



AUSTRALASIAN
COUNCIL OF
AUDITORS-GENERAL

The Chairman
Australian Accounting Standards Board
PO Box 204
Collins Street West Victoria 8007
AUSTRALIA

4 April 2008

Dear Professor Boymal,

**ITC 14 PROPOSED DEFINITION AND GUIDANCE FOR NOT-FOR-
PROFIT ENTITIES**

Attached is the Australasian Council of Auditors-General (ACAG) response to the Invitation to Comment referred to above.

The views expressed in this submission represent those of all Australian members of ACAG.

The opportunity to comment is appreciated and I trust you will find the attached comments useful.

Yours sincerely

A handwritten signature in dark ink, appearing to read 'Frank McGuinness', is written over a light-colored background.

Frank McGuinness
Chairman
ACAG Financial Reporting and Auditing Committee

ITC 14 – Invitation to Comment on the Proposed Definition and Guidance for Not-for-Profit Entities

ACAG has reviewed ITC 14 and provides the comments below in response to the requests for comment posed by the AASB. We express our comments from a public sector perspective and we do not express an opinion on the appropriateness of the definition and guidance for the private sector. However, we support the sector neutrality principle and we would be concerned if the definition and guidance is found to be appropriate for one sector but not the other.

(a) (i) invitation to comment on the New Zealand FRSB’s terminology – use of the term ‘public benefit entity’

ACAG believes that the term ‘public benefit entity’ would be appropriate in the Australian environment. We are supportive of the use of the positive terminology focusing on the entity’s primary objective. We have considered the issues concerning consistency/inconsistency across different jurisdictions and we do not believe that the inconsistency issue provides adequate reason to not implement the terminology.

We believe that the ‘public benefit entity’ terminology and the associated definition and guidance more effectively set the parameters for designating entities than the ‘not-for-profit’ terminology does, by better reflecting the intended scope of entities. The positive terminology will, we believe, assist in reducing inconsistency in application of the profit/not-for-profit distinction.

ACAG acknowledges the benefits of consistency with the United Kingdom and New Zealand terminology, and the AASB’s convergence goal with the FRSB. ACAG agrees that there are concerns regarding inconsistency of the terminology ‘public benefit entity’ with the terminology used for example, by the IASB, Canada and the United States and makes the following comments in this regard.

We do agree that there is potential for *some* incompatibility arising due to the different terminology: The terms ‘public benefit entity’ and ‘not-for-profit entity’ (or similar) may be slightly different in scope. However, the similarity of guidance in different jurisdictions reduces the potential for inconsistencies. For example, in the United States and Canada the criteria include:

United States:

- Contributions of significant amounts of resources from resource providers who do not expect commensurate or proportionate pecuniary return
- Operating purposes other than to provide goods or services at a profit

- Absence of ownership interests like those of business enterprises.¹

Canada:

- A lack of financial return from the not-for-profit entity by resource providers.²

We therefore believe that the proposed terminology would not make Australian Standards *significantly* less compatible with other jurisdictions.

Additionally, while ACAG is supportive of consistency goals, it is our opinion that consistency for consistency's sake should not override the goal of improving the quality of financial reporting in Australia. We believe that the 'public benefit entity' terminology will assist in achieving this goal and should therefore be adopted.

(a) (ii) invitation to comment on the New Zealand FRSB's definition of public benefit entity

We support the positive form of the definition, and agree with the first limb of the definition. However, we have some concerns with the second limb: '... and where any equity has been provided with a view to supporting that primary objective rather than for a financial return to equity holders.'

Our concern is best articulated by way of example.

Consider an entity with a primary purpose of providing goods or services for the public benefit, hence satisfying the first limb of the definition. If this entity has even a very small proportion of equity provided to it to support its primary objective, and a very large proportion of equity provided to it for the purpose of a financial return to equity holders, this entity could be defined as a public benefit entity because the definition specifies 'any equity'.

The guidance makes it clear that this is not the type of entity intended to be defined as a public benefit entity; however a literal reading of the definition could result in this outcome. The role of the guidance should be to explain the definition, not to qualify it. We suggest the following revised definition to clarify the intended scope of entities at the definitional stage:

"...reporting entities whose primary objective is to provide goods or services for community or social benefit and whose capital has primarily been contributed with a view to supporting that primary objective rather than for a financial return to equity holders."

¹ Financial Accounting Standards Board, 1980, Concepts Statement No. 4: Objectives of Financial Reporting by Nonbusiness Organizations [6].

² Canadian Institute of Chartered Accountants, 1997, CICA Handbook ss 4400 – 4460.

(a) (iii) invitation to comment on the New Zealand FRSB's guidance for identifying a public benefit entity

ACAG generally agrees that the guidance would be appropriate in the Australian environment. We support the requirement for the entity to determine its primary objective, the emphasis of substance over form, the guidance that public benefit entities need not exist for the benefit of the public as a whole, and the guidance to use professional judgement when there are conflicting indicators.

In particular, we agree with the guidance not giving a ranking to indicators, or making a distinction between primary and secondary indicator, as we believe that the strength of different indicators varies depending on the individual circumstances of an entity. We believe that no single indicator can be found that in every case would conclusively determine whether an entity was a PBE.

As a general comment, we agree with the specific indicators and associated guidance; however we have the following suggestions for improvement.

Founding Documents

We agree that this is a useful indicator and we agree with the guidance. However, where the entity is operating in a different manner than that specified in its founding documents, we suggest including guidance to apply substance over form, and to give reduced weighting to the founding documents indicator.

Nature of benefits

We agree that this is a useful indicator. However, we suggest that the first sentence in paragraph NZ AG 24 be amended for purposes of clarity to state (changes in bold): 'PBE's do not, as **their primary purpose**, exist to generate benefit in the form of a financial return to equity-holders.' This clarifies that an entity that generates a return for equity-holders where this is *incidental* to its public benefit purpose, may still be classified as a public benefit entity. This statement is adequately qualified in the last sentence of the paragraph which refers to possible expectations on the entity's use of this surplus. The guidance for the 'nature of benefits' indicator is otherwise appropriate.

Quantum of expected financial surplus

We agree that the quantum of financial surplus should be included as an indicator. However, the reference in paragraph NZ AG 26 to its being a "strong" indicator should be deleted. It is true that an entity targeting a long-term deficit or break-even position is likely to be a PBE. However, an entity may target a particular financial surplus and still meet the definition of a PBE. For this reason, we do not believe the quantum of the financial surplus can be regarded as a strong indicator.

Nature of equity interest

We agree that the nature of the equity interest is an indicator and generally support the associated guidance. However, we believe the nature of the equity interest is a strong indicator, because it is fundamental to a PBE that it does not exist to provide a financial return to equity holders. We therefore suggest that the following sentence be inserted at the start of paragraph NZ AG 30.

“The nature of equity interest is a strong indicator of an entity’s status as a PBE.”

Nature of funding

We agree with this indicator and generally agree with the associated guidance. However, we believe this guidance could usefully be expanded. We therefore suggest that the following sentence be added at the end of the current NZ AG 32:

“For example, a government agency that receives the majority of its funding from its government to be used for a range of specified activities with quantitative service delivery targets, but without any obligation to repay funding if targets were not met, is likely to be a PBE.”

Changing Classification

We agree with the guidance for entities required to change their classification. However, we request that if an Exposure Draft is issued, the AASB should provide guidance concerning:

- a) any relevant transitional provisions for entities, and
- b) the application of AASB 108 when an entity changes its classification, specifically concerning retrospective application.

Illustrative Examples

ACAG supports the use of illustrative examples. In accordance with the NZ Guidance, we agree that the examples should not conclude as to whether the example entity is profit-oriented or a public benefit entity, but rather illustrate the characteristics to be considered in reaching a conclusion. We request that the AASB utilise Australian-specific examples in any Exposure Draft that arises from this exercise.

ACAG believes that Paragraph NZ AG 37 should be relocated to directly follow paragraph NZ AG 17. Paragraph NZ AG 37 states:

In assessing the nature of an entity appropriate weighting needs to be given to each individual indicator. Depending on the circumstances some indicators will provide a stronger indication than others about the underlying nature of the entity. The entity will need to consider each indicator against the other indicators and make an overall assessment of whether or not the entity is a public benefit entity.

This guidance is important because it communicates to constituents that the indicators do not have a set ranking and that the circumstances of the entity will define which indicators are more determinative. It would be useful to include this

guidance directly under the list of relevant indicators and before the discussion of each indicator, to ensure that constituents have this consideration in mind when using the indicators in designating an entity as a profit-oriented entity or public benefit entity.

(a) (iv) invitation to comment on the requirement to disclose that an entity is a profit-oriented entity or public benefit entity

ACAG supports the requirement for each entity to disclose whether it is a profit-oriented entity or a public benefit entity. The designation has an effect on accounting policy choices, which themselves must be disclosed. It is logical that a designation affecting accounting policy choices should also be disclosed. This will assist users in understanding the nature of the entity and its reasons for selecting specific accounting policies. We agree that the requirement should be implemented as an Aus paragraph in AASB 101.

We further note that we believe it should *not* be a requirement for each entity to disclose its *reasons* for its designation as a profit-oriented entity or a public benefit entity. We believe that it is sufficient for users to be informed of the general reason for the selection of accounting policies (i.e. that the entity is a for-profit entity or a public benefit entity). We make this comment because the issue was raised in ED-100 Proposed Amendments to the New Zealand Equivalent to IAS 1 *Presentation of Financial Statements*, but was not subsequently inserted as a requirement in the New Zealand Guidance. We believe that this decision should be followed in Australia.

(b) Invitation to comment on the status of the guidance as an integral part of an Accounting Standard

ACAG supports the guidance forming an integral part of an Accounting Standard, as an Appendix to AASB 101. This will ensure that the guidance is given appropriate significance, as constituents will be obliged to apply it as a mandatory requirement of an accounting standard. Inadequate consideration of the guidance may result if it was provided as implementation guidance not forming an integral part of the standard.

AASB 101 is the appropriate standard as it requires that financial statements present fairly the entity's financial position, financial performance and cash flows. Designation as a profit-oriented entity or a public benefit entity affects the choice of accounting policies and therefore affects this fair presentation. Therefore, the guidance should form an integral part of AASB 101.