THE BOTTOM LINE

Issue 14

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.

A trending topic here at home is the Discussion Paper issued by the AASB that sets out its initial thoughts on what a third tier of reporting for smaller NFP private sector entities might look like. We highlight some of the key ideas coming out of this paper and share links for stakeholders to get involved in this project. From a global perspective, we summarise amendments that have recently been issued that impact liability classification and sale and leaseback accounting. We round out this issue by reminding readers that the days of 'grandfathering' are over.

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SPFS

Major first step in financial reporting reform for NFPs

Since 2020, the Australian Accounting Standards Board (AASB or the Board) has been keenly deliberating what simplified accounting requirements for smaller not-for-profit (NFP) entities could potentially look like. The Board recently issued a Discussion Paper (DP) setting out its initial discussions and resultant views regarding a proposed Tier 3 reporting tier for NFP private sector entities. This marks the first step in updating the NFP financial reporting framework.

The significance of this project cannot be emphasised enough. The NFP sector in Australia is large, encompassing a broad range of organisations that pursue a variety of charitable objectives in an effort to advance the likes of social wellbeing, culture, education, health, animal welfare, the environment and religion, all for the benefit of the broader community.

NFP entities are accountable to the communities they serve, especially those parties that rely on them for the goods or services they provide, as well as those that provide the NFP entities with resources. Users often rely on NFP financial statements when making decisions about whether to provide them with resources such as donated funds or assets. Financial statements are therefore a tool for NFP entities to communicate to stakeholders how they discharge their responsibilities and manage their resources (which are often limited).

It is therefore crucial to have a consistent, transparent and fit for purpose financial reporting framework for the NFP private sector.

Extensive targeted outreach, consultation and research have informed the AASB's preliminary views set out in the DP. For anyone interested in the details of the AASB's discussions and considerations underlying its preliminary views, they can read the 122-page document titled *Discussion Paper – Development of Simplified Accounting Requirements (Tier 3 Not-for-profit Private Sector Entities)*.

This article aims to summarise the key considerations regarding the form and content of an additional third reporting tier aimed at smaller NFP private sector entities.

Why is the Board pursuing this project?

The AASB's intention is to remove the ability of certain NFP entities to self-assess their reporting requirements and prepare special purpose financial statements (SPFS). Tier 1 or Tier 2 reporting requirements would be onerous for many of the smaller NFP entities affected by the removal of SPFS since they generally have fewer complex transactions and events. The aim is to develop a third reporting tier with accounting requirements that are easier to understand and apply, while ensuring the resulting financial statements remain useful to users.

Who are the proposals aimed at?

The preliminary views contained in the DP are expected to impact 'smaller' NFP private sector entities that currently:

a) prepare SPFS to satisfy a direction to prepare financial statements in accordance with Australian Accounting Standards (AAS);

b) comply with a regulatory direction, gather financial information or prepare various financial statements in accordance with the recognition and measurement (R&M) criteria specified in AAS; or

c) prepare Tier 1 or Tier 2 general purpose financial statements (GPFS) but would qualify for simpler accounting.

In developing its initial views, the AASB considered a 'smaller' NFP entity to be one with annual revenue between $500,000 and $3 million. However, the scope of the project does not include establishing and specifying reporting thresholds for the application of GPFS by NFP private sector entities as this falls within the remits of the relevant regulatory bodies.

What would the proposed Tier 3 look like?

The Tier 3 accounting requirements will be based on those transactions and other events that are common to smaller NFP entities.

The initial thinking is to present all these requirements in a stand-alone standard, consistent with the AASB's decision to develop AASB 1060 as a separate Tier 2 standard. Early feedback from stakeholders suggests that this approach is an appropriate one.

The stand-alone standard will be written in language that is easier to understand and will include guidance on applying the accounting requirements. It is proposed that the standard will also be accompanied by template financial statements.

What are some of the key topics with proposed simplifications?

Proposed classification, recognition and measurement simplifications

The table below lists some of the main classification, recognition and measurement simplifications proposed at this stage of the project:

TOPIC	PROPOSED SIMPLIFIED ACCOUNTING
Income (including revenue)	Income is deferred when there is an evidenced (e.g. written) common understanding that the entity is expected to use the inflows in a particular way. Income is recognised when the related outflows occur. For all other income transactions, income is recognised at the earlier of receipt of cash or controlling a receivable.
Leases	All leases remain off-balance sheet. Lease payments are recognised on a straight-line basis over the term of the lease unless another systematic basis is more appropriate. Right-of-use assets arising under concessionary (peppercorn) leases are not recognised. Disclosures will supplement the proposed lease accounting.
Employee benefits	These are recognised as an expense when the employee has rendered the service. All short- and long-term employee benefits are to be measured on an undiscounted basis. Long-service leave must reflect the probability that payment will be required.
Consolidation	A parent entity has the choice to prepare: • consolidated financial statements; or • separate financial statements with information about the parent entity's significant relationships.
Non-financial assets acquired at significantly less than fair value (i.e. donated assets)	Inventory is initially measured at cost (i.e. nil or nominal amount) or replacement cost. Other non-financial assets are measured at cost or fair value. Revaluation or fair value model cannot be applied if donated non-financial assets are initially measured at cost.

Simplified recognition and measurement requirements relating to impairment, financial instruments, borrowing costs, and changes in accounting policies and errors have also been included in the DP.

Proposed terminology and language simplifications

There are a number of areas where the proposed classification, recognition and measurement requirements will be the same as Tier 1 and/or Tier 2 but will be expressed in simpler language and terminology. Such topics include:

Inventory	Fair value measurement
Property, plant and equipment (except for the treatment of borrowing costs)	Investment property (except for the treatment of borrowing costs)
Investments in associates and joint ventures	Volunteer services

Topics proposed to be excluded from Tier 3 requirements

To avoid cluttering the Tier 3 standard with reporting requirements that are not ordinarily applicable to smaller NFP entities, the AASB proposes to omit specific topics from the standard.

The Board will seek feedback from stakeholders to further understand the types of transactions and events that are not common to these entities, however the types of items the Board may scope out of a Tier 3 standard include the following:

Business combinations	Share-based payments
Financial assets and financial liabilities that are 'more complex' financial instruments	The accounting by an operator in a service concession arrangement
Biological assets and agricultural produce at the point of harvest	Obligations arising under a defined benefit superannuation plan
Exploration and evaluation expenditures before the technical feasibility and commercial viability of extracting a mineral resource is demonstrable	

For transactions and other events and conditions that are scoped out of the Tier 3 standard, it is proposed that entities should:

- first apply Tier 2 reporting requirements; and
- in the absence of Tier 2 reporting requirements for the specific transaction, apply judgement to develop an accou
    - the principles and requirements in Tier 3 dealing with similar or related issues; and
    - the definitions, recognition criteria and measurement concepts in the Australian Conceptual Framework that do not conflict with Tier 3 accounting requirements.

When developing an accounting policy, an entity may also consider principles and requirements in Tier 1 and Tier 2 reporting requirements, or pronouncements of other standard-setting bodies with a similar conceptual framework, other accounting literature and accepted industry practices.

Topics for which possible simplifications have yet to be determined

Statement of changes in equity

With regard to the primary financial statements, the Board will deliberate the usefulness of the statement of changes in equity in an NFP context, taking into account stakeholder feedback during the current consultation process. The Tier 2 Simplified Disclosures standard permits entities to not present a statement of changes in equity when certain conditions are met.

Intangible assets

Intangible assets do not feature often in smaller NFP financial statements. However, the AASB is unsure if this is because such assets are not being identified and recognised, or whether these entities in fact do not make use of intangible assets. The Board is therefore seeking specific feedback regarding the extent of the existence of intangible assets by smaller NFP entities, as well as the types of intangible assets held, to inform future decisions regarding this topic.

What are the next steps?

The DP is out for comment until **31 March 2023**. Comments submitted by stakeholders to the Board will drive whether and how the project proceeds. Assuming the DP gets the required support, the likely next step would be an Exposure Draft.

How do stakeholders get involved?

There is much to be gained by the success of this project in the form of simplified accounting and reduced costs for smaller NFP entities. It will ensure more consistent application of recognition and measurement requirements by these entities, meaning improved quality and comparability of financial reporting in the sector.

There are various ways for interested stakeholders to get involved at this early stage of the project. Comments can be provided via:

- an online survey (https://www.surveymonkey.com/r/AASBTIER3NFP)
- email to the AASB (standard@aasb.gov.au)
- a formal submission (www.aasb.gov.au/current-projects/open-for-comment/)

The online survey is a quick and easy means for stakeholders to have their say. We strongly encourage NFP entities that may be impacted by the reform to read the 12-page overview of the DP and then complete the online survey before the closing date.

The AASB will also be hosting virtual outreach sessions until 31 March 2023. Anyone interested in attending these can register via this link.

Classification of liabilities with covenants

Back in early 2020, amendments were made to IAS 1 *Presentation of Financial Statements* to clarify the requirements relating to classification of debt as current or non-current. The changes included new guidance on how an entity assesses whether it has the right to defer settlement of a liability that is subject to specified conditions (aka covenants) within 12 months after the end of the reporting period. Stakeholders voiced concerns about the practical implications of this new guidance, and, after much deliberation, IAS 1 has been amended again to address stakeholder concerns.

IAS 1 (AASB 101 in Australia) is the accounting standard an entity looks to when assessing whether a liability should be classified as current or non-current at the end of a reporting period.

IAS 1 requires an entity to classify debt as non-current only if the entity can avoid settling the debt within 12 months after reporting date. Oftentimes, an entity's ability to defer settlement hinges on compliance with specified conditions. For example, a long-term loan could become repayable within 12 months from reporting date if the entity fails to comply with stipulated loan covenants in that 12-month period.

Several changes were made to IAS 1 as part of the 2020 amendments. However, the one that caused debate was the clarification that an entity has a right to defer settlement only if it complies with covenants based on its circumstances at the reporting date, even though compliance with the said covenants is required only after that date.

Stakeholders were concerned that this amendment would result in liabilities being classified as current even though, at reporting date, there is no contractual obligation to repay the liability within 12 months. Furthermore, the amendment ignored the design of conditions negotiated to reflect an entity's specific circumstances, for example, covenants that factor in seasonality of the entity's business.

In response to stakeholders' concerns, it was decided to amend IAS 1 with respect to classification (as current or non-current) and disclosure of liabilities for which the right to defer settlement for at least 12 months is subject to compliance with conditions after the reporting date.

The 2022 amendments can be summarised as follows:

- Only covenants that an entity is required to comply with on or before the end of the reporting period affect the entity's right to defer settlement for at least 12 months after the reporting date (and therefore classification as current or non-current).
- Where an entity's right to defer settlement of a liability is subject to the entity complying with covenants within twelve months after the reporting period, information that enables users of financial statements to understand the risk of the liability becoming repayable within twelve months after the reporting period must be disclosed in the notes.
- The amendments become effective for annual reporting periods beginning on or after 1 January 2024 and are applied retrospectively. Earlier application is permitted (as long as the 2020 amendments are adopted at the same time).
- The amendments defer the 2020 amendments (see below) by one year, to annual reporting periods beginning on or after 1 January 2024. Where the 2020 amendments are adopted after the 2022 amendments are issued, the 2022 amendments must be adopted at the same time.

Note that the Australian Accounting Standards Board is expected to issue the 2022 amendments by the end of year. To be clear, the other 2020 amendments are not impacted by the 2022 amendments (apart from the one-year deferral). The unaffected 2020 amendments that become effective on 1 January 2024 include:

- Clarification that, for a liability to be classified as non-current, the entity's right to defer settlement must exist at the end of the reporting period.
- Removal of the word 'unconditional' when referring to the right to defer settlement for at least 12 months to clarify that, if the right to defer settlement is subject to compliance with covenants, the right exists if the conditions are met at the end of the reporting period, even if the lender does not test compliance until a later date.
- New guidance to explicitly state that classification of a liability is unaffected by management intentions or expectations.
- Defining the word 'settlement' in the context of classifying a liability as current or non-current as "… a transfer to the counterparty that results in the extinguishment of the liability." Such a transfer can be of cash, goods and services, or the entity's own equity instruments.
- Guidance on how to classify a liability that includes a counterparty conversion option which could be recognised separately from the host debt component as either equity or a liability.

Improvements to sale and leaseback accounting

In September 2022, the International Accounting Standards Board (IASB) issued amendments to IFRS 16 *Leases* that clarify how a seller-lessee applies the subsequent measurement requirements of the standard to the lease liability that arises in a sale and leaseback transaction.

A sale and leaseback transaction is one in which an entity (seller-lessee) sells an asset it owns and immediately leases the asset back from the buyer (buyer-lessor). The amendment is aimed at improving the requirements in IFRS 16 relating to these sale and leaseback transactions, specifically those that include variable lease payments.

In a sale and leaseback transaction, the seller-lessee determines whether the transaction qualifies to be recognised as a sale under IFRS 15 Revenue from Contracts with Customers. If so, the right-of-use asset arising from the leaseback must be measured at the proportion of the previous carrying amount of the asset that relates to the right of use retained by the seller-lessee.

IFRS 16 is, however, silent when it comes to the measurement of the liability that arises in a sale and leaseback transaction. The amendment addresses this by requiring a seller-lessee to subsequently measure such lease liabilities in a way that does not result in the recognition of any gain or loss relating to the right of use it retains.

Applying the new requirement does not prevent the seller-lessee from recognising any gain or loss, in profit or loss, relating to the partial or full termination of a lease.

The change to IFRS 16 does not contain specific measurement requirements for lease liabilities arising from a leaseback. This means that, in practice, a seller-lessee may include variable lease payments that do not depend on an index or rate when calculating the lease liability. Any difference between estimated and actual lease payments would be recognised in profit or loss in the period in which they are incurred.

The inclusion of variable lease payments that are not dependent on an index or rate (such as lease payments linked to sales or use) contradicts the general definition of 'lease payment' in IFRS 16 which excludes such variable lease payments for purposes of calculating the lease liability. Seller-lessees will therefore have to develop and apply an accounting policy that results in information that is relevant and reliable, as required by IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors.

As part of the amendment to IFRS 16, the illustrative examples have been amended accordingly. Specifically, Example 25 has been added and illustrates a sale and leaseback with variable lease payments that do not depend on an index or rate.

The amendment is effective for annual reporting periods beginning on or after 1 January 2024, with earlier application permitted. A seller-lessee must apply the change retrospectively to sale and leaseback transactions entered into after the date of initial application. The date of initial application is the beginning of the annual reporting period in which IFRS 16 was first applied.

REGULATORY

'Grandfathering' regime comes to an end

On 9 August 2022, amendments to the Corporations Act 2001 received royal assent that see the end of a 'temporary' lodgement exemption that has been afforded to certain large, family-owned companies for nearly three decades.

The changes were introduced by the Senate to the Treasury Laws Amendment (2022 Measures No.1) Bill 2022.

While sudden and unexpected, many view the amendments as levelling the proverbial playing field: all large private companies will now be required to lodge financial statements with the Australian Securities and Investments Commission (ASIC). The only exception to this is where some other lodgement exemption or relief is available to the entity via, for example, a specific ASIC legislative instrument.

Backstory of the 'grandfathering' exemption

To provide a bit of context, the 'grandfathering' regime came about in 1995 during a legislative overhaul by the Keating government.

Prior to this, whether a company was required to prepare and lodge financial statements with ASIC was determined by whether it was an 'exempt' or 'non-exempt' proprietary company. An 'exempt' company was one that was essentially owned by private individuals. These companies did not have to lodge financial reports even though they were subject to audit and distributed to members.

In 1995, the basis for determining whether a company had to lodge financial statements with ASIC changed from the 'exempt / non-exempt test' to the 'small / large test'. A company that was assessed as being 'large' (by satisfying two of the three prescribed criteria), was obliged to lodge a financial report. The 'small / large test' still stands today although the criteria used to perform the assessment have been updated over the years.

Despite the introduction of the 'small / large test' in 1995, the lodgement exemption was retained for exempt private companies on the condition they continued to meet the old 'exempt proprietary company' definition and met certain other criteria. Where all the necessary conditions were met, these companies still had to prepare financial reports and have them audited within four months of year end, however they did not have to lodge these financial reports with ASIC. And so 'grandfathering' was born.

This 'grandfathering' arrangement was only intended to be temporary however it has prevailed for the last 27 years.

Consequences of the amendments

About 1,100 large proprietary companies currently benefit from having 'grandfathered' status. These companies will now have the same financial reporting obligations as any other large private company in Australia.

Large proprietary companies, including those that are 'grandfathered', are required to prepare general purpose financial statements applying the new Tier 2 Simplified Disclosure framework (as a minimum). These financial statements must be audited, and they must be lodged with ASIC within four months of year end.

Effective date of the changes

The amendments are effective from 10 August 2022, being the day after they received royal assent. This means that 'grandfathered' large proprietary companies with financial years ending on or after 10 August 2022 will have to lodge their audited financial statements with ASIC.

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