

Australasian Council of Auditors General Advisory Committee

Guidance on determining whether a government entity is not-for-profit or for-profit

Application date

It is proposed that this guidance paper be effective from 1 April 2005.

Introduction

This paper has been prepared by the Australasian Council of Auditors General Advisory Committee (AAC) to provide guidance to Auditors-General and their staff in Australia when assessing whether public sector entities have been appropriately classified as for-profit or not-for-profit entities in accordance with Australian Equivalents to International Financial Reporting Standards.

This paper is similar in substance to a separate paper prepared by the Heads of Treasuries Accounting and Reporting Advisory Committee (HOTARAC).

The AAC recommends the application of the principles outlined in this paper by Auditors-General in Australia at least until such time as the AASB provides separate guidance on this matter. It is acknowledge that the paper is only a guidance document and that each Auditor-General reserves the right to reach his/her own conclusions on the assessment of whether an entity is a for-profit or a not-for-profit.

The Issue:

The Australian equivalents to International Financial Reporting Standards (AEIFRS) issued by the Australian Accounting Standards Board (AASB) on 15 July 2004 establish reporting requirements for entities preparing general purpose financial reports. The standards issued by the AASB apply to entities in both the private and public sectors including not-for-profit entities. However, the IFRSs issued by the International Accounting Standards Board (IASB), which form the basis of the AASB Standards, focus on reporting by for-profit entities.

Hence, the AASB, to address the differing needs of a broader group of reporting entities, has provided some differential requirements for the public sector and some relief to not-for-profit reporting entities from certain aspects of the for-profit reporting requirements. **The standards define a not-for-profit entity as an entity "whose principal objective is not the generation of profit."**(AASB 136 Aus 6.2)

The Commonwealth, State and Territory governments are reporting entities for the purposes of AASB standards and these standards apply to their whole-of-government financial reports. It is clear that none of those governments has, as its principal objective, the generation of profit and, consequently, the whole-of-government financial reports are to be produced on a not-for-profit basis.

The AASB has recently recognised the General Government Sector (GGS) as a reporting entity and it is equally clear that, in no jurisdiction, does this sector have profit generation as its principal motive.

While GGS entities will normally be classified as not-for-profit, it may be that some entities in that sector are for-profit entities. Hence, these entities will be required to prepare their general purpose financial report incorporating some items on a basis different to that to be used for the whole-of-GGS and whole-of-government reports.

Similarly, in the PTE Sector, there may be some entities that are for-profit entities. These entities will be required to prepare their general purpose financial report incorporating some items on a basis different to that to be used for the whole-of-government report.

The issue is how to determine whether an entity is classified as either for-profit or not-for-profit based on the underlying substance of the circumstances using the above definition and to determine the criteria most relevant to making this classification.

Conclusions and Recommendations:

To determine whether an entity is classified as for-profit or not-for-profit, nine criteria were developed and evaluated against the AASB definition of a not-for-profit entity. The conclusions drawn from this analysis have been classified under two headings:

1. Effective criteria that provide a basis for discriminating between a for-profit and a not-for-profit entity. Some of these criteria provide either conclusive support or a strong but rebuttable presumption for determining whether an entity is either for-profit or not-for-profit. Other criteria provide varying degrees of support for an entity's in-substance classification as being either for-profit or not-for-profit, but which are not conclusive in isolation.
2. Rejected criteria that do not provide a basis for discriminating between a for-profit and a not-for-profit entity.

Effective Criteria:

These criteria are not mutually exclusive and provide clarification or further support for determining the underlying substance of the entity to be classified.

The most relevant criteria, ranking in approximate order, are:

1. Is the substance of the not-for-profit definition explicitly included or excluded in legislation, associated regulations or in its constitution?
2. Is the entity funded from the Government Budget to deliver, as its principal activity, goods &/or services for no or nominal cost to the beneficiary? (i.e. is the entity Budget dependent?)
3. Do the financial targets of the entity reflect profit concepts or an objective to be commercially successful?
4. Is the entity self-funding in the longer-term including raising sufficient revenue from its trading or provision of services to meet ongoing maintenance

- expenditures for all its assets and fund the replacement of the existing service potential of these assets?
5. Does the entity pay tax or is it subject to tax equivalent reporting to the Government?
 6. Does the entity intend to pay or has been paying dividends and are the dividend targets expected to be equal to or greater than the long-term bond rate expressed as a rate of return on equity or contributed capital?

Rejected Criteria:

The following criteria have been rejected, as they do not provide a basis for discriminators as between for-profit and not-for-profit:

1. A regulator sets prices.
2. The entity is a monopoly provider
3. The majority of revenue from its trading or provision of services is gained in a fully contestable market.

Using the criteria:

This analysis has focussed on the use of the identified criteria to form the basis of distinguishing a for-profit entity from a not-for-profit entity. While the determination may be clear and certain for some entities, in certain cases, the assessment as to whether a principal objective exists, and whether that the entity does or does not have an overriding profit motive, will remain a matter of professional judgment for preparers of financial reports, their auditors and key stakeholders, such as ministers.

In respect of the criteria, apart from the attempt at a broad ranking as to their relative importance, it has not been possible to derive appropriate weightings. This means that no single criteria will determine an entity's classification. For each entity, there may be a range of variables interacting on their orientation to profit or otherwise, and hence a criterion may have a different impact on each particular entity when determining the classification as either for-profit or not-for-profit.

It should be stressed that in determining an entity to be not-for-profit because its principal objective(s) are for the public benefit **does not** suggest in any respect that it should be any different from a for-profit entity in using its available resources in the most efficient and effective manner possible. There is no conflict between being classified as not-for-profit entity and attempting to maximise outcomes in the same manner as would a for-profit entity.

To facilitate determining the classification of an entity as either for-profit or not-for-profit, a flowchart incorporating the six criteria is attached as Appendix A. It is recognised that the process will always involve a degree of professional judgment and hence subjectivity and therefore the question boxes in the flow chart are linked by broken lines. This paper is an attempt to make the process as objective as possible so as to achieve consistent outcomes whenever the methodology and flowchart is applied. **By working down the flowchart the criteria are progressively applied until an accumulation of the considerations permits a decision to be derived.**

Discussion:

The discussion that follows evaluates the nine criteria referred to previously using the AASB definition of not-for-profit:

Criterion 1: Is the substance of the not-for-profit definition explicitly included or excluded in legislation, associated regulations or in its constitution?

If the legislation or regulations associated with the establishment of the entity or its constitution contain a clear statement describing the principal objective as being the generation of profit then the entity would be classified as being for-profit. If the principal objective(s) were stated as the achievement of some "public interest" outcome(s), then the entity would be classified as being not-for-profit.

Shareholder or equity holder resolutions, ministerial directions and government policy statements, providing they are consistent with legislation, regulations or the constitution of the company covering the purpose of the entity, may also be a means by which owners make it clear that they expect an entity to generate a profit and a positive return on investment as its principal objective. However, these shareholder resolutions, ministerial directions and government policy statements must accurately reflect the classification of the entity that would result from applying the balance of the criteria outlined in this paper to the underlying position.

When the principal objective is not explicitly set down either in legislation, regulations or in the entity's constitution, whether it should be classified as either for-profit or not-for-profit will often involve analysis of less explicit terminology. For example, the legislation might state that the key objectives of the entity are to be "commercial" in the conduct of its activities and efficient in the delivery of its community service obligations. However, an entity carrying out its activities according to commercially acceptable principles does not necessarily equate with the generation of profit as being the principal objective.

Alternatively, the legislation may require the entity to be "financially viable". However, being "financially viable" is not in itself conclusive in distinguishing a for-profit entity from a not-for-profit entity. There exists a clear community expectation that not-for-profit entities are "financially viable" and uses the resources at their disposal efficiently and effectively. In these cases, further analysis will be required to determine the classification of the particular entity.

From a legal interpretation, the presence or otherwise of an explicit principal objective will be the basis for determining the classification. However, with the intent that application of Standards is to be based on substance as distinct from rules or legal form, there is also an obligation to determine the substance underlying the motivations behind an entity's existence.

Situations do arise where an entity has more than one statutory "principal objective" which may be given equal weight. In such situations, the profit-generating objective must be dominant. A critical determinant of the appropriate classification of an entity in such situations would be the response of the board of governance where a decision had to be made between fulfilling the profit motive or achieving some public interest

outcome. A choice by the board of supporting the public interest outcome would indicate that the principal objective is consistent with the entity being not-for-profit.

A number of not-for-profit entities operating within the Australian community have separate and sometimes significant cash generating units. However, the cash generated is reinvested back into the group entity to achieve public interest outcomes. Hence, the existence of a cash generating unit, while suggestive of a profit motive needs to be assessed as to whether it provides returns or dividends to equity, or whether the cash generated is retained.

Hence, it can be concluded, that in the absence of an explicit objective, the impact of other criteria will need to be considered.

Criterion 2: Is the entity funded from the Government Budget to deliver as its principal activity, goods &/ or services for no or nominal cost to the beneficiary (i.e. the entity is Budget dependent)?

If the entity is funded by the government for its principal activities, being the delivery goods &/or services for no or nominal cost, then this would provide conclusive proof that the entity is not-for-profit.

An extension of the above can arise when the entity is funded by the government to meet specific community service obligations. In this context, the entity is delivering public benefit outcomes to sections of the community, which a for-profit entity would not undertake without financial assistance due to the absence of a profitable outcome. However, for an entity to be classified as not-for-profit based on the funding of community service obligations will require such activities to constitute the principal purpose of this entity.

The determination as to what percentage measure of total activities would constitute “principal activity” remains a matter of judgment. However, if more than half the expenditure of an entity is funded by the government to deliver goods and/or services for no or nominal cost to the beneficiary of the goods and/or service, then this would provide substantive evidence to support a not-for-profit classification.

Criterion 3: Do the financial targets of the entity reflect profit concepts or the objective to be commercially successful with explicit rates of return?

If the behaviour of management explicitly targets profits or rates of return in relation to its main activities, then in substance there is support for the entity being classified as a for-profit entity

It should be emphasised that management intention is the basis of the criterion as distinct from the actual rates of return achieved. An entity that incurs losses over a number of successive reporting periods does not necessarily imply the absence of an intent by management to achieve a profit. Conversely, successive profits over an extended period, where these are not distributed to equity holders, would not prevent an entity from being classified as not-for-profit.

There is a justifiable expectation that a not-for-profit entity should be aiming to operate efficiently and effectively with its scarce resources and that any profit or surplus is retained to further its ability to provide "public interest" or not-for-profit outcomes.

Alternatively 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.

Criterion 4: Is the entity self-funding in the longer-term including raising sufficient revenue from its trading or provision of services to meet ongoing maintenance expenditures for all its assets and to fund the replacement of the existing service potential of these assets?

The extent to which an entity is able to earn revenues to cover expenditure will be a consideration in determining whether it is a for-profit entity. However, the concept of self-funding covers more than periodic operating revenue exceeding operating expense. Self-funding involves that in the longer term, the entity will be able to earn sufficient revenue to cover the maintenance and replacement of its total existing service potential.

The greater the prospect for an entity to be self-funding in the longer-term, the more likely that the entity may be a for-profit entity. However, a not-for-profit entity could also aim to be self-funding in the longer term. Hence, the criterion by itself is unlikely to provide conclusive support in determining the classification of an entity.

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 to be provided by the government can vary regardless as to whether the entity is for-profit or not-for-profit. The government can in the early years of a for-profit entity provide considerable grants and subsidies to support an infant industry that it believes will provide further community benefits in the longer term eg employment.

Hence, the criterion by itself is unlikely to provide conclusive support in determining the classification of an entity. However, to be self-funding in the longer term is considered to be a necessary and essential criterion for classification as a for-profit entity. It should be noted that borrowing for new capital expenditure would not be a consideration so long as long-term revenues earned from trading or from providing services of the entity provide for the repayment of the borrowings including capital and interest.

Criterion 5: Does the entity pay tax or is it subject to tax equivalent reporting to the Government?

Whether or not an entity is obligated to pay tax or is part of a tax equivalent reporting regime will be a consideration in determining whether it is a for-profit entity. A taxable entity is likely, but not necessarily, to be earning a profit for distribution to

equity holders. Taxable income and accounting profits are different concepts and have a different basis for determination. Entities controlled by the government may be subject to a tax-equivalents regime, while having a principal objective of providing goods and/or services on a not-for-profit basis. Hence, the criterion by itself is unlikely to provide conclusive support in determining the classification of an entity.

Criterion 6: Does the entity intend to pay dividends and are the dividend targets expressed as a rate of return which is set at equal to or greater than the long-term bond rate expressed as a rate of return on equity or contributed capital?

Under the Corporations Act, a company may only declare dividends out of profit. In the situation where the owners or equity holders are entitled to a surplus or profit, this provides substantive support for the entity being classified as for profit.

If targeted dividend levels have been established they should be at least equal to or greater than the long-term bond rate expressed as a rate of return on equity or contributed capital, to support a commercial perspective of the entity being for profit.

This measure has been selected as it is the lowest rate of return that rational management of a for-profit entity would target, given that the risk associated with any project or entity would justify a rate of return above the risk free rate. In other words, if the risk free rate represents the lowest measure of the cost of capital, then rational management of a for-profit entity would be expected to earn a return in excess of this rate.

It is good business practice for dividends rates to be higher than interest rates payable to debt providers. This is to compensate the equity holder for the additional risk attaching to an equity investment.

Some public sector agencies are required to pay a dividend which is in the form of a pre-determined percentage of profit. Furthermore, profits could arise because assets are brought to account at historical cost, resulting in lower depreciation expenses. However, if such entities have an explicit principal objective of achieving public interest outcomes they would be classified as not-for-profit.

Rejected Criteria:

Criterion R1: Does a regulator set prices?

The presence of a price regulator is not seen as an effective criterion for determining the classification of a reporting entity. An entity operating in a market where a regulator or a pricing authority sets prices can be either a for-profit or a not-for-profit entity. They may be for-profit entities because for example, in a price-regulated market, entities can compete by controlling their costs, adjusting their margins and constructively marketing their products and/or services. These entities are able to earn a profit and distribute dividends to equity holders. Alternatively, a not-for-profit entity may deliver goods and/or services as a public benefit, while subject to prices being determined by a regulator.

Criterion R2: Is the entity a monopoly provider?

The fact that an entity is a monopoly provider is not seen as an effective criterion for determining the classification of a reporting entity. An entity operating as a monopoly in a market can be either a for-profit or a not-for-profit entity. They may be for-profit because for example, entities can charge what the market will bear with profits being distributable as dividends to equity holders. The government has traditionally filled the role of providing goods and/or services in the public interest when the timing of profits is considered too remote and uncertain.

Criterion R3: Is the majority of revenue from its trading or provision of services gained in a fully contestable market?

The extent to which an entity is able to earn the majority of its revenue from its trading or provision of services in a fully contestable market does not provide a basis for determining whether it is a for-profit entity or a not-for profit entity.

Prima facie, when a public sector entity is trading or providing services in a market in direct competition with for-profit private sector entities this would provide a rebuttable presumption that the public sector entity was for-profit. However, applying the primary and secondary criteria above to this entity would already have determined its classification without consideration of whether or not the market was fully contestable. An example of not-for-profit entities competing in a fully contestable market (broadly defined) would be a government museum and a government art gallery competing for patronage from members of the community

To further illustrate, a gift shop in a museum may sell goods to the community in competition with for-profit speciality shops or department stores. However, the museum will, in all probability, transfer any surplus arising from the gift shop to financially support the achievement of the public interest objectives of the museum. Hence, the criterion by itself is unlikely to provide conclusive support in determining the classification of an entity. The discussion of the museum shop also emphasizes that while the gift shop as a separate entity may be regarded as "for-profit", as a component of a larger entity being the museum, the entity as a whole would be regarded as "not-for-profit".

Attachment:

Appendix A: Determining the classification of an entity as for-profit or not-for-profit.

The observations on page 3 of this guidance paper relating to the application of Appendix A in supporting a judgement decision are repeated -

“To facilitate determining the classification of an entity as either for profit or not-for-profit, a flowchart incorporating the six criteria is attached as Appendix A. It is recognised that the process will always involve a degree of professional judgment and hence subjectivity and therefore the question boxes in the flow chart are linked by broken lines. This paper is an attempt to make the process as objective as possible so as to achieve consistent outcomes whenever the methodology and flowchart is

applied. By working down the flowchart the criteria are progressively applied until an accumulation of the considerations permits a decision to be derived.”

It is the clear intention that the exercise of professional judgement is essential and the various criteria need to be considered together when forming a view of the “for-profit/not-for-profit” classification.

Appendix A - Determining the classification of a government entity as for-profit or not-for-profit

