



New South Wales  
TREASURY

Mr Bruce Porter  
Acting Chairman  
Australian Accounting Standards Board  
PO Box 204  
COLLINS ST WEST VIC 8007

Contact: B Richardson  
Telephone: (02) 9228 4832  
Our Reference:  
Your Reference:

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Dear Mr Porter

**ED 171 Consolidated Financial Statements**

New South Wales Treasury welcomes the opportunity to provide comments on Exposure Draft 171 *Consolidated Financial Statements*.

NSW Treasury has four main areas of concern with the Exposure Draft:

1. Normal due process has not been followed
  - o The IASB has moved directly to an exposure draft without previously providing a discussion paper on the topic. In addition the comment period is 90 days instead of the usual 120-day period. We realise that the IASB has accelerated the project in response to the global financial crisis. However, control is a significant issue and debate on the issue should not be rushed.
  - o Moreover, this is not currently a joint project with FASB and this exposure draft will not result in convergence with US GAAP. Instead, FASB is presently revising consolidation requirements for variable interest entities.
2. The proposed definition of control

As stated in previous submissions on related areas, we prefer the Statement of Accounting Concepts - SAC I definition of control which refers to the 'capacity...to dominate decision making, directly or indirectly.....in achieving the objectives...'

  - o The term 'capacity...to dominate decision making, directly or indirectly' provides more guidance than 'power to direct' as it explicitly uses the term 'capacity', meaning the *ability* to dominate decision making. It may or may not 'actually' have been exercised. This is also strengthened by the term 'directly or indirectly.' You don't have to 'actually' dominate the decision making, but merely have the ability to dominate, directly or indirectly.
  - o We feel that, for not-for-profit entities, 'achieving objectives' is a broader term than 'generating returns' as service delivery objectives would be included. Moreover, the term is equally appropriate in the private sector.
3. The proposed definition of structured entity
  - o We feel that the definition at paragraph 30 – "A structured entity is an entity whose activities are not directed as described in paragraphs 23-29" – is circuitous: The reader is required to refer to paragraphs that have nothing to do with structured entities to try to determine what a structured entity is.
  - o The proposed definition could potentially capture a wider scope of entities than is currently the case under SIC-12.
  - o The elimination of the risks and rewards approach from SIC-12 could result in reducing consolidations.

4. The dichotomy between paragraphs relating to 'normal' control (voting rights) and paragraphs relating to control of structured entities

We feel that too much importance is given to the distinction between voting rights control and structured entities. We would prefer to see one set of factors applicable to all entities. This would be more consistent with the requirement of paragraph 14 of the exposure draft that a reporting entity shall consider all relevant facts and circumstances when assessing control.

Supporting our view, the Board observed at paragraph BC 109 of the Basis for Conclusions that whether a reporting entity concludes that an entity in which it has an interest is a structured entity should not affect the control assessment.

Our detailed comments to the specific questions raised are attached. If you have any queries, please contact me on (02) 9228 3019 or Barbara Richardson on (02) 9228 4832.

Yours sincerely



Robert Williams  
for Secretary

## NSW Treasury Comments on ED 171 Consolidated Statements

### AASB Specific Matters for Comment

1(a) Whether there are any regulatory or other issues arising in the Australian environment that may affect the implementation of the proposals, particularly any issues relating to:

(i) not-for-profit private sector entities; and

(ii) for –profit public sector entities;

1(b) Whether overall, the proposals would result in financial statements that would be useful to users; and

1(c) Whether the proposals are in the best interests of the Australian economy.

2. The suitability of the IASB's proposals in a not-for-profit public sector context if some or all of the proposals were to be adopted.

### NSW Treasury response:

1(a)(i) no comment

1(a)(ii) see response below for item 2

1(b) no comment

1(c) no comment

2.

Public sector specific issues (both for-profit and not-for-profit):

- Paragraph 41 states that a reporting entity shall prepare consolidated financial statements using uniform accounting policies for like transactions and other events in similar circumstances.  
In the public sector, inconsistent accounting policies for consolidating for-profit entities into a not-for-profit parent can arise. An example is revaluation adjustments which are recognised on an individual asset basis by for-profit entities and on an asset class basis by not-for-profit entities. This issue is referred to at item 3.3(e) of the AASB Public Sector Policy Paper and also in the AASB paper "Not-for-profit entity requirements in Australian Accounting Standards" (updated December 2008) at Part A – Issues and accounting treatments when a NFP parent has a for-profit subsidiary. It has also been previously raised by HoTARAC and NSW Treasury.
- As currently drafted, most public sector entities would meet the definition of a structured entity. This issue needs to be examined as part of the separate AASB project on the public sector.
- The distinction between an agency relationship and an administered relationship needs to be considered.

Other comments:

- Some guidance has been lost from AASB 127; e.g. the power to direct under statute (AASB 127.13(b)).
- The right to power (but not exercised) versus having power (but not exercised) – is there any difference? Needs to be further explained. Refer alternative view, paragraphs AV2 to AV7.

### Responses to IASB questions

#### Question 1

Do you think that the proposed control definition could be applied to all entities within the scope of IAS 27 as well as those within the scope of SIC-12? If not, what are the application difficulties?

#### Question 2

Is the control principle as articulated in the draft IFRS an appropriate basis for consolidation?

#### Questions 1 and 2

No. NSW Treasury does not think that the proposed control definition could be adequately applied to all entities, nor is the control principle an appropriate basis for consolidation. We have this view because the proposed definition at paragraph 4, which refers to "power to direct...to generate returns", raises concerns about three terms: power, returns and risks and rewards.

##### 1. Power

The word 'power' in the definition raises the question whether it is sufficient that the power exists or must it be exercised? It also raises a question about the difference between 'power' and the 'right to power' (see response to question 4).

Paragraph 8 of the exposure draft clarifies that “A reporting entity need not have exercised its power to direct the activities of an entity.....”. But this explanation is required to resolve the question that arises when you read the definition at paragraph 4. Therefore, the words “directly or indirectly” should be added after the word “power” in paragraph 4 for clarity.

As an alternative to the term “power to direct”, NSW Treasury suggests “capacity to dominate decision making, directly or indirectly.” We prefer this phrase because the word ‘capacity’ provides more guidance than the word ‘power’ – ‘capacity’ means the *ability* to dominate decision making. It may or may not ‘actually’ have been exercised. The words ‘directly or indirectly’ strengthen the idea that you don’t have to ‘actually’ dominate the decision making, but merely have the ability to dominate, directly or indirectly.

## 2. Returns

We are also not comfortable with the word ‘returns’. We note that the exposure draft uses the term ‘returns’ rather than ‘benefits’, as is currently used in IAS 27, because many interpret ‘benefits’ to imply only positive returns. The Board believes that ‘returns’ makes more explicit that a reporting entity may obtain positive or negative returns.

However, NSW Treasury believes that ‘returns’ has a connotation of ‘return on investment’ or ‘distributions to owners’; i.e. positive returns. Therefore, we see no advantage over the term ‘benefits’. Paragraph 16 states that if the entity ceases to receive returns it no longer controls the entity. This implies financial returns, which often would not apply in the public sector. For this reason, ‘benefits’ provides a better link with the idea of service potential in the public sector, as well as achieving objectives. Moreover, the term ‘benefits’ can be applied equally in the private sector.

The word ‘benefits’ also provides a link to the risks and benefits concept in SIC-12 which is missing from the exposure draft. Therefore, NSW Treasury prefers the term ‘achieving objectives’ instead of ‘returns’ but would prefer ‘benefits’ over the proposed ‘returns’ for the above reasons.

## 3. Risks and rewards

The proposed definition could be applied to entities within the scope of IAS 27, although NSW Treasury would prefer the alternate wording suggested above; i.e. ‘capacity to dominate decision making, directly or indirectly.’ However, question 1 also asks if the definition is broad enough to be applied to entities currently within the scope of SIC-12. Detailed comments in SIC-12 about obtaining the majority of the benefits and exposure to the risks of a structured entity (special purpose entity in SIC-12) are not included in the exposure draft. However, both the exposure draft and SIC-12 state that the application of the control concept requires, in each case, judgement in the context of all relevant factors.

NSW Treasury has commented in previous submissions to the AASB and the IASB that we believe that the risks and benefits concept is a subset of control. When a definition of control refers to power and returns, a risks and rewards approach is implied. NSW Treasury believes that ensuring the risks and rewards concept is incorporated into the definition of control would provide a conceptually robust basis for determining control for all entities.

Moreover, we agree with the concern raised in Alternative View 9 that, by eliminating the risks and rewards test, “an entity that clearly and obviously has the majority of risks and rewards of a structured entity can easily avoid consolidation by circumventing the power criterion.”

### Question 3

Are the requirements and guidance regarding the assessment of control sufficient to enable the consistent application of the control definition? If not, why not? What additional guidance is needed or what guidance should be removed?

No. NSW Treasury believes that having certain paragraphs (paragraphs 23-29) relating to “normal” control (related to voting rights) and different paragraphs (paragraphs 30-38) relating to control of structured entities is confusing. There should be one set of requirements and guidance without differentiating between types of entities. The following paragraphs are consistent with the need for one set of requirements:

- Paragraph 14 states that a reporting entity shall consider all relevant facts and circumstances when assessing control.

- Paragraph BC109 of the Basis for Conclusions states that whether a reporting entity concludes that an entity in which it has an interest is a structured entity should not affect the control assessment.

NSW Treasury considers that, as currently drafted, the exposure draft gives too much importance to voting rights; i.e. control is either demonstrated by voting rights or else the entity is a structured entity (paragraph 21). This will potentially capture a wider scope of entities than is currently the case with SIC-12 because SIC-12 has a limited focus on special purpose entities created to accomplish a narrow and well-defined objective.

#### **Question 4**

Do you agree with the Board's proposals regarding options and convertible instruments when assessing control of an entity? If not, please describe in what situations, if any, you think that options or convertible instruments would give the option holder the power to direct the activities of an entity.

We are unable to come to a decision as to whether or not we agree with the Board's proposals because we see inconsistencies in the reasoning behind their stance. We feel more clarification is needed regarding options as it is currently confusing in the exposure draft.

We also think two of the paragraphs in the Basis for Conclusions seem inconsistent – BC85 and BC86. In BC85, a reporting entity required to transfer little or no consideration to exercise an option is likely to have control of those shares and is in the same position as a passive majority voting shareholder. But if the option is exercisable at a price that equals the fair value of the shares as in BC86, the option holder does not obtain a return from those shares until the option is exercised. It is only once the option holder has obtained the shares that it has access to the returns and control. In such circumstances, the Board concluded that the option fails the second part of the control definition (the returns criterion). But would the entity required to transfer little or no consideration to exercise an option in paragraph BC85 be entitled to obtain a return? Wouldn't it be failing the second part of the control definition as well?

With options, the question to consider is "right to power" versus "power". Are they in substance different? We feel further explanation is required, as also discussed above in questions 1 and 2.

#### **Question 5**

Do you agree with the Board's proposals for situations in which a party holds voting rights both directly and on behalf of other parties as an agent? If not, please describe the circumstances in which the proposals would lead to an inappropriate consolidation outcome.

No, we do not agree because we find the proposals confusing. The general rule is that if an entity is truly acting as an agent, it neither controls nor consolidates the other entity. However, in SIC-12, when activities were 'conducted on behalf of the reporting entity', this was an indicator of a control relationship.

NSW Treasury is also concerned that the agency guidance may be interpreted as preventing an intermediate parent from preparing consolidated financial statements as described in paragraph BC96, although the Board says it has no intention to do so. This is an existing issue, as pointed out by the Board.

#### **Question 6**

Do you agree with the definition of a structured entity in paragraph 30 of the draft IFRS? If not, how would you describe or define such an entity?

No. NSW Treasury does not agree with the definition of a structured entity. It is not really a 'definition'. It says that if the entity's activities are not directed as described in specific paragraphs relating to control (which focus on voting rights), then it is a structured entity. So, if the entity doesn't "fit in" with those earlier paragraphs, it is going to meet the exposure draft 'definition' of a structured entity, which potentially widens the scope of a structured entity. However, just because voting rights may not be relevant does not necessarily mean the 'activities are restricted' per the definition of a structured entity.

The decision whether a reporting entity controls another entity requires judgement and an assessment of all the relevant facts and circumstances. This is the case no matter which type of entity is being assessed, as also discussed above in questions 1 and 2.

As also discussed in questions 1 and 2, we support the alternative view at paragraph AV9 that, by eliminating the risks and rewards test, “an entity that clearly and obviously has the majority of risks and rewards of a structured entity can easily avoid consolidation by circumventing the power criterion.”

**Question 7**

Are the requirements and guidance regarding the assessment of control of a structured entity in paragraphs 30–38 of the draft IFRS sufficient to enable consistent application of the control definition? If not, why not? What additional guidance is needed?

No. NSW Treasury believes that too much emphasis is being given to structured entities in the exposure draft. Paragraphs from SIC-12 have been shifted to the exposure draft without clarifying the interrelationship between two sets of criteria.

We are not clear how different the concept of ‘exposure to variability of returns’ for assessing control in the exposure draft is to the current risks and rewards approach from SIC-12. The relevant paragraphs on structured entities refer to the degree of exposure to the variability of returns. The more exposure to this variability, the more likely control exists. Is there any significant difference in meaning between ‘exposure to variability of returns’ versus ‘exposure to the majority of risks and rewards’? The only thing that seems to be missing is the qualifier ‘majority’ (of risks and rewards). It is not clear that ‘exposure to variability of returns’ would give the same outcome as the ‘majority of risks and benefits.’ Why avoid the term ‘risks and rewards’ when it is a commonly understood concept? Refer also our response to questions 1 and 2. In addition, we support the alternative views at paragraphs AV10-AV11 that the exposure draft hasn’t considered the incentive being created to purposefully predetermine and disperse the strategic operating and financing policies to avoid consolidation and that additional guidance is required to address the difficulty in assessing power to direct the activities of a structured entity.

We recommend retaining the basic information in paragraphs 30-31 in the body and moving paragraphs 32-38 to Appendix B Application guidance, which is still an integral part of the proposed standard. Paragraphs 32-38 provide guidance clarifying paragraph 31.

**Question 8**

Should the IFRS on consolidated financial statements include a risks and rewards ‘fall back’ test? If so, what level of variability of returns should be the basis for the test and why? Please state how you would calculate the variability of returns and why you believe it is appropriate to have an exception to the principle that consolidation is on the basis of control.

No. NSW Treasury does not believe it is appropriate to have an exception to the principle that consolidation is on the basis of control. To do so would be to defeat the purpose of the exposure draft; i.e. to have a single definition of control for all entities.

Having said this, we note that that a risks and rewards approach is implied in the proposed definition of control, which refers to power and returns (both positive and negative). In short, as discussed at question 7, we believe the risks and rewards approach is a subset of control.

In addition, the January 2009 IASB Update states at page 3 that an assessment of risks and rewards might be useful for implementing the controlling entity model in some circumstances, although it should not replace the control model. This supports our view.

**Question 9**

Do the proposed disclosure requirements described in paragraph 23 provide decision-useful information? Please identify any disclosure requirements that you think should be removed from, or added to, the draft IFRS.

**Question 10**

Do you think that reporting entities will, or should, have available the information to meet the disclosure requirements? Please identify those requirements with which you believe it will be difficult for reporting entities to comply, or that are likely to impose significant costs on reporting entities.

Yes, substantially, subject to the following. Although the disclosure requirements are extensive, they are warranted. We have no suggestions for additions to the draft IFRS.

We believe it will be difficult for entities to comply with the requirement in paragraph B38(b) related to the reporting entity's involvement with unconsolidated structured entities and associated risks. The requirement is to provide information on the nature and extent of, and changes in, the market risk (interest rate, prepayment, currency and other price risk), credit risk and liquidity risk from the reporting entity's involvement with uncontrolled structured entities (from both contractual and non-contractual commitments, and from past and present activities). We note that paragraph B39 does state that if obtaining any of the information for the required disclosures is impracticable, the reporting entity must disclose why it is impracticable and how it manages its exposure to risk. We question where the extent of the 'involvement with unconsolidated structured entities' ends.

#### **Question 11**

- (a) Do you think that reputational risk is an appropriate basis for consolidation? If so, please describe how it meets the definition of control and how such a basis of consolidation might work in practice.
- (b) Do you think that the proposed disclosures in paragraph B47 are sufficient? If not, how should they be enhanced?

- (a) No. NSW Treasury agrees with the comments in the Basis for Conclusion at paragraphs BC37-BC39.
- (b) Yes, the proposed disclosures in paragraph B47 are sufficient.

#### **Question 12**

Do you think that the Board should consider the definition of significant influence and the use of the equity method with a view to developing proposals as part of a separate project that might address the concerns raised relating to IAS 28?

Yes.

#### **Editorial Changes**

- 'half or less than half' in current standard while paragraph 27 in the exposure draft just says 'less than half' which is not the same.
- Paragraphs 26-29 should cross refer to Appendix Guidance paragraphs B9-B16.
- Disclosure paragraph 48(d): where is the limit of the 'involvement' with structured entities – needs to be restricted.

#### **Other comments**

- Status of joint ventures: paragraph BC58 of the exposure draft basis for conclusions confirms that only one party controls an entity and states that IAS 31 *Interests in Joint Ventures* provides accounting requirements for those entities with an interest in a joint venture. To avoid any confusion, we suggest that arrangements entailing joint control within the scope of IAS 31 be scoped out of the proposed standard.
- Common control model – the IASB decided to defer consideration of the common control model until Phase D of the Conceptual Framework on the Reporting Entity (paragraph BC34). However, since the discussion paper on the reporting entity includes the preliminary view that there may be occasions when combined financials are useful, we feel it should be addressed in the standard on consolidations. This may be a particular issue in the public sector.
- Lack of due process: the IASB has published an exposure draft without previously providing a discussion paper on the topic. In addition, the comment period is 90 days instead of the usual 120-day period. We realise that the IASB has accelerated the project in response to the global financial crisis. However, control is a significant issue and debate on the issue should not be rushed. Moreover, this exposure draft will not result in convergence with US GAAP as it is not currently a joint project with FASB. FASB is currently only revising consolidation requirements for variable interest entities (special purpose entities in Australia).