

9 September 2019

Ms Kris Peach
Chair
Australian Accounting Standards Board
PO Box 204
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AUSTRALIA

Dear Kris

Exposure Draft 291— *Not-for-Profit (NFP) Entity Definition and Guidance*

The Australasian Council of Auditors-General (ACAG) welcomes the opportunity to comment on ED 291. The views expressed in this submission represent those of all Australian members of ACAG.

ACAG notes ED 291 is proposing to replace the definition of a not-for-profit (NFP) entity as currently included in Australian Accounting Standards (AAS), with the definition of a public benefit entity as included in New Zealand standard XRB A1 Appendix A, subject to limited amendments to adapt it for the Australian context. ED 291 also proposes additional guidance to assist entities determine their appropriate entity classification.

Overall, the majority ACAG view is to support the proposed definition of NFP entity as outlined in ED 291, however ACAG has highlighted matters for consideration by the AASB prior to releasing the amending standard.

The majority ACAG view is similar to those expressed by the AASB in regard to why revision of the definition is needed, based on the feedback received from constituents in the past, which aligns with the timing of developing the revised financial reporting framework for NFP entities. The majority ACAG view believes it would be beneficial to replace the current NFP definition under the AAS with a definition that has greater focus on the nature and purpose of a NFP entity.

The divergent ACAG jurisdiction view is that the AASB has failed to provide evidence-based support for any change, that the change is not needed and the costs for entities to reassess their classification and make any changes is unnecessary.

ACAG also suggests the proposals be considered by the AASB, in conjunction with the Revised Conceptual Framework project, as it will eventually apply to the public sector.

The attachments to this letter address the AASB's matters for comment within the ED. ACAG appreciates the opportunity to respond and trusts that you find our comments useful.

Yours sincerely



Rod Whitehead
Chairman
ACAG Financial Reporting and Accounting Committee

AASB specific matters for comment

- 1. Do you agree that the current definition of not-for-profit entity in Australian Accounting Standards should be replaced with the proposed definition, which is based on the New Zealand definition of public benefit entity? Please indicate your reasons.**

Majority ACAG members view:

ACAG agrees that the current definition of a not-for-profit (NFP) entity in Australian Accounting Standards (AAS) should be replaced with the proposed definition, which is based on the New Zealand definition of a public benefit entity as it:

- is a positive statement about what these entities are, rather than what they are not
- is a substantive definition focusing on the primary objective of an entity rather than it not being the generation of profit; and
- clarifies that traditional measures of financial performance such as net profit and return on assets may not be as meaningful in the not-for profit context, whereas non-financial performance measures of efficiency and effectiveness are more meaningful.

As the new definition requires significant professional judgement, ACAG is of the view application will still be a challenge.

Divergent view:

One jurisdiction is of the view that the current definition of an NFP entity should not be replaced with the proposed definition as the AASB has not provided any evidence to suggest significant implementation issues exist with the current definition. The lack of such evidence is contrary to the AASB's stated evidence-based approach to standard setting.

Further, this jurisdiction does not agree with the characterisation of the current definition being a negative definition. Instead, this jurisdiction is of the view a residual characterisation would be more accurate.

- 2. Do you agree with the proposed implementation guidance and illustrative examples? Why, or why not? Please indicate any concerns about particular parts of the guidance, or particular examples.**

Overall, ACAG acknowledges the importance of including implementation guidance and examples to assist entities in assessing whether they are for-profit (FP) or NFP as this determination impacts the recognition, measurement, presentation and disclosure requirements applicable to an entity.

While ACAG acknowledges significant professional judgement is required to determine the appropriate classification, ACAG notes this is not helped by the fact that the proposed implementation guidance and examples in ED 291 are non-conclusive, which may not assist users in determining the appropriate classification. Further, ACAG is of the view the guidance and examples lack a public sector perspective and may not be sufficient to assist users in the public sector make the appropriate judgements to conclude whether an entity is FP or NFP. ACAG recommends the AASB consider:

- supplying further examples in the public sector context, as currently there is only one relevant example (e.g. Universities due to the full-fee paying student base, government insurance agencies where the primary objective may be to provide community/social benefit however they also provide equity returns to government), and

- the relevance of the ABS GFS Manual definitions for general government units (ABS GFS 2015, 2.36) and non-profit units (ABS GFS Manual 2015, 2.43). The current guidance does not address general government units which do not provide goods or services for community or social benefit.

ACAG has provided specific comments on the implementation guidance and examples in **Attachment 2**. ACAG suggests the AASB consider this feedback as part of finalising the amending standard.

3. Do you agree that in determining the classification of a group that it is necessary to consider the characteristics of the group and the controlling entity? Do you agree that the classification of the controlling entity of the group would most likely determine the classification of the group? Why, or why not?

ACAG agrees that in determining the classification of a group it is necessary to consider both the characteristics of the group and the controlling entity. However, ACAG believes that although the classification of the controlling entity of the group may be an indicator to determine the classification of the group, there may be instances when this is not the case. For example, consider a situation where a NFP entity's primary objective is to use cash dividends received from its FP subsidiary to make donations to various charitable causes. The assets and liabilities of the group would be mainly those of the FP subsidiary, plus cash held by the controlling entity. In this case, it does not seem to be appropriate to classify the group as a NFP entity and therefore potentially rework the carrying amounts of the FP subsidiary's assets to be in accordance with the NFP accounting policies of the group.

In light of the above, ACAG suggests that the AASB consider providing further guidance and examples to help preparers navigate instances where this is the case. The guidance could include that the classification of a group as FP or NFP is for the purpose of preparing the consolidated financial statements although may be an indicator to understand the nexus between the group and the entities within the group and determining the classification of individual entities.

Further, ACAG recommends the following wording suggestion to the last sentence of paragraph 11:

'The classification of the controlling entity in the group ~~would most likely determine~~ may indicate the classification of the group. However, determination about the classification of the group should be based on facts and circumstances, and the overall substance and significance of the commercial and charitable activities carried out by the group.

In addition to the wording amendments proposed above, ACAG suggests the AASB consider providing guidance on how to determine the significance of the commercial and charitable activities carried out by the group. For example, such significance could be determined based on non-financial performance measures and objectives (e.g. proportion of output or activities) and financial measures (e.g. proportion of underlying asset base, revenue earned or expenditure incurred on charitable commercial activities) versus.

4. Do you agree with the proposed guidance on the accounting consequences for an entity that changes its classification as a for-profit entity or a not-for-profit entity? Is this guidance sufficient? Why, or why not?

ACAG believes that the AASB should provide guidance on the major differences between FP and NFP accounting to assist entities in the event of a change in classification.

Other matters for consideration:

- **On initial application of the amending standards**
 - **Transition approach:** On initial application, there is likely to be reclassification of some entities (e.g. entities established to provide services for the public benefit but required to operate as a business venture). ACAG believes the AASB should consider whether it is appropriate to provide transitional relief– preferably to apply the standard prospectively as retrospective application may be difficult for users as they may not have access to sufficient information to do so (and would likely invoke impracticability under AASB 108 *Accounting Policies, Changes in Accounting Estimates and Errors*). ACAG recommends the AASB consider clarifying the transitional requirements prior to finalising the amending standard.
 - **Disclosure on transition:** ACAG supports applying the disclosure requirements in paragraph 28 of AASB 108. ACAG recommends including additional disclosure requirements regarding the underlying reasons for change in classification, to be disclosed preferably within the ‘basis for preparation disclosure’ as this significant change would be relevant to understanding the financial statements and may affect measurement basis.
 - **Effective date:** ACAG suggests aligning the application of the revised requirements with the forthcoming revised financial reporting framework for NFP entities so that entities need to transition to revised requirements only once. Further, the effective date would need to be considered based on the transition approach.
- **Ongoing application of the amending standard:**
 - **When a change in classification occurs, when should this be accounted for:** ACAG recommends the AASB clarify the timing of when a reclassification should be accounted for post initial application of the definition. Should this occur:
 - effective from the date of change in classification?
 - from the beginning of the year in which change in classification takes place?
 - from the beginning of the next year following the year in which change in classification takes place?
 - **Transition approach:** ACAG believes reclassification transition should be prospectively applied, as retrospective application would not be appropriate given the events that triggered the reclassification would not have existed in the past. ACAG recommends the AASB consider clarifying the reclassification transition requirements prior to finalising the amending standard.
 - **Disclosures in basis of preparation:** ACAG recommends that the AASB consider amending the disclosure requirements under AASB 101 *Presentation of Financial Statements* to require

entities to disclose the reasons why they are classified as FP or NFP, in light of the new definition, given its impact on recognition, measurement, presentation and disclosure requirements.

- 5. No transition requirements have been proposed for the initial adoption of the guidance. Are initial transition provisions required, and if so, what should they state?**

Please see response to Q4.

- 6. Do you agree that the definition and associated guidance should be included in AASB 1057 *Application of Australian Accounting Standards*? Why, or why not? If not, please indicate your preferred approach.**

ACAG agrees that the definition and associated guidance should be included in AASB 1057. This is because the definition of a NFP entity and associated guidance is more closely aligned to the objective of AASB 1057, which specifies the types of entities and financial statements which are required to apply AAS.

ACAG further proposes that the definition be included in the revised conceptual framework as it is one of the underlying concepts based on which AAS are developed.

- 7. Do you agree that the implementation guidance should form an integral part of AASB 1057, ie have mandatory status? Please indicate your reasons.**

Yes, ACAG agrees that the implementation guidance should form an integral part of AASB 1057 and have mandatory status. However, since the illustrative examples require professional judgement and are not definitive, ACAG believes that they should not be made an integral part of AASB 1057, and that they should not have mandatory status.

AASB general matters for comment

- 8. Whether *the AASB's Not-for-Profit Entity Standard-Setting Framework* has been applied appropriately in developing the proposals in this Exposure Draft?**

The majority view ACAG holds is that broadly the AASB have appropriately applied the concepts of the AASB's *Not-for-Profit Entity Standard Setting Framework*, by considering the need for NFP-specific amendments. ACAG does make note, however that ED 291 lacks an evidence-based approach as it does not demonstrate the key issues that the ED is proposing to address. ACAG recommends that the basis of conclusion in paragraphs BC 2 to BC 5 be elaborated to highlight these key issues so the proposals are understood in light of those circumstances.

The divergent ACAG jurisdiction view is that the AASB's *Not-for-Profit Entity Standard Setting Framework* has not been applied appropriately as the AASB has failed to provide evidence-based

support for any change, that the change is not needed and the costs for entities to reassess their classification and make any changes is unnecessary.

9. Whether there are any regulatory issues or other issues arising in the Australian environment that may affect the implementation of the proposals, including Government Finance Statistics (GFS) implications?

Please note our previous comments regarding the GFS requirements.

ACAG notes that the ACNC has a different definition of NFP to the proposed definition. The ACNC defines a NFP entity as ‘an organisation that does not operate for the profit, personal gain or other benefit of particular people (for example, its members, the people who run it or their friends or relatives)¹.

ACAG notes that the definition of charity² requires that the entity be not-for-profit, that the Charities Act does not define not-for-profit, and the ACNC’s guidance is not a formal legal instrument. ACAG is concerned that by the AASB defining NFP in a legislative instrument (an accounting standard), this may cause unintended consequences such the loss of charity status by some ACNC registered entities.

Thus, ACAG recommends the AASB investigate whether such a difference could result in unintended consequences.

10. Whether, overall, the proposals would result in financial statements that would be useful to users?

Subject to the feedback contained in this letter, the majority ACAG view is that the proposed amendments have the potential to assist preparers in appropriately classifying entities as FP or NFP. The appropriate classification as a FP or NFP entity is more likely to result in the entity adopting accounting policies that will provide users with the required information they need to assess the entity’s financial performance, financial position and cash flows.

The divergent ACAG jurisdiction view is that the change is not needed and would not be useful for users compared to the costs to be imposed.

11. Whether the proposals are in the best interests of the Australian economy?

ACAG is not able to comment on whether these proposals are in the best interests of the Australian economy.

¹ Source: <https://www.acnc.gov.au/for-charities/start-charity/not-profit>

² Source: <https://www.acnc.gov.au/for-charities/start-charity/legal-meaning-charity>

- 12. Unless already provided in response to specific matters for comment above, the costs and benefits of the proposals relative to the current requirements, whether quantitative (financial or non-financial) or qualitative? In relation to quantitative financial costs, the AASB is particularly seeking to know the nature(s) and estimated amount(s) of any expected incremental costs, or cost savings, of the proposals relative to the existing requirements.**

ACAG is not able to comment on this issue.

Other comments

ACAG recommends that the AASB develop a framework that incorporates concepts consistent with those in AAS to avoid interpretation and application issues e.g. considering the definition in light of the proposed concept of 'service capacity of assets' in AASB 13 *Fair Value Measurement*.

Attachment 2 - Question 2 detailed feedback

ACAG suggests the AASB address the following matters below:

Paragraph/Example reference	ACAG suggested comments for consideration
<p>Paragraph 3 of the Implementation guidance (IG) – definition of a NFP entity</p>	<p>The definition uses the term ‘equity holders’. ACAG suggests that the term ‘equity holders’ should be defined in the implementation guidance in light of terminology or context used in other standards. For example, the term ‘owners’ is used in AASB 101 <i>Presentation of Financial Statements</i> and AASB 1004 <i>Contributions</i> in the context of the public sector. This will facilitate understanding amongst users and preparers to determine the meaning of the term ‘equity holders’.</p>
<p>Paragraph 7 of the Implementation guidance (IG) – definition of a NFP entity</p>	<p>ACAG suggests the AASB clarify the second part of the definition that notes, ‘the provision of any equity is to support that primary objective rather than for a financial return to equity holders.’</p> <p>ACAG is of the view that the wording ‘any equity’:</p> <ul style="list-style-type: none"> • is absolute and is expected to pose implementation challenges especially in cases where there may be a number of variables to consider • appears contradictory and seems to make the indicators proposed in paragraphs 12-36 of the IG redundant, which aim to focus on the substance of an entity’s purpose, and • similarly, it appears to be contradictory with paragraph 37 of the IG that mentions in case of conflicting indicators, an entity should apply professional judgement and consideration should be given to overall indicators including significance of individual indicators. <p>Based on the above, ACAG requests clarification on the interpretation of the term ‘any equity’ i.e. should it be interpreted as such or should it be interpreted in light of facts, such as the significance of returns to the owners?</p>
<p>Paragraph 9 of the IG “Also, although in general terms NFP entities exist to provide goods and services for the community or social benefit, this does not necessarily imply that such entities exist for the benefit of the public as a whole.”</p>	<p>The guidance in the first part of this paragraph, which states ‘<i>community OR social benefit</i>’ appears inconsistent with the second part of the guidance, which makes an indirect reference to say that ‘<i>the society as a whole may be benefitted</i>’. The intention of the second part, referring back to benefits that</p>

<p>Many NFP entities exist for the direct benefit of a particular group of people, although it is also possible that society as a whole benefits indirectly (Emphasis added)”</p> <p>“For example, a community football club exists to promote and encourage football for the direct benefit of its members. However, society as a whole may also benefit indirectly through a healthier population and through the provision of organised activities for its youth (Emphasis added)”</p>	<p>the society as a whole may derive, is not clear. ACAG seeks clarification here –</p> <ul style="list-style-type: none"> • are these two points optional indicators such that an entity that either provides benefit to a particular community or to the society as a whole is eligible to be classified as NFP (subject to other indicators) or • whether the benefits to a particular community need to be seen in light of overall benefits that the society may derive. <p>Similarly, reference to ‘<i>benefits derived by the society as a whole</i>’ does not seem appropriate as the football club in this example seems to be providing direct benefits to its members. This example seems similar to example 4: Sports club which states, ‘<i>The benefits provided by Club AFC arise from the co-ordination of football competitions and the provision of football coaching and training to club members. This may indicate that Club AFC is a NFP entity</i>’. However, both these examples seem contradictory with paragraph 28 of IG: which provides, ‘<i>if the primary beneficiaries are members of the entity, it is necessary to consider other factors to determine whether the entity is a NFP entity (for example, the nature of the benefits and other indicators in this guidance)</i>’. The example of the football club and Example 4 may lead to these agencies being inappropriately classified as NFPs (without considering other indicators in the guidance, as mentioned in paragraph 28).</p> <p>In light of the above, ACAG recommends:</p> <ul style="list-style-type: none"> • inconsistencies between the guidance and the examples be considered, and • the ‘<i>benefits that the society may derive indirectly</i>’ should not be interposed over and above the specific purpose of the entity as it may render all entities to be classified as NFP entities.
<p>Paragraph 13 of the IG Stated objectives of a State-owned corporation (SOC)</p>	<p>Paragraph 13 outlines the objectives of statutory State-Owned Corporations (SOC) per the <i>State Owned Corporations Act 1989</i> (NSW) without concluding whether the SOC is FP or NFP. ACAG suggests that the AASB generalise this example rather than provide specific requirements of statutory State-Owned Corporations in NSW.</p>

<p>Paragraph 33-36 of the IG Nature of funding</p>	<p>Under ‘Nature of Funding’, ACAG suggests including the following which may indicate that an entity is NFP:</p> <ul style="list-style-type: none"> • interest free or low interest loans, for e.g. in the public sector, FP government businesses that borrow through the State rather than the market are usually required to pay a levy (financial accommodation levy/government guarantee fee) to ensure competitive neutrality between the government business and its private sector counterparts • the State guarantees the obligations of the public sector entity.
<p>Paragraphs 37 and IE 2: “In assessing this classification, an appropriate weighting needs to be given to each individual indicator.”</p>	<p>ACAG requests guidance to demonstrate how to apply the weighting mentioned in these paragraphs. This may be best demonstrated through an example to indicate which indicator may have a stronger weighting when concluding on the classification of the entity.</p> <p>ACAG acknowledges classification depends on facts and circumstances of each case and that professional judgement is required to be applied in case of multiple conflicting indicators, however, an example to demonstrate the weighting will be highly beneficial for users. For example, if half of the indicators suggest an entity is ‘FP’ and the other half indicate the entity is ‘NFP’, should some indicators (e.g. stated objectives combined with nature of benefits), have more weighting than the others?</p>
<p>Example 1: Wholly owned state entity General comment</p> <p>“...Nature of equity interest Entity A is a company. The equity interest is in the form of shares owned by the State Government. In the case of Entity A, the nature of the equity interest is clear. In addition, there may not be any restriction on the use of assets in the event Entity A is sold, wound up or ceases to operate. This may</p>	<p>For a State owned corporation, a key consideration for determining NFP status would be whether or not the entity raises capital in the market. Further, it is unlikely that any essential services entity would be able to set their own prices as pricing is generally subject to either ministerial control or an independent regulatory pricing tribunal. The guidance should also consider items such as ministerial direction powers, board independence, capital maintenance requirements, investment and borrowing powers, and market competition (governments create monopoly arrangements as a form of general revenue raising).</p> <p>In the public sector context, the fact that there is no restriction on the use of the assets on winding up or sale may not necessarily be an indicator that an entity is FP. This is because there are instances where the State Government has required FP government entities to distribute its assets to another public sector entity upon wind up or sale.</p>

<p>indicate that Entity A is a FP entity (Emphasis added)..."</p> <p>"... Purpose and use of assets If Entity A holds those assets to operate or sell in order to generate a commercial financial return for the State government, this may indicate Entity A is a FP entity (Emphasis added)..."</p>	<p>Insert the word 'primarily' so as to read <i>'If Entity A holds those assets primarily to operate or sell'</i>.</p>
<p>Example 2: Bicycle shop General comments</p>	<p>As per the facts pattern, the Trust is an NFP entity that sets up a bicycle shop (Company 1). One of the factors to determine the classification of the bicycle shop Company 1 is <i>'if in the event Company 1 ceases trading the trustees are able to determine how to use any residual assets of Company 1, then this may indicate that Company 1 is a FP entity. However, if the trust deed provides that in the event Company 1 ceases trading any residual assets must be donated to a charity that fulfils the same or a very similar charitable purpose to that of the Trust, then this may indicate that Company 1 is a NFP entity.'</i></p> <p>ACAG query why Company 1 would donate its assets to some other charitable organisation with similar objectives, when its own Trust is also charitable and if so, would render it being classified as FP. Further, the optics of the bicycle workshop lack practicality. Providing bicycles <i>'to enable the disadvantaged to benefit from exercise'</i> runs the risk of being perceived as demonstrating lack of social sensitivity. The optics of the bicycle workshop example lack practicality:</p> <ul style="list-style-type: none"> • Since the Trust is also charitable, why would donating assets to its own Trust be an indicator that make Company 1 get a FP entity classification? It may be unlikely that Company 1 would donate its assets to another charity fulfilling a similar charitable purpose, when its own Trust is also charitable. • Providing bicycles <i>'to enable the disadvantaged to benefit from exercise'</i> runs the risk of being perceived as demonstrating a lack of social sensitivity. <p>In addition to the response to Specific Matters for Comment 3, to provide examples to determine the classification of a group, ACAG suggests that this example be expanded to consider the factors preparers should consider in reaching a conclusion on whether the group is a FP or NFP entity.</p>



<p>Example 3 Private education organisation</p> <p>(a) "... Purpose and use of assets</p> <p>If Entity B uses its assets to provide high quality education to immigrant children from poverty-stricken countries, rather than to generate a financial return on its equity, then this may indicate that Entity B is an NFP Entity (Emphasis added)..."</p>	<p>Insert the word 'primarily' so as to read '<i>If Entity B uses its assets primarily to provide</i>'.</p>
<p>Example 5 Social enterprise</p> <p>(a) '...Stated Objectives</p> <p>If entity C's constitution states that its objective is to help children at LSES schools by providing healthy lunches, this may indicate that Entity C is a NFP entity....'</p>	<p>Insert the word 'primary' so as to read '<i>If Entity C's constitution states that its primary objective...</i>'</p>