

## Appendix 4: New Zealand Application Guidance: When is an Entity a Public Benefit Entity?

*This Application Guidance is published as an Appendix to NZ IAS 1 and is an integral part of NZ IAS 1.*

### INTRODUCTION

NZ AG 1 With the introduction of the New Zealand equivalents to International Financial Reporting Standards (IFRSs) reporting entities will designate themselves as either profit-oriented entities or public benefit entities (PBEs). NZ IAS 1, paragraph NZ 13.1, requires each reporting entity to disclose in the notes whether, for the purposes of complying with Generally Accepted Accounting Practice in New Zealand (NZ GAAP), it is a profit-oriented entity or a PBE.

NZ AG 2 PBEs are defined as:

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

NZ AG 3 Profit-oriented entities are not defined. Rather, the term profit-oriented entities encompass all entities other than PBEs. An entity must assess whether it is either a PBE or a profit-oriented entity, by considering whether or not it meets the definition of a PBE. Assessing whether an entity meets the definition of a PBE requires an entity to determine its primary objective.

NZ AG 3 The form of an entity is unlikely to be a conclusive factor in determining whether or not an entity is a PBE. PBEs are constituted in many different forms such as incorporated societies, trusts, statutory bodies and even companies. PBEs include a wide range of entity types, including charities, clubs, and non-commercial public sector entities. They exist in the private sector and in the public sector and may be small or large. In determining the designation of an entity which is a group, it is necessary to consider the characteristics of the group.

NZ AG 4 IFRSs are developed by the IASB for application by profit-oriented entities. New Zealand equivalents to IFRSs, however, apply to the general purpose financial statements of all New Zealand reporting entities. Because New Zealand equivalents to IFRSs apply to PBEs as well as profit-oriented entities the Accounting Standards Review Board (ASRB) agreed that amendments to the requirements of certain IFRSs should be made to ensure that:

- the NZ IFRSs are relevant to and can be applied by PBEs; and
- the financial information provided by all entities in New Zealand remains useful to users.

NZ AG 5 The ASRB has, therefore, set out the criteria for developing NZ IFRSs in ASRB Release 8 *The Role of the Accounting Standards Review Board and the Nature of Approved Financial Reporting Standards*.

NZ AG 6 Developing NZ IFRSs in accordance with the criteria in ASRB Release 8 ensures that where a profit-oriented entity not applying differential reporting concessions prepares its financial report in compliance with NZ IFRSs, the financial statements will also comply with IFRSs. However, where a PBE prepares its financial report in compliance with NZ IFRSs it may not be appropriate to assert compliance with IFRSs if:

- the PBE has transactions for which the measurement or recognition requirements in the New Zealand equivalent to an IFRS differ from those in the IFRS on which they are based; or
- the PBE elects to take advantage of concessions provided by the New Zealand equivalent to an IFRS.

NZ AG 7 As application of certain provisions in New Zealand equivalents to IFRSs will mean that an entity will not be able to assert compliance with IFRSs, it is necessary to limit application of these provisions to PBEs. For this purpose, it is also necessary to define PBEs and provide guidance to assist in determining if an entity is a PBE.

NZ AG 8 NZ IAS 1, paragraph 13.1, requires reporting entities to disclose in the notes to the financial statements:

*"... a statement that the financial statements have been prepared in accordance with NZ GAAP, together with a description of the financial reporting standards applied by the entity"*

NZ AG 9 A public benefit entity not applying differential reporting concessions would state:

*"The financial statements have been prepared in accordance with NZ GAAP. They comply with New Zealand equivalents to IFRSs, and other applicable Financial Reporting Standards, as appropriate for public benefit entities".*

## PURPOSE

NZ AG 10 The purpose of this New Zealand Application Guidance is to assist entities preparing general purpose financial statements to determine whether or not they are a PBE.

NZ AG 11 In many situations whether an entity is a profit-oriented entity or a PBE is important because it will affect accounting policies that have a material effect on the preparation and presentation of financial statements. Inappropriate classification may result in adoption of inappropriate accounting policies and failure to provide users with information appropriate to assessing the financial performance and position of an entity.

NZ AG 12 Whilst there are relatively few differences in accounting requirements for profit-oriented entities and PBEs, application by an entity of a single requirement that is not in accordance with IFRSs will mean that entity is not in compliance with IFRSs. In certain cases, depending on the nature of the activities of the entity, designation as a PBE or as a profit-oriented entity will not have a material impact on the selection of accounting policies, or on the ability of an entity to assert compliance with IFRSs.

## DETERMINING THE PRIMARY OBJECTIVE OF AN ENTITY

NZ AG 13 Whether an entity is a PBE is determined by the primary objective of an entity. In identifying the primary objective of an entity it is necessary to consider the substance of the entity's purpose and whether the goods or services are provided for community or social benefit.

NZ AG 14 Although in general terms PBEs 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. Many PBEs exist for the direct benefit of a particular group of people, although it is also possible that society as a whole benefits indirectly. For example, a football club exists to promote and encourage football for the direct benefit of its members. However, society as a whole may benefit through a healthier population and through the provision of organised activities for its youth.

NZ AG 15 In many cases it will be intuitively obvious whether an entity is a PBE or not. However, objectively determining the primary objective of an entity can be difficult where an entity has multiple objectives and such objectives are not ranked, or where the objectives are not clearly stated.

NZ AG 16 Paragraphs NZ AG 17 to NZ AG 30 discuss indicators that aim to focus on the substance of an entity's purpose and which should be considered in determining whether an entity is a PBE. These indicators are:

- the entity's founding documents;
- the nature of the benefits;
- the quantum of expected financial surplus;
- the nature of the equity interest; and
- the nature of an entity's funding.

### Founding documents

NZ AG 17 For many entities the governing legislation, a constitution, a trust deed, or other founding documents will specify the objectives of an entity, including for whom the benefits generated by the entity are intended. For example, the State-Owned Enterprises Act 1986 states that the principal objective of every State enterprise is to "operate as a successful business and to this end, to be —

- (a) As profitable and efficient as comparable businesses that are not owned by the Crown; and
- (b) A good employer; and
- (c) An organisation that exhibits a sense of social responsibility by having regard to the interests of the community in which it operates and by endeavouring to accommodate or encourage these when able to do so."

NZAG 18 The founding documents of an entity may also specify the objective of an entity in terms of the nature of the benefits the entity provides. For example, one of the objectives of District Health Boards is to improve, promote and protect the health of people and communities.

NZ AG 19 Many entities are established with multiple objectives. For example, CRIs are required by the Crown Research Institutes Act 1992 to:

- undertake research for the benefit of New Zealand;
- comply with any applicable ethical standards;
- promote and facilitate application of the results of research and technological developments;

- be a good employer and exhibit a sense of social responsibility; and
- operate in a financially responsible manner and generate an adequate rate of return.

NZ AG 20 Where an entity's founding documents indicate that an entity has multiple objectives, determining which of these objectives is the primary objective will depend on an assessment of the substance of the purpose of the entity.

NZ AG 21 The founding documents may require an entity to be financially viable or to generate an adequate rate of return. However, being financially viable is not in itself conclusive in distinguishing a profit-oriented entity from a PBE. There exists a clear community expectation that PBEs be financially viable and operate to ensure that the limited resources at their disposal are used effectively.

### **Nature of the benefits**

NZ AG 22 The nature of the benefits provided by an entity will usually indicate whether an entity is a PBE. For example, if the entity produces goods or services that are not provided at market prices, but are provided to consumers at no cost or for nominal consideration, the entity is likely to be a PBE.

NZ AG 23 PBEs do not exist to generate benefit in the form of a financial return to equity-holders. That is not to imply that PBEs never generate, or aim to generate, a financial surplus on the net assets employed. However, where a PBE does generate a financial surplus, it may be required or expected to be used to support the entity's primary objective of providing goods or services for the community or for social benefit.

NZ AG 24 PBEs may establish subsidiaries or discrete business units which operate to generate a return that can be used to support the primary activities of the parent entity. Such entities or business units may be profit-oriented. This fact does not affect the classification of the parent or group entity\*.

### **Quantum of expected financial surplus**

NZ AG 25 Many entities aim to generate revenues in excess of the expenses incurred. In order to continue operating all entities need to at least break even over the long term. The quantum of the expected surplus will provide a strong indication whether an entity is a PBE.

NZ AG 26 The objective of profit-oriented entities is to generate a commercial or market return that is, to maximise the financial return commensurate with the relative risks of operating.

NZ AG 27 PBEs do not operate to maximise financial return in this way. PBEs may plan to generate a financial surplus. However, the quantum of the expected financial surplus is not expressed in relation to a market return or other measure of commercial success.

NZ AG 28 PBEs may not quantify the expected financial surplus, or may do so in qualitative or general terms only. For example, an entity may specify that it aims to generate an adequate rate of return, or a financial surplus sufficient to remain solvent, or generate a financial surplus sufficient to repay any debts within a certain time period.

### **Nature of equity interest**

NZ AG 29 Where an entity is established to generate a financial return for the benefit of the equity-holders the ownership instrument is usually clearly defined. This is important for profit-oriented entities because it determines the level of benefits such as dividends and rights to the residual net assets. If an entity does not have any clear equity-holders or the nature of the equity instrument is unclear, the entity is likely to be a PBE.

NZ AG 30 The absence of clear equity holders may manifest itself in a number of ways, including:

- the absence of an individual or entity having a right to participate in any financial return or in the net assets of the entity were it to be wound up or otherwise cease to operate; or
- a requirement that in the event the entity ceases operating any residual net assets are to be applied to another entity with a similar purpose or to revert to another PBE. That is, the use of the assets is effectively restricted to providing goods or services for the benefit of the community or part thereof.

### **Nature of funding**

NZ AG 31 If an entity is funded wholly or primarily through the sale of goods and services it may not be a PBE. If an entity relies wholly or primarily on donations or other contributions that do not establish a financial interest in the entity, or which do not reflect a sale and purchase transaction, the entity is likely to be a PBE.

\*If a subsidiary or business unit is required to prepare general purpose financial reports its designation is determined by its own primary objective and not that of the parent of the group reporting entity. NZ IAS 27 *Consolidated and Separate Financial Statements* provides guidance on consistency of accounting policies to be adopted in the preparation of group financial statements.

## CONFLICTING INDICATORS

NZ AG 32 In some cases the above indicators may conflict with each other in respect of a single entity and the primary purpose or objective of the entity may not be obvious. Some indicators may indicate that an entity should be classified as profit-oriented and others may indicate the entity should be classified as a public benefit entity. In this situation professional judgment is required.

## CHANGING CLASSIFICATION

NZ AG 33 In certain situations, changing circumstances may lead to a change in an entity's classification. For example, a change in government policy may require that entities previously classified as public benefit entities are now to operate on a commercial basis, or vice versa.

NZ AG 34 Where an entity's classification changes from "public benefit entity" to "profit-oriented entity", the entity may need to apply IFRS 1 *First-time Adoption of International Financial Reporting Standards*, in order to assert compliance with IFRSs. Where an entity's classification changes and, as a result the entity's accounting policies change, the entity will need to ensure it complies with the requirements of NZ IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*.

## ILLUSTRATIVE EXAMPLES

NZ AG 35 These following examples aim to illustrate application of the guidance – When is an Entity a Public Benefit Entity? The examples are illustrative only and do not establish requirements.

NZ AG 36 While specific types of entity are referred to in the examples, the circumstances in relation to individual entities may vary significantly, and therefore the examples do not conclude as to whether the entity in question is or is not a public benefit entity. Rather, the examples illustrate characteristics to be considered by preparers in reaching a conclusion regarding the nature of an entity's purpose. 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.

### ILLUSTRATIVE EXAMPLES: DETERMINING THE NATURE OF AN ENTITY'S PURPOSE

#### Scenario 1: Crown Research Institute

Entity A is a company established under section 11 of the Crown Research Institutes Act 1992.

- *Founding documents – The Crown Research Institutes Act 1992*

The Crown Research Institutes Act 1992 (CRI Act) states that the purpose of every Crown Research Institute is to undertake research (section 4) and sets out the principles of operation CRIs are expected to follow in fulfilling this purpose. These principles are set out in section 5 of the Act and include, for example, that a CRI should undertake research for the benefit of New Zealand, operate in a financially responsible manner and be a good employer.

The CRI Act establishes a broad framework for the operation of CRIs. The primary objective (purpose) of CRIs is clearly stated in the CRI Act. The principles set out in section 5 are detailed, but they are not ranked and their implementation can be achieved in a number of ways. CRIs, therefore, appear to have discretion as to how they can achieve their purpose.

- *Nature of the benefits*

The key benefit of establishing CRIs is the production of research that will benefit New Zealand. In one sense the CRIs undertake research for community or social benefit. The New Zealand economy and entities operating in New Zealand can benefit from the research undertaken.

However, there may be discretion as to how research findings are distributed and in determining the nature of the research to be undertaken. Whether or not the Entity A is a public benefit entity may depend on whether Entity A distributes or undertakes research on a commercial fee-for-service basis, or whether it makes its research findings available free of charge or for a nominal charge.

- *Quantum of the expected financial surplus*

The CRI Act requires CRIs to operate in a financially responsible manner so that they maintain their financial viability. On its own maintaining "financial viability" is a general requirement and allows discretion as to what the financial targets should be.

Entity A has in place an operating agreement with the Shareholding Minister. If the operating agreement specified that Entity should aim to generate an expected financial surplus equivalent to a market return, this would indicate that Entity A is a profit-oriented entity. If the operating agreement specified a target rate of return, it would be necessary to consider how that rate of return was determined. If, for example, it was determined after benchmarking against commercial entities, this would indicate that Entity A was profit-oriented. If the rate of return was determined based on ensuring that Entity A covered its variable costs only, this may indicate that it is a public benefit entity.

- *Nature of equity interest*

Entity A is a company. The equity interest is in the form of shares owned by the Shareholding Minister. In the case of Entity A, the nature of the equity interest is clear. In addition, there is no restriction on the use of assets in the event a CRI is sold, wound up or ceases to operate. However, in this case, neither of these factors would appear to affect the nature of the purpose of the entity.

- *Nature of funding*

Entity A competes for funding from government and private sources. Revenue is derived through selling research services in a competitive environment. This may indicate that Entity A is a profit-oriented entity.

If Entity A relied on donations and grants from government and other organisations and such funds were provided on a non-exchange basis, this may indicate that Entity A is a public benefit entity.

## **Scenario 2: Charity Shop**

A charitable trust is established with objective of providing health services to the homeless. The trust receives an annual grant from the Government. The grant is sufficient to cover operating costs necessary to provide basic health care services to a limited number of people. To meet the increasing demand for its services and to fund an expanded range of services, the trust establishes a charity shop (Company 1).

Company 1 sells second hand bicycles and runs a successful bicycle hire service. All profits from Company 1 are returned to the trust to support the primary objective of providing health services to the homeless.

- *Founding documents – Constitution*

Company 1's constitution specifies that its objective is to raise funds to support the charitable trust.

- *Nature of the benefits*

The benefits derived from Company 1 are the funds generated through the sale and hire of bicycles. This may indicate that the shop is a profit-oriented entity.

If on the other hand the shop is used primarily as a vehicle to promote and publicise the objective of the trust or to provide employment to homeless people, then Company 1 may, subject to consideration of other factors, be a public benefit entity.

- *Quantum of the expected financial surplus*

The directors carefully manage Company 1 to ensure it meets its financial targets. The directors are experienced business people who donate their time to manage and guide the operation of Company 1. The directors aim to ensure that the return on the net assets invested in the shop is at least equivalent to a market return. If Company 1 does not generate adequate return the directors may recommend that the trust invest its funds in another activity. This may indicate that Company 1 is by nature an investment and therefore profit oriented.

If Company 1 was operated with the objective of generating a positive financial return and the level of the return was not determined with reference to market returns, the shop may be a public benefit entity.

- *Nature of equity interest*

In the situation described Company 1 is a company 100% owned and controlled by the trust. As such the ownership instrument is clear. In the event Company 1 ceases trading the trust is able to determine how to use any residual assets. This may indicate that Company 1 is profit oriented.

- *Nature of funding*

Company 1 raises revenue through the sale and hire of bicycles. Company 1 also serves as a collection point for donations to the trust. Such donations are not the property of the shop and are banked into a separate trust account controlled by the trust.

Given the objective of Company 1 is to maximise return, the sale and hire of bicycles must be at market rates. This would indicate that the entity is a profit-oriented entity.

### Scenario 3: Private Education Organisation

Entity Q is a private organisation dedicated to providing low-cost high quality education to children who immigrated to New Zealand from poverty stricken countries. Entity Q was established as a trust with an initial endowment of \$5M from the estate of a wealthy businessperson.

In order to supplement its income Entity Q accepts a limited number of fee paying students. The fees for such students were determined after market research into the pricing of such services. All fee revenue is applied by Entity Q to its objective of providing high quality education to children who immigrated to New Zealand from poverty stricken countries. The revenue from fee paying students has enabled Entity Q to expand the range of services it offers and to expand its roll of immigrant children.

- *Founding documents*

The trust deed establishing Entity Q states that the purpose of Entity Q is to provide high quality education to children who immigrated to New Zealand from poverty stricken countries. The trust deed also provides Trustees with broad powers as to how best to achieve this objective.

The trust deed also requires that, in the event the trust is wound up, any residual assets are to be applied to an organisation with similar objectives.

- *Nature of the benefits*

The nature of the benefits provided by Entity Q are the educational services delivered to the recipient children. The equity provided to Entity Q was done so for the benefit of immigrant children and not for the generation of a financial return. This would indicate that the entity is a public benefit entity.

The fact that Entity Q also sells education services to fee paying students at market rates does not necessarily change the objective of the entity.

If Entity Q established a subsidiary entity through which it ran its commercial education operations, that subsidiary may be a profit oriented entity. In this case it would also be necessary to consider whether the group reporting entity is a public benefit entity in its own right.

- *Quantum of the expected financial surplus*

The trustees carefully manage the resources of Entity Q in order to maximise the number of immigrant children it can accept and to maintain a high quality educational service. The trustees have a clear operational plan and have established clear financial targets in order to achieve its objectives.

The financial targets are not expressed in terms of return on equity, but rather in terms of meeting the development targets set out in the operational plan. This may indicate that the entity is a public benefit entity.

- *Nature of equity interest*

The trust deed requires that in the event Entity Q ceases operating any residual assets are to be applied to another entity with a similar purpose. The use of the assets is restricted and no individual can benefit privately from the assets.

This may indicate that the entity is a public benefit entity.

- *Nature of funding*

Entity Q receives funding from a number of sources:

- (i) investment income from the initial endowment;
- (ii) fee income from fee paying students; and
- (iii) donations from other fund raising activities.

The relative levels of funding from each of these sources may indicate whether Entity Q is a profit-oriented entity or a public benefit entity. If the majority of funding is raised from investment income or donations and applied to the provision of the education services, then the entity may be a public benefit entity. If the majority of the funding is raised through the sale of education services, it may indicate that the entity is a profit-oriented entity.

### Scenario 4: Sports Club

Club AFC is a football club established in a suburb of a large city. Club AFC is part of a regional group of clubs that co-operate together to organise competitions, coaching and training for a wide range of age-groups, from 5 year-olds through to senior grade football and representative grades.

- *Founding documents – Constitution*

Club AFC is established as a charitable trust. Its constitution states that it is a non-profit entity established to foster participation and to promote football in its suburb.

This indicates that Club AFC is likely to be a public benefit entity.

- *Nature of the benefits*

The benefits provided by Club AFC arise from the coordination of football competitions and the provision of football coaching, training and other facilities to the community. Hence, Club AFC provides benefits directly to a particular section of the public, and society as a whole may benefit indirectly. No individual person has a right to the equity or to any net surplus generated by the Club. This may indicate that the Club AFC is a public benefit entity.

On the other hand, if Club AFC were to sell its coaching and training services (eg to schools, other football clubs, or individuals) at normal market rates, this may indicate that Club AFC is a profit-oriented entity.

- *Quantum of the expected financial surplus*

The Club manages its finances carefully. Its financial targets are driven by its plans to develop its facilities and the services it offers. This may indicate that the Club is a public benefit entity.

If the Club set financial targets with the objective of generating a commercial rate of return, this may indicate that Club AFC is a profit-oriented entity.

- *Nature of equity interest*

There is no clear equity instrument. The Constitution states that in the event the Club is wound up or ceases operating, any residual assets are to be applied to an organisation with a similar purpose as Club AFC. This may indicate that the Club is a public benefit entity.

- *Nature of funding*

Club AFC receives funding from various sources:

- (i) Membership fees;
- (ii) Sponsorship;
- (iii) Bar and food sales; and
- (iv) Community grants.

Membership fees are set at a level to cover the Club's costs, after taking into account the funding expected to be received from other sources. This may indicate that Club AFC is a public benefit entity.

If Club AFC received the majority of its funding from the sale of football coaching or training services, or from ticket sales at football matches, this may indicate that Club AFC is a profit-oriented entity.