

AASB/NZ FRSB Joint Project Outline and Plan

Defining the Reporting Entity in the Public Sector (including consideration of the concept of control)

Introduction

At its meeting of 9 – 10 December 2009, the AASB considered a draft project proposal, *Defining the Reporting Entity in the Not-for-Profit Public Sector*. The minutes record:

The Board considered the draft project proposal and decided that work should proceed along the following lines:

- (a) Phase 1: determine the extent of the issues and current practice
 - (i) Part 1: identify the current issues arising from the application of control in the public sector. The issues should include the relationship of regulation to control; the relationship of state governments to local governments; administered items; the recognition of elements; the relationship of governments to universities; and special purpose entities in the public sector; and
 - (ii) Part 2: identify approaches currently adopted for dealing with control in the public sector in jurisdictions with conceptual frameworks similar to that in Australia. This should include a description of how the IPSASB deals with the concept of control in IPSAS 6 *Consolidated and Separate Financial Statements*; and
- (b) Phase 2: the definition of control
 - (i) Part 1: assess the existing definition of control in AASB 127 *Consolidated and Separate Financial Statements* against the issues identified in Part 1 of Phase 1 and, having regard to the approaches identified in Part 2 of Phase 1, consider whether there is a need to amend the definition of control and/or supplement the definition with additional guidance in a public sector context; and
 - (ii) Part 2: assess the definition of control being developed by the IASB from its ED 10 *Consolidated Financial Statements* against the issues identified in the same way as noted in Part 1 of Phase 2.

The Board noted that further phases of the project would be considered after outcomes of Phases 1 and 2 are known. A later phase might include, for example, consideration of whether control is an appropriate basis for identifying the boundaries of a reporting entity within a whole of government entity. This could be undertaken in the context of the disaggregation of a whole of government reporting entity, and might have implications for the current treatment of common control.

The minutes of the December 2009 meeting of the NZ FRSB record:

The FRSB received an update from AASB staff on the outcome of the AASB's discussions regarding the proposed project Control in the public sector (included in AASB Action Alert 130 at Agenda Item D3.2).

The FRSB agreed that the project should be undertaken jointly with the AASB, particularly as the AASB has funding for additional resources for this project.

Issues identified for consideration in the project include:

- participatory rights and protective rights and whether the IFRS based on ED 10 *Consolidated Financial Statements* will provide additional guidance in this area;
- variable interest entities, which may result in the IFRS based on ED 10 not being appropriate for application by PBEs; and
- trusts, in particular who controls the trust as proprietorship doesn't work for trusts.

AASB staff and FRSB staff were asked to develop a joint project plan for consideration at the February 2010 meetings of the Boards.

Staff was also asked to identify FRSB members for a possible joint sub-committee for this project. A concern that the projects currently identified as joint projects all relate to PBE issues, which has an impact on the PBE members of the FRSB, was noted.

Consideration of the plan was deferred until the March 2010 joint meeting of the Boards, to provide them with an opportunity to discuss it jointly.

The title of this project ‘Defining the Reporting Entity in the Public Sector (including consideration of the concept of control)’ is adopted to:

- (a) better reflect the broad nature of the pertinent issues (for example, rather than limit the project to control of an entity, control of an asset is also relevant); and
- (b) avoid pre-empting a possible outcome of the project (for example, as implied in the project’s subtitle, the project will include, but not be dominated by, consideration of whether control is an appropriate notion in a public sector context).

The remainder of this document outlines the background to some of the issues and a plan for progressing the project. This project is to be conducted jointly between the AASB and the FRFB, with Associate Professor Bryan Howieson (University of Adelaide), at least initially, acting as a consultant.

Background

Australian Context

In 2007 the AASB completed a short-term review of the requirements contained in Australian Accounting Standards AAS 27 *Financial Reporting by Local Governments*, AAS 29 *Financial Reporting by Government Departments*, and AAS 31 *Financial Reporting by Governments*. The outcome of this review was that, with some minor modifications, many of the requirements of these ‘industry-based’ standards were transferred to the relevant ‘topic-based’ standards where the requirements specifically relating to public sector reporting entities are typically expressed by way of additional ‘Aus’ paragraphs. Accordingly, AASB 127 *Consolidated and Separate Financial Statements* currently includes paragraphs Aus17.1-Aus17.10 under a section ‘Factors indicating control in the public sector’. At the time of the review, the AASB acknowledged that a number of important issues with respect to financial reporting in the public sector remain unresolved and would be addressed by the Board as resources allowed. One such issue is control of an entity in the not-for-profit public sector. This matter was not addressed in 2007 due to a combination of factors, including complex application and interpretation issues and on-going deliberations at the international level relating to revisions of the *Conceptual Framework* and a review of the definition of a reporting entity.

New Zealand Context

New Zealand consolidation requirements are contained within NZ IAS 27 *Consolidated and Separate Financial Statements*, which contains cross-references to IPSAS 6 *Consolidated and Separate Financial Statements* and FRS-37 *Consolidating Investments in Subsidiaries* that provide additional guidance on determining whether a public benefit entity (PBE) controls another entity. These cross-references to IPSAS 6 and FRS-37 have been in NZ IAS 27 since its adoption in New Zealand in November 2004. The cross-references were inserted because IPSAS 6 is specifically for public sector entities and there was strong support by PBEs for the guidance in FRS-37.

Even prior to the adoption of IFRSs in New Zealand, concerns had been raised about inconsistencies in the application of these standards to public sector ‘autonomous and independent entities’, typically in the context of, but not limited to, tertiary institutions. In August 2005, a Discussion Paper (DP), *Control and Public Benefit Entities that have Autonomy and Independence*, was issued by the FRSB for public comment. The DP resulted in the issue of ED 109 *Proposed Amendments to FRS-37 Consolidating Investments in Subsidiaries and NZ IAS 27 Consolidated and Separate Financial Statements*. The amendments proposed in ED 109 included:

- a definition of ‘autonomous and independent public sector entity’;
- that autonomous and independent public sector entities be consolidated in the financial statements of government as if they were wholly-owned subsidiaries as per FRS-37; and
- certain disclosures be provided about the names of the autonomous and independent public sector entities and the reasons for consolidating these entities.

However, in November 2006, based on feedback provided by respondents to ED 109, the FRSB decided not to proceed with the proposed amendments to FRS-37 and NZ IAS 27.

In June 2007 the FRSB issued for comment ED 112 *Proposed Application Guidance for NZ IAS 27 Consolidated and Separate Financial Statements to Assist in Determining Whether a Public Benefit Entity Controls Another Entity*. The proposed guidance was developed by the Business Combinations Working Group (BCWG) of the FRSB, in consultation with the Public Benefit Entity Working Group (PBEWG) of the FRSB. The guidance was derived from the guidance in FRS-37 and IPSAS 6. The proposals contained guidance on the ownership form of control, the power element, the benefit element, and the indicators of control.

However, in February 2008, the FRSB decided to defer further work on ED 112 and to instead focus on the IASB project on consolidation. The need for the additional guidance was no longer as pressing as previously thought because the Accounting Standards Review Board (ASRB) published ASRB Release 9 *Delay of the Mandatory Adoption of New Zealand Equivalents to International Financial Reporting Standards for Certain Small Entities*. This meant that FRS-37 would not be withdrawn in the near future.

In the latter part of 2008, IASB staff working drafts of ED 10 *Consolidated Financial Statements* were posted on the IASB website as the ED was developed. The BCWG and the PBEWG commenced consideration of PBE guidance for inclusion in the IFRS based on ED 10 in anticipation of the Standard being adopted in New Zealand. However, the FRSB suspended development of this guidance in light of the many changes that are likely to ED 10 and the delay in the publication of the forthcoming IFRS while the IASB and the FASB jointly develop further proposals.

The issues

Control of an Entity

In a letter to the AASB Chairman dated 18 November 2009, the Chairman of the Australasian Council of Auditors-General (ACAG) Financial Reporting and Auditing Committee revisited and re-prioritised a number of financial reporting issues that continue to cause concern within the public sector. Among the high-priority areas identified in the letter is the issue of the

‘Concept of control and significant influence in the public sector’. Examples provided by ACAG include:

- administered items;
- distinguishing between contributions from owners and revenue for entities under common control;
- determining control over public sector entities; and
- determining significant influence and accounting for associates in the absence of conventional ownership interests.

Similarly, the Chairman of the Heads of Treasuries Accounting and Reporting Advisory Committee (HoTARAC) wrote to the AASB Chairman on 27 November 2009, also nominating control in the public sector as a high priority issue.

These issues (and others) arguably reflect, *inter alia*, circumstances different from those normally found in the for-profit sector due to the different nature and mechanisms by which public sector entities are created and operate. Other issues that arise in the context of ‘control of an entity in the public sector’ include those that relate to the appropriateness of AASB 127:

- (a) focusing on there being an explicit parent (which is often not the case in a public sector context) – see paragraph Aus9.1 of AASB 127;
- (b) providing relief from the presentation of consolidated financial statements by wholly-owned subsidiaries (see paragraph 10 of AASB 127), given the various ways in which subsidiaries might be structured in the public sector;
- (c) stating that local governments are not controlled by governments (see paragraphs Aus17.7 and Aus17.9(c)) (In New Zealand, the Office of Auditor-General is of the view that the Crown does not control local government, but this may be an issue that emerges after interviews with New Zealand constituents); and
- (d) stating that regulation does not, of itself, mean that control exists (see paragraph Aus17.9(d)). (In New Zealand, paragraphs 4.17 and 4.18 of FRS-37 distinguish between regulatory control [established under legislation] and ownership control that entitles the parent entity to benefits as those benefits arise from the power to determine the financing and operating policies).

In New Zealand, concerns have been particularly expressed that the definition of control in NZ IAS 27 (see Appendix 1 to this memo) is inappropriate for PBEs and there is a belief that NZ IAS 27 together with NZ SIC-12 *Consolidation – Special Purpose Entities* is not as good as the exceptions to the power element in FRS-37 (see sub-paragraphs (a)(i) and (ii) of the definition of control in FRS-37 in Appendix 1 of this paper). However, to date, no amendments have been made for PBEs to the definition of control, hence the cross-reference in NZ IAS 27 to FRS-37.

Concerns have also been raised in New Zealand regarding the proposed definition of control and other aspects of ED 10 (see Appendix 1 to this memo for the definition of control proposed in ED 10) that may not work for PBEs. In relation to these concerns, the following issues were considered by the New Zealand BCWG in considering whether amendments would be needed to the IFRS based on ED 10:

- the provision of complementary benefits by a subsidiary;
- the nature of the benefits, that is, non-financial for PBEs;
- the objectives of PBEs are different from those of profit-oriented entities; and
- an acknowledgement that for PBEs, a structured entity may be established under legislation.

The AASB has not yet fully considered the suitability of the definition of control in ED 10 for the public sector.

Trusts

When considering additional guidance for inclusion in ED 10 when it is adopted in New Zealand, the BCWG also identified a particular issue relating to trusts that may need to be addressed. There are instances where a Mayor or a City Council appoint the trustees of a trust in accordance with a trust deed. However, there is no intention that the Mayor or the City Council control that trust, neither does the Mayor or the City Council want to control that trust. These parties are specified to appoint the trustees because there will always be a person holding the position of Mayor or there will always be people comprising that City Council.

Control of an Asset

In relation to ‘control of an asset’, anecdotal evidence suggests that in Australia there is a lack of consistency in how administered items are currently accounted for. AASB 1050 *Administered Items* only requires certain disclosures and there is confusion in practice as to which entity ‘controls’ or bears responsibility for such items. For example, as the name implies, an entity in, say, one department may simply administer (e.g., collect) some funds on behalf of another entity in a different department – at present there would seem to be confusion as to which department the administering entity/asset should be consolidated with.

There is no evidence of inconsistency in New Zealand regarding how non-departmental items are accounted for and reported. Section 32A of the *Public Finance Act 1989* requires that non-departmental appropriations be reported separately. Guidance and requirements to meet section 32A are provided by the Treasury. Section 6.4.1 of Treasury Instructions 2009 states:

In this section of the Treasury Instructions, the term ‘Crown’ is used where revenue, expenditure, assets or liabilities are being managed by a department of the Crown otherwise than for departmental purposes. Such items are also referred to as ‘non-departmental’.

The section also provides examples of Crown revenue, Crown expenditure, Crown assets and Crown liabilities. The concept of control is applied in determining what is non-departmental and, therefore, required to be reported separately. Government departments are required to report non-departmental appropriations in a separate schedule in accordance with a template developed by the Treasury.

Summary

Based on the extracts from minutes of the December 2009 AASB and FRSB meetings, the letter from the ACAG Reporting and Auditing Committee and the above discussion, the project could encompass the following broad issues over time:

- (a) Fundamentally, what is the basis for determining the boundary of a reporting entity in the public sector?
- (b) What entities are within that boundary and what assets are within that boundary?
- (c) With regard to entities, two sub-issues are:

- (i) Is 'control' the appropriate basis of determining the boundary or is another basis (e.g., accountability or stewardship) more appropriate given the needs of financial statement users; and
 - (ii) Should consolidation of an entity within the reporting entity be on a 'line-by-line' basis or a 'single line' basis?
- (d) With regard to assets, two sub-issues are:
- (i) Is 'control' the appropriate basis for determining the boundary or is another basis (e.g., accountability or stewardship) more appropriate given the needs of financial statement users; and
 - (ii) How should 'administered'/'non-departmental' items be accounted for?

Given the breadth of these issues, the first two phases of this project seek to initially establish the relative pervasiveness of the concerns associated with applying AASB 127 and NZ IAS 27 in a public sector/PBE context. In addition, the initial phases will explore whether these concerns are the result of interpretation issues or alternatively whether they reflect more fundamental limitations of the existing definitions and guidance.

As the IASB is also currently revisiting the definition of control through ED 10, it is necessary to consider the impact of any future amendments to that definition on its application in public sector/PBE contexts. Information gathered from these initial investigations can form a basis for later decisions by the Boards as to the extent to which the broader issues noted above need to be addressed and the manner in which they should be addressed. (For example, depending on the IASB's progress with ED 10, it may not be necessary to consider amending the definition or guidance on control currently in AASB 127 and NZ IAS 27, but instead to focus on the definition of control in the IFRS being developed from ED 10. Furthermore, it is understood that FRS-37 will not be amended as it will be withdrawn once the review of the New Zealand financial reporting framework has been completed).

Project work plan and timetable

Consistent with the Boards' discussions at the end of 2009, the following work plan anticipates the establishment of a joint subcommittee to undertake a substantive amount of the review function and preliminary decision making. Due to this, there will be a need to keep the Boards informed of progress. This could take the form of Board agenda papers, provided for noting, comprising notes on subcommittee deliberations, and possibly copies of subcommittee papers on key issues.

The estimated timing noted in the following table is subject to a range of factors that are beyond the control of the project team (for example, due process may delay the final form of the IASB's definition of control in ED 10). It is achievable only if most of the work is done by the subcommittee and in the event that the Boards substantively accept the subcommittee's recommendations. The timetable is provided to give a broad sense of the sequence and an indication of the time the project might take.

The steps and potential timing for progressing the Phases of the project are:

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Step	Estimated Timing
<i>Phase 1: determine the extent of the issues and current practice</i>	
<p><u>Part 1.</u> Identify the current issues arising from the application of control in the public sector. The issues should include the relationship of regulation to control; the relationship of state governments to local governments; administered items; the recognition of elements; the relationship of governments to universities; participatory rights and protective rights; trusts; and special purpose entities (including variable interest entities) in the public sector.</p> <ol style="list-style-type: none"> 1. Review relevant academic and other literature critiquing consolidation in the public sector. 2. Identify relevant interviewees in Australian Commonwealth, States and NZ Government agencies (particularly Treasuries and Auditors-General) 3. Conduct interviews with constituents to identify user needs, explore inter-entity relationships, consider practical implementation issues 4. Prepare written report summarising information received from the interviews and literature review and identifying perceived extent of problems. 	<ol style="list-style-type: none"> 1. Early to mid-February 2010 2. Early to mid-February 2010 3. Mid-February – mid-March 2010 4. Draft report to joint subcommittee late March 2010
<p><u>Part 2.</u> Identify approaches currently adopted for dealing with control in the public sector in jurisdictions with conceptual frameworks similar to that in Australia and New Zealand. This should include a description of how the IPSASB deals with the concept of control in IPSAS 6 <i>Consolidated and Separate Financial Statements</i>.</p> <ol style="list-style-type: none"> 1. Conduct an extensive review of existing pronouncements (e.g., IPSASB, UK) relative to Australian and New Zealand requirements. 	<ol style="list-style-type: none"> 1. February - March 2010
<p>Deliverable: Write up a discussion paper reviewing issues detailing investigations and findings.</p>	<p>March – April 2010 (first draft to joint subcommittee early-April 2010; second draft to Boards late April 2010)</p>
<i>Phase 2: the definition of control</i>	
<p><u>Part 1:</u> Assess the existing definition of control in AASB 127 and FRS-37/NZ IAS 27 against the issues identified in Part 1 of Phase 1 and, having regard to the approaches identified in Part 2 of Phase 1, consider whether there is a need to amend the definition of control and/or supplement the definition with additional guidance in a public sector context.</p> <ol style="list-style-type: none"> 1. Prepare report assessing definition including any potential amendments to existing Australian and New Zealand standards, having regard to the <i>Process for Modifying IFRSs for PBE/NFP</i>. 	<ol style="list-style-type: none"> 1. May - July 2010 (draft report to joint subcommittee early-July 2010)

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Step	Estimated Timing
<p>Part 2: Assess the definition of control being developed by the IASB from its ED 10 <i>Consolidated Financial Statements</i> against the issues identified in the same way as noted in Part 1 of Phase 2.</p> <p>1. Prepare report evaluating ED 10's proposals (or the requirements developed from ED 10) relative to outcomes of Phase 1 and Phase 2, part 1, having regard to the <i>Process for Modifying IFRSs for PBE/NFP</i>.</p> <p><i>[Note: depending on IASB's progress with ED 10, it might be more appropriate to undertake part 2 instead of part 1 of Phase 2. ED 10 was published in December 2008 with comments due to the IASB by 20 March 2009. At the October 2009 joint meeting of the IASB and the FASB, the Boards agreed to conduct their respective projects jointly. The FASB plans to publish an exposure draft (ED) in Q2 of 2010. The IASB will make available a staff draft of its proposed final standard and will also publish a request for views on the FASB proposals. After the public comment period for the FASB ED ends, the two Boards will jointly deliberate the issue with the expectation that they would produce improved and converged standards in H2 2010.]</i></p>	<p>1. August – October 2010 (draft report to joint subcommittee early October 2010)</p>
<p>Deliverables:</p> <ul style="list-style-type: none"> • Issue a Consultation Paper/ED. • Consider submissions on the Paper/ED as appropriate. • Issue further amendments to relevant Aus paragraphs in AASB 127 and NZ IAS 27, depending on outcome of Paper/ED. 	<p>November – December 2010 (first draft to joint subcommittee early-November 2010; second draft to Boards December 2010 – issue for 4 month comment period)</p> <p>May – June 2011</p> <p>September 2011</p>
<p>Phases 3+: to be determined</p> <p>Further phases of the project would be considered after outcomes of Phases 1 and 2 are known. A later phase might include, for example, consideration of whether control is an appropriate basis for identifying the boundaries of a reporting entity within a whole of government entity. This could be undertaken in the context of the disaggregation of a whole of government reporting entity, and might have implications for the current treatment of common control. Potential deliverables could include:</p> <ul style="list-style-type: none"> • Issue a Consultation Paper/ED. • Consider submissions on the Paper/ED as appropriate. • Issue amending Standards as necessary (e.g., AASB 127, Reporting Entity, and AASB 3 <i>Business Combinations</i> as amended by AASB 2008-11 <i>Amendments to Australian Accounting standard – Business Combinations Among Not-for-Profit Entities</i>). 	<p>Subject to outcome and timing of:</p> <ul style="list-style-type: none"> • Phases 1 and 2; • IASB ED 10; and • IASB/FASB Conceptual Framework project.

APPENDIX 1

Definitions of 'control'

AASB 127 and NZ IAS 27 (paragraph 4)

Control is the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities.

FRS-37 (paragraph 4.13)

“Control” by one entity over another entity exists in circumstances where the following parts (a) and (b) are both satisfied:

- (a) the first entity has the capacity to determine the financing and operating policies that guide the activities of the second entity, except in the following circumstances where such capacity is not required:
 - (i) where such policies have been irreversibly predetermined by the first entity or its agent; or
 - (ii) where the determination of such policies is unable to materially impact the level of potential ownership benefits that arise from the activities of the second entity.
- (b) the first entity has an entitlement to a significant level of current or future ownership benefits, including the reduction of ownership losses, which arise from the activities of the second entity.

IASB ED 10 (Appendix A)

control of an entity The power of a reporting entity to direct the activities of another entity to generate returns for the reporting entity.

IPSAS 6 (paragraph 7)

Control is the power to govern the financial and operating policies of another entity so as to benefit from its activities