

# Policy and Guidelines Paper

## Distinguishing For-profit from Not-for-profit Entities

## Preface

This NSW Treasury Policy & Guidelines Paper provides guidance to agencies in deciding whether they are a *for-profit* or *not-for-profit* entity, for the purpose of their general purpose financial report, prepared in accordance with Australian Accounting Standards.

The policy is applicable to all entities that are reporting GSF agencies within the meaning of section 7.3 of the *Government Sector Finance Act 2018* (GSF Act), and to the accountable authorities for those reporting GSF agencies. For the avoidance of doubt, this policy does not apply to universities and their controlled entities, or to their accountable authorities.

This policy applies to financial years ending on or after 30 June 2021 and supersedes the previous Treasury Policy and Guidelines Paper of the same name (TPP 05-04).

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For

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### Note

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This publication can be accessed from the Treasury's website [www.treasury.nsw.gov.au/](http://www.treasury.nsw.gov.au/).

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## Executive Summary

This NSW Treasury Policy & Guidelines Paper provides guidance to agencies in deciding whether they are a for-profit or not-for-profit entity, for the purpose of their general purpose financial report, prepared in accordance with Australian Accounting Standards.

This policy is based on the principle that financial reports should reflect economic substance rather than legal form. It seeks to guide, rather than replace, the use of professional judgement in the application of Australian Accounting Standards.

In deciding whether to classify an entity as for-profit or not-for-profit, for general purpose financial reporting, agencies must consider the following factors:

- statements by owners about the objectives of the entity, such as statements contained in legislation, regulations, entity constitutions and shareholder resolutions
- the governance framework applied to the entity i.e. the corporate structure adopted and the formal relationship with owners
- the purpose, nature and extent of funding from owners, focusing on the extent to which ongoing budget support is provided to an entity
- the targeted financial performance of the entity, as agreed between owners and the board/management, focusing on the extent to which the entity funds its expenses, maintains its asset base and provide returns to owners, and
- the classification of the entity under Government Finance Statistics (GFS).

The fact that an entity is classified as *not-for-profit* under Australian Accounting Standards does not imply that it is not required to operate efficiently, or in a commercial manner, as set out by its governance framework (including the NSW Commercial Policy Framework). Such a classification does not override legal requirements e.g. a requirement to pay dividends to owners. Similarly, the fact that an entity is classified as *for-profit* does not mean it is released from wider obligations to society imposed by owners or other external parties.

# 1. Introduction

## 1.1 Purpose of policy

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This NSW Treasury Policy & Guidelines Paper provides guidance to agencies in deciding whether they are a *for-profit* or *not-for-profit* entity, for the purposes of their general purpose financial report, prepared in accordance Australian Accounting Standards.

## 1.2 Definitions

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A *not-for-profit* entity is defined in various accounting standards<sup>1</sup> as one whose principal objective is not the generation of a profit. *For-profit* entity is not defined, but by implication is any entity that does not meet the definition of a *not-for-profit* entity.

## 1.3 Scope

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State Governments are not principally established to generate a profit. Hence the NSW Government is considered to be a *not-for-profit* entity. The General Government Sector (GGS) of the NSW Government is also considered to be *not-for-profit*, because it mainly comprises units established to provide goods and services for no or nominal consideration, which is incompatible with having profit as a principal objective.

There may be, however, some *for-profit* entities within the GGS e.g. those providing services at market rates exclusively to other GGS entities. Hence this policy addresses the classification of all entities controlled by the NSW Government, but not those of the Government as a whole, or the GGS.

## 1.4 Implications of classifying an entity

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The fact that an entity is classified as *not-for-profit* under Australian Accounting Standards does not imply that it is not required to operate efficiently, or in a commercial manner, as set out by its governance framework (including the NSW Commercial Policy Framework). Such a classification does not override legal requirements e.g. a requirement to pay dividends to owners. Similarly, the fact that an entity is classified as *for-profit* does not mean it is released from wider obligations to society imposed by owners or other external parties.

## 1.5 Application

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This NSW Treasury Policy & Guidelines Paper provides guidance on distinguishing whether an entity is a *for-profit* or *not-for-profit* entity and should be applied to all entities that are reporting GSF agencies within the meaning of section 7.3 of the GSF Act, and to the accountable authorities for those reporting GSF agencies. For the avoidance of doubt, this policy does not apply to universities and their controlled entities, or to their accountable authorities.

This policy applies to financial years ending on or after 30 June 2021 and replaces TPP 05-04 *Distinguishing For-profit from Not-for-profit Entities*.

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<sup>1</sup> Including AASB 102 *Inventories*, Aus6.1, AASB 116 *Property Plant and Equipment*, Aus6.1, AASB 136 *Impairment of Assets*, Aus6.2

## 2. Overall approach

This policy is based on the principle that financial reports should reflect economic substance rather than legal form

The exercise of professional judgement is considered essential in identifying the principal objective of any entity. There is no single factor that can conclusively determine the status of an entity.

While it is possible that a *not-for-profit* entity could have minor operations that could be regarded as *for-profit*, classification should be based on a consideration of the main activities of the entity. For example, a large Government department may operate a small bookshop selling departmental publications. The presence of the bookshop operation would not determine the classification of the department as a whole.

## 3. Specific guidance

The following factors, when considered together, will assist in the application of professional judgement to the task of identifying an entity's principal objective. Assessments of any one factor need to be considered in the light of contrary evidence arising from a consideration of the other factors. A final decision regarding the status of an entity should consider all available evidence and the overall substance of the entity.

The factors that entities must consider are:

- statements by owners about the objectives of the entity, such as statements contained in legislation, regulations, entity constitutions and shareholder resolutions
- the governance framework applied to the entity i.e. the corporate structure adopted and the formal relationship with owners
- the purpose, nature and extent of funding from owners, focusing on the extent to which ongoing budget support is provided to an entity
- the targeted financial performance of the entity, as agreed between owners and the board/management, focusing on the extent to which the entity funds its expenses, maintains its asset base and provides returns to owners, and
- the classification of an entity under Government Finance Statistics (GFS).

### 3.1 Statements about the objectives of the entity

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From a legal standpoint, an entity's objectives are those stated in legislation. However, the intent of the AASB *Framework* is that financial reports are to be based on substance as distinct from rules or legal form. Hence there is an obligation on preparers to determine the substance of the motivations behind an entity's existence. Statements in legislation are statements of owner's intentions at a point in time. Subsequent events may provide evidence that owners' intentions have, in substance, changed. Therefore, presumptions derived from legislation may be overturned if the other factors listed in this policy provide sufficient evidence to the contrary.

If the legislation or regulations associated with the establishment of an entity or its constitution explicitly states that the "principal", "main" or "sole" objective of the entity is to generate a profit, then a strong rebuttable presumption would arise that the entity is *for-profit*.

If the legislation or regulations state that the “principal”, “main” or “sole” objective of the entity is other than the generation of a profit, then a strong rebuttable presumption would arise that the entity is *not-for-profit*.

In some cases, owners’ statements and actions may be ambiguous and hence not useful in classifying an entity. For example, under the *State Owned Corporations Act 1989*, a number of objectives are promulgated for statutory State Owned Corporations (SOCs), without it being clear which one is the principal objective, as each are specified as being of equal importance. These objectives include (section 20E of the SOC Act):

- to be a successful business, including to operate efficiently with a view to maximizing net worth
- to exhibit a sense of social responsibility
- to operate in accordance with the principles of ecologically sustainable development, and
- to exhibit a sense of responsibility towards regional development.

In such situations there is no presumption and the classification of the entity will depend on consideration of all the factors detailed in this policy.

When the principal objective is not explicitly set down in legislation, regulations or the entity’s constitution, classification as *for-profit* or *not-for-profit* will often involve analysis of less explicit wording. Statements that an entity is to “operate commercially” or “be financially viable”, while indicative, do not necessarily mean that an entity’s principal objective is the generation of a profit.

Shareholder or equity holder resolutions, ministerial directions and government policy statements, providing they are consistent with legislation, regulations and entity constitution, may also be a means whereby owners make it clear that they expect an entity to generate a profit and a positive return on investment as its principal objective. However, such statements must also be tested against the balance of the factors outlined in this policy.

### **3.2 Governance framework**

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Entities that operate in accordance with competitive neutrality principles and face the same or very similar legal, financial and regulatory conditions as *for-profit* entities in the private sector are likely to be *for-profit*. Examples of such conditions include:

- commercially sound legal and corporate capital structures (eg a mix of debt and equity funding)
- shareholder relationship provides for the payment of dividends
- monitoring of performance against financial targets and industry best practice standards
- an obligation to pay income tax or income tax equivalents
- an entity charter or statement of corporate (or business) intent referring to the making of profits and returns to owners
- separation of ownership, (represented by shareholding Ministers), board and management, and
- explicit contractual arrangements and funding in respect of Community Service Obligations (CSOs).

Under the NSW Commercial Policy Framework, some entities may be subject to some but not all of the above. It is the extent to which such frameworks apply to an individual entity that provides an indication as to whether its principal objective is the generation of a profit.

An entity would not be prevented from being classified as *for-profit* if its governance framework required it to:

- meet economic development objectives
- be socially responsible, and/or
- be environmentally responsible

because all of these may be consistent with the generation of a profit and return to owners.

### **3.3 Purpose, nature and extend of funding from owners**

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Owners can provide funding to entities in a number of ways:

- injections of additional capital to maintain or expand the entity's activities
- payments for the delivery of specified outputs, usually described as CSOs. In return for CSO funding the entity delivers social benefits in the form of outputs purchased by government or purchased by customers and partly funded by Government, and
- grants and subsidies e.g. to cover operating losses from unprofitable activities.

Both *for-profit* and *not-for-profit* entities can receive injections of additional capital. Hence funding of this nature is not relevant to this policy.

The economic substance, rather than the legal form, of funding is relevant to all of these situations.

*For-profit* entities would normally receive CSO funding rather than grants/subsidies (unless those grants and subsidies are also made available to non-government entities). *Not-for-profit* entities are more likely to receive grants and subsidies (although financial management frameworks in some jurisdictions seek to link funding to 'outputs').

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 can vary over time. In the early years of a *for-profit* entity the government may provide considerable grants and subsidies to support an infant industry that it believes may provide further community benefits in the longer term.

Instances where ongoing government funding is provided to cover the costs of specific outputs, and these outputs represent the principal activity of the entity, suggest that the entity in question is *not-for-profit*. As a rule of thumb, if more than half the expenditure of an entity is funded by owners on an ongoing basis to provide goods and/or services at no or nominal cost to the recipients, then this would provide evidence to support a *not-for-profit* classification.

### **3.4 The targeted financial performance of the entity**

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If owners and management explicitly target profits or returns to owners in relation to its main activities, then this is evidence that the entity is *for-profit*. Intention is important, rather than actual profits/returns. That an entity incurs losses over a number of periods is not inconsistent with an entity having profit as its principal objective. Conversely, successive profits over a number of periods do not



prevent an entity being classified as *not-for-profit* where there is no intention to distribute these profits to owners.

That an entity targets a rate of return that is appropriate for the industry in which it operates suggests that it is a *for-profit* entity. Such a rate of return would:

- reflect the risk-return relationship, and
- theoretically be above the long-term government bond rate (which could be considered as a proxy for the risk-free rate).

It should be noted that industry rates of return may vary over the business cycle and an individual entity's rate of return may also vary over time depending on its life cycle.

The extent to which an entity is able to earn sufficient cash inflows from trading or the provision of services to cover operating cash outflows and fund the replacement of assets in the longer term ('self-funding') is indicative of whether the entity is *for-profit* or *not-for-profit*. However, while a *not-for-profit* entity could aim to be self-funding, it is unlikely that an entity that was not self-funding would be classified as *for-profit*. It should be noted that an entity that borrowed for capital expenditure could still be self-funding, provided that its future net operating cash flows are expected to cover the repayment of capital and interest.

There is a justifiable expectation that a *not-for-profit* entity should be aiming to manage its scarce resources efficiently and effectively and that any profit or surplus would be retained to support its "public interest" or non-profit outcomes.

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.

A number of *not-for-profit* entities contain cash generating units. The existence of cash generating units within an entity, however, does not mean that its principal objective is the generation of a profit. Normally, the net cash inflow of a cash-generating unit within a *not-for-profit* entity would be retained within the entity to achieve non-profit outcomes, not distributed to owners.

### 3.5 GFS Classification

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The Australian Bureau of Statistics classification of public sector entities may also provide evidence of an entity's status,

*Not-for-profit* entities that operate in the public sector are usually classified to the General Government Sector (GGS) as they would not be considered to be market producers. These public sector entities provide goods and services that are free, or at a price that is lower than the cost to provide the good or service. Also, the price that the consumer pays for these goods and services will not significantly influence the consumer's demand for them.

However, this does not mean that all *not-for-profit* entities are automatically classified to the GGS under GFS principles. Public Non-financial Corporations (PNFCs) and Public Financial Corporations (PFCs) may be considered *not-for-profit* and still meet the criteria to be classified outside the GGS.

## 4. Further information and contacts

This section is mandatory for all publications.

For further Information or clarification on issues raised in this paper, please contact:

Accounting Policy, NSW Treasury  
Email: [accpol@treasury.nsw.gov.au](mailto:accpol@treasury.nsw.gov.au)

## Appendix A List of relevant factors in distinguishing *for-profit* from *not-for-profit* entities

The purpose of this Appendix is to provide a list of the factors, discussed in the main body of the policy, that are relevant in determining the classification of an entity as *for-profit* or *not-for-profit*. This list is provided as a summary for convenience and does not override the text in the main body of the policy.

The relevant factors are:

- Statements by owners about the objectives of the entity
  - Legislation and regulations
  - Shareholder resolutions, ministerial directions and government policy statements
- The governance framework applied to the entity
  - Capital structures
  - Shareholder relationships providing for dividends
  - Monitoring of financial performance against financial targets and industry best practice standards
  - Obligation to pay income tax or equivalents
  - Charter or statement of corporate intent referring to profits and returns to owners
  - Separation of ownership, board and management
  - Explicit contractual arrangements and funding of CSOs
- Purpose, nature and extent of funding from owners
  - Grant/subsidy funding as opposed to CSO funding
  - Level of ongoing funding from the Budget
- Targeted financial performance of the entity
  - Explicit targets for profits and returns to owners
  - Level of targeted return
  - Entity ability to cover operating outflows and asset replacement
- Classification of the entity under Government Finance Statistics