



New South Wales
TREASURY

Professor David Boymal
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31 March 2008

Dear Professor Boymal

Comments on ITC 14 'Proposed definition and guidance for not-for-profit entities'

New South Wales Treasury welcomes the opportunity to make a submission on the above Invitation to Comment. Detailed comments are attached.

NSW Treasury supports the development of guidance regarding the 'not-for-profit' definition, because there are currently differing interpretations of the term. However, we do not support the use of the New Zealand 'public benefit entity' term, definition or guidance for the following reasons:

- It is a subjective term that has a wider connotation than the term 'not-for-profit'.
- It confounds two different concepts that are not mutually exclusive (i.e. public benefit' and a 'financial return to equity holders').
- It is not relevant to determining differential accounting treatments.
- It is inconsistent with IASB terminology.

Further, while we prefer the current 'not-for-profit' term and definition over the 'public benefit entity' concept, we strongly believe that the existing definition should be improved. Consistent with financial management theory, an improved definition should be based on whether or not equity is primarily provided with the objective of obtaining a financial return to equity holders.

However, any alternative definition and guidance should only be put forward after synthesizing all relevant Australian and overseas literature, including Government Finance Statistics principles and the Heads of Treasuries Accounting and Reporting Advisory Committee guidance.

If you have any queries regarding these comments, please contact me on (02) 9228 3019 or Dianne McHugh on (02) 9228 5340.

Yours faithfully

Robert Williams

Robert Williams
for Secretary

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

(i) *Terminology – use of the term ‘public benefit entity’*

NSW Treasury does not support the use of the ‘public benefit entity’ terminology; and prefers the existing ‘not-for-profit’ terminology. The term ‘public benefit’ is not supported as its meaning is unclear, subjective and emotive. In contrast, the ‘not-for-profit’ term is preferred as it is a more objective term that is consistent with financial management theory and IASB terminology.

The use of the term ‘public benefit’ has a much wider connotation than the term ‘not-for-profit’. For example, using the economist’s classification between ‘needs’ and ‘wants’, it could be asserted that all goods and services provided to meet ‘needs’ would be for community or social benefit, including food, water, clothing, shelter (housing and heating (including electricity)), education and health. However, most goods and services provided for community or social benefit can be, and are, provided by private sector as well as public sector entities, and by for-profit and not-for-profit entities (e.g. education services or medical services).

Therefore, the term ‘public benefit’ is not a good basis to distinguish between types of entities to which differential reporting requirements apply, as ‘public benefits’ are provided by both for-profit and not-for-profit entities.

The use of the term ‘public benefit’ has also changed over time. Goods and services that traditionally were provided by government as a ‘public benefit’ are now provided by for-profit private sector entities (such as electricity and transport). Osborne and Gaebler *Reinventing Government* (1992) emphasised this in saying that governments should ‘steer rather than row’. In short, there are very few services a government *must* provide. It has been suggested that, except for the legislature, judiciary, police and defence, most activities of government can be provided by the private sector.

In contrast, at the opposite end of the dimension to goods primarily provided for ‘public benefit’, are goods provided for *wants*, including luxury goods. However, this is also confusing and unhelpful given that, in the recent past, governments provided services, such as banking and insurance, not because of the nature of the benefits, but because the private sector would not take the risk and provide equity with the objective of a financial return. Today, private sector entities provide these services with an expectation of financial return.

(ii) Definition of public benefit entity

NSW Treasury does not support the definition of a ‘public benefit entity’, as it confounds (or mixes) two different concepts (i.e. ‘public benefits’ and ‘returns to equity holders’) that are not mutually exclusive.

While we prefer the current ‘not-for-profit’ definition over the ‘public benefit entity’ concept, we strongly believe that the existing definition should be improved. However, any alternative definition and guidance should only be put forward after synthesizing all relevant Australian and overseas literature, including Government Finance Statistics principles and the Heads of Treasuries Accounting and Reporting Advisory Committee (HoTARAC) guidance.

The main problems with the definition of a ‘public benefit entity’, together with NSW Treasury’s proposed alternative definition are discussed below.

Public benefit entity definition mixes two concepts – public benefit vs return on equity

The main problem with the definition of a ‘public benefit entity’ is that it confounds two concepts that are not mutually exclusive; i.e:

1. ‘The nature of the benefit’ - i.e. the ‘public benefit’ dimension in contrast to goods not provided for public benefit (this is implied but not stated); and
2. ‘Equity provided for a purpose’ – i.e. the dimension of equity provided ‘to achieve a return’ in contrast with equity invested ‘without an expectation of a return’.

The NZ definition incorrectly infers that an entity established to provide community or social benefits cannot have a primary objective of providing a financial return to equity holders. However, as discussed in the response to (i) above, there are numerous examples of public benefits that are provided both by for-profit and not-for-profit entities (e.g. education and medical services).

In summary, a definition which attempts to place these two concepts (i.e. public benefits and a financial return to equity holders) at opposite ends of the same dimension confounds the issues and is not relevant as a basis for determining the application of differential accounting treatments.

Proposed alternative definition

As discussed above, the current Australian ‘not-for-profit’ definition is preferred over the NZ definition. However, we recommend that the current Australian definition be improved.

We recommend a for-profit / not-for-profit entity be defined, based on whether or not equity is provided with the principle objective of obtaining a financial return to equity holders (rather than on whether profit is the principle objective); i.e.:

- A *for-profit entity* is an entity whose equity has been provided with a principle objective of obtaining a financial return to equity holders.
- A *not-for-profit entity* is an entity whose equity has not been provided with a principle objective of obtaining a financial return to equity holders.

These proposed definitions are more relevant for determining differential accounting treatments for the following 5 reasons:

1. They are consistent with financial management theory which states that "...equity holders invest equity with an objective of maximising the market value of the owner's equity" (*Fundamentals of Corporate Finance*, 1994, S. Ross, S. Thompson, M. Christenson, R. Westerfield and B. Jordan, page 14), which requires both re-investing profits and paying dividends.
2. They are consistent with the Preface to IFRSs which describes profit oriented entities as those "...that provide dividends or other economic benefits directly and proportionately to their owners, members or participants".
3. They are consistent with the proposed United Nations System of National Accounts requirements (that ultimately flow down to the Government Finance Statistics), which limit equity injections to circumstances where equity is provided for "commercial reasons", with a "valid expectation" of dividends.
4. They are consistent with the Australian Taxation Office definition, which states that any profit made by a non-profit organisation goes back into the operation of the organisation to carry out its purposes and is not distributed to any of its members.
5. It resolves a current misperception that a not-for-profit entity should not earn or target a profit. Instead, the critical distinction is whether profit is reinvested or intended to provide a financial return to equity holders.

(iii) *Guidance for identifying a public benefit entity*

In principle, NSW Treasury supports the development of additional guidance regarding the 'not-for-profit' definition, because there are currently differing interpretations. However, as we do not agree with the 'public benefit entity' definition, the NZ guidance regarding that definition is not supported.

However, putting aside the fundamental issue of what is the appropriate definition, the following additional comments are made regarding the NZ guidance:

- Nature of the benefits (NZ AG23-25) – As discussed, NSW Treasury does not believe that the 'nature of the benefit' is a relevant indicator. While it is relevant whether or not market prices are charged, this does not characterise the 'nature of the benefit' and is more appropriately addressed as part of the other indicators.
- Nature of equity interest (NZ AG30-31) – This is not necessarily a useful indicator in the public sector context. A government would expect a return on net assets on wind up for both for-profit and not-for-profit / public benefit entities. Also, in the public sector, it is not necessary for shares to be issued for a dividend to be paid or expected.

- Nature of funding (NZ AG32) – The meaning of funding wholly or ‘primarily’ through the sale of goods and services is unclear. Additional guidance could be provided, as per the HoTARAC paper¹, which uses a 50% rule of thumb and discusses funding during the start up years.
- Quantum of expected financial surplus (NZ AG26-29) – Additional guidance is required about what a ‘commercial’ or ‘market’ return is, in a monopoly context (e.g. water). For example, the HoTARAC paper refers to rates of return ‘appropriate for the industry’, rates that reflect the risk-return relationship and the ability to cover operating outflows and asset replacement. Also it needs to be more strongly emphasised that intention is important, rather than actual profits.
- Additional HoTARAC factors - Two factors in the HoTARAC paper which may be relevant are not discussed in the NZ guidance – i.e. ‘the governance framework’ and ‘classification under GFS’.

Finally, while the same definition could be adopted for all not-for-profit entities, some differential guidance may be needed for particular types of not-for-profit entities e.g. public sector versus private sector entities. This may mean the inclusion of additional or different indicators; e.g. consideration of GFS classification is particularly relevant in the public sector.

(iv) Requirement to disclose that an entity is a profit oriented or PBE entity

NSW Treasury agrees that entities should disclose their status as either profit oriented or a not-for-profit / public benefit entity, as this classification impacts on the accounting policies adopted.

(v) The status of the guidance as an integral part of an Accounting Standard

NSW Treasury agrees with the inclusion of guidance in an Appendix that is an integral part of an Accounting Standard. A possible location is either, AASB 101 *Presentation of Financial Statements* or AASB 108 *Accounting Policies, Changes in Accounting Estimates and Errors*. However, whichever Standard is chosen, a definition for a ‘not-for-profit entity’ (or equivalent term) should also be included in the main body of the Standard.

¹ A copy of the HoTARAC paper is attached to the HoTARAC submission on the ITC to the AASB.