

WORKING DRAFT

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

**Part 1 of Phase 1 – Identification of Issues Associated with the
Application of Control**

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Standards Board and the New Zealand Financial Reporting Standards Board

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Project Team Note to Boards:

As noted in agenda paper B12.1, this paper is an unamended version of the draft that was provided to sub-committee members for comment, except for the inclusion of section 9.0 and Appendix 4, which provide details of some of the suggestions made by sub-committee members for improving the content and structure of the paper. In addition, another definition of control, from the IASB staff draft of IFRS X *Consolidated Financial Statements*, has been added to Appendix 3 of this paper.

As also noted in agenda paper B12.1, we have not incorporated any sub-committee members' comments into the paper, pending resolution of the fundamental issues raised in agenda paper B12.2.

EXECUTIVE SUMMARY

This paper describes the findings of a review of relevant literature and a series of interviews that were conducted to identify current issues arising from the application of the control concept in the public sector. The issues identified, many of which are interrelated and some of which might also arise in a private sector context, include:

- 1) Conceptual issues:
 - (a) Transaction-neutrality: There is some concern that a concept of control based on private sector notions may not be suitable for the public sector because information needs of investors are likely to differ from information needs of users of public sector general purpose financial statements;
 - (b) Unresolved questions about users and their needs: There is some concern about inconsistent application of the definition of control due to different views on who the users of public sector financial statements are, who the primary users are, and what their information needs are;
 - (c) Identifying the reporting entity:
 - (i) Government departments as reporting entities: There is some concern that departments should not be treated as separate reporting entities and therefore about the validity of the distinction between controlled and administered items; and
 - (ii) The role of legislation in identifying reporting entities;
- 2) Interpretation issues relating to control of an entity:
 - (a) 'the power to govern' component of control:
 - (i) Absence of ownership instruments: it is sometimes difficult to determine whether 'power to govern' exists in the absence of ownership instruments;
 - (ii) Pervasive authority of governments: it is sometimes difficult to discern which of a government's powers are pertinent to the control question;
 - (iii) Regulatory power: it is sometimes difficult to determine whether certain regulatory powers give a government the 'power to govern'; and
 - (iv) Special purpose/auto-pilot entities established by legislation: it is sometimes difficult to determine whether the establishing government has an ongoing 'power to govern';
 - (b) 'the financial and operating policies' component of control:
 - (i) Financial dependence: it is sometimes difficult to determine the relationship of financial dependence to 'the financial and operating policies'. Opinions vary as to whether entities that are autonomous in their operations are controlled because they are accountable on the basis of financial dependency; and
 - (ii) Some think this component does not adequately address the relationship between governments and universities or local governments;
 - (c) 'so as to obtain benefits from its activities' component of control:
 - (i) The nature of benefits: direct versus indirect; and
 - (ii) The relationship of benefits to objectives, for example in relation to trusts;
 - (d) Accounting consequences:
 - (i) Single line vs line-by-line consolidation; and
- 3) Practice issues relating to control of an asset:
 - (a) Administered items: their definition and manner of disclosure; and
 - (b) Community facilities on local government land.

The paper concludes with a series of preliminary short to medium term recommendations that, subject to the outcome of the research still to be undertaken as part of this project, suggest the AASB and FRSB give consideration to:

- 1) continuing to monitor the IASB and IPSASB conceptual framework projects so that local experience can be used as input into the IASB and IPSASB deliberations;
- 2) providing converged amended guidance on the application of the control criteria in a public sector context – to at least address the main interpretation issues. In particular, consideration could be given to providing guidance on:
 - (a) the potential role of accountability in the definition of the public sector reporting entity;
 - (b) the distinction between ownership and regulatory forms of control;
 - (c) what constitutes ‘benefits’ in a public sector context;
 - (d) whether entities created by governments and then left on ‘auto-pilot’ are controlled; and
 - (e) AASB 1050 as to what constitutes an agency relationship for the purposes of administered items.

1.0 Introduction

1. This paper presents the findings relating to Part 1 of Phase 1 of the joint AASB/NZ FRSB Defining the Reporting Entity in the Public Sector project (Appendix 1 outlines the background to the project and Appendix 2 contains a copy of the project plan).
2. The objective of this Part of the project is to determine the extent to which there are issues in practice with the application in the public sector of the concept of control, which in terms of the relationship between entities, is prescribed in AASB 127 and NZ IAS 27, both entitled *Consolidated and Separate Financial Statements* (relevant definitions of control are provided in Appendix 3 of this paper). The review reflects both the Australian and New Zealand experience.
3. Application issues arise from practical implementation/interpretation issues, some of which are caused by underlying conceptual views about ‘control’ in a public sector context. These conceptual views have practical implications because they influence the way preparers and users interpret and understand ‘control’ as a basis for defining the boundaries of reporting entities in the public sector.
4. In this project, the discussion of the concept of ‘control’ has various interrelated dimensions, including those specifically related to:
 - (a) the control of entities, which is particularly pertinent to questions about the appropriate level of aggregation and disaggregation for the purposes of circumscribing reporting entities in the public sector. These questions give rise to issues relating to: whole of government reporting relative to sector reporting (e.g., general government sector reporting) relative to portfolio reporting (e.g., functional reporting) relative to departmental reporting. In relation to departmental reporting, questions about the nature of a department for financial reporting purposes arise, including whether a department should be regarded as a separate reporting entity or as an arm of government (the answer to which has implications for the issues arising under (c) immediately below); and
 - (b) the accounting method to be applied to reflect a control relationship between entities. For example, options include equity accounting, as a one line investment, or line-by-line consolidation. Given that both AASB 127 and NZ IAS 27 use control as a basis for identifying entities subject to the consolidation method, it is understandable that many commentators view the control concept in terms of its application to consolidated financial statements. This link is reflected in many of the sources reviewed for this project; and
 - (c) the control of assets, which is particularly pertinent to the distinction that is currently made between controlled and administered assets under AASB 1050 *Administered Items*.
5. The purpose of identifying application issues is to ultimately provide input to:
 - (a) an assessment of whether the concept of control is an appropriate basis for circumscribing a public sector reporting entity and, if so,
 - (b) provide a basis for developing improvements to the existing requirements relating to control, or, if considered necessary,
 - (c) provide a basis for identifying an alternative concept for circumscribing a public sector reporting entity.

These matters will be the subject of future papers (see the project plan in Appendix 2 of this paper – which lists the future papers). In the interim, this paper includes a preliminary recommendation that the Boards consider providing additional guidance on the application of the control concept in a public sector context.

6. In general, the literature reviewed for this paper suggests that the concept of control has been subject to varying interpretations and, consequently, inconsistent application in the public sector (e.g., Day (2009, p. 230); Newberry & Pont-Newby (2009, p.235)). In the context of AAS 31 *Financial Reporting by Governments*, the forerunner of the current Australian requirements, Challen and Jeffery (2005a, p. 73) have asserted:
“Because the collection of entities and activities embraced by the AAS 31 reporting entity is essentially arbitrary, and varies greatly between jurisdictions, AAS 31 reports are not comparable across jurisdictions.”

As reported later in this paper, some commentators conclude that control is a suitable basis for identifying reporting entities but argue that it needs to be clarified to deal with the unique circumstances found in the public sector. Others argue that control is an inappropriate basis for circumscribing an entity in the public sector.

2.0 Research Method

7. Two processes were undertaken to gather data for this paper. One process was to conduct a review of relevant academic and practitioner literature. The purpose of this literature review is to summarise recent papers that have critiqued the concept of control and the application of the concept of ‘control’ in the public sector context. The literature reviewed here is dominated by papers from the academic literature that have critiqued the control of an entity concept. Existing accounting standards, although helpful in explicating the notion of control, are emphasised less in the literature review as they take the concept of control as a ‘given’ and seldom incorporate critiques of the concept.
8. The second research process was to supplement the findings of the literature review by the analysis of interviews conducted with public sector practitioners. A total of fourteen interviews were conducted with a range of public sector (including local government) practitioners. Some interviews occurred on a one-to-one basis while others were conducted with small groups. Interviewees were identified either on a convenience basis (e.g., the interviewees were readily available to the interviewer) or were known by AASB and FRSB technical staff to be experts in public sector reporting. Interviewees were provided with information regarding the background and objectives of the project and open-ended questions were used as a starting point for interviewees’ reflections and observations. Interviewees were invited to elaborate where necessary upon their comments. Interviews were typically approximately one hour in length.
9. Interviewees were sourced from the following entities and sectors:
 - Auditor-General’s Department, South Australia;
 - The Audit Office, New South Wales;
 - Australian Local Governments (from New South Wales, Queensland, Western Australia);
 - Department of Finance and Deregulation (Commonwealth);
 - Department of Treasury and Finance, South Australia;

- Various other departments within the South Australian Government (interviewees met as a group reflecting a selection of preparers of financial statements);
- Department of Treasury and Finance, Tasmania;
- New South Wales Government Treasury;
- New Zealand Local Government;
- Office of the Controller and Auditor-General, New Zealand;
- Office of the Auditor-General, Western Australia; and
- The Treasury, New Zealand.

[Note to the sub-committee: the comments from some interviewees have yet to be fully incorporated into this paper. At this stage of the paper and in the interests of getting timely feedback from the sub-committee, the key issues raised by interviewees have been incorporated, but not all the fine detail is yet included here.]

10. Several of the issues identified by interviewees mirrored those found in the literature review and were, of course, informed by the practical experience of the interviewees. There was not necessarily a consistent position across interviewees or jurisdictions on some issues (e.g., control of an asset appeared to be a non-issue in New Zealand but a matter of concern in Australia) but some common themes were found. Trusts and statutory funds were typically provided by the interviewees as examples in which the application of control as specified in AASB 127 and NZ IAS 27 was problematic.
11. Issues identified by the literature review and interviews are discussed and summarised in the next five sections of this paper and preliminary recommendations are presented in the final section.

3.0 The Structure for the Analysis of the Issues

12. The literature review and interviews identified a wide set of issues relevant to this paper. These issues range from the conceptual (e.g., who are and what are the needs of users of public sector financial statements) to the practical (e.g., the materiality of line-by-line consolidation of local governments' trusts). Many of the issues are interconnected and this complicates the ability of this paper to neatly compartmentalise the issues. The following approach has been adopted in an attempt to meaningfully structure the discussion.
13. The issues identified have first been broken into those which are:
 - (a) conceptual and fundamental to defining the reporting entity in the public sector. This includes different views about the objectives of public sector financial reporting (including those objectives relative to private sector financial reporting) due to the wide diversity of users and their needs, which are the focus of section 4.0 below. Although these matters reflect underlying conceptual issues, they impact in a practical sense on the way in which different commentators and practitioners view 'control' as a basis for circumscribing a reporting entity in specific contexts such as local governments, trusts, government departments, statutory authorities, special purpose entities, and universities; and
 - (b) associated with the related issue of the tension between varying degrees of autonomy and accountability found across different public sector/publicly funded entities. (Alternatively, this latter group of issues can, at least in part, be viewed as issues about reconciling the *variety* of mechanisms for governance across entities in the public sector). They particularly relate to the understanding and

implementation of the definition of control in a public sector context. This broad group of issues is sub-divided between control of an entity issues (discussed in section 5.0) and the not unrelated control of an asset issues (discussed in section 6.0). In relation to control of an entity, the issues are further sub-divided on the basis of the components of the control definition in paragraph 4 of AASB 127 and NZ IAS 27:

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

The three key components of this definition around which section 5.0 of this paper's analysis is structured are:

- (i) 'the power to govern', in particular how the phrase is to be understood in a public sector context, including in relation to regulatory power (discussed in section 5.0(b));
- (ii) 'the financial and operating policies', in particular whether it is appropriate that power must be exercised over both financial and operating policies or whether it would be sufficient that power stem from only one of these factors (e.g., is dominance of funding arrangements sufficient [on the basis of 'accountability'] to require consolidation of an entity into the funding body's group) (discussed in section 5.0(c)); and
- (iii) 'so as to obtain benefits from its activities', in particular whether benefits need to be direct and what the form of these should benefits be (discussed in section 5.0(d)).

14. These categories of issues are necessarily interrelated and some overlap in the discussion that follows is unavoidable. Nonetheless, this structure assists in identifying key issues with the application of the control concept in the public sector. Examples from various classes of public sector entities are provided to illustrate the issues.

4.0 Conceptual Issues

15. Consistent with the conceptual frameworks emerging from the current ongoing work of the International Accounting Standards Board (IASB) and International Public Sector Accounting Standards Board (IPSASB), identifying the relevant reporting entity or entities in the public sector is very much tied to the identification of 'users' of public sector financial information and their information needs. Identifying the users and their needs is a major project in itself, a detailed examination of which is beyond the scope of the project of which this paper is a part, but within the scope of the Boards' Conceptual Framework projects. Although the related AASB/NZ FRSB Conceptual Framework projects will address these issues in detail, this paper considers them briefly because they are fundamental to the objective of this paper.

(a) Private sector/public sector standard setting context

16. It is important for an understanding of the discussion in this section that the private sector genesis of AASB 127 and NZ IAS 27 is acknowledged. This is because these two standards are essentially reproductions of the IASB's IAS 27 *Consolidated and Separate Financial Statements*. As noted in the IASB's Constitution (IASCF, 2010, p. 5, emphasis added), IFRSs are developed with the objective, inter alia, "to help *investors, other participants in the world's capital markets* and other users of financial information

make economic decisions”. It will be seen below that this context of investors, capital markets, and economic decisions is viewed by many (but not all) commentators as reflecting for-profit private sector/capital markets considerations whose relevance in the public sector would extend only to Government Business Enterprises (GBEs), which are outside the scope of this paper. In its Consultation Paper on a conceptual framework for public sector general purpose financial reporting, the IPSASB (2008, pp. 20 - 21) has indicated that although there are similarities between the private and public sectors, there “are also differences in how these [public sector] entities raise funds, and in the nature and range of decisions that can be made by many funders and consumers of the services they provide.”¹ Many commentators express the view that these differences have important implications for information needs of users and have potential consequential implications for the reporting obligations of public sector entities, including in relation to the concept of control.

17. As noted in Appendix 1, in Australia, these differences in sectoral users have resulted in the insertion of paragraphs Aus17.1 to Aus17.10 into AASB 127 to provide guidance on the application of IAS 27’s control concept in a public sector setting. In New Zealand, NZ IAS 27 contains cross-references to IPSAS 6 *Consolidated and Separate Financial Statements* and FRS-37 *Consolidating Investments in Subsidiaries* that provide guidance additional to that in IAS 27 on determining whether a public benefit entity (PBE) controls another entity. Many commentators think that these existing attempts to transpose the control concept derived from the for-profit private sector into the public sector are inadequate (and hence paves the way for this particular AASB/NZ FRSB project). As noted below, some of these commentators express concern that notions of control that reflect the economic decision needs of investors may be inappropriate for the information needs of the users of public sector general purpose financial statements.

(b) Who are the users?

18. One reason for the debate about the definition of the reporting entity (and the implications of control in that definition) in the public sector is the debate about the identity of the users of public sector general purpose financial statements and what their needs might be. Rutherford (1992) and Walker (2009) for example have suggested that many reports and accounting standards make assertions about who the users of public sector financial information are, and make claims about what their needs might be, but provide little, if any, evidence to substantiate those claims. Typical lists of users of public sector financial statements “include parliament and its oversight committees, the government and government-agencies, external monitoring parties such as credit-rating agencies, investors and creditors and the public and its special-interest groups” (Challen and Jeffery, 2005a, p. 72). In general, the interviewees for this paper identified the users of public sector financial statements as being Parliament and Parliamentary committees, Treasury, other government departments, credit rating agencies, and members of the media.
19. The US Federal Accounting Standards Advisory Board (FASAB) (2003, p. 4) on the basis of a joint US and Canadian study (OAGC and US GAO, 1986) asserted that public sector consolidated financial statements served five groups of users; namely, citizens, citizen intermediaries, Congress, Federal Executives, and Program Managers. The first

1 Paragraph 2.9 of the IPSASB Consultation Paper (IPSASB, 2008, pp. 20 – 21) details the nature of these differences.

two groups were perceived to be ‘external’ users and to be treated as the primary audience for the consolidated financial statements. Citizen intermediaries (such as analysts and the media) were considered to be highly important users of public sector consolidated financial statements as they “would analyse and interpret the more detailed information to deliver it to citizens. They also would provide more in-depth analysis that citizens may not have the desire, or the ability to perform” (FASAB, 2003, p. 7). More recently, the IPSASB (2008, p. 19) has suggested that the potential users of public sector general purpose financial statements are:

- “Recipients of services or their representatives;
- Providers of resources or their representatives; and
- Other parties, including special interest groups and their representatives.”

20. Again, these categories and the associated IPSASB discussion about their information needs appears to be asserted rather than empirically tested because the IPSASB arrived at these users on the basis of those “identified by many national standards setters and other authoritative bodies” (IPSASB, 2008, p. 18).
21. Interestingly, much of the literature reviewed for this paper and the interviewees were of the view that consolidated general purpose whole-of-government financial statements were unlikely to be extensively used by the public. For example, Jones (1992, p. 262) has suggested that “the publication of financial statements is not in the public interest because the public has no interest.” Rutherford (1992, pp. 269 – 270) describes research findings that would support Jones’s statement.
22. The reasons for this alleged lack of interest is explored in paragraph 26 below. Of immediate interest here, is the observation that it is difficult to clearly identify user groups for public sector general purpose financial statements. Indeed, major users of such reports could, in fact, be internal rather than external to the public sector.² Rutherford (1992, p. 271) summarises why this might be:

“The character of the user-community differs between the public and private sectors: in the public sector the dichotomy between internal and external users which is so obvious in the profit-seeking sector is much less marked. Rather, users spread out along a spectrum with fully internal, managerial users at one end and fully external users at the other. In the middle are a variety of intermediate users, internal from some perspectives and external from others. The classic example is the legislature in the case of central government: in principle capable of demanding any information it chooses; in practice severely constrained.”
23. It has even been suggested that some internal parties are unlikely to be users; Walker (2009, p. 191) has argued:

“In practice, parliamentarians, as a class, are not actively involved in making decisions about resource allocation. Rather, budget strategies are usually crafted by a small group of political leaders and their advisers, and bureaucrats from central agencies. Most members of government have little say in the matter ... Indeed, in Australian governments, many ministers are ‘budget-takers’ not ‘budget-makers’.”
24. A lack of clarity as to who are the actual users of public sector general purpose financial statements has led, as discussed in section 4.0(c), to a variety of interpretations as to what

2 A similar observation is made in the lists of users provided by the IPSASB (2008).

information and decision needs might best be met by the financial statements. The alternative conceptions about users and user needs results in disagreement about how the public sector reporting entities should be defined and identified, and therefore whether, and if so how, control should be applied.

(c) What are the information needs of users?

25. Ambiguity and disagreement about the identity of the users of general purpose financial statements has flow on effects for understanding what user needs are best served by public sector reporting. As reporting entities are identified on the basis of serving user needs, drawing the boundaries around public sector reporting entities is difficult partly because commentators differ as to what the actual information and decision needs of users are. There are a variety of dimensions to this issue. For example, by their nature general purpose financial statements report financial information but some major user groups may need non-financial information (e.g., changes in the number of public hospital beds). Even the financial information can be used for mixed purposes such as for economic management, performance measurement, or accountability. Given the lack of systematic evidence as to the identity of users of public sector financial statements and their needs, several commentators have sought to impute what user needs might be by reflecting upon alternative roles of government. Unfortunately, this exercise also ‘muddies the waters’ as commentators do not necessarily agree as to what those roles should be or what information should be provided to report on governments’ performance of those roles. Although there seems to be little disagreement among commentators that financial reporting by public sector entities is necessary, if for no other reason than to satisfy some notion of ‘accountability’ (see section 5.0(c)), the nature of this reporting is contested. These issues are explored in the remainder of this sub-section.
26. Some commentators suggest that it is superficial to expect that external users (such as citizens) have an interest in public sector financial information either in their role as taxpayers and/or as the recipients of government goods and services (see, for example, FASAB, 2003, p. 6). For instance, the FASAB was unclear as to the specific information needs of the external users but noted that they would require “highly summarised information” (FASAB, 2003, p. 6) of a financial nature. As noted in paragraphs 21 to 23, there is some scepticism about whether public sector financial statements are decision useful. Among the interviewees for this paper, there was a consensus that the general public (and in the case of local governments, ratepayers) were not active users of governments’ general purpose financial statements. Users were considered to have narrow information needs that reflected their specific interests in particular public sector programmes, projects, and activities; for example such interests might include: had money been spent on a particular project, had the money been “well” spent, and what types of outcomes had been achieved by the project? Many of the measures associated with these information needs are qualitative/non-financial rather than necessarily quantitative/financial as users’ interests were viewed as often being focussed upon the quality of the delivery of public goods and benefits rather than commercial interests. Rutherford (1992) has suggested the reason for this lack of interest in general purpose financial statements is that the rational citizen will be focussed upon the personal costs and benefits from government’s activities but these will be impossible to determine from the highly aggregated data contained in financial statements (Rutherford, 1992, p. 268):

“In general then, the interests of parties who are unequivocally external to government units appear, *a priori*, to be sufficiently heterogeneous to make it highly unlikely that general purpose financial statements, which must necessarily be highly aggregated ..., can provide information useful for taking the kinds of decisions such parties wish to make.”³

27. In an attempt to unearth possible user needs, Walker (2009, p. 178) identified eight different classes of users of public sector financial information and then went on to suggest eighteen different classes of ‘judgment’ that these users may wish to make about government financial performance. In keeping with the observation in paragraph 0 that there may be both external and internal users of public sector financial statements and that the distinction between the two groups is not always clear, he noted that there was great diversity in the nature of these judgments, for example, some occur on a ‘routine’ basis (pricing of government services), some are ‘conditional’ on particular expected events occurring (e.g., maintenance of infrastructure), while others might be ‘exceptional’ and only arise upon the occurrence of extreme or extraordinary events (e.g., delays in payments to creditors). This caused him to suggest that (Walker, 2009):
- (a) some of the information that users would require for these judgments might be readily available in a relevant form from other existing sources (e.g., budget papers, Australian Bureau of Statistics reports, etc.); and
 - (b) “even for the judgments for which it is hypothesized consolidated financial statements convey relevant data, *different forms of consolidated statement* (encompassing different sets of entities) *may be relevant for different purposes*” (Walker, 2009, p. 198, emphasis in original).
28. With regard to the first point, although agreeing that much financial information of relevance can be found elsewhere, Wise (2006, p. 70) notes that one of the benefits of whole-of-government consolidated financial statements is that they provide “one reference source that allegedly details total government resources and obligations.”
29. Walker’s second point notes the complexity of producing one set of ‘general purpose’ financial statements for an entity that conducts a diverse range of activities that often have ‘not-for-profit’ objectives. He concludes that in an attempt to at least capture relevant information for ‘routine’ decisions, “the optimal form of reporting by national, state and territory governments would take the form of ‘whole public sector’ reports, accompanied by consolidated statements encompassing both the general government and the non-financial public trading enterprise sectors” (Walker, 2009, p. 201).
30. Consolidation of individual entities across the whole public sector may run the risk of aggregating ‘too much’ with the result that it becomes difficult, if not impossible, for users to identify information relevant to their specific needs – e.g., someone interested in, say, particular services such as health or transport may be unable to find the information they need if public sector financial statements are too highly aggregated. Challen and Jeffery (2005a, p. 76) have argued that the level of aggregation in current public sector financial statements is “so heterogeneous as to render many of the ensuing results beyond sensible interpretation.” Newberry and Pont-Newby (2009, p. 239) refer to a

3 A similar observation is made by the IPSASB (2008, p. 24): “In some cases, [citizens] can also make decisions about personal circumstances ... In most cases, these decisions will not be made directly in response to information included in [general purpose financial reports].” Notwithstanding this observation, the IPSASB (2008, pp. 24 - 25) does go on to suggest that there will be common information needs across user groups.

New Zealand Society of Accountants study “which reported no empirical demonstration that consolidated financial statements are useful, and dismissed as ‘unsubstantiated’ claims that ‘full consolidation, or whole of government reporting is most useful’.” To some extent this problem could be addressed by the provision of single line equity accounted amounts, or segment information or, as suggested by Walker (2009), the provision of supplementary financial statements or schedules.

31. Other writers have pointed to how the diverse roles of government complicate the issue of what are the appropriate objectives of financial reporting by governments. For example, Challen and Jeffery (2005a, p. 72) note that it “is important to recognise the different objectives of alternative forms of different government financial reporting” because the users have different needs while Newberry and Pont-Newby (2009, p. 235) note that the purposes of government “range from macro-economic (fiscal policy) to micro-economic (better management and more effective distribution), but there is a long history of inconsistencies and tensions between macro-economic and micro-economic concepts. These inconsistencies include how the reporting entity should be defined ... [and] point to disparity also in underlying ideas on the role of government”.
32. From the literature review and the interviews conducted for the purpose of this paper, most obvious in the public sector is a tension between the use of financial information for economic management/performance purposes versus its use for accountability/stewardship purposes. Chow et al. (2007, p. 39) have highlighted this conflict:

“there is also a real risk that in seeking to make [whole of government] information more useful from an economic perspective (and hence more valuable for governmental macro-economic decision-making), the government may be neglecting one of the principal reasons for producing public sector financial statements, namely public accountability.”
33. Rutherford (1992, p. 271) has gone so far as to suggest that the inability to identify a dominant ‘decision’ in the public sector may be one of the reasons that accountability is emphasised by many commentators on public sector reporting. To varying degrees, the interviewees for this paper acknowledged the perceived importance of accountability as an objective of public sector reporting.⁴ Some of them indicated that accountability as a basis for reporting needs to be considered beyond administrative boundaries. Queensland Treasury (2010, p. 2) notes:

“A government minister may have responsibility for more than one function. Those functions may be encompassed in a single portfolio or administered through a number of portfolios. The specification of separate objectives for each function will usually be an indication of the existence of separate economic entities, regardless of whether the functions are combined in the one portfolio or administered separately though more than one portfolio.”
34. One interviewee suggested that the identification of reporting entities within whole-of-government should not be tied to which entity has, for example, authority for expenditures or budgets as these characteristics simply represent administrative vagaries

⁴ In its Consultation Paper on a conceptual framework for public sector reporting, the IPSASB (2008, p. 25) has reached the preliminary view that one of the objectives of financial reporting by public sector entities should be to provide information for “accountability purposes”. The other proposed objective is to provide information for “making resource allocation, political and social decisions.”

and convenience. Rather the boundaries of reporting entities should reflect the concepts of accountability, stewardship, government policy objectives, and ministerial influence as these four factors linked better to the interests of users. Two interviewees were emphatic that these factors demonstrated that user needs were driven by the desire for information about the accountability, legal, and policy responsibilities of public sector entities. One way that an interviewee suggested this might be operationalised was that in addition to whole-of-government reporting, reporting entities could be identified at the ministerial or portfolio level, thus capturing those resources that the relevant Minister or portfolio had the capacity to deploy.

35. Not all interviewees were in favour of an approach that emphasised ‘accountability’, pointing to the difficulty of satisfying a multitude of stakeholders (a point effectively noted by Walker (2009)). Nonetheless, there was a strong underlying theme that the identification of reporting entities in the public sector should allow an account to be made of performance against established public policy responsibilities. In keeping with the concepts of accountability and performance, Challen and Jeffery (2005a, 2005b) argue that one of the key objectives of defining the public sector reporting entity should be achieving a correspondence between budgetary reporting and outcomes reporting. Consequently, they suggest the reporting entity should be the General Government Sector (GGS) as defined by the sectoral classifications provided in the Government Finance Statistics (GFS). The underlying principle is that “all entities funded by budget appropriations must be amalgamated into a single institutional unit (Challen and Jeffery, 2005a, p. 73). This would result, they suggest, in a stable public sector entity that is comparable across jurisdictions.

(d) Impact of public finance and audit legislation on what constitutes a ‘reporting entity’

36. The title of this project is “Defining the Reporting Entity in the Public Sector” and some issues arise as to the *identification* of reporting entities in the public sector. For example, various interviewees raised the issue of whether departments should be identified as reporting entities; some interviewees suggested that the current tendency to treat them as such was a product of administrative convenience. This issue was raised earlier in paragraphs 33 and 34.
37. In this sub-section, attention is drawn to how certain public sector entities might be deemed by legislation to be reporting entities. Such legislative requirements typically reflect accountability objectives.
38. Some interviewees from offices of auditors-general suggested that the identification of public sector reporting entities in their jurisdiction was influenced by legislative and administrative requirements that effectively deemed some entities to be reporting entities. That is, in some cases specific public finance legislation deems components of the government to be reporting entities. Heald and Georgiou (2009, p. 224) note that in the U.K.:
“Only those reporting entities classified by the [Office for National Statistics] as belonging to the central government sector and over which parent entities exercise in-year budgetary and spending control will be consolidated in the resource accounts of government departments, even if IAS27 indicates control.”

39. In South Australia, for example, financial statements are prepared and audited for ‘public authorities’ as defined by the *Public Finance and Audit Act 1987*. These public authorities are defined in section 4 of the Act as:

public authority means—

- (a) a government department;
 - (b) a Minister;
 - (c) a statutory authority—
 - (i) that is an instrumentality of the Crown; or
 - (ii) the accounts of which the Auditor-General is required by law to audit;
 - (d) such other body or person as is prescribed,
- but, subject to any other provision of this Act, does not include a statutory authority where the Act by or under which the authority is appointed or established provides for the auditing of the accounts of the authority by a person other than the Auditor-General.

40. Once identified as a reporting entity, a public authority is required to prepare general purpose financial statements in accordance with accounting standards, which under current requirements would mean the recognition of the authority’s assets that meet the asset recognition criteria and line-by-line consolidation of controlled entities.

(e) Summary

41. In summary, a lack of understanding about the relevant users of public sector financial statements and their information needs, combined with a lack of agreement as to which roles of government should be the focus of financial reporting, mean that there is a resulting lack of clarity about the objectives of public sector financial statements. As a consequence different commentators, including some practitioners, have argued either that one set of general purpose financial statements is inadequate for reflecting the diverse activities of government and/or that defining the public sector reporting entity on the basis of ‘control’ is too narrow to capture relevant information about government activities that might be ‘not-for-profit’ in nature, particularly with regard to the concept of accountability. As the current definition of ‘control’ reflects private sector concepts, many of the commentators reviewed above argue that it does not result in public sector reporting entities that match the decision needs of citizens. Walker (2009) has concluded that prior efforts to promote ‘control’ have placed too much emphasis on “processes” rather than on “objectives” and so have been preoccupied with establishing tests for defining the reporting entity rather than considering whether those tests would result in decision useful information in a public sector context. As a result, he concludes that “tests of control of a governing body are not the appropriate basis for determining the scope of public sector financial statements (Walker, 2009, p. 207).

5.0 Interpretation Issues Relating to the Definition Control of an Entity

42. A second key set of concerns are more directly related to the use of the concept of ‘control’ in existing standards. These concerns reflect alleged limitations of the existing definition of control to appropriately reflect the diverse nature of the interrelationships and mechanisms of governance between differing public sector entities, as defined by administrative or other arrangements. This issue is not unrelated to the points made in section 4.0 above in that an understanding of what constitutes ‘control’ in the public sector and its implications for financial reporting is dependent on one’s view about what

should be reported about public sector entities and activities. Nevertheless, the nature and limitations of the different mechanisms by which public sector entities may be interrelated do form an important practical consideration in defining the public sector reporting entity. This section of the paper proceeds by first identifying alternate forms of control referred to in the literature and then presents an analysis of the key issues associated with each major component of the control definition. This approach helps add structure to the discussion but risks giving the impression that the different issues are independent; in fact, it will be seen that the concerns are often interrelated.

(a) Forms of control

43. Various forms of control can be identified in the literature. The New Zealand FRS-37 neatly summarises (particularly in paragraph 4.15) the various forms of control that are discussed in the literature and by interviewees:
- Control of an ownership form – one entity dominates the operating and financing policies of another entity *and* has a significant entitlement to ownership benefits from that entity. The ownership form of control could be achieved by the holding of equity instruments but might also be established by legislation;
 - Control of a regulatory form – there is specific authority under regulation to impose a specified form of compliance on the regulated entity’s operations. In regulatory control, the entitlement to benefits arises directly from legislation rather than through the power to dominate an entity’s operating and financing policies;
 - Control of a purchase form – a customer/supplier relationship that effectively compels a provider entity into certain courses of action; and
 - Control of a lending form – a borrower/lender relationship that effectively compels a borrower entity into certain courses of action.
44. FRS-37 and AASB 127 employ the ownership form of control for both the private and public sectors and reject reporting entities derived from the other forms of control. For example, paragraph Aus17.1 of AASB 127 makes reference in a public sector context to “the factors that are considered in determining whether one entity has the power to govern the financial and operating policies of another entity” while paragraph Aus17.2(b) refers to the government having “the residual financial interest in the net assets of the other entity” – both factors are captured by the FRS-37 definition of the ownership form of control.⁵ The ownership form of control reflects capital market concepts of related entities in which traditionally the acquisition of a substantial number of voting equity instruments brings⁶ with it both dominance over another entity’s operating and financing policies and exposes the dominant entity to the risks and rewards that come from the ownership of those equity instruments. As noted in paragraphs 16 and 17 of this paper, this perspective made its way to a public sector context, at least in part, due to the decision by standards-setters to adopt ‘sector neutral’ accounting standards (Barton, 2005). In the public sector, governments’ operations can be conducted via numerous different mechanisms and agencies and information that is relevant to the users of public sector financial statements may not be captured by reporting entities that are defined on the basis of in-substance ownership models of control but might be better addressed using notions of accountability (that reflect some form of regulatory control) or the relevance of data to stakeholders’ routine judgements

5 Also see paragraphs Aus17.9(a) and Aus17.9(b) where the ownership form of control is similarly employed.

6 Modern accounting standards also contemplate scenarios of effective control where less than fifty percent of voting equity might be held by the dominant entity. See, for example, AASB 127, paragraph 13.

(e.g., Walker (2009), Newberry and Pont-Newby (2009)). The link with the discussion in section 4.0 of this paper can be seen here.

(b) 'The power to govern' component of control

45. Both the literature review and interviewees discussed at length questions about the manner in which power might be exercised in the public sector; in particular, different perspectives were expressed about the ability or otherwise of government to dominate the day-to-day operating and financing activities of public sector entities. One of the primary sources for the difficulty in determining control is that it is often exercised in a variety of broader mechanisms than that contemplated by the IASB in the private sector context. Queensland Treasury (2010, p. 2) has suggested that:

“In the public sector, a parent/subsidiary relation and the existence of control is generally specified by legislative or executive authority or by administrative arrangement where there is power to give policy direction.”

46. Heald and Georgiou (2000, p. 160) have highlighted the problem caused by the lack of well defined ownership instruments (e.g., voting shares) in most public sector inter-entity arrangements (an observation that was also made by two of the interviewees):

“Though it is customary to speak of assets being vested in a Crown body, it is not customary ... to speak of one Crown body having an ownership interest in another Crown body: this limits the easy transfer of the commercial analogy of looking to ownership as an indicator of control.”

47. It was suggested by the two interviewees that in cases where ownership instruments did not exist, it was necessary to explore the ‘substance’ of the relationship (e.g., via the relevant legislation or contracts) to determine whether a control relationship exists between one public sector entity and another. As an example of this, paragraph Aus17.3 of AASB 127 refers to situations in which “the government has broad discretion, under existing legislation, to appoint or remove a majority of members of the governing board of [an] entity.”⁷
48. With regard to dominance of an entity’s decision making, a fundamental point of contention would seem to revolve around the matter of the “capacity” to dominate decision making. The literature and most interviewees noted that the government might ultimately have the power to do whatever it wishes (subject to Constitutional constraints) via legislation but this was not viewed as sufficient for arguing that control existed for financial reporting purposes. Dodd and van Zijl (1990, p. 17), for example, observe that “although it is possible (albeit extremely unlikely) that government could coercively acquire all private property in New Zealand, no one would argue that this was a reason for consolidating the Crown with all private sector entities.” One interviewee noted that governments have four forms of intervention (delivery of services, owning assets, regulation, and taxation) but it did not follow that the exercise of any of these interventions would necessarily result in control for financial reporting purposes; e.g., a government may impose taxation on tobacco products but this would not mean that

7 Similarly, the IPSASB (2008, p. 44) has noted that the power to govern in a public sector context “is often reflected in the government’s right [through legislation or contract] to appoint or dismiss the majority of the voting members of the other entity’s management or governing body.”

tobacco companies should be consolidated into public sector financial statements as a result.

49. Several interviewees distinguished between the ‘ownership’ forms of control and ‘regulatory’ forms of control identified above in paragraph 43. The former, they argued, gave rise to ‘participatory rights’ in another entity while the latter gave rise to ‘protective rights’. The opinion of the interviewees was that consolidation was appropriate for entities that exhibited ownership forms of control between themselves but regulatory controls were not a basis for consolidation. Ownership forms of control were characterised by the existing tests in AASB 127 and NZ IAS 27 that reflect the situation where one entity has the power to dominate the financial and operating activities of another and enjoys the benefits and risks associated with the other entity’s activities. In the case of regulatory forms of control, interviewees commented that a public sector entity/government may have certain powers granted to it by legislation to intervene in the decision making of another entity but only on the occurrence of a remote set of circumstances or via a change in legislation. The expectation is that such power is only exercised in rare circumstances and only then with regard to protecting the rights and interests of other parties (e.g., taxpayers) and not for any ‘ownership’ purpose on the part of the government.
50. It is this protective capacity of government to involve itself in the affairs of other entities that would seem to be the source of much confusion about the operation of the control test for public sector financial reporting purposes; that is, is the possession of a regulatory form of power by one entity over another enough to require the consolidation of the latter entity with the former? Under the existing control definition, the answer is likely to be ‘no’ (although some interviewees’ comments would indicate that this interpretation is not always understood in practice). Although government through regulatory control could dominate the financial and operating policies of another entity, it is not the objective of this form of control to do so. Dodd and van Zijl (1990, p. 10) note: “If the Crown became dissatisfied with the board [of another entity] it would probably seek to replace the board rather than become operationally involved in the management of [the entity].” In the case of local governments, for example, government involvement in the removal of the councillors occurs only rarely and to protect ratepayers. In such cases, the government does not operate the council but rather temporarily appoints a commissioner or similar officer to do so only until a new set of councillors can be appointed. This line of argument needs to be contrasted with the position quoted earlier in paragraph 47 and footnote 7 that the government’s ability to appoint or dismiss the members of an entity’s management or governing board was an indicator of control.
51. Some Australian interviewees referred to various examples of small statutory authorities⁸ that were not consolidated in state whole-of-government financial statements. The interviewees stated that these authorities were not controlled because the government had no operational or strategic influence over them even though these entities were created by legislation (and in this sense were analogous to similar issues found with private sector special purpose entities (SPEs)) and the relevant state government could nominate some of the governing board members of these authorities. In addition, it was noted that

8 These statutory authorities included entities like the Plumbers and Gas-fitters Registration Board and the Health Professional Registration Boards in Tasmania and the various cemetery boards in Western Australia.

the question of control was often not a practical matter anyway due to the immaterial size of many of these authorities.

(c) *'The financial and operating policies' component of control*

52. Closely related to the question of what mechanisms are used by public sector entities for control, is the matter of whether control should extend to both financial and operating policies of an entity. Criticisms of ownership based forms of 'control' suggest that user needs with regard to public sector entities extend beyond powers to dominate decision making and financial return. Indeed, many entities are established so as their operating decision making is independent of executive government (Challen and Jeffery, 2005a).⁹ Freedom from political interference in the day-to-day operations of a public sector entity is highly prized by some entities and generally expected by the public. A failure by some parties to understand the accounting concept of control can be a source of friction between reporting entities and auditors. One interviewee noted that the use of the word 'control' in its financial reporting sense (the capacity to control) was not always well understood by preparers of public sector financial statements and attempts to communicate to various officers in autonomous and independent public sector entities that they were 'controlled' for financial reporting purposes led to hostility as it was counter to their understanding of the nature of their relationship with government.¹⁰
53. Where, for example, a public sector entity might be financially but not operationally dependant on a government, ownership based forms of control would exclude such entities from the government's consolidated accounts. For example, paragraph Aus17.9(c) of AASB 127 notes that financial dependence would not be sufficient to constitute control over an entity if that entity maintains discretion over whether it will accept government resources and how those resources are utilised.¹¹ However, opinion is divided as to whether some other tests based, for example, on 'accountability' should be adopted in these circumstances of financial dependence on government to ensure that entities that are receivers of public monies should form part of the government reporting entity. Financial dependence might be a signal that an entity is a reporting entity on accountability grounds rather than a signal that it is controlled by another entity.
54. Universities are an example of this issue (Wise (2006); Day (2009)). Universities have control over their operating policies (albeit that operations are managed to best leverage off the public policy of the government of the day), but they may be substantially financially dependent upon government.¹² Under the existing definition, as only financing policies are (potentially) dominated by government, universities are not consolidated with whole of government financial statements. For instance, Queensland Treasury (2010, p. 2) has directed:

9 It has also been noted that, on occasions, governments have sought to specifically distance themselves from certain public sector entities/agencies to reduce political costs (Walker (2009), Wise (2006)). For example, Wise (2006, pp. 68 – 69) describes the disagreement in 2004 between the NSW government and the NSW Auditor-General regarding whether the WorkCover Scheme Statutory Funds should be consolidated (the total liabilities of the Funds were \$2.4 billion at that time).

10 See the discussion regarding universities in paragraph 65 as a good example of these sorts of tensions.

11 A similar observation can be found in the international context. Paragraph 37(b) of IPSAS 6, *Consolidated and Separate Financial Statements*, states that "Entities that are economically dependent on a public sector entity" are not controlled by that public sector entity.

12 Relative to New Zealand, this matter is made more complex in Australia as public universities receive both Federal and State funding. See section 6.0(a) below.

“While private schools, private hospitals, local government authorities and universities may be financially dependent, to a greater or lesser degree, on state or federal governments or agencies thereof, they would not be considered to be ‘controlled’ by those governments or agencies for the purpose of AASB 127.”¹³

55. However, commentators on this situation cannot agree as to whether it is appropriate to not consolidate universities (and other similarly placed entities) with the governments who fund them. For example, Wise (2006, pp. 70 – 71) has concluded that under existing accounting standards the failure to include universities and local governments means that:
- “whole-of-government consolidated financial statements do not necessarily include all government resources and obligations ... Subjective interpretation of the concept of control has resulted in the exclusion of substantial organisations such as universities and local governments, that are economically associated with, but not necessarily totally dependant on central governments.”
56. Although Wise (2006) suggests that the ownership form of control fails because it does not consolidate universities (and local governments), Newberry and Pont-Newby (2009, p. 241) suggest that the ownership form would fail even if it did result in the consolidation of these entities because the ‘ownership’ basis to the consolidation:
- “could imply the central government had obtained use of the assets of those entities to secure its own debt management and financial market activities.”
57. Either way, these critiques of the ‘ownership’ form of control suggests it is problematic in the public sector context because it fails to address community accountability expectations by omitting certain entities or it results in misleading information about a central government’s resources and obligations by including certain entities.
58. The conduct of government activities via trusts or autonomous funds are often presented as another example of the contentious nature of the use of the ownership form of control (e.g., Day (2009)), although such an example also can be found in private sector contexts. FRS-37, for example, suggests in paragraph 4.19 that fiduciary relationships, such as those between a trustee and the beneficiaries of a trust, do not satisfy the ownership form of control¹⁴ because the trustee’s power over the operating and financing activities of the trust are governed by the duty to act in the best interests of the beneficiaries (who may not be the government, at least directly) and the trustee’s ability to benefit from the trust is limited to those benefits specified in the trust deed (i.e., the trustee’s benefits are not a function of the operating and financing policies of the trust (the issue of benefits is further explored in the next sub-section of this paper)).¹⁵ Consequently, any government established trust (or entity based on any fiduciary relationship) would appear to be outside the scope of the establishing government reporting entity when the ownership form of control is adopted as the basis for circumscribing the reporting entity, notwithstanding that it might effectively manage large sums of public monies or potentially expose the government to financial and political risk (e.g., the collapse of a major statutory fund may necessarily require a government ‘bail out’ even if no legal responsibility to do so existed).

13 This extract is highly paraphrased from the guidance in paragraph Aus17.9(c).

14 A similar issue arises in the context of administered items where, for example, a government department might have responsibility for administering a statutory fund.

15 Similar statements are made in paragraph Aus17.9(b) of AASB 127.

(d) *'So as to obtain benefits from its activities' component of control*

59. Under existing accounting definitions, an entity controls another if its power over the operating and financing activities of the second entity allows it to “obtain benefits” from the “activities” of the second entity. For example, paragraph 29 of IPSAS 6 states, “For the purposes of establishing control, the controlling entity needs to benefit from the activities of the other entity”. However, an issue of debate is the extent to which the benefits that arise from the activities of the ‘controlled’ entity must directly flow to the ‘controlling’ entity. As a basis for comparison, consider a for-profit entity ‘X’ that controls another entity ‘Y’ because its objective is to maximise the wealth of the shareholders of X. Consistent with its for-profit objective, any benefits (and risks) that arise from X’s control over Y flow directly to X because of the ownership interests X holds in Y. In the public sector, on the other hand, governments often create entities to implement public policy and/or provide goods and services specifically at little or no cost to the direct consumer (sometimes referred to as ‘public goods’). The ‘benefits’ to the government may not take a direct economic return (such as a dividend) to the government but rather allow the government to meet its public policy and social objectives. Is an entity, whose operating and financial policies are determined by government, controlled by the government for financial reporting purposes when its activities or goods or services are provided to parties other than the government?
60. AASB 127 arguably provides conflicting guidance on the matter of benefits. Paragraph Aus17.8 states:
“For a government to control an entity, it must have the power to require an entity’s assets to be deployed towards achieving government objectives.”
61. This statement implies that ‘benefits’ can take the form of the satisfaction of the government’s aims, even if the government is not the direct recipient of an entity’s activities. However, paragraph Aus17.9(b) goes on to indicate that a government does not control another entity if (emphasis added):
“*it cannot benefit from the resources or residual resources of the entity, notwithstanding that it may have the power to govern the entity’s financial and operating policies. For example, where a government acts as a trustee for a trust and its relationship with the trust does not extend beyond the normal responsibilities of a trustee, the government does not control the trust as it cannot deploy the resources or residual resources of the trust for its own benefit*”.
62. This latter paragraph creates confusion because it can be interpreted as implying that the government needs to directly benefit from the activities of the entity (which contradicts the implications of paragraph Aus17.8). What may be intended is that where the government takes on a role such as Public Trustee, for example, to administer the wills and estates of certain citizens, it does not directly economically benefit from the disposition of those wills and estates other than, perhaps, from normal commercial fees for its services. Nonetheless, even if the government received no economic benefit from its Public Trustee role, the Public Trustee entity may still be ‘controlled’ for financial reporting purposes because it could be argued that it allows the government to achieve its social objectives (such as providing for the distribution of the estates for those who die intestate).

63. With regard to whether benefits need to directly flow to government, some interviewees expressed the position that, for consolidation purposes, the government did not need to be the direct recipient of those benefits generated by another public sector entity provided that the latter entity was conducting its activities in accordance with the government's objectives or for a public purpose (one interviewee referred to these benefits as 'complementary benefits'). As discussed in the trusts example in section 6.0(b) below, other interviewees expressed the view that even if an entity's operations met the government's objectives, they believed it would not need to be consolidated with government if there was no direct benefit to government. A resolution to this debate might be found within existing accounting guidance as the situation described above has financial reporting parallels with arrangements where SPEs are established on 'auto pilot'. Subject to the particular facts in each case, such an SPE would often be consolidated with the entity that created it even though that latter entity is not actively involved in the day-to-day decision making of the SPE. This is because the SPE's activities are conducted solely to provide benefits to the entity which established it (see paragraph 10 of AASB/NZ FRSB Interpretation 112 *Consolidation – Special Purpose Entities*).¹⁶ As noted in paragraph 59 in the context of public goods, there may be an issue as to whether the term 'benefits' in this context is to include the broader term 'objectives' (which may be non-financial) of the government that established the SPE as any benefits may be enjoyed by parties other than the government. However, this analogy to Interpretation 112 should be contrasted with the position adopted in practice with respect to many small statutory authorities (as described in paragraph 51 above) where the view has been taken that these authorities are not controlled by state governments even though they were created by statute.

6.0 Two Examples – Universities and Trusts

64. This section provides examples to illustrate the issues described above. The first example given here is the case of universities which was one of the commonly cited example of the difficulties of applying the control test in existing standards.

(a) Universities

65. Section 5.0(c) of this paper made reference to universities as a matter of contention with regard to consolidation. In Australia, the fact that public universities have been jointly funded by Commonwealth and State governments does complicate the debate – as one interviewee described it, universities "serve two masters". As a consequence, universities have not been consolidated into government financial statements because it was unclear as to which government 'controlled' the universities. However, an argument was presented in section 5.0(c) above (Wise, 2006) that universities should be consolidated with government for financial reporting purposes on accountability grounds as they are receivers of significant sums of public monies. However, some care is needed with the use of the accountability criterion in this context. Although Australian public universities may have some level of financial dependence on Commonwealth and State governments, there is no evidence that these governments have the power to control

16 A similar conclusion is reached in paragraph 5.34 of the IPSASB consultation paper (IPSASB, 2008, pp. 47 – 48) in the context of statutory authorities, government business enterprises and sovereign wealth funds. Even though the legislation that created these entities and established their strategy, financing and operating policies incorporated requirements that these policies could not be changed, the powers under those policies are for the benefit of the government's objectives and the managers of such entities cannot do otherwise but operate as instructed by the enabling legislation.

the day-to-day operating policies of universities (even though, strategically, universities must react to the educational policy objectives of governments). The universities are established under State legislation but this legislation arguably provides for regulatory rather than ownership based control. Several interviewees were of the view that the fact that universities may be financially dependent on governments seems to be an argument that they are 'reporting entities' but it does not necessarily follow that they should therefore be part of a government economic entity. If neither State nor Commonwealth governments have the power to dominate the operating policies of universities, then under the existing standards they should not be consolidated with either form of government, notwithstanding that the operations of universities may contribute to the general objective of governments of improving the education levels of the citizens. Nevertheless, there may be accountability reasons as to why universities should produce general purpose financial statements in their own right.

66. In the New Zealand context, a source of complexity is removed as there are only two tiers of government, not three as in Australia. Nevertheless, control of universities has been a controversial issue in New Zealand. One interviewee mentioned that universities are currently equity accounted rather than consolidated. This current accounting position appears to be a compromise that reflects an impasse between New Zealand universities (that believe that an accounting treatment based on government 'control' threatens their perceived independent status) and New Zealand Treasury (which argues that universities are controlled by the national government under powers from the statute under which New Zealand universities operate. In addition, the relevant Minister is entitled to, or can direct the disposition of, any residual net assets in the [unlikely] event that a New Zealand university is wound up).

(b) Trusts

67. An argument was made by some interviewees to support the view that in certain circumstances the financial statements of trusts should be consolidated with the entity that created them while other interviewees suggested that such consolidation was inappropriate. It should be noted that in all cases, interviewees for both positions did qualify their comments by stating that the treatment of any trust would depend upon the actual facts of each case.
68. Charitable trusts were raised as an example of where there might be grounds to consolidate the trust with the entity that created it. It was noted that the trustees of such trusts regularly objected to the assertion they were controlled by the government citing that they had power over the day-to-day activities of the trust. However, the interviewee who raised this example indicated that, like the SPEs noted in paragraph 63 above, the trustee only had discretion within the terms and conditions of the trust deed and that those terms and conditions were set so that the trust would serve a public purpose: that is, that the benefits of the trust's operations flowed to the community but allowed the government to meet its own public service objectives. As such these charitable trusts were 'controlled' by the government for financial reporting purposes and so should, according to the interviewee, be consolidated.
69. A counter position was argued by another interviewee with regard to trusts set up by local governments. It was indicated that local governments often were proactive in establishing trusts for various local community purposes. It was argued that although a

local government may have established the trust and had the power to appoint the trustee, these factors in themselves did not result in the trust being controlled by the local government entity. The claim was made that in such cases the local government entity merely performed an administrative role in establishing the trust because no other entity was suitably placed to perform this task and it was not the intention of councils to control the day-to-day decision making of such trusts. The purpose of these trusts was to provide benefits to the local community, not to provide benefits to the local government. Such a view may need to be reconciled to the position noted in paragraph 68 (and in section 5.0(d)) that the trust may provide benefits to the local government if it allows that local government to achieve its objectives.¹⁷

70. In addition to the issue of control, a local government interviewee also raised points relating to the materiality and accounting method associated with trusts. The interviewee suggested on the basis of their experience that if trusts were to be consolidated with the local government, then the needs of those interested in information about the trusts would not be served as that information would effectively ‘disappear’ within the local government entity’s own financial statements. The point was made that if trusts did have to be consolidated, it would be better to do so using a one line investment method rather than the line-by-line consolidation method as users would at least be able to see the net investment in the trust under the one line method.

7.0 Practice Issues in relation to Control of an Asset

71. As noted in Appendix 1, this project is also considering whether any implementation issues arise with regard to ‘control over an asset’. Implementation issues arise with regard to a variety of assets; one example is sovereign wealth funds which as the IPSASB (2008, p. 47) describes:

“may be established and owned by a government, central bank, or other government agency to provide for pension benefits or future infrastructure or other needs. These can represent a significant store of wealth for the government, and be of significant economic and fiscal importance in supporting the delivery of a government’s economic and other policy initiatives.”

72. Control over an asset was primarily a matter addressed in interviews as it did not appear to be the subject of attention in much of the literature that was reviewed.

(a) Administered/controlled items

(i) Australia

73. In Australia, it is common for departments to administer assets on behalf of other entities. As noted in Appendix 1, it is stated that there is a lack of consistency in Australia as to how administered items are currently accounted for. Guidance is provided in AASB 1050 *Administered Items* only with respect to certain disclosures and no definition of ‘administered items’ is provided. Paragraphs 10 to 14 of AASB 1050 indicate that a public sector entity should only recognise those assets and liabilities that it controls, not those for which it acts as an agent or manages on behalf of some other entity. Similarly only income and expense items that relate to assets and liabilities that

¹⁷ As an aside, it was also argued that many of the trusts established by local governments were immaterial relative to the financial position of the establishing local government.

the entity can deploy for its own objectives should be recognised by it for accounting purposes. For example, an entity that collects taxes on behalf of the government would not recognise these taxes as its income because the entity “does not normally control the future economic benefits embodied in tax collections” (AASB 1050, paragraph 15).

74. The Australian interviewees indicated that the question of what constitutes control of an asset was subject to differing interpretations. Like their New Zealand counterparts (see paragraph 75 below), there was agreement among the Australian interviewees that Chief Executive Officers (CEOs) of departments were responsible for those items they controlled rather than those they managed (‘administered’) on behalf of other entities. One interviewee suggested that the accounting for administered items was an issue because government departments were typically treated as reporting entities but that they were better characterised as convenient administrative vehicles into which administered items fell as part of their activities. Departments were being used as the reporting entity, it was argued, because of the requirements of AASB 127 that there be control over the financing and operating policies of an entity but using departments as reporting entities may not necessarily reflect appropriate fields of accountability and responsibility. The potential problems of identifying departments as reporting entities were discussed earlier in paragraph 34. Some other interviewees indicated that there was a need for greater clarification as to what characteristics constituted ‘administration’ and what constituted ‘control’ and they suggested that one criterion might be whether the entity could use the asset to ‘meet its own objectives’.

(ii) New Zealand

In New Zealand, administered items are referred to as ‘non-departmental’ items and there is no New Zealand equivalent to AASB 1050. Appendix 1 to this paper (page 31) suggests that there is no evidence of a debate 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’.

75. 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.
76. The New Zealand interviewees confirmed that non-departmental items were non-controversial in that jurisdiction. It is a well-established policy that the Chief Executive Officer (CEO) of a public sector department is responsible for the financial management of his/her department. Consequently, any assets over which that CEO has rights regarding its use and where that asset is used by the CEO’s department for the production of its outputs, the asset is recognised in the statement of financial position of

that department. Otherwise the asset is seen as the responsibility of the relevant Minister. It was noted by the interviewees that disputes as to where responsibility for an asset lay were rare and were normally resolved by determining who had the primary decision making rights with regard to the use of the asset in question. If necessary, a determination was sent to the relevant Minister via the New Zealand Treasury. Assets that were viewed as 'non-departmental' are audited and shown in schedules contained in the notes of the financial statements of the department which managed the asset. The interviewees were of the opinion that the schedules describing the non-departmental items were decision useful in allowing users of the financial statements to understand the full range of activities performed by the entity.

(iii) Summary of administered/controlled items

77. The different perspectives between Australian and New Zealand public sector entities with regard to administered items would seem to stem from a lack of explicit guidance in Australia about what distinguishes 'control' from 'administration' of an asset. The issue is also linked to the question of whether departments are reporting entities. As noted in paragraphs 37 and 38, departments may be deemed to be reporting entities by certain legislation. Although there seems to be underlying agreement among Australian interviewees that 'control' depends on whether the entity that manages the asset also enjoys the benefits of using the asset, this concept has not been formalised as an accounting standard. There would appear to be an implicit understanding among the Australian interviewees that the administering entity has power over the day-to-day operations as to how the asset is managed, but not over how its outputs are employed or dispersed.

(b) Community facilities on local government land

78. Two Australian local government interviewees raised a control over asset issue with regard to community facilities that were built by non-council entities on council controlled land. Unlike the control over a trust entity issue described in paragraph 69 above, this situation related to buildings and other facilities (e.g., golf courses) which are built by various community groups (e.g., sporting clubs) on land provided by the local government. The land may be owned outright by the council or may have been vested in the council by the relevant state government which maintains ultimate ownership of that land. Councils lease the land on a long-term basis to the community group which provides the facilities on that land; the leases typically charge the lessee with responsibility for the management and maintenance of any facilities built on the land. The council has no involvement in the day-to-day management or operations of the entity which builds the facilities. Often these facilities are not presently recognised on local governments' statements of financial position as these entities do not believe that they own or control the facilities. However, a local council interviewee indicated that there is concern that "at present there are different interpretations being applied by the accounting and local government fraternities in each state" as to whether the facilities built on the council land are controlled by the council and consequently should be recognised on the council's statement of financial position. Some of this pressure to have these facilities recognised by councils as assets is coming from local government auditors. The local government interviewee indicated that there is concern that such recognition would improperly impact on the operating statement and renewal profiling aspects of councils' asset management practices as well as potentially misleading the

relevant lessees as to their responsibilities for maintaining the assets built on council controlled land.

8.0 Conclusions and Recommendations

79. This review suggests that the ownership form of control adopted in existing accounting standards is a source of confusion for defining the reporting entity in the public sector. The sources of this confusion are inter-related ideological and interpretation issues. There would appear to be a lack of understanding as to who are the users of public sector financial statements and what their information needs might be. Walker's (2009) analysis indicates that in existing accounting pronouncements users and their needs are either ignored or are presumed with little, if any consideration, as to whether the existing control test for consolidation is relevant or appropriate. The current control test does not reflect (1) the diversity of opinions as to what should be the objective of public sector financial reporting that might be satisfied by consolidated financial statements and (2) the wide diversity in government activities and the forms of governance used to conduct these activities which are argued to entail accountability concepts that extend beyond those found in ownership based relationships.
80. In general, the literature suggests that the ownership form of control would appear to be inadequate as a basis of consolidation in the public sector on the basis that it reflects the nature of financial relationships between entities rather than public sector concerns that extend beyond financial considerations to matters of 'accountability' (however defined). Interviewees, on the other hand, were generally favourably disposed to employing some concept of 'control' but felt that more guidance was required with respect to its application in the public sector context.

Preliminary recommendations:

81. The outcome of the research reported in this paper indicates that the concept of control can work in practice, but needs further guidance. Pending the further work to be undertaken on this project (see Appendix 2 of this paper) and developments at the IASB and the IPSASB, it is recommended that the AASB and NZ FRSB give consideration in the short-term to several interpretation issues that could be addressed by providing guidance in particular areas (included in the list below – some of these preliminary recommendations reflect issues of education or correcting misinterpretations by preparers about existing requirements).
- (a) In keeping with the move to convergence with New Zealand, the two Boards should evaluate whether the AASB 127 and NZ IAS 27 should be converged with regard to the same set of guidance with regard to the public sector application of control. A converged response would reflect more current thinking and local institutional requirements.
- (b) It is unlikely that the conceptual issues described in this paper can be quickly addressed in the Australian and New Zealand context. Indeed, it is probably desirable that matters of concept are addressed in concert with work being conducted on the respective conceptual frameworks of the IASB and IPSASB. These projects should continue to be monitored and opportunities taken for inputting local experience into the deliberations of the IASB and IPSASB;

- (c) Notwithstanding the above point, the Boards may wish to give consideration to providing guidance on the potential role of accountability in the definition of the public sector reporting entity (e.g., as discussed in paragraph 53 accountability relating to financial dependence may be just an indicator that an entity is a reporting entity rather than an indicator that it is ‘controlled’ by another entity);
- (d) There is a clear need to explicitly recognise the nature of, and distinction between, ownership forms of control and regulatory forms of control. The current New Zealand approach of cross-references to IPSAS 6 and FRS-37 goes part way to achieving this but a coherent discussion should be incorporated into both AASB 127 and NZ IAS 27. The discussion of regulatory control should provide guidance/criteria as to when intervention by, say a government, is of a ‘protective’ nature – e.g., at present, the removal of a managing board of an entity by the government can be seen as both the exercise of ownership based control and as an expression of regulatory control. More guidance is required as to how these two motivations can be distinguished.
- (e) Further guidance is needed to clarify what the nature of benefits might be in the public sector and the extent to which benefits must flow directly to the controlling entity. Although it would be safe to say that there would be general agreement that the benefits can be both financial and non-financial, and that they can flow to parties other than the controlling entity, there is ambiguity as to how these benefits are to be understood in practice. For example, the benefits are often expressed as ‘meeting the government’s objectives’ – what are these objectives? Must the controlled entity be conducting programs/providing services that can be linked to a specific government policy or is it sufficient that these activities are in the broad public interest?;
- (f) Clarification is required with regard to situations in which entities are created and then effectively left on ‘auto pilot’ (e.g., trusts, some statutory funds). This may simply require referring preparers of financial statements to the principles in AASB/NZ FRSB Interpretation 112; and
- (g) Consideration should be given to supplementing the requirements of AASB 1050 for administered items. Although there does not appear to be an issue with regard to such items in New Zealand, the variety of State and Commonwealth governments in Australia heightens the risk of inconsistent treatment of these items in the financial statements of public sector entities. It is possible that the process that is currently employed in New Zealand could be provided as a model for generating consistency across the various Australian governments. It would be necessary to provide criteria and examples that allow preparers to clarify the nature of the agency relationship when an asset is administered for another (e.g., that the administering entity cannot benefit from its operating activities with regard to the asset).

9.0 Feedback from Project Sub-Committee Members

A draft version of this paper was circulated for comment to the project sub-committee members. The main components of the feedback received from the sub-committee are provided in Appendix 4 of this paper. Depending on the outcome of the Boards’ discussions of the issues addressed in agenda paper B12.2, consideration will be given to amending this paper for the sub-committee members’ comments.

APPENDIX 1 – BACKGROUND TO THE PROJECT

Introduction

The project was originally proposed at the 9 – 10 December 2009 meeting of the AASB. 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.

As noted above, the project is also a topic of interest in the New Zealand context and a joint AASB/NZ FRSB approach has been undertaken. 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 where it was approved with minor amendments.

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.

An Overview of the General 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); 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 2) 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. 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 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 following broad issues can be identified with regard to defining the reporting entity in the public sector:

- (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 users of financial statements; 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 users of financial statements; 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 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).

APPENDIX 2 – PROJECT PLAN

Step	Estimated Timing
<i>Phase 1: determine the extent of the issues in 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. 	<p>February – September 2010</p> <p>February – September 2010</p> <p>February – September 2010</p> <p>Draft report late October 2010</p>
<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. 	<p>1. November – December 2010</p>
<p>Deliverable: Write up a discussion paper reviewing issues detailing investigations and findings.</p>	<p>January – March 2011 (first draft to joint subcommittee April 2011; second draft to Boards June 2011)</p>

Step	Estimated Timing
<i>Phase 2: the definition of control</i>	
<p>Assess the definition of control to be included in the IFRS expected to be developed by the IASB from its ED 10 <i>Consolidated Financial Statements</i> 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> <p>1. Prepare report evaluating the definition of control developed from IASB ED 10 relative to outcomes of Phase 1 and make recommendations for amending Australian and New Zealand standards, having regard to the <i>Process for Modifying IFRSs for PBE/NFP</i>.</p> <p><i>[Staff note to the sub-committee: the previous project plan contemplated this phase focusing on the existing definition of control in AASB 127 and FRS-37/NZ IAS 27, but noted that if the IASB progressed with its ED 10 proposals on a timely basis, it might be more appropriate to focus on the definition of control arising out of ED 10. Because it is now expected that the IASB will issue the new IFRS on consolidation in Q4, 2010, we have amended the project plan accordingly. This revised timing is based on the expectation that the new IFRS on consolidation would not be operative until 1 January 2013.]</i></p>	<p>1. April – December 2011 (draft report to joint subcommittee November 2011)</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 domestic standards , depending on outcome of Paper/ED. 	<p>January - February 2012 (first draft to joint subcommittee January 2012; second draft to Boards February 2012 – issue for 4 month comment period)</p> <p>July - August 2012</p> <p>November 2012</p>

Step	Estimated Timing
<i>Phases 3+: to be determined</i>	
<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:</p> <ul style="list-style-type: none"> • 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; and/or • relevant issues from the not-for-profit perspective. <p>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 3 – RELEVANT 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.

IASB staff draft IFRS X Consolidated Financial Statements

control An **investor** controls an **investee** when the **investor** is exposed, or has rights, to variable returns from its involvement with the **investee** and has the ability to affect those returns through its power over the **investee**.

power The current ability to direct the relevant activities.

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

APPENDIX 4 – FEEDBACK FROM PROJECT SUB-COMMITTEE MEMBERS

A draft version of this paper was circulated for comment to the project sub-committee members. The main components of the feedback received from the sub-committee are paraphrased below:

Structure of Paper

1. Reduce the length and reformat the paper by placing much of the discussion in an appendix.
2. Include all the recommendations included in section 8.0 in the executive summary.

Content of Paper

3. Note that one of the purposes of the paper is to ‘provide input into proposed requirements relating to control’ (see paragraph 5).
4. Reference the remaining Australian Statements of Accounting Concepts (SAC 1 *Definition of the Reporting Entity* and SAC 2 *Objective of General Purpose Financial Reporting*).
5. Consider the implications of the conclusions in the paper for transaction neutrality.
6. Discuss the issue of the reporting entity in the context of the GGS, given that AASB 1049 *Whole of Government and General Government Sector Financial Reporting* is silent on the question of whether GGS is a separate reporting entity.
7. If conceptual issues are to be addressed, consider when the needs of users might override the application of line-by-line consolidation of controlled entities (particularly in light of the IASB contemplating non-consolidation by investment companies).
8. Have regard to the fact that some comments from the literature review are about AAS 31 *Financial Reporting by Governments*, which has been superseded in light of AASB 1049.
9. Note that many organisations are established with some protections to prevent or at least slow potential policy swings of government and the implications of those on the institutions of public benefit services.
10. Address the ability of the government to exercise coercive power to acquire revenue and the consequent demand from the public for the independence of certain public institutions.
11. Note that issues relating to community facilities on local government land should be resolvable with the currently available guidance on lease accounting or service concession accounting.
12. Omit references to ‘pressure’ from auditors.
13. Refer to the New Zealand uncertain position re the possibility of adoption of IPSASB standards for the public sector.

Other Potential Technical Improvements to the Paper

Control vs Accountability

14. Make clear in section 4 whether accountability is being referred to in the context of the *objective* of reporting or as a basis for *defining* the reporting entity.
15. Explicitly acknowledge in section 4 that some commentators accept the control test even though others may not, particularly in the context of transaction neutrality.

16. Explicitly acknowledge in the conclusion the differences between the findings of the literature review (which tend to reject control as a test) and the interviewees (who tend to accept control albeit subject to the provision of more guidance).
17. Note the range of views relating to the place of 'accountability'. Some are of the view that it is not clear that accountability is superior to 'control' for defining the reporting entity but others took the view that accountability plays an important role. The ramifications of adopting accountability as a basis for defining the reporting entity need to be further examined.

Benefits

18. The discussion in the paper on the nature of 'benefits' should include reference to the Framework (para. Aus54.2) to include service potential and benefits that satisfy the entity's objectives.
19. There needs to be further discussion of the view expressed by some commentators that a key factor should be the receipt of benefits by others meets a government's objectives. The discussion should include the view that government is an agent of the people, not the beneficiary.

Administered Items

20. If the paper continues to explore the validity of the distinction between controlled and administered items it will need to be discussed within the context of a debate about the reporting entity.
21. Section 7.0 should address arguments for and against the view that control of an asset is the relevant basis for financial reporting.
22. There should be further discussion about the fact that defining a department as a reporting entity is more of the nature of a convenience rather than a true reporting entity – do departments control everything or administer everything?
23. The work being done by the AASB in relation to administered items as part of its GAAP/GFS Harmonisation for Not-for-Profit Entities within the GGS project should be acknowledged.

'Auto-pilot' entities

24. Note that there are a range of funds established by government for different purposes.

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