



New South Wales
TREASURY

ACCOUNTING POLICY
DISTINGUISHING FOR-PROFIT FROM
NOT-FOR-PROFIT ENTITIES

Office of Financial Management

**Policy &
Guidelines Paper**

PREFACE

This NSW Treasury Policy & Guidelines Paper provides guidance to NSW public sector entities in deciding whether they are a *for-profit* or *not-for-profit* entity, for the purpose of their general purpose financial report, prepared in accordance with Australian Equivalents to International Financial Reporting Standards (AEIFRS).

The policy is applicable to all NSW public sector entities (including statutory State Owned Corporations) for financial years beginning on or after 1 January 2005. The policy is issued as part of the adoption of AEIFRS.

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EXECUTIVE SUMMARY

This NSW Treasury Policy & Guidelines Paper provides guidance to NSW public sector entities in deciding whether they are a *for-profit* or *not-for-profit* entity, for the purpose of their general purpose financial report, prepared in accordance with Australian Equivalents to International Financial Reporting Standards (AEIFRS).

This policy is based on the principle that financial reports should reflect economic substance rather than legal form. It seeks to guide, rather than replace, the use of professional judgement in the application of AEIFRS.

In deciding whether to classify an entity as *for-profit* or *not-for-profit*, for general purpose financial reporting, NSW public sector entities must consider the following factors:

- statements by owners about the objectives of the entity, such as statements contained in legislation, regulations, entity constitutions and shareholder resolutions;
- the governance framework applied to the entity ie the corporate structure adopted and the formal relationship with owners;
- the purpose, nature and extent of funding from owners, focusing on the extent to which ongoing budget support is provided to an entity;
- the targeted financial performance of the entity, as agreed between owners and the board/management, focusing on the extent to which the entity funds its expenses, maintains its asset base and provide returns to owners; and
- the classification of the entity under Government Finance Statistics (GFS).

The fact that an entity is classified as *not-for-profit* under AEIFRS does not imply that it is not required to operate efficiently, or in a commercial manner, as set out by its governance framework (including the NSW Commercial Policy Framework). Such a classification does not override legal requirements eg a requirement to pay dividends to owners. Similarly, the fact that an entity is classified as *for-profit* does not mean it is released from wider obligations to society imposed by owners or other external parties.

This policy effectively issues the Heads of Treasuries Accounting and Reporting Advisory Committee paper of the same name, which was developed with the intention of being applied across all Australian jurisdictions.

1. INTRODUCTION

1.1 PURPOSE OF POLICY

This NSW Treasury Policy & Guidelines Paper provides guidance to NSW public sector entities in deciding whether they are a *for-profit* or *not-for-profit* entity, for the purposes of their general purpose financial report, prepared in accordance with Australian Equivalents to International Financial Reporting Standards (AEIFRS).

1.2 DEFINITIONS

A *not-for-profit* entity is defined as one whose principal objective is not the generation of a profit (AASB 136 *Impairment of Assets*, Aus para 6.2). *For-profit* entity is not defined, but by implication is any entity that does not meet the definition of a *not-for-profit* entity.

1.3 SCOPE

State Governments are not principally established to generate a profit. Hence the NSW Government is considered to be a *not-for-profit* entity. The General Government Sector (GGS) of the NSW Government is also considered to be *not-for-profit*, because it mainly comprises units established to provide goods and services for no or nominal consideration, which is incompatible with having profit as a principal objective.

There may be, however, some *for-profit* entities within the GGS eg those providing services at market rates exclusively to other GGS entities. Hence this policy addresses the classification of all entities controlled by the NSW Government, but not those of the Government as a whole, or the GGS.

1.4 IMPLICATIONS OF CLASSIFYING AN ENTITY

The fact that an entity is classified as *not-for-profit* under AEIFRS does not imply that it is not required to operate efficiently, or in a commercial manner, as set out by its governance framework (including the NSW Commercial Policy Framework). Such a classification does not override legal requirements eg a requirement to pay dividends to owners. Similarly, the fact that an entity is classified as *for-profit* does not mean it is released from wider obligations to society imposed by owners or other external parties.

1.5 APPLICATION

This NSW Treasury Policy & Guidelines Paper is issued as a Treasurer's Direction under section 9 and section 45E of the *Public Finance and Audit Act 1983* and therefore applies to all entities that are required to prepare general purpose financial statements under the Act. The policy is also mandatory for Statutory State Owned Corporations. A specific reference to the policy will be included in the Statements of Corporate Intent of those entities.

This policy applies to financial years beginning on or after 1 January 2005. This coincides with the adoption of the Australian Equivalents to the International Financial Reporting Standards. The policy must be applied retrospectively by adjusting the opening balance of each affected component of equity at the beginning of the comparative period (ie 1 July 2004 for 30 June year end entities). This is consistent with AASB 1 *First-time Adoption of Australian Equivalents to International Financial Reporting Standards* and AASB 108 *Accounting Policies, Changes in Accounting Estimates and Errors*.

2. OVERALL APPROACH

This policy is based on the principle that financial reports should reflect economic substance rather than legal form, in line with the AASB *Framework for the Preparation and Presentation of Financial Reports* ie

“If information is to represent faithfully the transactions and other events that it purports to represent, it is necessary that they are accounted for and presented in accordance with their substance and economic reality and not merely their legal form.” (*Framework*, paragraph 35).

The exercise of professional judgement is considered essential in identifying the principal objective of any entity. There is no single factor that can conclusively determine the status of an entity.

While it is possible that a *not-for-profit* entity could have minor operations that could be regarded as *for-profit*, classification should be based on a consideration of the main activities of the entity. For example, a large Government department may operate a small bookshop selling departmental publications. The presence of the bookshop operation would not determine the classification of the department as a whole.

3. SPECIFIC GUIDANCE

The following factors, when considered together, will assist in the application of professional judgement to the task of identifying an entity’s principal objective. Assessments of any one factor need to be considered in the light of contrary evidence arising from a consideration of the other factors. A final decision regarding the status of an entity should consider all available evidence and the overall substance of the entity.

The factors that entities must consider are:

- statements by owners about the objectives of the entity, such as statements contained in legislation, regulations, entity constitutions and shareholder resolutions;
- the governance framework applied to the entity ie the corporate structure adopted and the formal relationship with owners;
- the purpose, nature and extent of funding from owners, focusing on the extent to which ongoing budget support is provided to an entity;
- the targeted financial performance of the entity, as agreed between owners and the board/management, focusing on the extent to which the entity funds its expenses, maintains its asset base and provides returns to owners; and
- the classification of an entity under Government Finance Statistics (GFS).

3.1 STATEMENTS ABOUT THE OBJECTIVES OF THE ENTITY

From a legal standpoint, an entity's objectives are those stated in legislation. However, the intent of the AASB *Framework* is that financial reports are to be based on substance as distinct from rules or legal form. Hence there is an obligation on preparers to determine the substance of the motivations behind an entity's existence. Statements in legislation are statements of owner's intentions at a point in time. Subsequent events may provide evidence that owners' intentions have, in substance, changed. Therefore, presumptions derived from legislation may be overturned if the other factors listed in this policy provide sufficient evidence to the contrary.

If the legislation or regulations associated with the establishment of an entity or its constitution explicitly states that the "principal", "main" or "sole" objective of the entity is to generate a profit, then a strong rebuttable presumption would arise that the entity is *for-profit*.

If the legislation or regulations state that the "principal", "main" or "sole" objective of the entity is other than the generation of a profit, then a strong rebuttable presumption would arise that the entity is *not-for-profit*.

In some cases, owners' statements and actions may be ambiguous and hence not useful in classifying an entity. For example, under the *State Owned Corporations Act 1989*, a number of objectives are promulgated for statutory State Owned Corporations (SOCs), without it being clear which one is the principal objective, as each are specified as being of equal importance. These objectives include (section 20E of the SOC Act):

- to be a successful business, including to operate efficiently with a view to maximizing net worth;
- to exhibit a sense of social responsibility;
- to operate in accordance with the principles of ecologically sustainable development; and
- to exhibit a sense of responsibility towards regional development.

In such situations there is no presumption and the classification of the entity will depend on consideration of all the factors detailed in this policy.

When the principal objective is not explicitly set down in legislation, regulations or the entity's constitution, classification as *for-profit* or *not-for-profit* will often involve analysis of less explicit wording. Statements that an entity is to "operate commercially" or "be financially viable", while indicative, do not necessarily mean that an entity's principal objective is the generation of a profit.

Shareholder or equity holder resolutions, ministerial directions and government policy statements, providing they are consistent with legislation, regulations and entity constitution, may also be a means whereby owners make it clear that they expect an entity to generate a profit and a positive return on investment as its principal objective. However, such statements must also be tested against the balance of the factors outlined in this policy.

3.2 GOVERNANCE FRAMEWORK

Entities that operate in accordance with competitive neutrality principles and face the same or very similar legal, financial and regulatory conditions as *for-profit* entities in the private sector are likely to be *for-profit*. Examples of such conditions include:

- commercially sound legal and corporate capital structures (eg a mix of debt and equity funding);
- shareholder relationship provides for the payment of dividends;
- monitoring of performance against financial targets and industry best practice standards;
- an obligation to pay income tax or income tax equivalents;
- an entity charter or statement of corporate (or business) intent referring to the making of profits and returns to owners;
- separation of ownership, (represented by shareholding Ministers), board and management; and
- explicit contractual arrangements and funding in respect of Community Service Obligations (CSOs).

Under the NSW Commercial Policy Framework, some entities may be subject to some but not all of the above. It is the extent to which such frameworks apply to an individual entity that provides an indication as to whether its principal objective is the generation of a profit.

An entity would not be prevented from being classified as *for-profit* if its governance framework required it to:

- meet economic development objectives;
- be socially responsible; and/or
- be environmentally responsible;

because all of these may be consistent with the generation of a profit and return to owners.

3.3 PURPOSE, NATURE AND EXTENT OF FUNDING FROM OWNERS

Owners can provide funding to entities in a number of ways:

- injections of additional capital to maintain or expand the entity's activities;
- payments for the delivery of specified outputs, usually described as CSOs. In return for CSO funding the entity delivers social benefits in the form of outputs purchased by government or purchased by customers and partly funded by Government; and
- grants and subsidies eg to cover operating losses from unprofitable activities.

Both *for-profit* and *not-for-profit* entities can receive injections of additional capital. Hence funding of this nature is not relevant to this policy.

The economic substance, rather than the legal form, of funding is relevant to all of these situations.

For-profit entities would normally receive CSO funding rather than grants/subsidies (unless those grants and subsidies are also made available to non-government entities). *Not-for-profit* entities are more likely to receive grants and subsidies (although financial management frameworks in some jurisdictions seek to link funding to 'outputs').

The lower the level of government support in the form of subsidies and grants, the more likely that the entity may be a *for-profit* entity. However, the level of grants and subsidies can vary over time. In the early years of a *for-profit* entity the government may provide considerable grants and subsidies to support an infant industry that it believes may provide further community benefits in the longer term.

Instances where ongoing government funding is provided to cover the costs of specific outputs, and these outputs represent the principal activity of the entity, suggest that the entity in question is *not-for-profit*. As a rule of thumb, if more than half the expenditure of an entity is funded by owners on an on-going basis to provide goods and/or services at no or nominal cost to the recipients, then this would provide evidence to support a *not-for-profit* classification.

3.4 THE TARGETED FINANCIAL PERFORMANCE OF THE ENTITY

If owners and management explicitly target profits or returns to owners in relation to its main activities, then this is evidence that the entity is *for-profit*. Intention is important, rather than actual profits/returns. That an entity incurs losses over a number of periods is not inconsistent with an entity having profit as its principal objective. Conversely, successive profits over a number of periods do not prevent an entity being classified as *not-for-profit* where there is no intention to distribute these profits to owners.

That an entity targets a rate of return that is appropriate for the industry in which it operates suggests that it is a *for-profit* entity. Such a rate of return would:

- reflect the risk-return relationship; and
- theoretically be above the long-term government bond rate (which could be considered as a proxy for the risk-free rate).

It should be noted that industry rates of return may vary over the business cycle and an individual entity's rate of return may also vary over time depending on its life cycle.

The extent to which an entity is able to earn sufficient cash inflows from trading or the provision of services to cover operating cash outflows and fund the replacement of assets in the longer term ('self-funding') is indicative of whether the entity is *for-profit* or *not-for-profit*. However, while a *not-for-profit* entity could aim to be self-funding, it is unlikely that an entity that was not self-funding would be classified as *for-profit*. It should be noted that an entity that borrowed for capital expenditure could still be self-funding, provided that its future net operating cash flows are expected to cover the repayment of capital and interest.

There is a justifiable expectation that a *not-for-profit* entity should be aiming to manage its scarce resources efficiently and effectively and that any profit or surplus would be retained to support its "public interest" or non-profit outcomes.

The overriding targets for an entity may be expressed in terms of the quality of services to be delivered, with the entity searching for the lowest cost options to meet the service objective. While the setting of targets in qualitative terms suggests the entity is more likely to be a *not-for-profit* entity, such a framework does not conclusively rule out the entity from a *for-profit* classification.

A number of *not-for-profit* entities contain cash generating units. The existence of cash generating units within an entity, however, does not mean that its principal objective is the generation of a profit. Normally, the net cash inflow of a cash-generating unit within a *not-for-profit* entity would be retained within the entity to achieve non-profit outcomes, not distributed to owners.

3.5 GFS CLASSIFICATION

The Australian Bureau of Statistics classification of public sector entities also provides evidence of an entity's status, because the ABS is independent of government and their classification takes into account whether an entity is predominantly providing services for no or nominal consideration or at prices so low that they do not have a significant impact on demand ('economically significant prices'). Consequently, entities classified to the General Government Sector would normally be *not-for-profit*.

This, however, does not always mean that entities classified to the Public Financial Corporations Sector or the Public Non-Financial Corporations Sector would be *for-profit*, because the GFS classification between the GGS and PTE/PFE Sectors is not identical to the distinction between a *not-for-profit* and *for-profit* entity. Further, the GFS classification may not be conclusive as there is a trend towards user pays and cost reflective pricing whereby pricing for services provided by *not-for-profit* entities (e.g. universities) could have significant impact on demand.

APPENDIX A

LIST OF RELEVANT FACTORS IN DISTINGUISHING *FOR-PROFIT* FROM *NOT-FOR-PROFIT* ENTITIES

The purpose of this Appendix is to provide a list of the factors, discussed in the main body of the policy, that are relevant in determining the classification of an entity as *for-profit* or *not-for-profit*. This list is provided as a summary for convenience and does not override the text in the main body of the policy.

The relevant factors are:

- Statements by owners about the objectives of the entity
 - Legislation and regulations
 - Shareholder resolutions, ministerial directions and government policy statements
- The governance framework applied to the entity
 - Capital structures
 - Shareholder relationships providing for dividends
 - Monitoring of financial performance
 - Obligation to pay income tax or equivalents
 - Charter or statement of corporate intent referring to profits and returns to owners
 - Separation of ownership, board and management
 - Explicit contractual arrangements and funding of CSOs.
- Purpose, nature and extent of funding from owners
 - Grant/subsidy funding as opposed to CSO funding
 - Level of ongoing funding from the Budget
- Targeted financial performance of the entity
 - Explicit targets for profits and returns to owners
 - Level of targeted return
 - Entity ability to cover operating outflows and asset replacement
- Classification of the entity under Government Finance Statistics

APPENDIX B

MAIN DIFFERENCES COMPARED TO PREVIOUS AUSTRALIAN REQUIREMENTS

- Classification as a *for-profit* or *not-for-profit* entity under AEIFRS impacts on recognition, measurement and disclosure requirements across a number of Standards (including AASB 116 *Property, Plant and Equipment*, AASB 136 *Impairment of Assets*, AASB 120 *Government Grants*, AASB 1004 *Contributions*, AASB 140 *Investment Property* and AASB 124 *Related Party Disclosures*). Previously, however, the distinction between a *for-profit* and *not-for-profit* entity impacted on a much limited number of Standards, namely AASB 1005 *Segment Reporting* and AASB 1010 *Recoverable Amount of Non-Current Assets*. Of these, only AASB 1010 potentially impacted on recognition or measurement.
- Under current Standards, the AASB defines a *not-for-profit* entity as an entity whose principal objective is not the generation of profit (per AASB 136, para Aus6.2). Previously a *not-for-profit* entity was defined in AASB 1010 as an entity whose financial objective did not include the generation of profit.
- In theory, therefore the change to the definition of a *not-for-profit* entity reduces the number of *for-profit* entities, as profit has to be *the main objective*, not just *an objective*.
- In practice, however, there is limited impact for the NSW public sector. This is mainly because NSW public sector entities applied AASB 1041 *Revaluation of Non-Current Assets* rather than AASB 1010. This was because, AASB 1010 only applied where the cost basis was applied, while NSW public sector entities are required to adopt fair value. In contrast, AASB 1041 did not refer to the *for-profit / not-for-profit* distinction, but achieved the same outcome as the current AASB 136 by saying that specialised assets that are not part of a cash generating operation must be valued at depreciated replacement cost.
- Further, NSW Treasury's previous Asset Valuation Policy (TPP 03-02) already incorporated the principles in AASB 136, including the revised *not-for-profit* entity definition, based on the exposure drafts issued at that time. At the time the previous Asset Valuation Policy was issued, NSW Treasury reviewed the classification of Commercial Policy framework agencies, on a basis that was in-substance consistent with the new definition and with the guidance provided in this policy.
- In summary, this means that at the date of transition to AEIFRS there should be no difference in the *for-profit / not-for-profit* classification previously adopted under AGAAP, unless an entity's circumstances have changed or there has been a reconstruction within the public sector. Any change in classification must be supported by a brief that at least considers the factors outlined in this policy. A brief should be prepared in consultation with Treasury, where a classification is borderline or indeterminate.