RMIT University

School of Accounting and Law

Building 108, Level 15
239 Bourke Street
Melbourne VIC 3000
Australia

GPO Box 2476V
Melbourne VIC 3001
Australia

Tel. +61 3 9925 5700
Fax +61 3 9925 5741
www.rmit.edu.au

2nd April 2008

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

Dear Sir,

Invitation to Comment, ITC 14 Proposed Definition and Guidance for Not-for Profit Entities

Responding to the published Invitation I attach my comments.

The comments I have made may be summarised as follows.

- The present distinction between entities of a for and not for profit nature does not appear to cause difficulties and appears well bedded down in the Australian context.
- It is unclear whether the NZ FRSB concept of a public benefit entity is intended to exactly mirror the idea of a not-for profit entity, or, if not, what the difference might be. If the intention is that the types of entities covered by the two terms are the same it seems unnecessary to introduce a new term.
- While the NZ FRSB Guidance defines a 'Profit –orientated entity' as one that is not a 'Public Benefit entity' (NZ AG 2), the Guidance is confusing because also appears to define a Profit-orientated entity an entity as one concerned with generating a 'commercial or market return', (NZ AG 27 and Scenario 2).

- The notion of 'profit' introduced in the NZ Guidance is that of 'an adequate rate of return', (NZ AG 20, 27, 29, possibly 30 and Scenario 2), rather than the usual accounting idea that 'profit' is a surplus, or residue.
- The idea at the centre of the NZ FRSB Guidance that public benefit entities are to be distinguished by the motive of their establishment being to further 'the public benefit' does not seem to deal with two possibilities. These are that
  - the idea of public benefit may not be inconsistent with the intention to derive a profit (which would be a Profit-orientated entity as defined in the Guidance), and
  - establishment of an entity to serve the benefit of members might be against a broader, or general, public good.
- Overall the impression is that the distinction between profit-orientated and public benefit entities employed in the Guidance becomes 'difficult' to follow, indeed is admitted to be so in NZ AG 32 – 35.

If Guidance were to be offered in Australia on the distinction between Profit and Not for Profit entities it is suggested it ought to contain two characteristics. Firstly, to define profit as a surplus, or residual, that may occur whatever the nature of an entity and, secondly, to indicate these types of entities should be distinguished on the basis of their purpose or function in the use of scarce resources. But my view is that the distinction is well established in Australia already.

I trust that my comments will be of some help and apologise for my late response,

Yours faithfully

Dr Tom Rowles
Senior Lecturer

Response to Invitation to Comment ITC14
Proposed Definition and Guidance for Not-for Profit Entities

Dr Tom Rowles
Senior Lecturer
School of Accounting and Law
RMIT University

I am an academic in the School of Accounting and Law at RMIT University with an interest in financial reporting by public sector and not for profit entities. In addition to including public sector issues in my teaching programme I have undertaken research activities and have published on financial reporting issues relevant to this important sector of an economy. The following comments are offered on the issues raised in ITC 14.

As understood, the issue raised in ITC 14 concerns the applicability to the Australian context of the idea of a 'public benefit entity' as that idea is understood in the New Zealand, and perhaps United Kingdom, financial reporting context. While not claiming to be an authority on the idea of a 'public benefit entity', the comments offered reflect understanding of the idea as it is communicated in ITC 14 and the various scenarios contained therein. Broadly these comments support of continuation of the use of the Australian terms, 'for profit' and 'not for profit entities', subject to observations made in point 2 below. The following comments are made supporting this position.

1. As a general proposition, it is noted that terminology in financial reporting, or accounting more generally, frequently creates difficulty, and clarification will be necessary when it becomes apparent that terms and expressions have become consequential in the preparation and interpretation of financial statements. That having been said, consideration by the Board of terminological issues to remove ambiguity and

uncertainty would seem to makes a standard setters responsibility more difficult, may stymie the standard setting process and involve a cost to the standard setting process, not least in the diversion of skilled staff from other tasks that might be more important. In the Australian context development of financial indicators relevant to not for profit entities might be thought to be such an issue of alternative importance, and one relevant to the distinction between the purpose of entities raised in ITC 14.

2. The response offered here to the Boards Invitation is limited because it is difficult to understand the nature of difficulties constituents have experienced in distinguishing between for profit and not for profit entities referred to in the penultimate paragraph on page iii, and the nature of the research that the Board has found useful referred to in the final paragraph on that page.

3. The observation on page iii of the ITC that the Australian financial reporting Framework is substantially arranged about the distinction between 'profit' and not for 'profit entities' is noted here to be one that seems natural; arising from real differences in the operations of entities concerned with the use of scarce resources and differences in decisions to be made about operating activities. Generally, the distinction is easily drawn, and no difficulty seems to have been experienced in practice in Australia other than then noted in point 2 above. For example, the dichotomy has not presented any particular difficulty when instructing undergraduate or graduate students.

4. Based on the information contained in ITC 14, the New Zealand FRSB dichotomises financial reporting standards on the basis of whether an entity is operated, or not, for 'a public benefit' rather than in Australia where the relevant dichotomy relates to whether an entity's primary purpose is to generate a profit rather than employ scarce resource in the achievement of some other goal. In the New Zealand construct, entities not meeting the definition of 'public benefit entities' are by definition 'profit orientated entities', NZ AG 3: that is, it is understood *implicitly*, public benefit entities do not pursue profit making objectives, and, with greater difficultly, entities not concerned with the profit making are operated for the public benefit. Reservations about this are noted in points 7

and 8 below. An issue that arises is whether 'public benefit' equates exactly with 'not for profit' as that idea has come to be understood in Australia and elsewhere. This is apparently the intent of the New Zealand Guidance as contained in ITC 14, though the interpretation drawn here is that such equivalence is not established.

5. While the terms 'for profit' and 'not for profit' as used in Australia seem to be mutually exclusive, the 'terms for profit' and 'public benefit' do not seem mutually exclusive, and the distinction in NZ AG 3 is one that creates great difficulty, and might be considered to be flawed. For example, an entity described as a 'public benefit entity' might engage in profit seeking activities and remain one dedicated to the public benefit: that is, the public receives the benefit of the profit seeking activity. (Scoping out this possibility seems to be the purpose of the Scenarios provided by FRSB, and included in the Invitation). The category 'public benefit entity' emerges as a construct that is a question of fact, to be determined in each instance against cumbersome criteria; and making the necessary distinction does not seem to simplify the accountants' task. (In a more general sense, a profit seeking entity that meets the market test by surviving by the provision of goods and services to the public generally might be considered to be operating in 'the public interest'.)

6. The Australian distinction between 'profit seeking' and 'not for profit entity' turns on the objective of an entity in the use of scarce inputs, and 'profit' is understood as a residual, or surplus, that might arise from the operation of either type of entity. By contrast, in the FRSB usage, identification of 'for profit' behaviour is more complex. In NZ AG 3, Profit-orientated entities are not defined, yet in NZ AG 27 a 'profit – orientated entity is also defined as an entity with the objective of generat(ing) a commercial market return…' This idea is developed further in NZ AG 28 – 30, and articulated further in Scenario 1, p.6, as '…an aim to generate an expected financial surplus equivalent to a market return…', and ambiguity is therefore created. It, is, for example, unclear what the status of an entity would be that does not meet this definition of a Public Benefit entity, but which does not have the defined objective in NZ AG 2.

7. In this respect, it is observed that the scenario constructed in Scenario 2: Charity Shop, p.7, would seem to be conceptually flawed: a seller of a homogeneous or semi homogeneous good, such as bicycles, operating in a competitive market would be a price taker. Much of the analysis of what might constitute a profit orientated entity seems beset with confusion between profit as a surplus and a construct built around intent to earn a 'market rate' (see also NZ AG 27). Even accepting that some entities might have the market power to set a return, in many (it is to be hoped, most) instances this would not be so. A construct built on intent to earn a market return is therefore flawed: profit is generally to be understood as a surplus, or residual. (In Alfred Marshall's exposition of the behaviour of the firm, a 'normal' return' is handled as cost, and 'profit' is calculated as a surplus, or residual, above costs that include a normal return. Examples of such an approach to reporting a 'normal return' as a cost and 'profit' as a surplus can be identified in extant accounts from the nineteenth century. Exposition of Marshall's approach is quite usual in economics textbooks in the twentieth century, and, of course, in accounting profit is taught as a surplus or residual.)

8. A situation can be envisaged in which an entity is a 'not a for profit entity' but, at the same time, might be construed as not existing for the 'public benefit' as defined in NZ AG 2. Examples that come to mind include trade associations, unions and medical colleges and associations and, in the Australian context, possibly service clubs; frequently such institutions have the character of advancing the interests of members at the cost of society generally, an idea not canvassed in NZ AG 15. Such organisations are perhaps better understood as having the character of Adams Smith's notion of combinations against the public good, however much they have come to be accepted and serve a social function other than promotion of a 'general (or public) good'.

9. In as much as the expressions 'for profit' and 'not for profit' might be causing difficulties it is suggested that the term 'profit' be amplified or defined in any Guidance to be provided in its usually understood sense as a surplus, or residual, calculated after consideration of additions to and deductions from wealth in an operating period. Similarly, any such Guidance ought to stress that the essence of the necessary distinction

lies as a matter of judgment on the operating objective(s) of an entity. However, this point is judge here to be adequately covered in existing material, and to be a matter of general understanding.

Dr Tom Rowles, 31st March, 2008

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