure of the impact of new accounting pronouncements is imperative for investors and market confidence. This includes when there has been, or will be, no impact.

Impact of AASB 16 on Net Tangible Assets calculations

ASIC stated in its media release that it considers right-of-use (ROU) assets recognised in accordance with AASB 16 as intangible assets and not tangible assets.

AASB 16 offers no guidance as to whether recognised ROU assets are tangible or intangible assets. This has created differing views to date as to whether ROU assets should be treated as tangible or intangible, particularly when calculating ratios such a Net Tangible Assets (NTA). Some were of the view that since AASB 16 is silent on the matter, the nature of an ROU asset as tangible or intangible should follow the nature of the underlying asset i.e. if the underlying asset was a tangible asset (such as an office building), the resulting ROU asset would be assessed as tangible too.

Based on ASIC's media release, ASIC does not share this view at this stage. This development is particularly important for AFSL holders who are required to report on their NTA. This means that any ROU assets recognised under AASB 16 should be excluded from the NTA calculations, while the related lease liabilities are included.

Any resulting breaches of financial condition requirements should be reported to ASIC by directors and auditors, as required by the Corporations Act. Compliance must be considered from the commencement of the financial year in which the new standard first applies since the financial condition requirements are on an 'at all times' basis.

Interestingly, the Australian Prudential Regulation Authority (APRA) and the Basel Committee have shared their informal views via FAQs on this subject and their common interpretation is different to that of ASIC's. Their position is to assess the ROU asset based on the nature of the underlying asset.

The above will be of relevant consideration for listed entities since they are required to report NTA per security in their Appendix 4D *Half Year Report* and 4E *Preliminary Final Report*. At the time of writing, the ASX had not issued their views or any guidance on the matter. In the absence of any clarity at this stage, it may be prudent for listed entities to disclose what they have and have not included in their NTA per security calculations.

Another possible area of consideration is financial covenants. If there is any doubt as to the treatment of these new ROU assets arising under AASB 16 when it comes to calculating covenants, it is probably best to ask the financier the question rather than make any assumptions.

Role of directors

As always, directors are reminded of their responsibility for the financial report and the quality of the information presented therein. Complex areas such as accounting estimates (including impairment of non-financial assets which continue to be the subject of many of ASIC's 'name and shame' media releases), accounting policies and taxation should be allocated the appropriate level of experience and expertise. Directors are encouraged to refer to the following ASIC information sheets: INFO 183 Directors and financial reporting and INFO 203 Impairment of non-financial assets.

Governance reviews

ASIC stated that over the next six months, it will be reviewing the governance processes over financial reporting of several companies, generally where reported net assets and profits were materially changed following ASIC inquiries on financial reports for recent reporting periods.

ASIC will look at how audit committees and directors fulfil their roles in ensuring quality financial reporting and supporting the audit process. As part of these reviews, ASIC will also review the identification and effectiveness of actions taken by the audit firms of the companies in addressing root causes from an audit perspective.

For the full media release (19-341MR), please click here.

ASIC 31 December 2019 focus areas	
1.	Impact of new accounting standards
2.	Impairment testing and asset values
3.	Revenue recognition
4.	Expense deferral
5.	Off-balance sheet arrangements
6.	Tax accounting
7.	Operating and financial review
8.	Non-IFRS information
9.	Estimates and accounting policy choices

New and revised Australian standards and interpretations

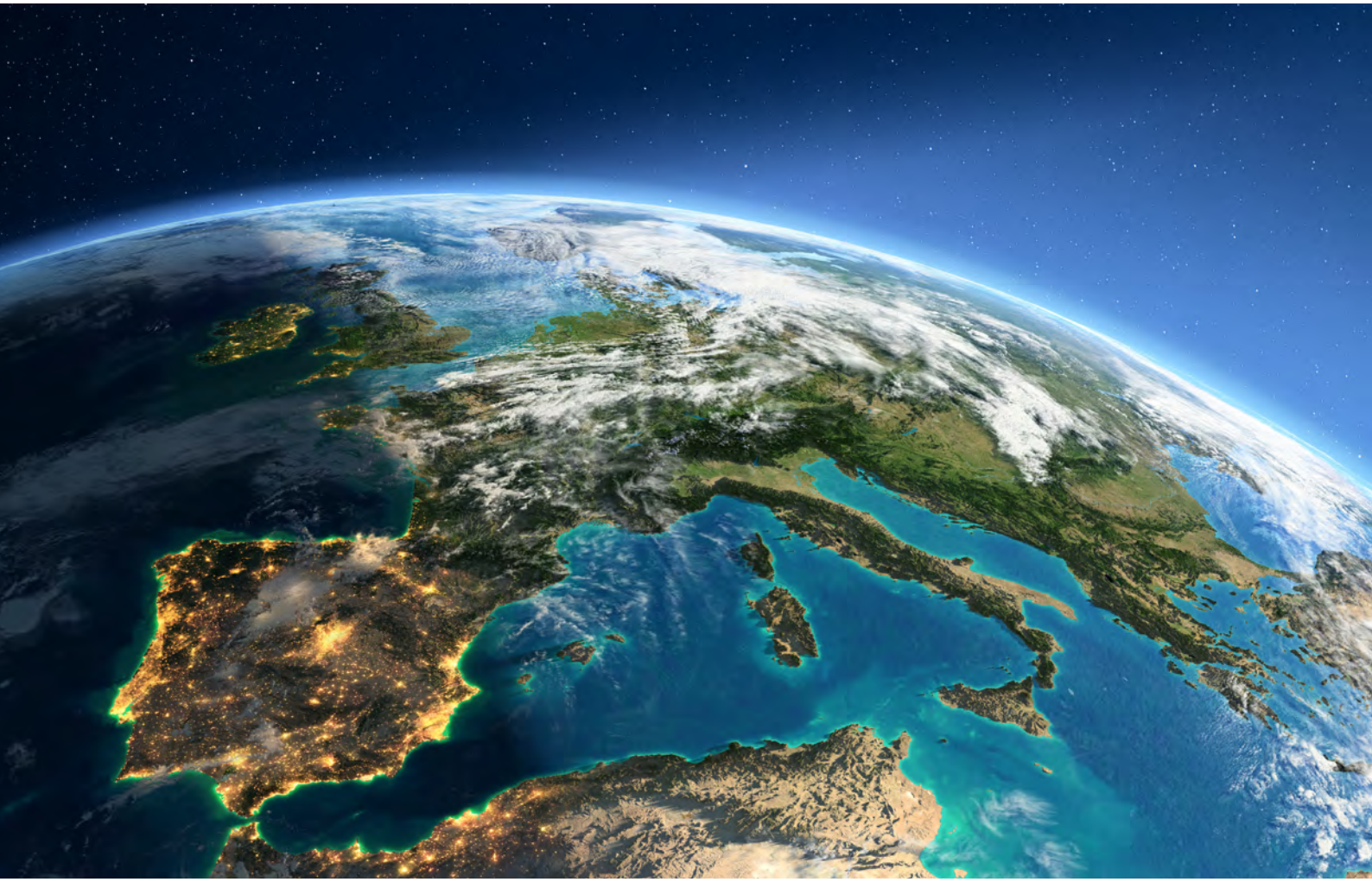
The table below lists the new Australian standards, amendments and interpretations that are applicable for the first time to annual or half-year financial reporting periods ended 31 December 2019.

All entities

Standard / Amendment / Interpretation	Mandatory effective date
AASB 16 *Leases*	1 January 2019
AASB 2017-6 *Amendments to Australian Accounting Standards – Prepayment Features with Negative Compensation*	1 January 2019
AASB 2017-7 *Amendments to Australian Accounting Standards – Long-term Interests in Associates and Joint Ventures*	1 January 2019
AASB 2018-1 *Annual Improvements 2015-2017 Cycle*	1 January 2019
AASB 2018-2 *Amendments to Australian Accounting Standards – Plan Amendment, Curtailment or Settlement*	1 January 2019
AASB 2018-3 *Amendments to Australian Accounting Standards – Reduced Disclosure Requirements*	1 January 2019
Interpretation 23 *Uncertainty Over Income Tax Treatments*	1 January 2019

NFP entities only

Standard / Amendment / Interpretation	Mandatory effective date
AASB 15 *Revenue from Contracts with Customers*	1 January 2019
AASB 1058 *Income of Not-for-Profit Entities*	1 January 2019
AASB 2017-1 *Amendments to Australian Accounting Standards – Transfers of Investment Property, Annual Improvements 2014-2016 Cycle and Other Amendments* [AASB 1, AASB 128 AASB 140]	1 January 2019
AASB 2018-4 *Amendments to Australian Accounting Standards – Australian Implementation Guidance for Not-for-Profit Public Sector Licensors*	1 January 2019
AASB 2018-8 *Amendments to Australian Accounting Standards – Right-of-Use Assets of Not-for-Profit Entities*	1 January 2019
AASB 2019-6 *Amendments to Australian Accounting Standards – Research Grants and Not-for-Profit Entities*	1 January 2019
AASB 2019-8 *Amendments to Australian Accounting Standards – Class of Right-of-Use Assets arising under Concessionary Leases*	1 January 2019
Interpretation 22 *Foreign Currency Transactions and Advance Consideration*	1 January 2019



Recent agenda decisions by the IFRS Interpretations Committee

The IFRS Interpretations Committee (the Committee) publishes agenda decisions to explain why standard-setting is not required to address specific questions regarding the application of IFRS that have been submitted to the Committee. While not authoritative guidance, the agenda decisions provide useful insight into the interpretation of IFRS. The table below lists the agenda decisions issued since June 2019:

Agenda decision	Related standard
Lease term and useful life of leasehold improvements	IFRS 16 *Leases* IAS 16 *Property, Plant and Equipment*
Compensation for delays or cancellations	IFRS 15 *Revenue from Contracts with Customers*
Lessee's incremental borrowing rate	IFRS 16 *Leases*
Presentation of liabilities or assets related to uncertain tax treatments	IAS 1 *Presentation of Financial Statements* IFRIC 23 *Uncertainty over Income Tax Positions*
Disclosure of changes in liabilities arising from financing activities	IAS 7 *Statement of Cashflows*
Fair value hedge of foreign currency risk on non-financial assets	IFRS 9 *Financial Instruments*
Subsequent expenditure on biological assets	IAS 41 *Agriculture*

With the new leases standard being front of mind for many entities at the moment, the two agenda decisions relating to IFRS 16 (or AASB 16 in Australia) are explored further below.

Lease term and useful life of leasehold improvements

The first question raised in this submission was how to determine the lease term of a cancellable or renewable lease.

The **cancellable** lease in the submission is one which does not state a contractual term but continues indefinitely until either party gives notice of termination. The notice period is less than 12 months and neither party incurs a contractual termination penalty on termination. The **renewable** lease described in the request specifies an initial period, with indefinite renewal at the end of the initial period unless either party to the contract terminates the contract.

The Committee noted that in applying paragraph B34 of IFRS 16, the broader economics of the contract and not only the contractual termination payments need to be considered. Thus, if either party has an economic incentive not to terminate the lease because doing so would result in a penalty that is more than insignificant, the contract is enforceable beyond the date on which it can be terminated. Examples of such an economic incentive would be the cost of replacing the asset or the cost of abandoning leasehold improvements.

Another consideration which the Committee noted is whether each party has the right to terminate the lease without permission from the other party with no more than an insignificant penalty. Only when both parties have such a right is a lease no longer enforceable. Consequently, if only one party has such a right, the contract is enforceable beyond the date on which the contract can be terminated by that party.

The second question the submitter asked was whether the useful life of any related non-removable leasehold improvements is limited to the lease term. Non-removable leasehold improvements are those acquired by the lessee and constructed on the underlying asset being leased.

In response, the Committee referenced paragraphs 56 and 57 of IAS 16/AASB 116 *Property, Plant and Equipment,* stating that if the lease term of the related lease is shorter than the economic life of those leasehold improvements, it must be considered whether the entity expects to use the leasehold improvements beyond the lease term. If not, the useful life of the non-removable leasehold improvements is the same as the lease term. The might often be the case where the entity uses and benefits from such leasehold improvements only for as long as it uses the underlying asset.

Lessee's incremental borrowing rate

The issue raised was whether a lessee's incremental borrowing rate (IBR) used to calculate the lease liability should reflect the interest rate in a loan with a similar payment profile to the lease payments.

Consistent with the guidance in paragraph BC162 of IFRS 16, the Committee noted that the definition of a lessee's IBR contained in Appendix A necessitates that a lessee's IBR be a lease-specific rate that takes into account the terms and conditions of the lease. The IBR should reflect the rate the lessee would have to pay to borrow:

- over a similar term to the lease;
- with a similar security to the security in the lease;
- the amount needed to obtain an asset of similar value to the right-of-use asset; and
- in a similar economic environment.

The definition of a lessee's IBR does not explicitly require a lessee to determine its IBR to reflect the interest rate in a loan with a similar payment profile to the lease payments. However, the Committee observed that in applying judgement when determining the rate, it would be consistent with the IASB's objectives for the lessee to refer, as a starting point, to a readily observable rate on a loan with a similar payment profile to that of the lease. A lessee would then adjust such an observable rate as needed to determine its IBR that meet the requirements of IFRS 16.

To this end, lessees should use a borrowing rate of an amortising loan (and not a loan with a lump sum principal repayment at maturity) as a starting point since the majority of lease payments consist of principal and interest.

For details of all agenda decisions issued to date, refer to the Agenda Decisions on the IFRS website.

The AASB have recently issued the amending standards below which may be relevant for our readers. NFP entities should especially take note of amending standards 2019-4 and 2019-6 below.

New disclosures for NFPs preparing special purpose financial statements

In Issue 3 of The Bottom Line, we mentioned the Australian Accounting Standards Board's (AASB) proposals to require entities lodging special purpose financial statements (SPFS) with the Australian Securities and Investments Commission (ASIC) and NFP entities lodging SPFS with the Australian Charities and Not-for-profits Commission (ACNC) to make certain disclosures regarding the extent of their compliance with the recognition and measurement (R&M) requirements of Australian Accounting Stan dards (AAS).

The proposals have since been mandated via AASB 2019-4 *Amendments to Australian Accounting Standards – Disclosure in Special Purpose Financial Statements of Not-for-Profit Private Sector Entities on Compliance with Recognition and Measurement Requirements.* The AASB, however, decided that the new disclosures would not apply to for-profit private sector entities considering the current proposals to eliminate SPFS for certain of these entities from 30 June 2021 onwards.

Medium and large charities registered with the ACNC that prepare SPFS, as well as NFP entities lodging SPFS with ASIC under the Corporations Act (such as companies limited by guarantee), will be captured by the changes and be required to make the disclosures outlined below in their financial statements:

- The basis on which the decision to prepare SPFS was made.
- Compliance with the R&M requirements in AAS:
  - For each material accounting policy applied and disclosed in the SPFS that does not comply with the R&M requirements in AAS (except for consolidation and equity accounting), disclose an indication of where it does not comply, or disclose that an assessment of compliance has not been made; and
  - Whether or not the SPFS comply overall with the R&M requirements in AAS (except for consolidation and equity accounting), or state that such an assessment has not been made.
- Application of the consolidation and equity accounting requirements:
  - If the NFP entity has determined that its interests in other entities give rise to interests in subsidiaries, associates or joint ventures it shall disclose whether or not it has consolidated or equity accounted those interests in line with the requirements of AASB 10 *Consolidated Financial Statements* and AASB 128 *Investments in Associates and Joint Ventures.* If it has not, it shall disclose that fact and the reasons why; or
  - If the NFP entity has not made this assessment and was not required by legislation to do so, it shall instead disclose that no assessment has been made.

Included in the amending standard is implementation guidance and examples to assist affected NFPs in making the appropriate disclosures.

The new disclosures are required to be made in financial statements for annual reporting periods ending on or after 30 June 2020.

New IFRS standards not yet issued in Australia

When the International Accounting Standards Board (IASB) issues an accounting standard, the Australian-equivalent standard is often not approved and issued in Australia by the AASB immediately. However, Australian entities preparing general purpose financial statements (GPFS) under Tier 1 of the differential reporting framework must make specific disclosures about the potential effect of international standards issued by the IASB which have yet to be approved and issued in Australia. This is so that such entities can explicitly state compliance with IFRS standards.

To address this issue, the [AASB issued] *AASB 2019-5 Amendments to Australian Accounting Standards – Disclosure of Effect of New IFRS Standards Not Yet Issued in Australia.* This amending standard adds paragraph 17 to AASB 1054 *Australian Additional Disclosures* and clarifies that, in complying with paragraph 30 of AASB 108 *Accounting Policies, Changes in Accounting Estimates and Errors,* entities intending to assert compliance with IFRS must also disclose the potential effect of IFRS standards that are yet to be issued by the AASB.

This standard applies to annual periods beginning on or after 1 January 2020.

Deferral of AASB 15 and AASB 1058 for research grants

NFP entities that receive research grants and have December year ends are affected by this amending standard.

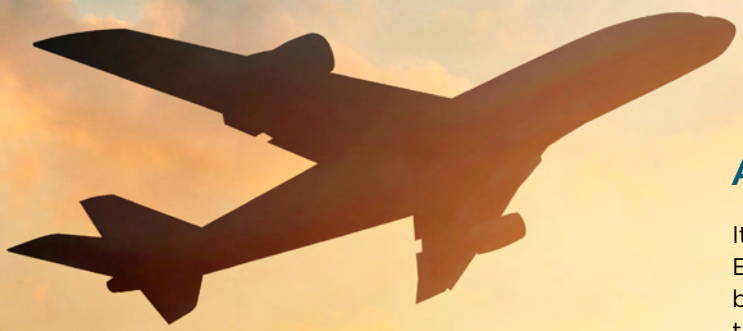
AASB 2019-6 *Amendments to Australian Accounting Standards – Research Grants and Not-For-Profit Entities* allows NFP entities to apply the new revenue standard (AASB 15) and income standard (AASB 1058) to research grants for annual reporting periods beginning on or after 1 July 2019 instead of 1 January 2019. The AASB have thus provided more time for 31 December NFP entities to implement the new standards for research grants only.

The option to extend the implementation period cannot be applied on an individual research grant basis – it is all or nothing.

AASB 2019-6 amends illustrative examples 4A and 4B that accompany AASB 15 to clarify the analysis of how AASB 15 applies in several research grant examples. The amendments do not change the requirements of AASB 15 or the conclusions of the examples. An additional illustrative example (example 4D) has been added to AASB 15.

NFP entities with 31 December 2019 year ends should be aware of the following:

- Such entities can elect not to apply AASB 15 and AASB 1058 to research grants and instead continue to apply the provisions of AASB 1004 *Contributions* and/or AASB 118 *Revenue;*
- Where deferral is elected, research grant contracts would have to be separately identified. This could be a challenge where a research grant is one component within a larger agreement. The amending standard does not define 'research grant'.



AASB 16 is upon us!

It's been a long time coming but AASB 16 is now here. Entities with 31 December 2019 reporting periods will be in the midst of applying this standard and making the extensive new disclosures required by it in their financial reports. 30 June 2020 year ends have a bit (although not much) more time to get to grips with the new leases standard.

HLB Mann Judd's Leases Series breaks down AASB 16 into bite-size chunks to assist entities in understanding and applying the key concepts of this major new standard as they begin or progress with their implementation projects.

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