

A public benefit or profit-oriented entity?

By *Peter Casey*



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New Zealand has led the world in the improvement of financial reporting within the public sector. The sector-neutral standards that NZ has developed and applied over the past 20 years have been a key tool for enabling improved accountability and efficiency in the NZ public sector. With the adoption of International Financial Reporting Standards (IFRS), the underlying International Accounting Standards Board's (IASB) conceptual framework presented real challenges to NZ standard-setters.

A key challenge is that the IASB's conceptual framework is driven solely by the reporting needs of profit entities and, at this stage, the IASB ignores their applicability to public sector organisations.

The diversity of the nature, scope and focus of entities and their associated activities presents ongoing challenges to accountants in the public sector. In undertaking financial reporting, understanding exactly what type of entity you are dealing with is just one of the challenges for public sector accountants. As part of determining how the entity fits under IFRS, you first have to decide whether it is a profit-oriented entity (POE) or public benefit entity (PBE). The public sector has both of these in its midst, and the decision may not be clearcut.

NZ Equivalent to International Accounting Standard 1, *Presentation of Financial Statements* (NZ IAS 1):

- a) prescribes the basis for presentation of general purpose financial statements in order to ensure comparability both with the entity's financial statements of previous periods and with the financial statements of other entities; and
- b) sets out overall considerations for the presentation of financial statements, guidelines for their structure and minimum requirements for their content.

NZ IAS 1 includes additional definitions applicable to all entities. This includes "public benefit entities" (PBEs). 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."

With the introduction of NZ equivalents to International Financial Reporting Standards (NZ IFRS), reporting entities will designate themselves as either POEs or PBEs. Paragraph NZ I 3.1 of NZ IAS 1 requires each reporting entity to disclose in the notes whether, for the purposes of complying with Generally Accepted Accounting Practice in NZ (NZ GAAP), it is a POE or a PBE.

Profit-oriented entities are not defined. Rather, the term POE encompasses all entities other than PBEs. Therefore, an entity must decide whether it is either a PBE or a POE by considering whether or not it meets the definition of a PBE.

The NZ Application Guidance (AG) in NZ AG 3 notes: "the form of an entity is unlikely to be a conclusive factor in determining whether or not an entity is a PBE... They exist in the private sector and in the public sector and may be small or large."

Determining whether an entity is a PBE is determined by the primary objective of an entity. NZ AG 16 lists the indicators that 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
- nature of the benefits
- quantum of expected financial surplus
- nature of the equity interest
- nature of the entity's funding.

As stated earlier, the diversity of the nature, scope and focus of entities and their associated activities presents ongoing challenges to accountants in the public sector. As an illustration, I will now apply the above indicators to the organisation that I manage, Auckland Regional Holdings (ARH).

ARH (www.arh.co.nz) is an organisation established by statute with specific statutory objectives, principles and functions. The organisation is not a company and has an appointed board of directors who are the custodian of investments worth \$1.3 billion. The board is appointed by, and accountable to, the Auckland Regional Council, which is also the sole beneficiary of the financial distributions from the organisation. So, is ARH a PBE?

ARH is a unique organisation. It is not a company, like Christchurch City Holdings Ltd or Dunedin City Holdings Ltd which were set up by the owners of the underlying assets at their own initiative. ARH was established by Parliament and as the custodian of a large investment portfolio must both manage its assets prudently and act in the long-term interests and for the benefit of the Auckland region.

The following assesses ARH against the five indicators.

- **Founding document**

ARH's founding document is the Local Government (Auckland) Amendment Act 2004. Its statutory objectives are to:

- (a) act in the long-term interests and for the benefit of the Auckland region; and
- (b) without limiting paragraph a), manage its assets prudently.

- **Nature of the benefits**

The tangible benefit provided by ARH to its sole beneficiary is funding, which in its Long Term Funding Plan (a statutory requirement) is forecast to provide \$1 billion over 10 years.

- **Quantum of expected financial surplus**

ARH has set long-term investment objectives with 10 long-term target returns of NZ Government bond index + 1.5 % p a and a 20-year target of out-performing inflation

(CPI) by 5.5%. The return on the fund in its first year of operation was 13%.

- **Nature of equity interest**

ARH is not a company; it has no shares and as a statutory body can only be dissolved by Parliament. The sole beneficiary of funding is explicitly stated as the Auckland Regional Council, which is the body that also appoints the Board.

- **Nature of funding**

ARH generates its funding from its commercial investments. It has no rating or taxing ability.

In applying the above five indicators, the last four clearly indicate that ARH is a POE. However, indicator one suggests that ARH is not a typical POE in that it has an extra overlay to consider, on an ongoing basis, as an inherited part of its business. That is, how its investment management activities can, and will, be managed in the long-term interests and for the benefit of the Auckland region.

ARH is not alone in the public sector in having to balance in a more explicit manner both commercial and wider community needs. This requirement, both for the organisation as a POE and the accountants working within it, provides ongoing challenges that require rigour and careful analysis, hallmarks of the accounting profession. ■

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