



30 June 2016

Warren Allen
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Dear Warren

EXPOSURE DRAFTS – PBE INTERESTS IN OTHER ENTITIES

Thank you for the opportunity to provide comments on the five proposed PBE accounting standards relating to interests in other entities (the exposure drafts).

We have considered the contents of the exposure drafts and we are broadly supportive of the accounting standards proposed by the NZASB. Our comments mainly focus on the exposure draft on PBE IPSAS 35 *Consolidated Financial Statements*.

The reason we have a particular interest in this proposed accounting standard is because it not only determines whether Entity A consolidates Entity B, but it is also used to determine whether Entity B is a public entity under the Public Audit Act 2001. Therefore, the issues that arise for us in relation to this standard include concerns about what is, or is not, appropriately classed as a public entity, and about how far the Auditor-General's mandate is intended to extend.

Because this standard has the status of legislation, it needs to be written, as far as possible, in language that is clear, precise, and consistent. Some examples of where we think the standard could be clearer are provided in the attachment to this letter.

Our interest is in having a standard that makes sense, is based on principles and is clear, so that it can be readily and consistently applied across different entity types. There are a range of entities in the public sector that we are required to apply the standard to. For example, trusts, charitable trusts, incorporated societies, and increasingly limited partnerships. Because this is a standard that applies to public benefit entities, we would expect that it will be applied in many cases to entities other than companies. In the public sector, we come across a lot of trusts where this standard would need to be applied.

Trusts do not have ownership instruments, such as shares. Therefore, it can be quite challenging to assess whether trusts are public entities and/or should be consolidated by the potential 'parent' entity. We often encounter trusts which dispute that they are "controlled" under the financial reporting standards. Because trusts are generally discretionary and are set up to operate quite autonomously within the boundaries set out in their trust deed, the concept of "control" does not fit comfortably for trusts. Another common view is that a potential parent entity does not receive benefits from the trust's activities because they are not the direct

beneficiaries of the trust. However, this is a narrow view of “benefits” and does not take into account complementary benefits.

In our view, it would be helpful if the standard could explicitly acknowledge that it does apply to entities other than companies, and explain how concepts such as ‘financial and operating policies’, ‘power’, and ‘non-financial benefits’ are intended to apply to these sorts of entities.

In our view, the definitions of control and benefits in the exposure drafts are an improvement to the existing standard. However, the definition of power as it is currently drafted is too rigid and limiting.

We are concerned about how the definition of power in the exposure drafts could be interpreted for autopilot arrangements. There is a lack of emphasis on autopilot arrangements and it is not clear that the exceptions to the ongoing need for power, found in PBE IPSAS 6, still apply.

There is a long history to trying to improve the accounting standard on control. Although there were some problems with the wording of FRS-37, it did clearly recognise that control could exist even where there is no ongoing power (autopilot arrangements).

When IFRS was adopted, cross-references to some paragraphs of FRS-37 and IPSAS 6 were inserted in NZ IAS 27 for public benefit entities in order to recognise that control could arise in autopilot arrangements. However, there were different interpretations of the cross-references, with some people considering them only to the extent they did not conflict with the underlying standard, whereas we considered them part of the standard.

The current PBE accounting standard, PBE IPSAS 6, incorporated FRS-37 as Application Guidance. We understand this was done to maintain the “status quo” until a new standard could properly incorporate the autopilot concept, as well as improve on some of the wording in FRS-37.

In our view, the modifications made by the NZASB to IPSAS 35 to include guidance on predetermination are helpful. However, it is unclear how these will be interpreted because the definition of power has not been modified and predetermination has not been embedded throughout the standard where power is discussed.

The most clear statement in our view is in paragraph BC5 which notes: “...*although the definition of power uses the terms “existing rights” and “current ability”, this does not preclude the possibility that an entity could control another entity in situations where power has already been exercised through predetermination of activities.*” In our view, the sentiments of this statement need to be embedded throughout the standard. This is discussed further in the attachment to this letter.

In our view, where power has been exercised by Entity A on establishment of Entity B, such that Entity B cannot deviate significantly from the predetermined activities, it could be argued that Entity A no longer has the “current ability” to direct the relevant activities (based on existing rights). Therefore, it could be argued that Entity A does not control Entity B. We would like to see wording changes to the exposure drafts, if this is not the intention of the NZASB.

In our view it is important that the exposure drafts acknowledge the need for ongoing reconsideration of control judgements, as circumstances change.

The attachment to this letter responds to the questions in the Invitation to Comment dated February 2016.

If you have any questions about our submission, please contact me.

Yours sincerely

A handwritten signature in blue ink, appearing to read 'Todd Beardsworth', with a long horizontal flourish extending to the right.

Todd Beardsworth
Assistant Auditor-General (Accounting and Auditing Policy)
Office of the Controller and Auditor-General of New Zealand

Appendix - Our Responses to the XRB Questions in the Exposure Draft

ED NZASB 2016-1 PBE IPSAS 34 Separate Financial Statements

1. ***Do you agree that no substantive changes to IPSAS 34 are required to make it suitable for application by PBEs in New Zealand? If you disagree, please describe the additional changes that you consider to be appropriate.***

We agree that no substantive changes to IPSAS 34 are required to make it suitable for application by PBEs in New Zealand.

ED NZASB 2016-2 PBE IPSAS 35 Consolidated Financial Statements

2. ***Do you consider that the IPSASB's reasons for retaining investment entity accounting in the financial statements of a non-investment controlling entity are relevant for both public sector and not-for-profit public benefit entities in New Zealand? If you do not agree, please explain why.***

We agree with the IPSASB that users would find it most useful if the accounting for investments applied in a controlled investment entity's financial statements were extended to its controlling entity's financial statements.

3. ***Do you agree with how we have proposed to modify IPSAS 35 by including more guidance on predetermination (see paragraphs 21, 29.1, 35.1, AG8.1, AG53 and Example 29A)? If you do not agree, please explain why.***

We do not agree with the proposed modifications because they are not clear enough. In particular we are concerned that the definition of power in the exposure draft does not include the notion of predetermination. We consider further modifications are needed to embed the notion of predetermination, otherwise the NZASB will risk inconsistency in application of this standard.

4. ***Do you agree with the proposal to include integral application guidance on network and partner agreements in PBE IPSAS 35 (paragraphs AG31.1 to AG31.7)? If you do not agree, please explain why.***

We are not aware of any such arrangements in the public sector, however, such guidance may be helpful for not-for-profit PBEs.

5. ***Do you agree with the other proposed modifications to IPSAS 35 in PBE IPSAS 35? If you disagree, please provide reasons and indicate the nature of any additional modifications that you consider to be appropriate.***

Predetermination of activities (autopilot arrangements)

We note that some of the proposed modifications that relate to predetermination attempt to incorporate autopilot arrangements as controlled entities. The Basis for Conclusions explains that the expanded discussion of predetermined activities was added due to concerns that the language used in the definition of power, could, in the absence of further guidance, be read as excluding control obtained through predetermination of activities.

We agree it is helpful to add the expanded discussion on predetermined activities. However, without a modification to the power definition, and further clarity throughout the standard, it is unclear that an 'exception to power element' could apply where there has been predetermination of activities at the time an entity is established. Below are some examples of areas where predetermination has not been embedded, and where additional clarity is needed.

Definition of power

The words "existing rights" and "current ability" in the definition of power contradict the concept of predetermination. In our view, the power definition itself needs to explicitly acknowledge that power could include any decision-making rights that a controlling entity has already exercised by determining the purpose and design of the controlled entity.

In such cases, where there has been predetermination of activities, for example by deciding what a trust's objects and purposes are, '*existing rights that give the current ability to direct the relevant activities*' would not be required for control to exist.

In our view, the standard would be clearer if power is defined as follows:

"Entity A has power in relation to Entity B if Entity A has rights that enable Entity A to direct the relevant activities of Entity B. Entity A's rights must be existing rights that give it the current ability to direct the relevant activities of Entity B, except where Entity A has determined the purpose and design of Entity B and therefore established restrictions on the relevant activities of Entity B, which limit the ability of others to make decisions about those relevant activities."

Paragraph 29.1

In our view, paragraph 29.1 should be moved to 26.1 so that the discussion on the situation of rights already having been exercised is before the discussion on situations where the rights have yet to be exercised.

Paragraph 36

Paragraph 36 infers that there must be ongoing power for the controlling entity to “direct” the activities in order for control to exist. It therefore precludes the possibility that an entity could control another entity in situations where power has already been exercised through predetermination of activities.

Paragraph AG8.1

Paragraph AG8.1 is not sufficiently clear because it is not linked to paragraphs AG9 to AG11. If these paragraphs are read in isolation under the heading of “Power”, it could be argued that you do not need to take into account paragraph AG8.1 when assessing whether control exists. In our view, there needs to be clarification in paragraphs AG9 to AG11 that the entity does not need to have existing rights that give it the current ability if these rights have already been exercised.

Paragraphs AG16 and AG17

Paragraphs AG16 and AG17 do not make any reference to predetermination. In our view, without reference to predetermination, these paragraphs preclude the possibility that an entity could control another entity in situations where power has already been exercised through predetermination of activities.

Paragraph AG60 (c)

Part (c) of paragraph AG60 infers that a trust can only be controlled if the controlling entity has the power to replace the trustee of the trust. It does not take into account autopilot arrangements where control can exist where power has already been exercised through predetermination of activities.

Illustrative examples

Although the examples are not part of PBE IPSAS 35, it would be helpful to users if the examples are as realistic as possible, and relevant to New Zealand public benefit entities. It is also important that the examples are clear about the conclusion reached, and assist in applying the standard to different types of entities.

We are pleased that Example 29A has been included to illustrate that control is possible where there is predetermination of a trust’s activities at inception. However, based on our experience Example 29A is restrictive and not typical (see further detail below). We also think that it would be helpful to users if there were two or three realistic examples of autopilot arrangements, as this is a challenging concept to apply.

Example 28

Example 28 is a concern because it is overly simplistic and could therefore be misleading. We have given some examples above of where we think there is a lack of acknowledgement of the notion of predetermination. Example 28 is another example which appears to preclude the possibility that an

entity could control another entity in situations where power has already been exercised through predetermination of activities.

Example 28 is quite broad and therefore is not typical of what we see in New Zealand. There are examples in the public sector where a local authority establishes a trust and transfers assets to it. However, it is usually one type of asset rather than a number of different assets, for example a leisure centre.

Although we have seen examples where the purposes of a trust extend to other charitable purposes, it is certainly not prevalent. For some of these trusts that we have seen, we are of the view that the local authority controls the trust under an autopilot arrangement.

Therefore, when considering Example 28 and the more typical New Zealand examples, and thinking about paragraph 29.1 on predetermination of activities, there are questions about whether or not the local government could control the trust through an autopilot arrangement.

In our view, the example needs to be expanded and changed, and the analysis needs to consider whether or not the trust is controlled through an autopilot arrangement, and the reasons it is, or is not, controlled. We include some questions below to prompt further thought about enhancing the example to be helpful to users.

We note that Example 28 contains the sentence: "*The trust can decide the nature and extent of facilities to be provided and can engage in any other charitable purpose.*"

- Does this mean that the trust can dispose of, or change the use of, the assets it holds? If so, this needs to be made clear.
- Are the trust's objects restricted to the local government's boundaries?
- If the words '*and can engage in any other charitable purpose*' were removed from this sentence, would the conclusion on control change? If the conclusion on control does not change, what further changes would be needed so that the example aligned with the concept of autopilot arrangements in paragraph 29.1?

If this clarity is not added, it might be better if the example is removed so that it does not confuse users. We are also concerned that the addition of Example 29A to specifically illustrate predetermination automatically means that the other examples exclude predetermination.

Example 29A

Example 29A is very prescriptive, and as a result not typical in the public sector. There are not many examples of trusts currently in the public sector where the trust deed is so prescriptive that it details an investment strategy and qualification criteria.

We think it would be better for users to have more realistic examples and Example 29A could be more realistic if it is less prescriptive. We also think that Example 29A could be improved, if the second, and fourth paragraphs were changed or removed.

The second sentence of the second paragraph states the trustees have no power to alter, vary, revoke or add to the powers and provisions declared in the trust deed without the consent of Entity A. We see few autopilot arrangements where the trust deed is so restrictive as to require the controlling entity's approval to change any provisions in the trust deed.

In many cases, the trust deed is silent on whether any changes can be made to the trust deed. In our view, the conclusion for Example 29A would not change if the second sentence of the second paragraph simply stated: "*The trustees are not able to significantly change the objects or purposes of the trust, for example to providing services that are unrelated to Entity A or its clients.*"

The fourth paragraph states that if the trust is wound up, surplus assets must be transferred to Entity A or, subject to Entity A's approval, a charitable body with similar objectives.

Again, we see few autopilot arrangements where the wind up clause requires the controlling entity's approval to transfer any surplus assets to a charitable body with similar objectives. In our view, the conclusion for Example 29A would not change if the fourth paragraph simply stated: "*If the trust is wound up, surplus assets must be transferred to a charitable body with similar objectives.*"

Establishment of entities and predetermination of activities

The standard is unclear about whether a controlling entity itself must establish a controlled entity in order for predetermination to apply. In order for an autopilot arrangement to apply, the controlling entity needs to have determined the purpose and design of the controlled entity, and, in so doing, established significant restrictions on the relevant activities of the controlled entity, which limit the ability of others to make decisions about those relevant activities and ensure that the establishing entity receives the significant benefits from those activities.

The wording appears to indicate that so long as in substance the controlling entity has determined the purpose and design of the controlled entity, whether or not they have actually established the controlled entity themselves is not important. That is, if someone else has established the controlled entity on behalf of the controlling entity, this is essentially the same as the controlling entity establishing the controlled entity itself.

For example, there are some trusts in the public sector that we believe are controlled by an entity under an autopilot arrangement, whereby the trust has been established by a settlor who was a board member of the entity. However, in substance, the entity has determined the purpose and design of the trust, even if the board itself is not listed as the 'settlor' of the trust. It would be helpful if the standard was clear about this one way or the other, because it can be an area of confusion and contention.

Benefits or significant benefits?

Paragraph AG8.1 implies that there is a requirement for benefits to be 'significant', although this concept of 'significant benefits' does not seem to appear elsewhere in the standard. It would be less confusing for users if the word 'significant' is removed from the second sentence of AG8.1, and simply states: '.....receives benefits from those activities.'

Exclusion of proposed modification paragraphs in some references

Paragraph 20, part (a) refers to paragraphs 23-29 for guidance on power over the other entity. This excludes paragraph 29.1 which discusses predetermination.

Paragraph AG19 refers to paragraphs AG5–AG8 for discussion about the purpose and design of the other entity. This excludes paragraph AG8.1 which discusses predetermination.

ED NZASB 2016-3 PBE IPSAS 36 Investments in Associates and Joint Ventures

6. ***Do you agree that no substantive changes to IPSAS 36 are required to make it suitable for application by PBEs in New Zealand? If you disagree, please describe the additional changes that you consider to be appropriate.***

We agree that no substantive changes are required.

ED NZASB 2016-4 PBE IPSAS 37 Joint Arrangements

7. ***Do you agree with the proposed modifications to IPSAS 37 in PBE IPSAS 37? If you disagree, please provide reasons and indicate the nature of any additional modifications that you consider to be appropriate.***

We support the proposed modifications to IPSAS 37 in PBE IPSAS 37.

ED NZASB 2016-5 PBE IPSAS 38 Disclosure of Interests in Other Entities

8. ***Do you agree that no substantive changes to IPSAS 38 are required to make it suitable for application by PBEs in New Zealand? If you disagree, please describe the additional changes that you consider to be appropriate.***

We agree that no substantive changes are required.

General

9. ***Do you agree with the Reduced Disclosure Regime concessions proposed in the EDs? If you disagree, please provide reasons and indicate any additional concessions that you consider would be appropriate.***

We agree with the Reduced Disclosure Regime concessions proposed in the EDs.

10. Do you agree with the proposal that the final PBE Standards should have an effective date of 1 January 2019, with earlier application permitted?

We agree with the proposal that the final PBE Standards should have an effective date of 1 January 2019, with earlier application permitted.

11. Do you have any other comments on the EDs?

- (a) The discussions around the importance of considering the purpose and design of an entity are helpful. It is also helpful that the standard acknowledges that, in many cases, there will be more than one party with decision-making rights, and it is necessary to weigh up the relative significance of those decision-making rights.
- (b) There is a small typo in paragraph 21. The last sentence, where it refers to how decisions about the relevant activities are made, misspells the word "activities".
- (c) The overall structure of the standard is very complex, resulting in the reader having to flick backwards and forwards to find all the relevant information and 'piece together' the concepts. There is also a lot of repetition of the same concepts but in slightly different ways. The language is not always clear, precise, and consistent. Some examples of this are given below.
 - (i) The references to 'entity', 'other entity', 'controlling entity', 'entity being assessed for control' when there is more than one entity could be confusing to users. If the entities were named 'Entity A' and 'Entity B', it might be clearer as to which entity is being referred to.
 - (ii) Paragraph 31 explains that '*Non-financial benefits include advantages arising from scarce resources that are not measured in financial terms and economic benefits received directly by service recipients of the entity.*' It would be helpful to be clear about who the 'service recipients' are, which entity they are receiving services from, and the sort of advantages and economic benefits they would receive.

To illustrate, here is an example: Entity A is a school board, and Entity B is a charitable trust that Entity A has established. Entity B's objects are to promote, advance and develop education at Entity A, and to promote and assist Entity A, its students and staff members. In this situation, who are the 'service recipients' of Entity B? Which entity are they receiving services from, and what economic benefits would they receive?
 - (iii) Paragraph 31 refers to 'congruent activities' and later 'complementary objectives'. It is unclear whether or not these are two different concepts. Also, paragraph 36 refers to 'congruent objectives'. 'Activities' implies day-to-day operations, whereas 'objectives' is a broader concept, and can imply the parameters that an entity can operate within.

'Financial policies' and 'financial activities' are also used interchangeably as if they are the same.

These terms could be interpreted by some people as two different concepts. In our view, it would be helpful if the standard used the same term consistently where it has the same meaning. If there are different terms used deliberately, it would be helpful to be clear why different terms are used by explaining that these are both relevant in different ways and at different times.

- (iv) Paragraph AG27 includes: '*Usually, to be substantive, the rights need to be currently exercisable. However, sometimes rights can be substantive, even though the rights are not currently exercisable.*' This sentence is unclear because it is not explicit about the circumstances where rights can be substantive, even though these are not currently exercisable, and it does not explain how you tell the difference.