

**AASB Project Proposal**  
**Defining the Reporting Entity in the Not-for-Profit Public Sector**

**Introduction and background**

1. 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 standards were transferred from these 'industry-based' standards 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. This approach is consistent with the AASB's principle 2.2 of its document *AASB Approach to Public Sector Issues* (see agenda paper 17.3. At the time of the review, the AASB acknowledged that a number of important issues with respect to financial reporting in the public sector remained unresolved and would be addressed by the Board as resources allowed. One such issue was 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 (see below) 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.
2. In the expectation that resources are now available (see paragraphs 18 and 19 below), this project proposal outlines the scope of a project that would address the control issue noted in paragraph 1, and outlines an approach, including a plan, for dealing with the issue. The working title of this project proposal is 'defining the reporting entity in the not-for-profit public sector' rather than 'control of an entity in the not-for-profit public sector' 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 noted below, the project should include consideration of whether control is an appropriate notion in a not-for-profit public sector context).

**The issues**

3. The requirements in AAS 27, AAS 29, and AAS 31 that applied to the application of the 'control' concept in the public sector were transferred to AASB 127 *Consolidated and Separate Financial Statements* where they currently appear in a number of Aus paragraphs. In particular, paragraphs Aus17.1 – Aus17.10 provide the most direct guidance on the application of the control principle in the public sector.
4. Paragraph 12 of AASB 127 requires consolidated financial statements to include all of the subsidiaries of a parent and paragraph 4 defines a subsidiary as an entity that is "controlled by another entity". Control is defined in paragraph 4 as:

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

5. In the context of applying this definition in the public sector, paragraph Aus17.2 identifies two indicators:
  - (a) an entity is accountable to Parliament, or to the Executive, or to a particular Minister; and
  - (b) the government has the residual financial interest in the net assets of the other entity.
  
6. Paragraph Aus17.3 goes on to outline a variety of factors that might be indicative of ‘accountability’, including the existence of the power of a government to appoint or remove the governing board of an entity, the power to approve or veto operating and capital budgets of an entity, or the entity is required to provide reports to Parliament. Accountability issues might be one example in which users of public sector consolidated financial statements might have a legitimate interest in not only economic considerations but also issues about the nature and location of public spending projects. In addition, some argue that the debate about the application of ‘control’ based relationships is a vexed issue in public sector contexts because the relationships between some public sector entities may, for example, be specifically designed (e.g., by statute) to allow an entity to make its operating (if not its financing) decisions independently of any government influence. There is discussion related to this issue in paragraph Aus17.9 of AASB 127 where an attempt is made to demonstrate the limitations of ‘control’ in the public sector. However, some potential contradictions are apparent – e.g., paragraph Aus17.9 suggests that control is not necessarily achieved simply because the government might impose some requirements on the operation of an entity, but it is quite likely that one of these requirements is the provision of reports to Parliament, which is an indicator of control in paragraph Aus17.3(e).
  
7. Paragraph Aus17.4 identifies a residual financial interest as being either that:
  - (a) the government is exposed to the residual financial liabilities of an entity; or
  - (b) the government has the right to receive the residual net assets of that entity upon its winding up.
  
8. However, later illustrations of the operation of this indicator of control tend to discuss issues about whether the subject entity is operating in a way which allows the government to meet its objectives (e.g., paragraph Aus17.8), which would appear to be a broader set of ‘benefits’ than those specified in paragraph Aus17.4(b). Given the proposals of the IASB in its Exposure Draft ED10 *Consolidated Financial Statements* to change the definition of ‘control’, particularly away from ‘benefits’ to ‘returns’, it will be important to consider what is the nature of the benefit or return to a controlling government. This is particularly important given that, unlike private sector entities, any benefit or return may on occasion accrue to, say, the public at large rather than directly to the government.
  
9. In a letter to the AASB Chairman dated 18 November 2009 (see agenda paper 17.6), the Chairman of the Australasian Council of Auditors-General (ACAG) Reporting and Auditing Committee (on behalf of ACAG) revisits and re-prioritises a number of financial reporting issues that continue to cause concern within the public sector. Among the high-priority areas identified is the issue of the ‘Concept of control and

significant influence in the public sector' for which a number of concerns remain unresolved. 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.

10. These issues (and others) reflect, *inter alia*, circumstances different to 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' 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 sub-subsidiaries might be structured in the public sector;
  - (c) stating that local governments are not controlled by governments (see paragraph Aus17.7 and Aus17.9(c)); and
  - (d) stating that regulation does not, of itself, mean that control exists (see paragraph Aus17.9(d)).
11. In relation to 'control of an asset', anecdotal evidence suggests that there is a lack of consistency in how administered items are currently accounted for under AASB 1050 *Administered Items* and confusion 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. The *AASB Approach to Public Sector Issues* (see agenda paper 17.3) states, in relation to administered items, under item 3(d) 'Control in the Public Sector':

Control of an asset in the not-for-profit public sector, including the implications for administered items – the AASB decided at its December 2006 meeting, following consultation with constituents, that the current requirements now in AASB 1050 *Administered Items*, applicable to government departments, were, at that time, adequate for the foreseeable future. The AASB intends to examine the issues as part of this project given that the question of accounting for administered items by government departments (and other not-for-profit public sector entities) raises some fundamental conceptual issues relating to users' needs and the application of the concepts of control and reporting entity (see topic 3.2(n) below). Accordingly, the AASB will consider the accounting for administered items in light of its decisions regarding these fundamental conceptual issues. The outcome of the AASB's deliberations may have implications for the treatment of restructures of administrative arrangements and the restructuring of administered activities of government departments.

12. In summary, the discussion in paragraphs 3 to 11 above suggests that the project should encompass the following broad issues (within which the specific application issues identified above by ACAG are examples):

- (a) Fundamentally, what is the basis of determining the boundary of a reporting entity in the not-for-profit 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 of 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' items be accounted for?

### **Benefits of addressing the issues**

13. Benefits of undertaking this proposed project include:
- (a) It would address an issue of high priority and concern to public sector constituents. As noted in paragraph 9 above, ACAG has identified the importance of this topic and further reinforced its priority in a letter to the AASB Chairman dated 18 November 2009.
  - (b) Considerable confusion and diversity in practices across Australian governments exists in the application of the control criteria in AASB 127 with respect to public sector entities. The proposed project would assist in reducing this diversity and uncertainty and lead to more comparable consolidation practices between the Commonwealth, States and Territory governments. This in turn would assist users of government financial statements by increasing the level of transparency and accountability of governments.
  - (c) Similarly, considerable confusion and diversity exists with respect to the accounting treatment of 'administered items' across Australian public sector entities. There are a variety of interpretations about the application of 'substance over form' in the recognition and disclosure associated with administrative items. The proposed project would assist in providing clearer criteria for the treatment of these items and thus lead to more comparable financial statements between the Commonwealth, States and Territory governments. This in turn would assist users of government financial statements by increasing the level of transparency and accountability of governments by identifying which public sector entities were responsible for the administered items.

### **Approach to dealing with the issues**

14. Staff suggest that a project be undertaken following the AASB's usual process of progressing similar work, with the objective of initially amending the Aus paragraphs of AASB 127 to address current practice issues, and ultimately fundamentally revisiting those Aus paragraphs from a more conceptual perspective. Consistent with the Boards' decision at their joint October 2009 meeting, the work should be progressed jointly with the New Zealand Financial Reporting Standards Board (FRSB). Although New Zealand accounting standards do not have paragraphs equivalent to the Aus paragraphs in AASB 127, if both Boards agree that the *Process for Modifying IFRSs for PBE/NFP*

justifies some modifications to IFRS, then the Aus paragraphs could be used as a starting point.

15. Consistent with the AASB and FRSB's recent deliberations on working arrangements, it is envisaged that there would be a subcommittee of members from each Board to assist with the development of the project out-of-session. It is expected that the subcommittee may need to meet at least once during each phase of the project (see paragraph 17). Board discussions are expected to be limited to one or two discussions per phase – once before issuing each Consultation Paper/ED, and once before finalising any amendments to standards.

### *Cross-cutting issues*

16. The project would need to have regard to cross-cutting issues being addressed in other projects including:
  - (a) The AASB's GAAP/GFS Harmonisation Project. Currently, GAAP adopts a control notion for determining the boundaries of a reporting entity and for determining the consequential accounting treatment of controlled entities. In contrast, in relation to the GGS, GFS focuses more on the functions (non-market versus market activities) of an entity in determining the boundaries and accounting treatment of public sector entities. Currently, AASB 1049 *Whole of Government and General Government Sector Financial Statements* deals with this 'convergence difference' by amending GAAP to facilitate the GFS form of GGS reporting. This project should have regard to GFS principles, and AASB 1049 should ultimately be reviewed in light of the outcome of this project.
  - (b) The IASB's Financial Crisis Project Consolidated Financial Statements is directly relevant to the proposed project. In December 2008, the AASB issued (in the form of ED 171) the IASB's ED10 for public comment. The IASB's ED10 has proposed a new definition for control (paragraph 4): "A reporting entity controls another entity when the reporting entity has the power to direct the activities of that other entity to generate returns for the reporting entity." Adoption of this definition by the IASB could have significant implications for the criterion of 'control' in the public sector where, as noted in paragraph 8 above, generating returns may not be an appropriate basis for defining relationships between public sector entities. The project that is the subject of this proposal should monitor and integrate with any decisions emerging from the Consolidated Financial Statements project. To the extent that the Consolidated Financial Statements project does not resolve issues relating to the consolidation of public sector financial statements, this project should address them. The IASB project is a Memorandum of Understanding project being undertaken jointly with the FASB and an IFRS is scheduled to be issued in the third quarter of 2010.
  - (c) The AASB's Conceptual Framework project with regard to the reporting entity concept, which is closely related to the IASB's and IPSASB's Conceptual Framework project. The reporting entity concept phase of the project is being undertaken jointly between the IASB and the FASB. In June 2008 the AASB issued ITC 17 Request for Comment on IASB Discussion Paper *Preliminary Views on an improved Conceptual Framework for Financial Reporting: The Reporting Entity*. On the basis of comments received on the Discussion Paper, FASB staff are currently preparing a draft ED. The project which is the subject of this proposal should have regard to any relevant developments in the Conceptual

Framework project. This will be important in relation to the consolidation of public sector entities phase of this proposed project. It may also have implications for the administered items phase of this proposed project, given that phase raises fundamental issues such as whether or not government departments are reporting entities in their own right as distinct from arms of government that should be subject to segment-like reporting principles. An IASB ED is scheduled to be issued in the fourth quarter of 2009, and a Final Chapter is scheduled for the fourth quarter of 2010.

***Project plan***

17. To address the concern that there are practice issues that need to be resolved in the short-term, and acknowledging that in the medium to longer term some of the work in the cross-cutting projects will inform the Board’s thinking on this project, it is anticipated that the proposed project would entail four phases:
- (a) Phase 1: Review of the Aus paragraphs in AASB 127 (this phase would accept that control, as currently defined in GAAP, is an appropriate basis for determining the boundary of a public sector reporting entity and line-by-line consolidation and would focus on improving the guidance on applying that concept in a not-for-profit public sector context, having regard to the Board’s *Process for Modifying IFRSs for PBE/NFP*. Although the aspiration of this phase would be improvements to the Aus paragraphs in AASB 127, it is conceivable that an outcome of this phase is that it is not possible to address the practice issues in AASB 127 without revisiting the concept of control. In that case, it may be appropriate to embark on phase 4 sooner than this plan contemplates)
  - (b) Phase 2: Appropriateness of line-by-line consolidation (this phase would again accept the definition of control as defined in GAAP, but question the accounting consequences of control. It would include consideration of paragraph 10 [relief from consolidation] of AASB 127 and the suitability of the GFS approach to GGS reporting)
  - (c) Phase 3: Accounting for administered items (given the Board’s previous consideration of this issue, this phase should not be commenced until the Board’s Conceptual Framework project has addressed the notion of user needs and reporting entity in a public sector context)
  - (d) Phase 4: Defining the not-for-profit public sector reporting entity (this phase, being at a conceptual level, would fundamentally question the suitability of the notion of control in a not-for-profit public sector context. If control is an appropriate basis, how should it be defined in that context? This phase should be undertaken within the context of the outcome of the Board’s Conceptual Framework project – see paragraph 16(c) above)
18. The steps and potential timing for progressing the Phases of the project would include:

<b>Step</b>	<b>AASB Meeting</b>
<b><i>Phase 1: Review of Aus paragraphs of AASB 127</i></b>	
1.1 Agreement on the scope and approach of the project.	December 2009
1.2 Appoint project consultant.	
1.3 Interviews with constituents to identify user needs, explore inter-entity relationships, consider practical implementation issues; and provide feedback on any draft proposals that emerge	March 2010

from the research project.	
1.4 Write up discussion paper reviewing issues, following the <i>Process for Modifying IFRSs for PBE/NFP</i> , detailing investigations and findings.	
1.5 Possibly issue a Consultation Paper/ED.	June 2010
1.6 Consider submissions on the Paper/ED as appropriate.	September 2010
1.7 Issue first round of amendments to relevant Aus paragraphs in AASB 127.	November 2010
<b><i>Phase 2: Appropriateness of line-by-line consolidation</i></b>	
2.1 Consider what level of disaggregation of not-for-profit public sector financial statements best meets users' information needs. Undertake consultation with constituents as to the nature of their information needs and whether these are adequately satisfied by way of 'one line' consolidation in government financial statements or whether 'line-by-line' consolidation is necessary to provide sufficient information and accountability. Have regard to GFS principles. Identify relevant costs and implementation issues. Write up discussion paper reviewing issues, following the <i>Process for Modifying IFRSs for PBE/NFP</i> , detailing and justifying proposed basis for consolidation in the public sector	February 2011
2.2 Possibly issue a Consultation Paper/ED.	May 2011
2.3 Consider submissions on the Paper/ED as appropriate.	September 2011
2.4 Issue further amendments to relevant Aus paragraphs in AASB 127, depending on outcome of Paper/ED.	December 2011
<b><i>Phase 3: Accounting for administered items</i></b>	
3.1 Describe existing treatment of 'administered items'. Identify the underlying basis on which assets are classified as either 'controlled' or 'administered' by a particular public sector entity. Explore whether the distinction between 'controlled' and 'administered' assets has any validity and serves financial statement user needs.	Subject to outcome and timing of Conceptual Framework project
3.2 Possibly issue a Consultation Paper/ED.	
3.3 Consider submissions on the Paper/ED as appropriate.	
3.4 Issue amendments to relevant Standards	
<b><i>Phase 4: Defining the not-for-profit public sector reporting entity</i></b>	
4.1 Consider the implications of the outcomes of the Conceptual Framework project and issue an invitation to Comment (if appropriate, and depending on whether and what type of Consultation Paper is issued at the end of each Phase) and ultimately an Exposure Draft for a three-month comment period.	Subject to timing of Conceptual Framework project
4.2 Consider submissions on the ITC and ED as appropriate.	
4.3 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> ).	

19. The estimated timing of the above Phases/steps is subject to a range of factors that may be beyond the control of the project team. They are provided above to give a broad

sense of the sequence and an indication of the period of time Phases/steps might take. Depending on developments in other projects (see paragraph 16 above), it may be appropriate to reorder some of the Phases (see, for example, paragraph 17(a) above.

## **Resource implications**

### *Staffing*

20. Phase 1 would be conducted by a private contractor under supervision. In addition, a project manager (50%) for about three years and the time of other staff supporting the private contractor and project manager and senior staff reviewing the work.

### *Other costs*

21. Consultation with constituents, comprising travel costs (expected to be primarily domestic, although some travel to New Zealand may be necessary). Later phases of the project may require the conduct of roundtables within Australia (primarily Melbourne, Sydney, and Canberra) and include the hire of venues and catering.

## **Questions for the AASB**

**Question 1:** Is this project proposal the appropriate basis for the approach to addressing the AASB's active Work Program Project?

**Question 2:** Do Board members agree with the proposed scope of the project? If not, what changes would the Board require?

**Question 3:** Do Board members agree with the proposed sequence for the Phases of the project? If not, what changes would the Board require?

**Question 4:** What would Board members anticipate in relation to the consultative document(s)?

- (a) Issue something at the end of each Phase, or only after all Phases?
- (b) Discussion Paper, Invitation to Comment, Exposure Draft?

**Question 5:** Do Board members have any other comments on the project proposal?