Sample Internal Memo

To:

From:

Date:

Subject: FINANCE POSITION PAPER

APPLICATION OF REVISED ACCOUNTING STANDARDS:
AASB 15 REVENUE FROM CONTRACTS WITH CUSTOMERS
AASB 1058 INCOME OF NOT-FOR-PROFIT ENTITIES
AASB 16 LEASES

Purpose: To approve a methodology for compliance with the updated accounting standards *AASB 15 Revenue from Contracts with Customers, AASB 1058 Income of Not-for-Profit Entities* and *AASB 16 Leases.*

Scope:
AASB 15 Revenue from Contracts with Customers: Revenue from contracts with customers (for consideration in exchange for the) transfer goods or services that are an output of the entity's ordinary activities.
AASB 1058 Income of Not-for-Profit Entities: Transactions where on initial recognition of an asset the consideration is significantly less than fair value principally to enable entity to further its objectives, or volunteer services.
AASB 16 Leases: replaces the current concept of operating and finance leases (for lessees) and will require lessees to recognise most of their leases on the balance sheet.

1. AASB 15 Revenue from Contracts with Customers; AASB 1058 Income for Not-for-Profit Entities

Discussion on Matter:
The application of AASB 15 and AASB 1058 will apply to annual reporting periods beginning on or after 1 January 2019 for not-for-profit entities. The first applicable reporting period for Victorian councils will be 2019-20. As in their titles, both standards apply to income recognition in Council's financial statements and both may affect the timing of such. This paper discusses the criterion contained in these Standards and provides examples for their application.

1.1 AASB 15 Revenue from Contracts with Customers
AASB 15 changes revenue recognition from the current "transfer of risks and rewards" model to a "transfer of control" model. As such, revenue is now recognised when Council satisfies a performance obligation by transferring a promised good or service to a customer.

Application of the Framework under AASB 15
To determine the timing of income recognition, the following five steps are recommended:

1. Identify if a Contract with Customer creates **enforceable** rights and obligations
2. Identify Separate Performance Obligations ‘Distinct’ or separate promises to transfer goods or services that are sufficiently **specific**
3. Determine Transaction Price Amount expected
4. Allocate transaction price to performance obligations
5. Recognise Revenue Performance obligation satisfied when control transferred – ‘over time’ or ‘at-a-point-in-time’

An example of this process is detailed below using capital grants as an example.

For most capital grants which meet the stated criteria, this standard requires the initial recognition of a contribution as a liability, which is then recognised as income as council progressively satisfies the specific performance obligations. This means that where council is midway through the construction of a building, and the performance obligation is to construct the entire building, we would recognise grant income in line with the proportion of the costs incurred to date.

The effect on timing of the recognition of income under AASB 15 is seen by the following:

1. Where a Grant establishes a performance obligation that approximates the amount received and there is a contract with Council which establishes:
   a. Sufficiently specific performance obligations and
   b. These obligations can be enforced (ie grant money refunded if not delivered or delivered for less cost)
   - The income should be recognised **as Council meets these milestones**.

Example
Council is successful in receiving a $20m to construct a Community Hub.
The Grant Funding Agreement stipulates funding must be spent on Hub and if not spent on this project returned to funding agency.

- Contract – yes funding agreement
- Identifiable performance obligations
- Revenue recognised as expenditure incurred

2. In the case of a grant which has been received by a council to further its objectives with no specific obligations
   - Council will recognise the income **on receipt of the grant** (or earlier if control can be demonstrated).

Example
Council receives annual funding from the Victoria Grants Commission (paid quarterly). The Local Government (Financial Assistance) Act 1995 states that general purpose grants are untied. Therefore, councils can use the grants as required by local needs.

- No identifiable performance obligations
- Revenue recognised as funding is received

3. Where a customer has paid in advance of the receipt of service, a contract is not complete until the council has provided the required services. Examples include:
   - gym memberships
   - venue hire charges
   - ➢ Sufficiently specific performance obligations and
   - ➢ These obligations can be enforced (customer entitled to refund if not delivered)
   - ➢ The income should be recognised **as Council meets these milestones**.

1.2 AASB 1058 Income for Not-for-Profit Entities

This standard establishes principles for not-for-profit entities that apply to:

- Transactions where the consideration to acquire an asset is *significantly less than fair value* principally to enable a not-for-profit entity to further its objectives; and
- The receipt of volunteer services.

As per AASB 15, this standard has the potential to impact the timing of the recognition of contribution revenue. The standard however is designed to assist in determining how to account for contributions received that are **not in the form of revenue from contracts** with customers.

When Council receives a contribution the initial accounting for the asset is a simple debit to the balance sheet. AASB 1058 provides direction on how to account for the other side of this entry which for Council are most likely revenue or liability.

Similar to AASB 15, an assessment will be made to determine if Council has an **unmet performance obligation** at the time of gaining control of the contribution, and if so then a liability will need to be recognised until the obligation is met. Alternatively, it will be recognised as income upon control of the contribution.

Volunteer Services
Local governments, government departments, general government sectors (GGSs) and whole of governments shall recognise an inflow of resources in the form of volunteer services as an asset (or an expense, when the definition of an asset is not met) if:

- the fair value of those services can be measured reliably; and
- the services would have been purchased if they had not been donated

It is to be noted that Council acknowledges that volunteer work is always unpaid and that it does not replace paid workers (as stated on the website). Initial discussions do not indicate any change to reporting.

Position/Recommendation

- Finance Staff have undertaken a high-level review of all revenue streams to determine where the revised standards may have effect and have identified where further analysis will be required.
- Prior to the end of financial year, Finance Staff will undertake a detailed review of significant contracts (including grants) that are likely to be not complete contracts

at 1 July 2019 to determine if any revision to accounting treatment will be required on transition.

- Further analysis will be required to determine if Council will have changed reporting requirements for Peppercorn leases, where the value of the lease receipt is significantly lower than market price.
- At this stage, it does not appear that Volunteer services will require any reporting changes.

AASB 16 Leases

AASB 16 defines Lease as a contract or part of a contract that conveys the right to control of the use of an identified asset for a period of time in exchange for consideration. AASB 16 replaces the current concept of operating and finance leases (for lessees) and will require lessees to recognise most of their leases on the balance sheet. This key change means most operating leases will be recognised as assets and liabilities.

There are two key elements within the definition that highlights whether the lease falls under this standard:

1. Right to Control:
   - lessee obtain ALL economic benefits from use of the assets
   - lessee direct the use of assets
2. Lease term:
   - commence when lessor makes asset available for use by lessee
   - non-cancellable period + optional renewal periods (if certain) + periods after an optional termination date if certain not to terminate early

In terms of transition, NFPs are provided with a choice between two methods:

- full retrospective application – with restatement of comparative information in each prior period presented or
- partial retrospective application – without restating comparatives. Under this approach, the cumulative effect of initially applying the new requirements is recognised as an adjustment to equity at the date of initial application.

The changes to AASB 16 Leases is to be introduced for the 2019/20 financial year, however, the model accounts and VAGO required a disclosure in the 2018/19 accounts (Note 8.2):

“Council has elected to adopt the modified retrospective approach to the transition to the new lease standard. This will mean that only existing operating leases for non low value assets, with remaining terms greater than 12 months, will be recognised on transition (1 July 2019). Based on our current lease commitments and an assumption of a continuation of the current leasing arrangements Council expects that the transition to the new standard will see the initial recognition of $480,839 in lease related assets and an equivalent liability”

The leases referred to in the above note were for photocopier and gym equipment leases. The YMCA currently manages X COUNCIL’s aquatic and leisure facilities and the management of these facilities includes leasing of gym equipment. Officers are currently undertaking an assessment of these leases to determine if they are required to be reported under AASB 16.

Position/Recommendation

- Finance Staff will continue to review any leases which meet the recognition criteria listed above.

Officer's detailed review of income recognition

To determine the if the change in accounting standards would require a change in the treatment of income, accounting staff consulted with officers in the business units. The key determinants were:

- Identify if a Contract with Customer creates **enforceable** rights and obligations
- Identify Separate Performance Obligations 'Distinct' or separate promises to transfer goods or services that are sufficiently **specific**

1. Permit income

Review of the following accounts was conducted.

1.1 Road construction permits
Income in these accounts include:

- Asset protection permits
- Vehicle crossing permits
- Hording permits
- Road opening permits

Officers have determined that this income should continue to be accounted at time of receipt. These permits entitle the applicant to proceed with an action and they are not entitled to a refund if the works do not happen – therefor are not linked to a specific deliverable.

1.2 Urban development permits
Income in these accounts include:

- Planning permit
- Subdivision certifications
- Extend time of permits
- Planning permit amendments

These fees are charged to make an application and do not guarantee the grant of a planning permit (for example). We earn this income at lodgement and only refund if the matter is withdrawn.

1.3 Building Services permits and fees
Income in these accounts include:

- Building permits
- Council consents
- Lodgement fees
- Copies of plans

The fees cover the receipting of the application and its assessment as well as inspections when they commence the actual works and the issue of a final certificate or an occupancy certificate. This may vary depending upon the fee type.

We have a refund process when they withdraw application, but not all fees may be refunded if they choose not to proceed, for example inspection fees.

2.0 Registrations fees

Income in these accounts include:

- Health registrations
- Animal registrations
- Pool registrations

Income for these annual registrations is reflected in the period for which they relate. No change to recognition.

2.1 Hall hire and Pavilion and sports ground rentals

In relation to income for Pavilion and sports ground rentals Recreation Services invoice for these fees.

- Seasonal summer allocations will be invoiced in November each financial year
- Annual and seasonal winter allocations fees will be invoiced in May each financial year (though all fees have been waived due to COVID19)
- In relation to income for Casual sports ground rentals (5912) Recreation Services these are invoiced once permits are approved. These requests may come in at any time, there are no set timeframes for receiving applications for casual bookings. Customers may receive refunds on these permits on cancellations with 14 days' notice of booking date.

Income for these annual registrations is reflected in the period for which they relate. No change to recognition.

2.2 Government Grants – operating

In terms of accounting for various government grants, they are to be assessed on a case by case basis. Most operating grants apply to an annual allocation period, such as Victoria Grants Commission (general), Libraries funding and funding for aged services including Home and Community Care programs. They will continue to be accounted for in the period for which they relate. These grants funds may be provided to fund general operations or to deliver on various outcomes. For the most part however, they do not create:

- A Contract with Customer with **enforceable** rights and obligations
- Separate Performance Obligations 'Distinct' or separate promises to transfer goods or services that are sufficiently **specific**

2.3 Government Grants – project and capital funding

These grants however, are usually linked to specific outcomes and deliverables. Where it is found that they do create specific enforceable rights and obligations the will be accounted for as income received in advance until these obligations are met. Examples include:

- Roads to Recovery funding
- Working 4 Victoria funding
- DET funding for Wheatsheaf Community Hub construction

2.4 Developer and Subdivider contributions

These contributions are received because of developer and subdivider activity taking place and are not dependant on the delivery of specific outcomes and do not create enforceable rights and obligations to the contributor. This income will continue to be recognised at the time of the activity.

Officer's detailed review of AASB 16 Leases

X Council has two distinct services for waste collection. Half of the municipality is serviced under contract and the remaining half is serviced by an internal team. The waste trucks used by the internal team are owned and not leased. The new AASB16 standard has required officers to interrogate the contract services for waste collection and have determined that this will require adoption of the new leasing standard. As per the guidance document issued by Local Government Victoria, *Guidance on transition to new Accounting Standards 2018-19,* the following tests were applied:

Assessment		Comment
Is there an identified asset?	Yes	Requirement for fit for purpose vehicles to be supplied under the contract
Does Council have the right to obtain the benefits from using the assets?	Yes	Contract restricts the use of assets to X COUNCIL only Vehicles are to be covered with X COUNCIL signage
Is the contract greater than 12 months?	Yes	7 years
Materiality	Yes	
Is there a lease?	Yes	

Under the transition options for AASB 16, Council may choose not to apply AASB 16 to contracts that were not previously identified as containing a lease as the contract was entered prior to 2019.

Table 4: AASB 16 Leases

AASB 16 Leases options or practical expedients available on transition (or ongoing)				
Paragraph number	**AASB 16 Accounting Option**	**LGV Position**	**Rationale**	**Example/Reference**
Transition options				
C3	An entity (lessor or lessee) is not required to reassess whether a contract is, or contains, a lease at the date of initial application. The entity is permitted to: - Apply AASB 16 to contracts previously identified as leases under AASB 117 *Leases* / Interpretation 4 *Determining whether an Arrangement contains a Lease* - Not to apply AASB 16 to contracts that were not previously identified as containing a lease applying AASB 117 *Leases* / Interpretation 4 *Determining whether an Arrangement contains a Lease*.	**Mandate the use of this practical expedient.** A grandfathering approach is considered practical for agreements that were previously assessed at inception as not containing leases under AASB 117 and associated interpretations. However, we encourage councils to identify contracts which could meet the definition of a lease under AASB 16 since on renewal date of those contracts; they will need to be accounted for under AASB 16.	The cost of applying AASB 16 is significant given the number of leases in place at councils. The preference would be to focus on putting time and effort into ensuring that existing leases are accounted for correctly under AASB 16. Councils must apply AASB 16 to new or varied contracts from 1 July 2019.	Appendix C – Example 5 Appendix C – Example 6 Appendix C – Example 8 The new standard will need to be applied to existing operating leases: • with a remaining term greater than 12 months, and • for assets that are above the low value threshold

X COUNCIL has elected to apply this option to the one operating lease held (photocopiers) and the Waste Contract as they were entered into in prior years. However, any new leases entered into from 2019 (including a potentially new Waste Contract in 2024) will be recognised in line with the AASB16 requirements.