IMPLEMENTING IPSAS: A GUIDE FOR TRAINERS

IFAC®

Consolidation and Public Sector Combinations

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Consolidation

Introduction

Governments, and in some cases, other public sector entities, carry out policies and deliver services through a variety of entities. Some are organizational and accounting entities such as departments, special funds and accounts that are integral to the public sector entity and through which it directly delivers public services and performs its executive function.

Others may be separate corporate entities with their own management, which, under legislation, have been delegated financial powers and operational authority. In some cases, these entities could be jointly controlled with other entities.

Governments or other public sector entities frequently have the power to direct the operations of one or more entities so as to benefit from the activities of those entities. It may also be exposed to a financial burden or loss that may arise as a result of the activities of those entities.

The objective of government and other public sector entity general purpose financial statements is to provide an accounting of the full nature and extent of the financial affairs and resources which the entity controls, including those related to the activities of its agencies and enterprises. This information is needed in order that users understand the operations of the entity, can assess accountability for the use and management of resources entrusted to it and for decision making purposes.

The disclosure of information about the resources, obligations and service delivery or other activities that an entity as a whole, whether a government or other public sector entity, has the power to direct, including those it can direct through other entities, will be necessary for accountability and decision making purposes. This is particularly so when the results of such direction can generate benefits for the public sector entity or expose it to a financial burden or loss.

This section of this module focuses on requirements of IPSAS 34, *Separate Financial Statements*; IPSAS 35, *Consolidated Financial Statements*; IPSAS 36, *Investments in Associates and Joint Ventures*; IPSAS 37, *Joint Arrangements* and IPSAS 38, *Disclosure of Interests in Other Entities*.

Specific topics include:

- Which entities are required to prepare and present consolidated financial statements
- What is the scope of consolidated financial statements
- Establishing control for financial statement reporting purposes
  - Identifying controlled entities
  - Conditions and indicators that are used in analyzing relationships between entities to establish whether control exists
- Consolidation procedures
  - Consolidation adjustments
  - Conforming accounting policies
  - Conforming reporting dates
  - Reporting non-controlling interests
- Equity method
- Preparation and presentation of separate financial statements.
  - Accounting for controlled entities, jointly controlled entities and associates
- Disclosures.

Learning Objective

- IPSAS 34, *Separate Financial Statements*
- IPSAS 35, *Consolidated Financial Statements*
- IPSAS 36, *Investments in Associates and Joint Ventures*
- IPSAS 37, *Joint Arrangements*
- IPSAS 38, *Disclosure of Interests in Other Entities*
- You are able to apply:
    - The requirements for the preparation and presentation of consolidated financial statements
    - The definition of "control"
    - Consolidation procedures

IPSAS 34, *Separate Financial Statements*

An entity that is required by IPSAS 35 to prepare consolidated financial statements may also choose (or be required by regulation) to prepare separate financial statements. Consolidated financial statements report the financial position and performance of the economic entity as a whole. Separate financial statements report the financial position and performance of the individual entity that prepares those separate financial statements.

IPSAS 34 prescribes the accounting and disclosure requirements for investments in controlled entities, joint ventures and associates when an entity prepares separate financial statements. IPSAS 34 does not require a controlling entity to prepare separate financial statements. However, when a controlling entity chooses to prepare separate financial statements (or is required to do so by regulation), it must follow the requirements in IPSAS 34.

IPSAS 35, *Consolidated Financial Statements*

An entity that prepares and presents financial statements under the accrual basis of accounting applies IPSAS 35 in the preparation and presentation of consolidated financial statements for the economic entity. An entity that is a controlling entity–i.e., an entity that controls another entity–is required by IPSAS 35 to prepare consolidated financial statements (with some exceptions where the controlling entity is itself a controlled entity).

Consolidated financial statements are prepared for an economic entity presented as those of a single entity. An economic entity for financial reporting purposes is a group of entities comprising the controlling entity and the entities it controls, whether incorporated or unincorporated. Other terms sometimes used to refer to an economic entity include administrative entity, financial entity, consolidated entity, and group.

Presenting consolidated financial statements is consistent with the objectives of public sector entity general purpose financial statements. That is, to provide an accounting of the full nature and extent of the financial affairs and resources which the entity controls, including those related to the activities of its agencies and enterprises. The consolidated financial information is intended to assist users to understand the operations of the entity, assess accountability for the use and management of resources entrusted to it and for decision making purposes.

In an exception to its general requirements, IPSAS 35 does not require an investment entity to prepare and present consolidated financial statements. An investment entity is an entity that:

a) Obtains funds from one or more investors for the purpose of providing those investor(s) with investment management services;

b) Has the purpose of investing funds solely for returns from capital appreciation, investment revenue, or both; and

c) Measures and evaluates the performance of substantially all of its investments on a fair value basis.

The definition of an investment entity includes some sovereign wealth funds, some pension funds and some funds holding controlling interests in public-private partnership projects (PPP) or private finance initiatives (PFI). Because these entities exist for the purpose of generating returns, the needs of the users of their financial statements are best met by reporting all of their investments at fair value.

To meet its objective, IPSAS 35:

a) Requires an entity (the controlling entity) that controls one or more other entities (controlled entities) to present consolidated financial statements;

b) Defines the principle of control, and establishes control as the basis for consolidation;

c) Sets out how to apply the principle of control to identify whether an entity controls another entity and therefore must consolidate that entity;

d) Sets out the accounting requirements for the preparation of consolidated financial statements; and

e) Defines an investment entity and sets out an exception to consolidating particular controlled entities of an investment entity.

IPSAS 36, *Investments in Associates and Joint Ventures*

A controlling entity (or its controlled entity) may be an investor in an associate. In such cases, consolidated financial statements prepared and presented in accordance with IPSAS 35 are also prepared so as to comply with IPSAS 36.

An associate is an entity over which the investor (controlling entity) has significant influence that does not amount to control or joint control.

IPSAS 36 applies only to investments where the investment leads to the holding of a quantifiable ownership interest. This includes ownership interests arising from investments in the formal equity structure of another entity. A formal equity structure means share capital or an equivalent form of capital, such as units in a property trust. Quantifiable ownership interests may also include ownership interests arising from other investments in which the entity’s ownership interest can be measured reliably (for example, interests in a partnership). Where the equity structure of the other entity is poorly defined, it may not be possible to obtain a reliable measure of the ownership interest.

A controlling entity may also be an investor in a joint venture. Again, consolidated financial statements prepared and presented in accordance with IPSAS 35 are also prepared so as to comply with IPSAS 36.

A joint venture is a joint arrangement whereby the parties that have joint control of the arrangement have rights to the net assets of the arrangement. Joint control is the agreed sharing of control of an arrangement by way of a binding arrangement, which exists only when decisions about the relevant activities require the unanimous consent of the parties sharing control.

IPSAS 36 requires an entity with joint control of, or significant influence over, an investee to account for its investment in an associate or a joint venture using the equity method unless the investment is classified as held for sale, in which case the entity accounts for the investment in accordance with IPSAS 44, *Non-current Assets Held for Sale and Discontinued Operations* (see Module 8).

IPSAS 37, *Joint Arrangements*

IPSAS 37 establishes principles for financial reporting by entities that have an interest in arrangements that are controlled jointly (i.e., joint arrangements). A joint arrangement is an arrangement of which two or more parties have joint control. A joint arrangement can be either a joint operation or a joint venture.

IPSAS 37 defines joint control as "the agreed sharing of control of an arrangement by way of a binding arrangement, which exists only when decisions about the relevant activities require the unanimous consent of the parties sharing control."

A joint operation is a joint arrangement whereby the parties that have joint control of the arrangement have rights to the assets, and obligations for the liabilities, relating to the arrangement.

A joint venture is a joint arrangement whereby the parties that have joint control of the arrangement have rights to the net assets of the arrangement.

A joint arrangement that is not structured through a separate vehicle is a joint operation. A joint arrangement in which the assets and liabilities relating to the arrangement are held in a separate vehicle can be either a joint venture or a joint operation.

IPSAS 37 refers to an entity with an interest in a joint operation as a joint operator. An entity with an interest in a joint venture is referred to as a joint venturer.

A joint operator recognizes, in relation to its interest in a joint operation, the following items:

a) Its assets, including its share of any assets held jointly;

b) Its liabilities, including its share of any liabilities incurred jointly;

c) Its revenue from the sale of its share of the output arising from the joint operation;

d) Its share of the revenue from the sale of the output by the joint operation; and

e) Its expenses, including its share of any expenses incurred jointly.

A joint venturer recognizes its interest in a joint venture as an investment and accounts for that investment using the equity method in accordance with IPSAS 36 (unless the investment is classified as held for sale, in which case the entity applies IPSAS 44 in accounting for the investment).

IPSAS 38, Disclosure of Interests in Other Entities

IPSAS 38 requires an entity to disclose information that enables users of its financial statements to evaluate:

a) The nature of, and risks associated with, its interests in controlled entities, unconsolidated controlled entities, joint arrangements and associates, and structured entities that are not consolidated; and

b) The effects of those interests on its financial position, financial performance and cash flows.

IPSAS 38 does not include any accounting requirements in addition to those in IPSAS 34–IPSAS 37. Instead, IPSAS 38 prescribes the detailed disclosure requirements for entities that prepare and present consolidated financial statements.

IPSAS 34 – 38

- An entity's investment in another entity, whether that entity is:
    - A controlled entity (consolidation accounting)
    - An investment in an associate or joint venture (equity method)
    - A joint operation (accounting for assets and liabilities) determines which standard applies
- Concepts of control and significant influence drive assessment of what type of an investment an entity has

These issues are discussed in more detail later in this module.

Analyzing control and influence

- **Control** – An entity controls another entity when the entity is exposed, or has rights, to variable benefits from its involvement with the other entity and has the ability to affect the nature or amount of those benefits through its power over the other entity
- **Joint Control** – Agreed sharing of control of an arrangement by way of a binding arrangement, which exists only when decisions about the relevant activities require the unanimous consent of the parties sharing control
- **Significant Influence** – Power to participate in the financial and operating policy decisions of another entity but is not control or joint control of those policies

Determining which standard applies to accounting for an interest in another entity relies on understanding how the various levels of influence over an investment are assessed.

Whether an entity controls another entity relies on professional judgment, in relation to the definition of control and the particular circumstances of each case.

Control

Control is defined as follows:

An entity controls another entity when the entity is exposed, or has rights, to variable benefits from its involvement with the other entity and has the ability to affect the nature or amount of those benefits through its power over the other entity.

It follows that an entity controls another entity if–and only if–the entity has all the following:

a) Power over the other entity;

b) Exposure, or rights, to variable benefits from its involvement with the other entity; and

c) The ability to use its power over the other entity to affect the nature or amount of the benefits from its involvement with the other entity.

It is important to note that control does not necessarily require a majority shareholding or other equity interest. It does not require an entity to have the responsibility of management (or involvement in) the day to day management. Each of the three factors needs to be considered.

Power over the other entity

Control is the ability on an entity to exert power to direct the relevant activities of the other entity. The relevant activities are those activities that significantly affect the nature or amount of the benefits the entity receives from its involvement with the other entity. The right to direct the financial and operating policies of another entity indicates that an entity has the ability to direct the relevant activities of another entity and is frequently the way in which power is demonstrated in the public sector.

Power arises from rights. In some cases assessing power is straightforward, such as when power over another entity is obtained directly and solely from the voting rights granted by equity instruments such as shares, and can be assessed by considering the voting rights from those shareholdings.

However, public sector entities often obtain power over another entity from rights other than voting rights. They may also obtain power over another entity without having an equity instrument providing evidence of a financial investment. An entity may have rights conferred by binding arrangements. These rights may give an entity power to require the other entity to deploy assets or incur liabilities in a way that affects the nature or amount of benefits received by the first-mentioned entity. The assessment of whether such rights give rise to power over another entity may be complex and require more than one factor to be considered.

An entity can have power over another entity even if it does not have responsibility for the day-to-day operation of the other entity or the manner in which prescribed functions are performed by that other entity. Legislation may give statutory bodies or statutory officers powers to carry out their functions independently of government. Legislation may also set out the broad parameters within which the statutory body is required to operate, and result in the statutory body operating in a manner consistent with the objectives set by Parliament or a similar body. The existence of statutory powers to operate independently does not, of itself, preclude an entity having the ability to direct the operating and financial policies of another entity with statutory powers so as to obtain benefits. For example, the independence of a central bank in relation to monetary policy does not preclude the possibility of the central bank being controlled. All facts and circumstances would still need to be considered.

The existence of rights over another entity does not necessarily give rise to power for the purposes of assessing control. An entity does not have power over another entity solely due to the existence of:

a) Regulatory control; or

b) Economic dependence.

An entity can have power without having exercised that power. An entity with the current ability to direct the relevant activities has power even if its rights to direct have yet to be exercised. Evidence that the entity has been directing the relevant activities of the entity being assessed for control can help determine whether the entity has power, but such evidence is not, in itself, conclusive in determining whether the entity has power over the entity being assessed for control. In the case of an entity established with predetermined activities, the right to direct the relevant activities may have been exercised at the time that the entity was established (sometimes referred to as an 'autopilot' arrangement).

Sometimes more than one entity will have rights over another entity. If two or more entities each have existing rights that give them the unilateral ability to direct different relevant activities, the entity that has the current ability to direct the activities that most significantly affect the nature or amount of benefits from that entity has power over that other entity.

An entity can have power over an entity being assessed for control even if other entities have existing rights that give them the current ability to participate in the direction of the relevant activities, for example when another entity has significant influence. However, an entity that holds only protective rights does not have power over another entity, and consequently does not control the other entity.

Exposure, or rights, to variable benefits from its involvement with the other entity

Having power over another entity is not sufficient to establish control. The entity must also have exposure, or have rights, to variable benefits from its involvement with the other entity.

An entity is exposed, or has rights, to variable benefits from its involvement with another entity when the benefits it seeks have the potential to vary as a result of that other entity's performance. Entities expect positive financial or non-financial benefits over time. However, in a particular reporting period, the actual impact of an entity's involvement with another entity can be only positive, only negative or a mixture of both positive and negative.

The entity's benefits can be only financial, only non-financial or both financial and non-financial. Non-financial benefits can occur when the activities of another entity are aligned with the objectives of the entity and support the entity in achieving its objectives. For example, an entity may obtain benefits when another entity with aligned activities provides services that the first entity would have otherwise been obliged to provide. Aligned activities may be undertaken voluntarily or the entity may have the power to direct the other entity to undertake those activities. IPSAS 35 refers to these aligned activities as congruent activities.

Non-financial benefits can also occur when two entities have complementary objectives (that is, the objectives of one entity add to, and make more complete, the objectives of the other entity).

The following examples illustrate financial benefits that an entity may receive from its involvement with another entity:

- Dividends, variable interest on debt securities, other distributions of economic benefits;
- Exposure to increases or decreases in the value of an investment in another entity;
- Exposure to loss from agreements to provide financial support, including financial support for major projects;
- Cost savings (for example, if an entity would achieve economies of scale or synergies by combining the operations or assets of the other entity with its own operations or assets);
- Residual interests in the other entity's assets and liabilities on liquidation of that other entity; and
- Other exposures to variable benefits that are not available to other entities.

Examples of non-financial benefits include:

- The ability to benefit from the specialized knowledge of another entity;
- The value to the entity of the other entity undertaking activities that assist the entity in achieving its objectives;
- Improved outcomes;
- More efficient delivery of outcomes;
- More efficient or effective production and delivery of goods and services;
- Having an asset and related services available earlier than otherwise would be the case; and
- Having a higher level of service quality than would otherwise be the case.

Although only one entity can control another entity, more than one party can share in the benefits of that other entity. For example, holders of non-controlling interests can share in the financial benefits such as surpluses or distributions from an entity or the non-financial benefits such as the alignment of activities with desired outcomes.

Link between Power and Benefits

To have control over another entity, an entity must be able to demonstrate a link between its power over that other entity and the benefits it is exposed, or has rights, to from that other entity.

An entity controls another entity if the entity not only has power over the entity being assessed for control and exposure or rights to variable benefits from its involvement with the other entity, but also has the ability to use its power to affect the nature or amount of the benefits from its involvement with the entity being assessed for control.

The existence of aligned objectives alone is insufficient for an entity to conclude that it controls another entity. In order to have control the entity would also need to have the ability to use its power over the entity being assessed for control to direct that other entity to work with it to further its objectives.

An entity with decision-making rights determines whether it is a principal or an agent. It also determines whether another entity with decision-making rights is acting as an agent for the entity. An agent is a party primarily engaged to act on behalf and for the benefit of another party (the principal) and therefore does not control the other entity when it exercises its decision-making authority. Thus, sometimes a principal's power may be held and exercisable by an agent, but on behalf of the principal.

Joint control

Joint control is defined as follows:

Joint control is the agreed sharing of control of an arrangement by way of a binding arrangement, which exists only when decisions about the relevant activities require the unanimous consent of the parties sharing control.

There are two types of joint arrangement, joint operations and joint ventures, each with different accounting requirements. Both require joint control to be present. The definition of joint control requires the existence of a binding arrangement under which decisions about the relevant activities require the unanimous consent of the parties sharing control.

Binding arrangements can be evidenced in several ways. A binding arrangement is often, but not always, in writing, in the form of a contract or documented discussions between the parties. Statutory mechanisms such as legislative or executive authority can also create enforceable arrangements, similar to contractual arrangements, either on their own, or in conjunction with contracts between the parties.

Significant influence

Significant influence is defined as follows:

Significant influence is the power to participate in the financial and operating policy decisions of another entity but is not control or joint control of those policies.

Whether an investor has significant influence over the investee is a matter of judgment based on the nature of the relationship between the investor and the investee. In order to be able to assess whether an entity has significant influence over an associate, an entity must hold a quantifiable ownership interest in the associate. This can be either in the form of a shareholding or other formal equity structure, or in another form in which the entity's interest can be measured reliably.

If an entity holds a quantifiable ownership interest and it holds, directly or indirectly (e.g., through controlled entities), 20 per cent or more of the voting power of the investee, it is presumed that the entity has significant influence, unless it can be clearly demonstrated that this is not the case. Conversely, if the entity holds, directly or indirectly (e.g., through controlled entities), less than 20 per cent of the voting power of the investee, it is presumed that the entity does not have significant influence, unless such influence can be clearly demonstrated. A substantial or majority ownership by another investor does not necessarily preclude an entity from having significant influence.

The existence of significant influence by an entity is usually evidenced in one or more of the following ways:

a) Representation on the board of directors or equivalent governing body of the investee;

b) Participation in policy-making processes, including participation in decisions about dividends or similar distributions;

c) Material transactions between the entity and its investee;

d) Interchange of managerial personnel; or

e) Provision of essential technical information.

The existence and effect of potential voting rights that are currently exercisable or convertible, including potential voting rights held by other entities, are considered when assessing whether an entity has significant influence. Potential voting rights are not currently exercisable or convertible when, for example, they cannot be exercised or converted until a future date or until the occurrence of a future event.

Potential voting rights include share warrants, share call options, debt or equity instruments that are convertible into ordinary shares, or other similar instruments that have the potential, if exercised or converted, to give the entity additional voting power or to reduce another party's voting power over the financial and operating policies of another entity.

An entity loses significant influence over an investee when it loses the power to participate in the financial and operating policy decisions of that investee. The loss of significant influence can occur with or without a change in absolute or relative ownership levels. It could occur, for example, when an associate becomes subject to the control of another government, a court or an administrator. It could also occur as a result of a binding arrangement.

Control, influence, and accounting

Influence	Accounting
Control	Consolidation
Joint Control	Joint venture – equity method (IPSAS 44 if held for sale) Joint operation – assets, liabilities, revenue, expenses
Significant influence	Equity method (IPSAS 44 if held for sale)
Lack of influence	Financial Instrument –IPSAS 41 or other IPSASs as appropriate

The ability of an entity to exert control or influence over another entity is the factor which determines which standard to apply and the method used for recognizing and measuring the investment in the other entity.

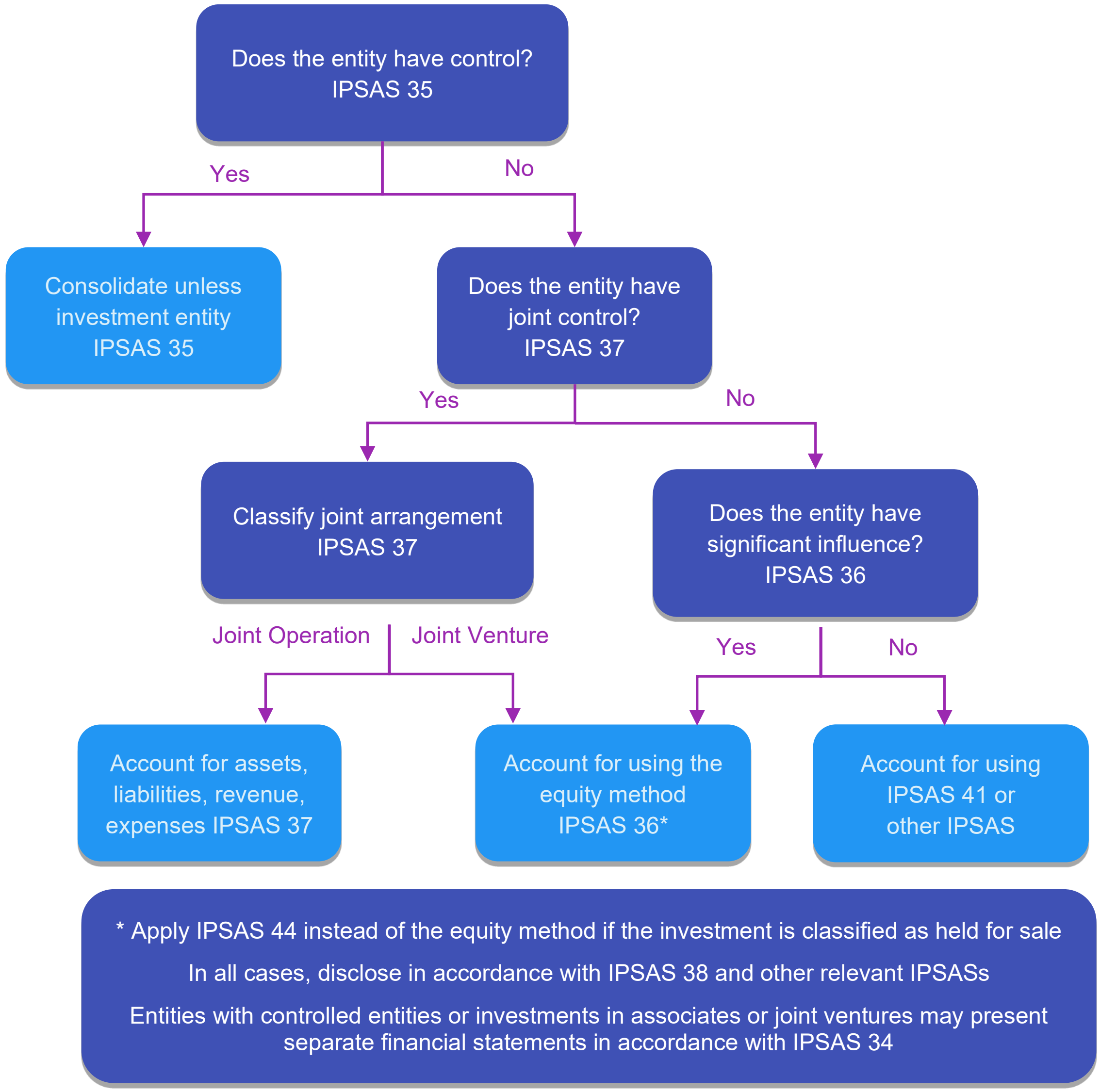
If an entity controls the other entity, the investment is consolidated in accordance with IPSAS 35.

If the entity has joint control, the entity needs to consider what type of joint arrangement it has. If the investment is a joint venture, the entity accounts for its investment in the other entity using the equity method in accordance with IPSAS 36 (or applies IPSAS 44 if the investment is classified as held for sale). If the investment is a joint operation, the entity accounts for assets and liabilities, revenues and expenses in accordance with IPSAS 37.

If the entity has ability to significantly influence the relevant activities of the other entity, the investment is accounted for using the equity method in accordance with IPSAS 36 (or in accordance with IPSAS 44 if the investment is classified as held for sale).

If the entity has little or no ability to influence the relevant activities of the other entity, the investment is accounted for as a financial instrument in accordance with IPSAS 41 (see the Financial Instruments module for more details).

Involvement with other parties



Entity is a controlling entity

A controlling entity is an entity that controls one or more entities. IPSAS 35 requires controlling entities to present consolidated financial statements, with limited exceptions.

The first exception is where the controlling entity is an investment entity. An investment entity is an entity that:

a) Obtains funds from one or more investors for the purpose of providing those investor(s) with investment management services;

b) Has the purpose of investing funds solely for returns from capital appreciation, investment revenue, or both; and

c) Measures and evaluates the performance of substantially all of its investments on a fair value basis.

Investment entities are required to measure its investment in a controlled entity at fair value through surplus or deficit in accordance with IPSAS 41.

The second exception is where the controlling entity is an intermediate controlling entity (i.e., it is controlled by another entity) that meets all the following conditions:

a) It is itself a controlled entity and the information needs of users are met by its controlling entity's consolidated financial statements, and, in the case of a partially owned controlled entity, all its other owners, including those not otherwise entitled to vote, have been informed about, and do not object to, the entity not presenting consolidated financial statements;

b) Its debt or equity instruments are not traded in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local and regional markets);

c) It did not file, nor is it in the process of filing, its financial statements with a securities commission or other regulatory organization for the purpose of issuing any class of instruments in a public market; and

d) Its ultimate or any intermediate controlling entity produces financial statements that are available for public use and comply with International Public Sector Accounting Standards (IPSASs), in which controlled entities are consolidated or are measured at fair value through surplus or deficit in accordance with IPSAS 35.

The most likely circumstance in which a controlling entity does not have to prepare consolidated financial statements is when it is a wholly owned, controlled entity and its controlling entity prepares consolidated financial statements that comply with IPSASs for public use. Most public sector entities do not issue financial instruments with potential voting rights. In most cases, the government will issue debt for or on behalf of public sector entities under its control.

In some instances, an economic entity will include a number of intermediate controlling entities. For example, a department of health may be the ultimate controlling entity. There may be intermediate controlling entities at the local or regional health authority level.

A controlling entity that is exempted from presenting consolidated financial statements may present separate financial statements in accordance with IPSAS 34 as its only financial statements.

The procedures for preparing consolidated financial statements are discussed later in this module.

Entity has joint control

A joint arrangement is an arrangement of which two or more parties have joint control. A joint arrangement (which can be either a joint operation or a joint venture) has the following characteristics:

a) The parties are bound by a binding arrangement; and

b) The binding arrangement gives two or more of those parties joint control of the arrangement.

In a joint arrangement, no single party controls the arrangement on its own. A party with joint control of an arrangement can prevent any of the other parties, or a group of the parties, from controlling the arrangement.

An arrangement can be a joint arrangement even though not all of its parties have joint control of the arrangement. IPSAS 37 distinguishes between parties that have joint control of a joint arrangement (joint operators or joint venturers) and parties that participate in, but do not have joint control of, a joint arrangement.

An entity that has joint control of a joint arrangement will need to determine the type of joint arrangement in which it is involved. The classification of a joint arrangement as a joint operation or a joint venture depends upon the rights and obligations of the parties to the arrangement. The classification of a joint arrangement is discussed in more detail later in this module.

Where the joint arrangement in which an entity is involved is a joint venture, the entity accounts for its interest using the equity method in accordance with IPSAS 36 (or in accordance with IPSAS 44 if the interest is classified as held for sale). Where the joint arrangement is a joint operation, the entity accounts for assets, liabilities, revenue and expenses associated with the joint operation in accordance with IPSAS 37. These accounting requirements are discussed in more detail later in this module.

Entity has significant influence

Significant influence is the power to participate in the financial and operating policy decisions of another entity but is not control or joint control of those policies. Where an entity has significant influence over another entity, that other entity is an associate.

Where an entity holds a quantifiable ownership interest in an associate, either in the form of a shareholding or other formal equity structure or in another form in which the entity's interest can be measured reliably, the entity accounts for its interest using the equity method, in accordance with IPSAS 36 (or in accordance with IPSAS 44 if the interest is classified as held for sale).

The equity method is discussed later in this module.

Entity does not have control, joint control or significant influence

Where an entity does not have control, joint control or significant influence over another entity, the entity accounts for its interest in that other entity as an investment. The entity accounts for its investment as a financial instrument in accordance with IPSAS 41 (or other IPSASs where appropriate).

The financial statements of an entity that does not have a controlled entity, a joint venture or an associate are not separate financial statements under IPSAS 34. In these cases, entities apply the requirements of other IPSASs for the preparation and presentation of financial statements.

Consolidation Procedures (IPSAS 35)

- Combine assets, liabilities, net assets/equity, revenues, expenses and cash flows
- Eliminate investments in controlled entities
- Eliminate balances and transactions between entities of the economic entity
- If necessary, adjust to conform accounting policies
- If necessary, adjust for significant transactions between financial statement dates
- Identify minority interests in surplus or deficit and net assets/equity

The consolidated financial statements of an economic entity combine the financial statements of the controlling entity and its controlled entities line by line, by adding together like items of assets, liabilities, net assets/equity, revenue, and expenses on a uniform basis of accounting.

In order that the consolidated financial statements present financial information about the economic entity as that of a single entity, the following steps must be taken:

Eliminate the carrying amount of the controlling entity's investment in controlled entities

In order that the consolidated financial statements present financial information about the economic entity as that of a single entity, the carrying amount of the controlling entity's investment in each controlled entity and the controlling entity's portion of net assets/equity of each controlled entity are eliminated.

Adjustments are made to eliminate balances and transactions between entities within the economic entity in full

As the purpose of consolidated financial statements is to present the effects of transactions of the economic reporting entity with organizations and individuals external to that entity, balances and transactions between entities within the economic entity are eliminated in full, including:

a) Revenues from sales and transfers;

b) Revenues recognized consequent to an appropriation or other budgetary authority;

c) Expenses;

d) Dividends or similar distributions; and

e) Surpluses and deficits resulting from transactions within the economic entity that are recognized in assets, such as inventory and fixed assets, are eliminated in full.

Deficits within the economic entity may indicate an impairment that requires recognition in the consolidated financial statements.

If necessary, adjust to conform accounting policies:

Consolidated financial statements shall be prepared using uniform accounting policies for like transactions and other events in similar circumstances. If a member of the economic entity uses accounting policies other than those adopted in the consolidated financial statements for like transactions and events in similar circumstances, appropriate adjustments are made to its financial statements in preparing the consolidated financial statements. This would include making adjustments where a controlled entity does not prepare its financial statements in accordance with IPSASs, for example where a state-owned enterprise prepares its financial statements in accordance with IFRS.

If necessary, adjustment for significant transactions between dates of financial statements used for consolidation

The financial statements of the controlling entity and its controlled entities used in the preparation of the consolidated financial statements should be prepared as of the same reporting date.

When the reporting dates of the controlling entity and a controlled entity are different, the controlling entity either:

a) Obtains, for consolidation purposes, additional financial information as of the same date as the financial statements of the controlling entity; or

b) Uses the most recent financial statements of the controlled entity adjusted for the effects of significant transactions or events that occur between the date of those financial statements and the date of the consolidated financial statements.

Identify non-controlling interests in surplus or deficit and net assets/equity

Non-controlling interests are presented in the consolidated statement of financial position within net assets/equity, separately from the controlling entity's net assets/equity.

The surplus or deficit for the period and each gain or loss recognized directly in net assets/equity are attributed to the owners of the controlling entity and non-controlling interests. The total amount recognized in the statement of changes in net assets/equity is attributed to the owners of the controlling entity and to the non-controlling interests even if this results in the non-controlling interests having a deficit balance.

If a controlled entity has outstanding cumulative preference shares that are classified as equity instruments and are held by non-controlling interests, the entity shall compute its share of surplus or deficit after adjusting for the dividends on such shares, whether or not such dividends have been declared.

Acquisitions, disposals and loss of control (IPSAS 35)

- Revenues and expenses of controlled entity are included from date of acquisition
- Revenues and expenses included until date control ceases during reporting period
- Gain or loss reported on disposal of controlled entity
- If control ceases, the controlled entity is accounted for as financial asset

IPSAS 35 provides guidance on including revenues and expenses of controlled entities either acquired or disposed of during the reporting period and accounting for an entity that ceases to be a controlled entity in the period.

The revenue and expenses of a controlled entity acquired in the reporting period are included in the consolidated financial statements from the acquisition date.

The revenue and expenses of a controlled entity which ceases to be controlled during the reporting period are included in the consolidated financial statements until the date on which the controlling entity ceases to control the controlled entity.

When an entity ceases to be a controlled entity, but the former controlling entity retains an interest in that former controlled entity, the former controlling entity recognizes the investment retained at its fair value, and subsequently accounts for it in accordance with other IPSAS.

The fair value is considered to be either the:

- Fair value on initial recognition of a financial asset in accordance with IPSAS 41; or
- Cost on initial recognition of an investment in an associate or joint venture

When an entity loses control of its former controlled entity, but retains no interest in that entity, the difference between the proceeds from its disposal and its carrying amount as of the date of disposal is recognized as the gain or loss on the disposal of the controlled entity.

Investment Entities (IPSAS 35)

- Fair Value Requirement
  - Exception for controlled entity that provides services related to the investment activities
- Determining Whether an Entity is an Investment Entity
- Judgments and Assumptions
- Accounting for a Change in Investment Entity Status

Fair value requirements

With one exception, an investment entity does not consolidate its controlled entities. Instead, it measures an investment in a controlled entity at fair value through surplus or deficit in accordance with IPSAS 41.

The one exception is where an investment entity has a controlled entity that is not itself an investment entity and whose main purpose and activities are providing services that relate to the investment entity's investment activities. In these circumstances, the investment entity consolidates that controlled entity by following the usual consolidation accounting requirements.

Where the controlling entity of an investment entity is not itself an investment entity, it presents consolidated financial statements in which it:

- Measures the investments of the controlled investment entity at fair value through surplus or deficit in accordance with IPSAS 41; and
- Consolidates the other assets, liabilities, revenue and expenses of the controlled investment entity in accordance with the usual consolidation accounting requirements.

Determining Whether an Entity is an Investment Entity

An entity shall consider all facts and circumstances when assessing whether it is an investment entity, including its purpose and design.

The definition of an investment entity requires that the entity have one or more investors. An investment entity may have several investors who pool their funds to gain access to investment management services and investment opportunities that they might not have had access to individually. Having several investors would make it less likely that the entity, or other members of the economic entity containing the entity, would obtain benefits other than capital appreciation or investment revenue.

However, in the public sector it is also common for an investment entity to be formed by, or for, a single controlling entity that represents or supports the interests of a wider group of investors (e.g., a pension fund, government investment fund or trust).

An investment entity is typically, but is not required to be, a separate legal entity. The investors in an investment entity will often, but not always, have ownership interests in the form of equity or similar interests (e.g., partnership interests), to which proportionate shares of the net assets of the investment entity are attributed.

The definition of an investment entity requires that the purpose of the entity is to invest solely for returns from capital appreciation, investment revenue (such as dividends or similar distributions, interest or rental revenue), or both. Documents that indicate what the entity's investment objectives are, such as the entity's mandate, constitution, offering memorandum, publications distributed by the entity and other corporate or partnership documents, will typically provide evidence of an investment entity's purpose.

An entity that has additional objectives that are inconsistent with the purpose of an investment entity would not meet the definition of an investment entity.

An entity's purpose may change over time. In assessing whether it continues to meet the definition of an investment entity, an entity would need to have regard to any changes in the environment in which it operates and the impact of such changes on its investment strategy.

An entity's investment plans also provide evidence of its purpose. One feature that differentiates an investment entity from other entities is that an investment entity does not plan to hold its investments indefinitely; it holds them for a limited period. In other words, an investment entity will have an exit plan for its investments.

Judgments and Assumptions

Judgment is involved in assessing whether an entity is an investment entity. An investment entity must disclose information about the significant judgments and assumptions made in determining that it is an investment entity, unless it has all of the following characteristics:

a) It has obtained funds from more than one investor;

b) It has ownership interests in the form of equity or similar interests; and

c) It has more than one investment.

The absence of any of these characteristics does not necessarily disqualify an entity from being classified as an investment entity. However, the absence of any of these characteristics means that greater reliance is placed on judgment in in determining that an entity is an investment entity. Consequently, the entity is required to disclose information about the significant judgments and assumptions made in making that determination.

Accounting for a Change in Investment Entity Status

An entity may cease to be an investment entity. In such cases, it applies acquisition accounting in accordance with IPSAS 40, *Public Sector Combinations*, to any controlled entity that was previously measured at fair value through surplus or deficit. The entity uses the date of the change of status as the deemed acquisition date. The fair value of the controlled entity at the deemed acquisition date represents the transferred deemed consideration when measuring any goodwill or gain from a bargain purchase that arises from the deemed acquisition. All controlled entities are consolidated in accordance with the usual consolidation accounting requirements from the date of change of status.

When an entity becomes an investment entity, it shall cease to consolidate its controlled entities at the date of the change in status, with one exception. The exception is a controlled entity that is not itself an investment entity and whose main purpose and activities are providing services that relate to the investment entity's investment activities. IPSAS 35 requires investment entities to consolidate such entities using the usual consolidation accounting requirements. The investment entity applies the requirements of IPSAS 35 in relation to a loss of control to those controlled entities that it ceases to consolidate. In other words, the investment entity accounts for those controlled entities as though it had lost control of those controlled entities at that date.

Investments in Associates and Joint Ventures (IPSAS 36)

- Accounted for using equity method
  - Investment initially recognized at cost
  - Carrying amount adjusted for share of surplus or deficit
  - Carrying amount reduced for distributions received
  - Elimination of unrealized surpluses and deficits
  - Adjusted to conform accounting policies
  - Adjusted for significant transactions between reporting dates
- Tested for impairment
- Accounted for in accordance with IPSAS 44 if associate or joint venture is classified as held-for-sale, or part of a disposal group that is classified as held-for-sale

Subject to the exemption discussed below, an investment in an associate or a joint venture is accounted for using the equity method, in accordance with IPSAS 36. The definitions of an associate, a joint venture, significant influence and a joint control are discussed earlier in this module.

An entity need not apply the equity method to its investment in an associate or a joint venture if the entity is a controlling entity that is exempt from preparing consolidated financial statements under IPSAS 35 or if all of the following apply:

a) The entity itself is a controlled entity and the information needs of users are met by its controlling entity's consolidated financial statements, and, in the case of a partially owned entity, all its other owners, including those not otherwise entitled to vote, have been informed about, and do not object to, the entity not applying the equity method.

b) The entity's debt or equity instruments are not traded in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local and regional markets).

c) The entity did not file, nor is it in the process of filing, its financial statements with a securities commission or other regulatory organization, for the purpose of issuing any class of instruments in a public market.

d) The ultimate or any intermediate controlling entity of the entity produces financial statements available for public use that comply with IPSASs, in which controlled entities are consolidated or are measured at fair value in accordance with IPSAS 35.

Under the equity method:

a) The investment in the associate or joint venture is initially recognized at cost,

b) Subsequently, the carrying amount of the investment is increased or decreased to recognize the investor's share of surplus or deficit of the investee after the date of acquisition

c) The investor's share of the investee's surplus or deficit is recognized in the investor's surplus or deficit for the reporting period.

d) Distributions received from the investee reduce the carrying amount of the investment.

e) Adjustments to the carrying amount may also be necessary for changes in the investor's proportionate interest in the investee arising from changes in the investee's equity that have not been recognized in the investee's surplus or deficit. Such changes include those arising from the revaluation of property, plant and equipment and from foreign exchange translation differences. The investor's share of those changes is recognized in net assets/equity of the investor.

Equity method procedures

Many of the procedures that are appropriate for the application of the equity method are similar to the consolidation procedures described in IPSAS 35. Furthermore, the concepts underlying the procedures used in accounting for the acquisition of a controlled entity are also adopted in accounting for the acquisition of an investment in an associate or a joint venture.

An economic entity's share in an associate or a joint venture is the aggregate of the holdings in that associate or joint venture by the controlling entity and its controlled entities. The holdings of the economic entity's other associates or joint ventures are ignored for this purpose. When an associate or a joint venture has controlled entities, associates or joint ventures, the surplus or deficit and net assets taken into account in applying the equity method are those recognized in the associate's or joint venture's financial statements (including the associate's or joint venture's share of the surpluses or deficits and net assets of its associates and joint ventures), after any adjustments necessary to give effect to uniform accounting policies.

Gains and losses resulting from "upstream" and "downstream" transactions between an entity (including its consolidated controlled entities) and its associate or joint venture are recognized in the entity's financial statements only to the extent of unrelated investors' interests in the associate or joint venture.

"Upstream" transactions are, for example, sales of assets from an associate or a joint venture to the investor. "Downstream" transactions are, for example, sales or contributions of assets from the investor to its associate or its joint venture. The investor's share in the associate's or joint venture's gains or losses resulting from these transactions is eliminated.

When downstream transactions provide evidence of a reduction in the net realizable value of the assets to be sold or contributed, or of an impairment loss of those assets, those losses shall be recognized in full by the investor. When upstream transactions provide evidence of a reduction in the net realizable value of the assets to be purchased or of an impairment loss of those assets, the investor shall recognize its share in those losses.

The contribution of a non-monetary asset to an associate or a joint venture in exchange for an equity interest in the associate or joint venture shall be accounted for as a gain or loss resulting from an upstream or downstream transaction, except when the contribution lacks commercial substance, as that term is described in IPSAS 45, Property, Plant and Equipment. If such a contribution lacks commercial substance, the gain or loss is regarded as unrealized and is not recognized unless, in addition to receiving an equity interest in an associate or a joint venture, an entity receives monetary or non-monetary assets. Such unrealized gains and losses shall be eliminated against the investment accounted for using the equity method and shall not be presented as deferred gains or losses in the entity's consolidated statement of financial position or in the entity's statement of financial position in which investments are accounted for using the equity method.

If, in addition to receiving an equity interest in an associate or a joint venture, an entity receives monetary or non-monetary assets, the entity recognizes in full in surplus or deficit the portion of the gain or loss on the contribution relating to the monetary or non-monetary assets received.

An investment is accounted for using the equity method from the date on which it becomes an associate or a joint venture. On acquisition of the investment, any difference between the cost of the investment and the entity's share of the net fair value of the investee's identifiable assets and liabilities is accounted for as follows:

a) When an entity has included goodwill relating to an associate or a joint venture in the carrying amount of the investment, amortization of that goodwill is not permitted.

b) Any excess of the entity's share of the net fair value of the investee's identifiable assets and liabilities over the cost of the investment is included as revenue in the determination of the entity's share of the associate or joint venture's surplus or deficit in the period in which the investment is acquired.

Appropriate adjustments to the entity's share of the associate's or joint venture's surplus or deficit after acquisition are made in order to account, for example, for depreciation of the depreciable assets based on their fair values at the acquisition date. Similarly, appropriate adjustments to the entity's share of the associate's or joint venture's surplus or deficit after acquisition are made for impairment losses such as for property, plant and equipment or, where relevant, goodwill.

Financial statements used

The most recent available financial statements of the associate or joint venture are used by the entity in applying the equity method. When the end of the reporting period of the entity is different from that of an associate or a joint venture, the entity either:

a) Obtains, for the purpose of applying the equity method, additional financial information as of the same date as the financial statements of the entity; or

b) Uses the most recent financial statements of the associate or joint venture adjusted for the effects of significant transactions or events that occur between the date of those financial statements and the date of the entity's financial statements.

Uniform accounting policies

The entity's financial statements are prepared using uniform accounting policies for like transactions and events in similar circumstances.

If an associate or a joint venture uses accounting policies other than those of the entity for like transactions and events in similar circumstances, the entity needs to make adjustments to the associate's or joint venture's financial statements so that the associate's or joint venture's accounting policies conform to those of the entity when applying the equity method.

There is, however, one exception to this requirement. If an entity has an interest in an associate or a joint venture that is an investment entity, the entity shall, when applying the equity method, retain the fair value measurement applied by that investment entity associate or joint venture to its interest in controlled entities.

If an associate or a joint venture has outstanding cumulative preference shares that are held by parties other than the entity and are classified as equity, the entity computes its share of surplus or deficit after adjusting for the dividends on such shares, whether or not the dividends have been declared.

If an entity's share of the deficit of an associate or a joint venture equals or exceeds its interest in the associate or joint venture, the entity discontinues recognizing its share of further deficits. The interest in an associate or a joint venture is the carrying amount of the investment in the associate or joint venture determined using the equity method together with any long-term interests that, in substance, form part of the entity's net investment in the associate or joint venture. For example, an item for which settlement is neither planned nor likely to occur in the foreseeable future is, in substance, an extension of the entity's investment in that associate or joint venture. Such items may include preference shares and long-term receivables or loans, but do not include trade receivables, trade payables or any long-term receivables for which adequate collateral exists, such as secured loans.

Deficits recognized using the equity method in excess of the entity's investment in ordinary shares are applied to the other components of the entity's interest in an associate or a joint venture in the reverse order of their seniority (i.e. priority in liquidation).

After the entity's interest is reduced to zero, additional deficits are provided for, and a liability is recognized, only to the extent that the entity has incurred legal or constructive obligations or made payments on behalf of the associate or joint venture. If the associate or joint venture subsequently reports surpluses, the entity resumes recognizing its share of those surpluses only after its share of the surpluses equals the share of deficits not recognized.

Impairment losses

After application of the equity method, (including recognizing the associate's or joint venture's deficits), the entity applies IPSAS 41 to determine whether it is necessary to recognize any additional impairment loss with respect to its net investment in the associate or joint venture.

Whenever application of IPSAS 41 indicates that the investment in an associate or a joint venture may be impaired, an entity applies IPSAS 26, *Impairment of Cash-Generating Assets*, and possibly, IPSAS 21, *Impairment of Non-Cash-Generating Assets*. The requirements of IPSAS 21 and IPSAS 26 are discussed in the Assets module.

In determining the value in use of the cash-generating investment in accordance with IPSAS 26, an entity estimates:

a) Its share of the present value of the estimated future cash flows expected to be generated by the associate or joint venture, including the cash flows from the operations of the associate or joint venture and the proceeds from the ultimate disposal of the investment; or

b) The present value of the estimated future cash flows expected to arise from dividends or similar distributions to be received from the investment, and from its ultimate disposal.

Using appropriate assumptions, both methods give the same result.

The recoverable amount of an investment in an associate or a joint venture is assessed for each associate or joint venture, unless the associate or joint venture does not generate cash inflows from continuing use that are largely independent of those from other assets of the entity.

Associates or joint ventures classified as held-for-sale or part of a disposal group classified as held-for-sale

Where an associate or a joint venture is classified as held-for-sale (or is part of a disposal group that is classified as held-for-sale), the entity does not account for its interest in the associate or joint venture using the equity method. Instead, it accounts for its interest in accordance with IPSAS 44 (that is, the interest is measured at the lower of its carrying amount and fair value less costs to sell). The reqreuirements of IPSAS 44 are covered in Module 8, *Presentation*.

Joint Arrangements (IPSAS 37)

- Joint Operation or Joint Venture?
  - No separate vehicle – joint operation
  - Separate vehicle – consider:
    - Structure and legal form
    - Terms
    - Other factors and circumstances
- Accounting for Joint Operations
  - Assets, liabilities, revenue and expenses

IPSAS 37 defines joint control as *"the agreed sharing of control of an arrangement by way of a binding arrangement, which exists only when decisions about the relevant activities require the unanimous consent of the parties sharing control."*

A joint arrangement is an arrangement of which two or more parties have joint control (joint control is discussed earlier in this module). A joint arrangement has the following characteristics:

a) The parties are bound by a binding arrangement; and

b) The binding arrangement gives two or more of those parties joint control of the arrangement.

A joint arrangement can be either a joint operation or a joint venture. To determine the appropriate accounting treatment for a joint arrangement, an entity needs to determine whether the joint arrangement is a joint operation or a joint venture.

Determining the type of joint arrangement

IPSAS 37 defines a joint operation as a joint arrangement whereby the parties that have joint control of the arrangement have rights to the assets, and obligations for the liabilities, relating to the arrangement.

IPSAS 37 defines a joint venture as a joint arrangement whereby the parties that have joint control of the arrangement have rights to the net assets of the arrangement.

The distinction between a joint operation and a joint venture therefore depends on the rights and obligations of the parties with joint control over the joint arrangement.

A joint arrangement that is not structured through a separate vehicle is a joint operation. Where the joint arrangement does not create a separate vehicle, the parties cannot have rights to the net assets of the arrangement. IPSAS 37 defines a separate vehicle as a separately identifiable financial structure, including separate legal entities or entities recognized by statute, regardless of whether those entities have a legal personality.

A joint arrangement in which the assets and liabilities relating to the arrangement are held in a separate vehicle can be either a joint venture or a joint operation. In such cases, an entity has to apply judgment when assessing whether a joint arrangement is a joint operation or a joint venture.

An entity determines the type of joint arrangement in which it is involved by considering its rights and obligations arising from the arrangement. An entity assesses its rights and obligations by considering:

- The structure and legal form of the arrangement;
- The terms agreed by the parties or established by legislative or executive authority; and
- When relevant, other facts and circumstances.

Sometimes the parties are bound by a framework agreement that sets up the general terms for undertaking one or more activities. The framework agreement might set out that the parties establish different joint arrangements to deal with specific activities that form part of the agreement. Even though those joint arrangements are related to the same framework agreement, their type might be different if the parties' rights and obligations differ when undertaking the different activities dealt with in the framework agreement. Consequently, joint operations and joint ventures can coexist when the parties undertake different activities that form part of the same framework agreement.

If facts and circumstances change, an entity shall reassess whether the type of joint arrangement in which it is involved has changed.

Accounting for joint operations

A joint operator recognizes in relation to its interest in a joint operation:

a) Its assets, including its share of any assets held jointly;

b) Its liabilities, including its share of any liabilities incurred jointly;

c) Its revenue from the sale of its share of the output arising from the joint operation;

d) Its share of the revenue from the sale of the output by the joint operation; and

e) Its expenses, including its share of any expenses incurred jointly.

A joint operator account for the assets, liabilities, revenues and expenses relating to its interest in a joint operation in accordance with the IPSASs applicable to the particular assets, liabilities, revenues and expenses.

So for example, property plant and equipment used in the joint operation is accounted for in accordance with IPSAS 45, Property, plant and equipment. Other modules discuss the accounting treatments for different assets, liabilities, revenues and expenses.

IPSAS 37 specifies the accounting for transactions such as the sale, contribution or purchase of assets between an entity and a joint operation in which it is a joint operator:

Sales or Contributions of Assets to a Joint Operation

When an entity enters into a transaction with a joint operation in which it is a joint operator such as a sale or contribution of assets, it is conducting the transaction with the other parties to the joint operation. As such, the joint operator recognizes gains and losses resulting from such a transaction only to the extent of the other parties' interests in the joint operation.

When such transactions provide evidence of a reduction in the net realizable value of the assets to be sold or contributed to the joint operation, or of an impairment loss of those assets, those losses shall be recognized fully by the joint operator.

Purchases of Assets from a Joint Operation

When an entity enters into a transaction with a joint operation in which it is a joint operator such as a purchase of assets, it shall not recognize its share of the gains and losses until it resells those assets to a third party.

When such transactions provide evidence of a reduction in the net realizable value of the assets to be purchased or of an impairment loss of those assets, a joint operator shall recognize its share of those losses.

Party to a joint operation that is not a joint operator

A party that participates in, but does not have joint control of, a joint operation also accounts for its interest in the arrangement as described above if that party has rights to the assets, and obligations for the liabilities, relating to the joint operation. If a party that participates in, but does not have joint control of, a joint operation does not have rights to the assets, and obligations for the liabilities, relating to that joint operation, it accounts for its interest in the joint operation in accordance with the IPSASs applicable to that interest.

Separate Financial Statements (IPSAS 34)

- Not required by IPSAS (election or regulation)
    - Except where exempt from consolidation or applying equity method
- Controlled entities, joint ventures and associates accounted for:
    - At cost
    - In accordance with IPSAS 29/41
    - Using the equity method
- Dividends and similar distributions:
    - Surplus or deficit; or
    - Reduce carrying amount of the investment (equity method)

An entity that is required by IPSAS 35 to prepare consolidated financial statements may also choose (or be required by regulation) to prepare separate financial statements in accordance with IPSAS 34. Consolidated financial statements report the financial position and performance of the economic entity as a whole. Separate financial statements report the financial position and performance of the individual entity that prepares those separate financial statements.

Separate financial statements are those presented by an entity, in which the entity elects (subject to the requirements of IPSAS 34) to account for its investments in controlled entities, joint ventures and associates either:

- At cost;
- In accordance with IPSAS 41; or
- Using the equity method as described in IPSAS 36.

Separate financial statements are those presented in addition to

- Consolidated financial statements; or
- The financial statements of an investor that does not have controlled entities but has investments in associates or joint ventures in which the investments in associates or joint ventures are required by IPSAS 36 to be accounted for using the equity method.

IPSAS 34 prescribes the accounting and disclosure requirements for investments in controlled entities, joint ventures and associates when an entity prepares separate financial statements. IPSAS 34 does not require an entity to prepare separate financial statements. However, when an entity chooses to prepare separate financial statements (or is required to do so by regulation), it must follow the requirements in IPSAS 34.

The financial statements of an entity that does not have a controlled entity, associate or joint venturer's interest in a joint venture are not separate financial statements. An entity that is exempted from preparing consolidated financial statements or from applying the equity method may present separate financial statements as its only financial statements. Where an entity takes advantage of the exemptions and presents separate financial statements as its only financial statements, it discloses that fact, along with details of the entity that has prepared the consolidated financial statements, and details of its controlled entities, joint ventures and associates.

Preparation of separate financial statements

When an entity prepares separate financial statements, it accounts for similar investments in controlled entities, joint ventures and associates either:

a) At cost;
b) In accordance with IPSAS 41; or
c) Using the equity method as described in IPSAS 36.

The entity should apply the same accounting for each category of investments.

Where an entity has investments that are accounted for at cost or using the equity method, these should be accounted for in accordance with IPSAS 44 when they are classified as held for sale or for distribution (or included in a disposal group that is classified as held for sale or for distribution).

Where an entity has investments accounted for in accordance with IPSAS 41, the measurement of these investments is not changed when they are classified as held for sale or for distribution (or included in a disposal group that is classified as held for sale or for distribution).

If a controlling entity is an investment entity (or is the controlling entity of an investment entity) that is required to measure its investment in a controlled entity at fair value through surplus or deficit, it also accounts for that investment in the same way in its separate financial statements.

Dividends or similar distributions from a controlled entity, a joint venture or an associate are recognized in the separate financial statements of an entity when the entity's right to receive the dividend or similar distribution is established. The dividend or similar distribution is recognized in surplus or deficit, unless the entity elects to use the equity method. Where an entity uses the equity method, the dividend or similar distribution is recognized as a reduction from the carrying amount of the investment.

Disclosure Requirements (IPSAS 38)

- Significant judgments and assumptions made
- Information about its interests in:
  - Controlled entities
  - Joint arrangements and associates
  - Structured entities that are not consolidated
  - Non-quantifiable ownership interests
  - Controlling interests acquired with the intention of disposal
  - Current value measurement

IPSAS 38 prescribes the requirements for disclosing information about interests in other entities. Its objective is to require an entity to disclose information that enables users of its financial statements to evaluate:

a) The nature of, and risks associated with, its interests in controlled entities, unconsolidated controlled entities, joint arrangements and associates, and structured entities that are not consolidated; and

b) The effects of those interests on its financial position, financial performance and cash flows.

To meet this objective, an entity discloses:

a) The significant judgments and assumptions it has made in determining:
   (i) The nature of its interest in another entity or arrangement;
   (ii) The type of joint arrangement in which it has an interest; and
   (iii) That it meets the definition of an investment entity, if applicable; and

b) Information about its interest in:
   (i) Controlled entities;
   (ii) Joint arrangements and associates;
   (iii) Structured entities that are not consolidated;
   (iv) Non-quantifiable ownership interests;
   (v) Controlling interests acquired with the intention of disposal; and
   (vi) Current value measurement.

An investment entity discloses information about its unconsolidated controlled entities.

IPSAS 38 sets out the detailed disclosure requirements for each type of interest in another entity. The aim of these disclosures is to provide information to enable users of the entity's financial statements to evaluate:

- The nature, extent and financial effects of the entity's interests in other entities;
- The nature of, and changes in, the risks associated with the entity's interests in other entities; and
- For consolidated financial statements, the interest that non-controlling interests have in the economic entity's activities and cash flows.

Transitional Provisions for First-time Adopters of Accrual-basis IPSASs

Transitional provisions for first-time adopters of accrual-basis IPSASs are provided in IPSAS 33, *First-time Adoption of Accrual Basis International Public Sector Accounting Standards (IPSASs)*. See the First-time Adoption of Accrual Basis IPSAS module for further details.

Questions and Discussion

Visit the IPSASB webpage

http://www.ipsasb.org

That concludes our module on consolidation. Participants should refer to the review questions to test themselves on their knowledge.

Review Questions

Question 1

A public sector entity that prepares financial statements that (a) has controlled entities or (b) does not have controlled entities follows the requirements set out in IPSAS 35, Consolidated Financial Statements.

a) **True or false. Why?**

b) **True or false. Why?**

Question 2

The separate financial statements of government departments, funds, agencies and enterprises are adequate in providing users with the information they need to assess accountability for the management of the financial resources and activities that the government controls.

True or False?

Question 3

Based on the information presented below, does the government control the transportation authority?

Scenario:

A government has established a transportation authority. The transportation authority has assumed many responsibilities previously held by the government. The authority is responsible for the regional transportation network in the metro and regional areas of the jurisdiction, including public transport and major roads and bridges. The authority receives approximately 2/3rds of its funding for operations from a share of the government's fuel taxes and general tax revenues. The remainder of the revenue for operations comes from non-government sources such as fares, advertising and property development. The government contributes toward rapid transit projects. The authority has raised capital through significant borrowings that are guaranteed by the government.

The authority is allowed to operate autonomously; however, the authority's mandate is established by legislation and the government sets the regional transportation vision. The government has the power to appoint and remove a majority of the members of the board of directors of the transportation authority. The government has never exercised this power.

The authority's board of directors is responsible for hiring, compensating, and monitoring the performance of the management and for providing oversight of the authority's strategic planning, finances, major capital projects, and operations. The government has the power to veto operating and capital budgets, including fares and capital financing plans.

Question 4

Consolidated financial statements combine the assets, liabilities, net assets/equity, revenue, and expenses of the controlling entity and its controlled entities by adding together like items of assets, liabilities, net assets/equity, revenue, and expenses.

True or False?

Question 5

Based on the information presented below, prepare the consolidated statement of financial performance and the consolidated statement of financial position of the government.

Scenario:

The Government controls three entities, Entities A, B and C. Entities A and B have been created by legislation to provide government services. The Government provides funding through annual appropriations approved by the legislature. Government does not report an investment in these entities in its separate financial statements. Entity C is a state-owned enterprise without share capital.

At the start of the reporting period, the government entered into a joint venture with another government, and created Entity D. The Government has a 50% interest in Entity D.

Other than funding provided to Entities A and B through appropriations, there were no other inter-organizational transactions. The Government provided CU 116,100 through appropriations, comprised of CU 91,100 to Entity A and CU 25,000 to Entity B. No dividends or similar distributions were paid (or declared) by Entity C or Entity D during the reporting period.

At the end of the reporting period, the Government had outstanding payables (CU 9,110 to Entity A, CU 2,500 to Entity B).

The Government and Entities A, B, C and D use the same accounting policies. The Government accounts for its investments in Entities C and D at cost in its separate financial statements. There are no minority interests in Entity C.

The separate financial statements of each entity are show below:

Statements of financial performance:

	Government	Entity A	Entity B	Entity C	Entity D
Revenue					
Tax revenue	15,123,780				
Appropriations		91,100	25,000		
Non-exchange revenue	15,123,780	91,100	25,000	0	0
Sales				152,050	278,980
Exchange revenue	0	0	0	152,050	278,980
Total Revenue	**15,123,780**	**91,100**	**25,000**	**152,050**	**278,980**
Expenses					
Employees	12,153,690	72,960	17,320	106,430	197,880
Depreciation & amortization	153,200	370	290	18,540	15,650
Utilities	806,790	5,080	1,140	11,210	26,240
General expenses	1,250,320	11,720	5,080	9,780	29,870
Appropriations	116,100				
Finance costs	637,610	600	750	5,740	7,570
Total Expenses	**15,117,710**	**90,730**	**24,580**	**151,700**	**277,210**
Surplus for period	**6,070**	**370**	**420**	**350**	**1,770**

Statements of financial position:

	Government	Entity A	Entity B	Entity C	Entity D
Assets					
Cash & cash equivalents	2,510	170	1,650	890	350
Receivables: Government		9,110	2,500		
Receivables: tax	1,250,220				
Receivables: other				4,280	4,980
Inventories	3,560	80	10	2,510	610
Current assets	1,256,290	9,360	4,160	7,680	5,940
Property, plant & equipment	4,607,940	8,070	9,110	520,750	297,050
Intangible assets		15,880	5,120		2,770
Investment: Entity C	75,000				
Investment: Entity D	35,000				
Non-current assets	4,717,940	23,950	14,230	520,750	299,820
Total Assets	**5,974,230**	**33,310**	**18,390**	**528,430**	**305,760**
Liabilities					
Payables: Entity A	9,110				
Payables: Entity B	2,500				
Payables: other	215,380	940	520	2,090	
Provisions	18,500	150	70	6,500	1,120
Current borrowings	2,514,660	2,070	5,460	80,990	75,930
Current liabilities	2,760,150	3,160	6,050	89,580	77,050
Employee benefit obligations	785,000	19,450	2,500	45,220	39,540
Borrowing	9,467,000	10,310	8,900	100,000	117,400
Non-current liabilities	10,252,000	29,760	11,400	145,220	156,940
Total Liabilities	**13,012,150**	**32,920**	**17,450**	**234,800**	**233,990**
Net Assets (Liabilities)	**(7,037,920)**	**390**	**940**	**293,630**	**71,770**
Net Assets/Equity					
Contributions from owners				75,000	70,000
Accumulated Surplus (deficit)	(7,037,920)	390	940	218,630	1,770
Total Net Assets/Equity	**(7,037,920)**	**390**	**940**	**293,630**	**71,770**

Answers to Review Questions

Question 1

a) ***True***

b) ***False***

IPSAS 35 only applies to a government or other public sector entity which controls other entities. IPSAS 35 requires, except in rare circumstances, such entities to prepare and present consolidated financial statements in which they consolidate controlled entities.

If a public sector entity does not control other entities, then it does not apply the requirements in IPSAS 35. It follows the requirements of other IPSASs as appropriate in preparing its financial statements under the accrual basis of accounting.

The most common situation when a public sector entity that controls other entities may not need to prepare consolidated statements is when it is controlled by another entity such as a government and that other entity prepares consolidated financial statements. Another consideration in that circumstance, which could still mean that consolidated statements are required, is whether there are users of the public sector entity's financial statements who need the information provided in consolidated financial statements. For example, the government's consolidated financial statements provide an overall financial picture of all its controlled entities (the economic entity), but there may still be users that need information about the group of entities providing education services and controlled by the Ministry of Education, with the result that the Ministry would provide consolidated financial statements, even though it is controlled by the government.

If the entity does not need to prepare consolidated statements then it may still prepare separate financial statements in which it accounts for controlled and jointly controlled entities and associates in accordance with IPSAS 34, *Separate Financial Statements*.

Question 2

False

While the financial statements of individual departments, funds, agencies and enterprises prepared by their respective managements are important accountability documents, they do not on their own provide the public and other users with an understandable overview of the full nature and extent of the financial resources and activities that the government controls.

The objectives of a government's or other public sector entity's general purpose financial statements are to provide an accounting of the full nature and extent of the financial activities and resources that the reporting entity controls, including those related to the activities of its controlled agencies and enterprises. Consolidated financial statements are prepared for an economic entity as if it were a single entity. This allows users to understand the operations of the reporting entity and assess accountability for the use and management of resources entrusted to it. Consolidated financial statements also provide information that is useful for decision making purposes.

Question 3

The authority is controlled by the government.

The government has the power to direct the relevant activities of the authority. The authority's mandate is established by legislation and the government sets the regional transportation vision. The government has the power to appoint and remove members of the board of directors. The fact that it has not chosen to exercise its power is not relevant to the question of control. It has the right to veto operating and capital budgets.

The government has exposure, or rights, to variable benefits from its involvement with the authority. The government's ability to direct the authority to cooperate with it in achieving its transportation objectives provides it with non-financial benefits. The government is exposed to the residual liabilities of the authority because it has guaranteed its significant capital debt. The government is therefore also exposed, or has rights, to financial benefits

The government has the ability to use its power over the authority to affect the nature or amount of the benefits from its involvement with the authority. By setting the regional transport vision, the government can influence the services provided by the authority. The government can also influence the nature or amount of the financial benefits it receives through its power to veto operating and capital budgets, including fares and capital financing plans

The government therefore has power over the authority; exposure, or rights, to variable benefits from its involvement with the authority; and the ability to use its power over the authority to affect the nature or amount of the benefits from its involvement with the authority. It therefore controls the authority in accordance with IPSAS 35.

Question 4

Partly true.

The objective of consolidated financial statements is to present financial information about the group of controlled entities and the controlling entity, that is, the "economic entity" as if it were a single entity. In order to do this, the assets, liabilities, revenues and expenses are added together line-by-line. But in addition to this, transactions within the group must be removed, so that only the effects of transactions of the economic entity with organizations and individuals external to that entity are included. In order to remove the impact of transactions within the group, the following adjustments are made:

a) The carrying amounts of the controlling entity's investment in each controlled entity and the controlling entity's portion of net assets/equity of each controlled entity are eliminated

b) Balances and transactions between entities within the economic entity are eliminated in full.

In addition to the adjustments in (a) and (b), it is also necessary to:

c) Conform the accounting policies of controlled entities to those of the controlling entity.

d) Separately identify (when applicable) the minority interests in the surplus or deficit for the reporting period and the net assets/equity of consolidated controlled entities.

e) If the financial statements of a controlled entity are prepared for a different reporting date, make adjustments for the effects of significant transactions or events that occur between that date and the reporting date of the controlling entity.

Question 5

The following tables show a worked example, using three steps. These steps do not have to be followed in this order.

Step 1: Combine the totals for the Government and the controlled entities

At this stage, no adjustments to eliminate intra-economic entity transactions are made.

Statement of financial performance:

	Government	Entity A	Entity B	Entity C	Total
Revenue					
Tax revenue	15,123,780				15,123,780
Appropriations		91,100	25,000		116,100
Non-exchange revenue	15,123,780	91,100	25,000	0	15,239,880
Sales				152,050	152,050
Exchange revenue	0	0	0	152,050	152,050
Total Revenue	**15,123,780**	**91,100**	**25,000**	**152,050**	**15,391,930**
Expenses					
Employees	12,153,690	72,960	17,320	106,430	12,350,400
Depreciation & amortization	153,200	370	290	18,540	172,400
Utilities	806,790	5,080	1,140	11,210	824,220
General expenses	1,250,320	11,720	5,080	9,780	1,276,900
Appropriations	116,100				116,100
Finance costs	637,610	600	750	5,740	644,700
Total Expenses	**15,117,710**	**90,730**	**24,580**	**151,700**	**15,384,720**
Surplus for period	**6,070**	**370**	**420**	**350**	**7,210**

Statement of financial position:

	Government	Entity A	Entity B	Entity C	Total
Assets					
Cash & cash equivalents	2,510	170	1,650	890	5,220
Receivables: Government		9,110	2,500		11,610
Receivables: tax	1,250,220				1,250,220
Receivables: other				4,280	4,280
Inventories	3,560	80	10	2,510	6,160
Current assets	1,256,290	9,360	4,160	7,680	1,277,490
Property, plant & equipment	4,607,940	8,070	9,110	520,750	5,145,870
Intangible assets		15,880	5,120		21,000
Investment: Entity C	75,000				75,000
Investment: Entity D	35,000				35,000
Non-current assets	4,717,940	23,950	14,230	520,750	5,276,870
Total Assets	**5,974,230**	**33,310**	**18,390**	**528,430**	**6,554,360**
Liabilities					
Payables: Entity A	9,110				9,110
Payables: Entity B	2,500				2,500
Payables: other	215,380	940	520	2,090	218,930
Provisions	18,500	150	70	6,500	25,220
Current borrowings	2,514,660	2,070	5,460	80,990	2,603,180
Current liabilities	2,760,150	3,160	6,050	89,580	2,858,940
Employee benefit obligations	785,000	19,450	2,500	45,220	852,170
Borrowing	9,467,000	10,310	8,900	100,000	9,586,210
Non-current liabilities	10,252,000	29,760	11,400	145,220	10,438,380
Total Liabilities	**13,012,150**	**32,920**	**17,450**	**234,800**	**13,297,320**
Net Assets (Liabilities)	**(7,037,920)**	**390**	**940**	**293,630**	**(6,742,960)**
Net Assets/Equity					
Contributions from owners				75,000	75,000
Accumulated Surplus (deficit)	(7,037,920)	390	940	218,630	(6,817,960)
Total Net Assets/Equity	**(7,037,920)**	**390**	**940**	**293,630**	**(6,742,960)**

Step 2: Eliminate the intra-economic entity transactions and balances

The following intra-economic entity transactions and balances are eliminated:

- Appropriations between the Government and Entities A and B
- Outstanding payables/receivables in respect of appropriations
- Government investment in Entity C

Adjustments to statement of financial performance:

	Previous Total	Appropriations	Receivables & Payables	Investment	Adjusted Total
Revenue					
Tax revenue	15,123,780				15,123,780
Appropriations	116,100	(116,100)			0
Non-exchange revenue	15,239,880	(116,100)	0	0	15,123,780
Sales	152,050				152,050
Exchange revenue	152,050	0	0	0	152,050
Total Revenue	**15,391,930**	**(116,100)**	**0**	**0**	**15,275,830**
Expenses					
Employees	12,350,400				12,350,400
Depreciation & amortization	172,400				172,400
Utilities	824,220				824,220
General expenses	1,276,900				1,276,900
Appropriations	116,100	(116,100)			0
Finance costs	644,700				644,700
Total Expenses	**15,384,720**	**(116,100)**	**0**	**0**	**15,268,620**
Surplus for period	**7,210**	**0**	**0**	**0**	**7,210**

Adjustments to statement of financial performance:

	Previous Total	Approp- riations	Receivables & Payables	Investment	Adjusted Total
Assets					
Cash & cash equivalents	5,220				5,220
Receivables: Government	11,610		(11,610)		0
Receivables: tax	1,250,220				1,250,220
Receivables: other	4,280				4,280
Inventories	6,160				6,160
Current assets	1,277,490	0	(11,610)	0	1,265,880
Property, plant & equipment	5,145,870				5,145,870
Intangible assets	21,000				21,000
Investment: Entity C	75,000			(75,000)	0
Investment: Entity D	35,000				35,000
Non-current assets	5,276,870	0	0	(75,000)	5,201,870
Total Assets	**6,554,360**	**0**	**(11,610)**	**(75,000)**	**6,467,750**
Liabilities					
Payables: Entity A	9,110		(9,110)		0
Payables: Entity B	2,500		(2,500)		0
Payables: other	218,930				218,930
Provisions	25,220				25,220
Current borrowings	2,603,180				2,603,180
Current liabilities	2,858,940	0	(11,610)	0	2,847,330
Employee benefit obligations	852,170				852,170
Borrowing	9,586,210				9,586,210
Non-current liabilities	10,438,380	0	0	0	10,438,380
Total Liabilities	**13,297,320**	**0**	**(11,610)**	**0**	**13,285,710**
Net Assets (Liabilities)	**(6,742,960)**	**0**	**0**	**(75,000)**	**(6,817,960)**
Net Assets/Equity					
Contributions from owners	75,000			(75,000)	0
Accumulated Surplus (deficit)	(6,817,960)				(6,817,960)
Total Net Assets/Equity	**(6,742,960)**	**0**	**0**	**(75,000)**	**(6,817,960)**

Step 3: Apply equity method of accounting for Entity D (joint venture)

The Government jointly controls Entity D, and has a 50% interest in the entity. The Government recognizes its share of Entity D's surplus for the period in Surplus or Deficit, and increases the carrying amount of its investment in Entity D by its share of Entity D's surplus.

Adjustments to statement of financial performance:

	Previous Total	Share of Surplus	Consolidated Statement of Financial Performance
Revenue			
Tax revenue	15,123,780		15,123,780
Appropriations	0		0
Non-exchange revenue	15,123,780	0	15,123,780
Sales	152,050		152,050
Exchange revenue	152,050	0	152,050
Total Revenue	**15,275,830**	**0**	**15,275,830**
Expenses			
Employees	12,350,400		12,350,400
Depreciation & amortization	172,400		172,400
Utilities	824,220		824,220
General expenses	1,276,900		1,276,900
Appropriations	0		0
Finance costs	644,700		644,700
Total Expenses	**15,268,620**	**0**	**15,268,620**
Share of surplus of joint venture	**0**	**885**	**885**
Surplus for period	**7,210**	**885**	**8,095**

Adjustments to statement of financial position:

	Previous Total	Share of Surplus	Consolidated Statement of Financial Position
Assets			
Cash & cash equivalents	5,220		5,220
Receivables: Government	0		0
Receivables: tax	1,250,220		1,250,220
Receivables: other	4,280		4,280
Inventories	6,160		6,160
Current assets	1,265,880	0	1,265,880
Property, plant & equipment	5,145,870		5,145,870
Intangible assets	21,000		21,000
Investment: Entity C	0		0
Investment: Entity D	35,000	885	35,885
Non-current assets	5,201,870	885	5,202,755
Total Assets	**6,467,750**	**885**	**6,468,635**
Liabilities			
Payables: Entity A	0		0
Payables: Entity B	0		0
Payables: other	218,930		218,930
Provisions	25,220		25,220
Current borrowings	2,603,180		2,603,180
Current liabilities	2,847,330	0	2,847,330
Employee benefit obligations	852,170		852,170
Borrowing	9,586,210		9,586,210
Non-current liabilities	10,438,380	0	10,438,380
Total Liabilities	**13,285,710**	**0**	**13,285,710**
Net Assets (Liabilities)	**(6,817,960)**	**885**	**(6,817,075)**
Net Assets/Equity			
Contributions from owners	0		0
Accumulated Surplus (deficit)	(6,817,960)	885	(6,817,075)
Total Net Assets/Equity	**(6,817,960)**	**885**	**(6,817,075)**

Public Sector Combinations

Learning Objective

- Be able to identify public sector combinations
- Be able to classify public sector combinations as either an amalgamation or an acquisition
- Understand how to account for amalgamations
- Understand how to account for acquisitions.

Public Sector Combinations

A public sector combination is the bringing together of separate operations into one public sector entity.

An operation is an integrated set of activities and related assets and/or liabilities that is capable of being conducted and managed for the purpose of achieving an entity's objectives, by providing goods and/or services.

IPSAS 40, *Public Sector Combinations*, defines a public sector combination as "the bringing together of separate operations into one public sector entity."

The scope of IPSAS 40 includes all transactions or other events that meet the definition of a public sector combination–any transaction or other event that brings together separate operations into one public sector entity.

A key feature of the definition of a public sector combination is that it brings together operations. It is therefore important to understand what constitutes an operation.

IPSAS 40 defines an operation as "an integrated set of activities and related assets and/or liabilities that is capable of being conducted and managed for the purpose of achieving an entity's objectives, by providing goods and/or services."

An operation consists of inputs–and processes that are applied to those inputs–that have the ability to create outputs. Although operations usually have outputs, outputs are not required for an integrated set of activities and related assets and/or liabilities to qualify as an operation. The three elements of an operation are defined in IPSAS 40 as follows:

a) Input: Any economic resource that creates, or has the ability to create, outputs when one or more processes are applied to it.

b) Process: Any system, standard, protocol, convention or rule that when applied to an input or inputs, creates or has the ability to create outputs.

c) Output: The result of inputs and processes applied to those inputs that provide, or have the ability to provide, goods and/or services.

Examples of operations include entities, functions of an entity and geographical areas of an entity.

Examples

Public Sector Combinations

- Nationalizations:
  - Purchases
  - Seizures
  - Bailouts
- Reorganizations of local or regional governments
- Transfers of operations from one government to another
- Restructurings of central government ministries

Not Public Sector Combinations

- Transactions that do not include operations
- Joint arrangements

Public sector combinations can involve whole entities, for example where a company is nationalized as a result of a bailout. Such combinations occurred in some countries following both the financial crisis and the COVID-19 pandemic.

Public sector combinations can also involve functions of an entity, for example where a function of one government ministry is transferred to another government ministry; and geographical areas, for example where a reorganization of local government results in a new entity being formed from areas transferred from other entities.

If the assets and liabilities involved in a transaction or other event do not constitute an operation, the transaction or other event is not a public sector combination. Such transactions or other events are accounted for in accordance with other IPSAS.

Joint arrangements are not public sector combinations because they do not result in an entity gaining control over operations. Entities have joint control, not control, over joint arrangements.

Discussion Question

A public sector entity purchases a site to be used for landfill waste disposal. The purchase includes the land and buildings on the site. The public sector entity assumes the liability to restore the site at the end of its useful life. No staff or processes are transferred as a result of the purchase.

Does the purchase of the landfill waste disposal site constitute a public sector combination? Explain your reasoning.

Answer:

The purchase of the landfill waste disposal site does not constitute a public sector combination.

A public sector combination is the bringing together of separate operations into one public sector entity.

An operation is an integrated set of activities and related assets and/or liabilities. In this case, no activities are included in the purchase; only assets and a liability are transferred, and therefore the purchase does not involve an operation.

If follows that, as the purchase does not involve an operation, it cannot be a public sector combination, which is the bringing together of separate operations.

Types of Public Sector Combination

An **amalgamation** gives rise to a resulting entity and is either:

a) A public sector combination in which no party to the combination gains control of one or more operations; or

b) A public sector combination in which one party to the combination gains control of one or more operations, and in which there is evidence that the combination has the economic substance of an amalgamation.

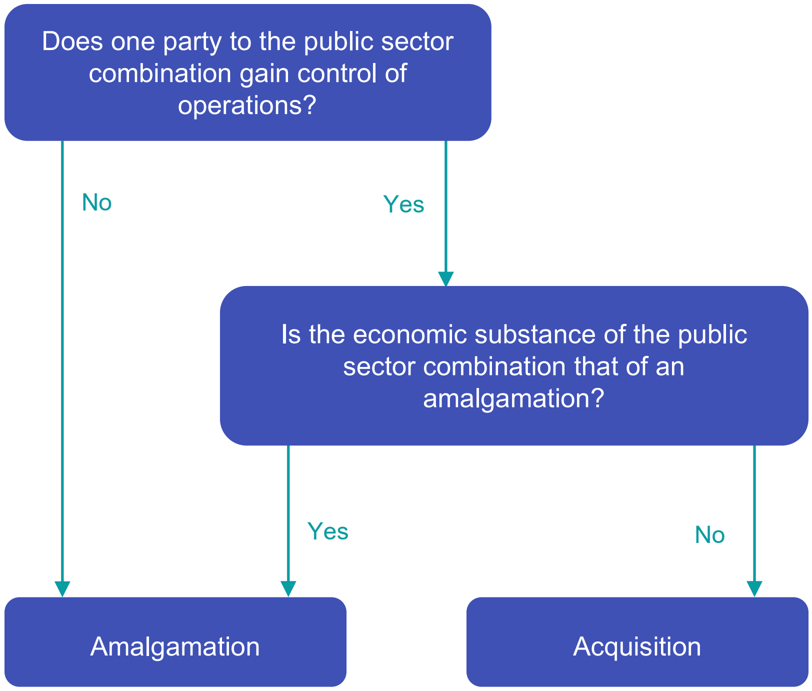
An **acquisition** is a public sector combination in which one party to the combination gains control of one or more operations, and there is evidence that the combination is not an amalgamation.

Under IPSAS 40, there are two types of public sector combination – amalgamations and acquisitions.

Because the two types of public sector combination are accounted for using different methods, it is important to be able to distinguish between amalgamations and acquisitions.

IPSAS 40 provides guidance on distinguishing between amalgamations and acquisitions.

Classification of Public Sector Combinations



The diagram above summarizes the factors that are used to determine whether a public sector combination should be classified as an amalgamation or an acquisition.

The first factor is **control**. If no party to a public sector combination gains control of one or more operations as a result of the combination, the combination shall be classified as an amalgamation.

The second factor is the **economic substance of the transaction**. If one party to a public sector combination gains control of one or more operations as a result of the combination, then the entity that gains control needs to consider the economic substance of the combination in classifying the combination as either an amalgamation or an acquisition. A combination in which one party gains control of one or more operations is classified as an acquisition, unless it has the economic substance of an amalgamation. Determining the economic substance of a combination requires the entity to exercise professional judgment.

Entity Gains Control

An entity ***gains control*** of an operation if and only if the entity ***gains*** all the following:

a) Power over the operation

b) Exposure, or rights, to variable benefits from its involvement with the operation

c) The ability to use its power over the operation to affect the nature or amount of the benefits from its involvement with the operation

The principles and guidance in IPSAS 35 are used in determining whether one party to a public sector combination gains control of one or more operations as a result of the combination. Under IPSAS 40, the test is whether control is gained; and the control gained can relate to an operation, rather than being limited to a whole entity.

For further details of the control test, see the discussion of control in IPSAS 35 earlier in this module.

A public sector combination effected primarily by the transfer of consideration (i.e., by transferring cash or other assets or by incurring liabilities) usually results in one entity gaining control of one or more operations.

The gaining of control of operations by a party to the combination is an essential element of an acquisition, but is not sufficient in itself to determine whether a combination is an acquisition.

Where one party to a public sector combination gains control of one or more operations as a result of the combination, the entity that gains control considers the economic substance of the combination in determining the appropriate classification.

Assessing the Economic Substance of a Combination

- Consideration
  - Other than to compensate for transfer of net assets
  - No consideration paid
  - No (former) owners
- Decision Making
  - Under common control
  - Imposed by third party
  - Approval by referenda

The factors that are taken into account when assessing the economic substance of a combination are consideration (the payment of cash or another asset) and decision making.

Indicators relating to consideration

The combination may be an amalgamation where:

- Consideration is paid for reasons other than to compensate those with an entitlement to the net assets of a transferred operation for giving up that entitlement;
- Consideration is not paid to those with an entitlement to the net assets of a transferred operation; or
- Consideration is not paid because there is no-one (whether an individual or an entity) with an entitlement to the net assets of a transferred entity.

Indicators relating to the decision-making process

The combination may be an amalgamation where:

- A public sector combination is imposed by a third party without any party to the combination being involved in the decision-making process;
- A public sector combination is subject to approval by each party's citizens through referenda; or
- A combination of operations under common control occurs.

These indicators, individually or in combination, will usually provide evidence of whether the economic substance of the combination is that of an amalgamation. A combination does not need to satisfy both of these indicators to be classified as an amalgamation.

Unlike the private sector, amalgamations are common in the public sector.

Example 1

The territorial boundaries of two existing municipalities, A and B, are redrawn by Parliament through legislation; neither Parliament nor Central Government controls A or B. Responsibility for part of each municipality's former territory is transferred to a new municipality, C. Operations in respect of the transferred territories are combined to form C.

A and B remain otherwise unchanged and retain their governing bodies. A new governing body (unrelated to the governing bodies of A and B) is elected for C to manage the operations that are transferred from the other municipalities.

Should this public sector combination be classified as an amalgamation or an acquisition?

Answer:

In determining whether this should be classified as an amalgamation or an acquisition, the first question to consider is whether one of the parties to the combination has gained control of operations as a result of the combination.

C has a newly elected governing body, unrelated to the governing bodies of A and B. Neither A nor B has power over the C. Neither do they have exposure, or rights, to variable benefits from any involvement with C.

Neither A nor B have gained control over C as a result of the public sector combination. Consequently, the combination is classified as an amalgamation.

Example 2

The Primary School Nutrition operation is transferred from the Government's Department of Health to its Department of Education. Both departments are controlled by the Government prior to and after the combination.

As the Government controls the same operations both before and after the public sector combination, the Government does not report a combination in its consolidated financial statements. The combination is reported by the Department of Education.

Should this public sector combination be classified as an amalgamation or an acquisition?

Answer:

In determining whether this should be classified as an amalgamation or an acquisition, the first question the Department of Education considers is whether one of the parties to the combination has gained control of operations as a result of the combination.

In this scenario, the Department of Education gains:

a) Power over the Primary School Nutrition operation;

b) Exposure, or rights, to variable benefits from its involvement with that operation; and

c) The ability to use its power over that operation to affect the nature or amount of the benefits from its involvement with that operation.

The Department of Education concludes that, as a result of the public sector combination, it has gained control of the Primary School Nutrition operation. It then considers whether the economic substance of the combination is that of an amalgamation.

In considering the economic substance of the public sector combination, the Department of Education notes that it obtains access to economic benefits or service potential that are similar to those that could have been obtained in a voluntary transaction; this may suggest that the economic substance of the combination is that of an acquisition.

In considering the indicators relating to consideration, the Department of Education notes that the public sector combination does not include the payment of consideration because the combination took place under common control, and the Government, the controlling entity, did not specify any consideration in the terms of the combination. Consequently, although the absence of consideration may suggest that the economic substance of the combination is that of an amalgamation, this is not of itself conclusive and other factors also need to be taken into account.

In considering the indicators relating to the decision-making process, the Department of Education notes that the public sector combination takes place under common control. The combination was directed by the Government. This provides evidence that the ultimate decision as to whether the combination took place, and the terms of the combination, are determined by the Government, the controlling entity. This provides evidence that the economic substance of the combination is that of an amalgamation.

Taking these factors together, the Department of Education considers that the public sector combination should be classified as an amalgamation. In coming to this decision, the fact that the public sector combination takes place under common control is considered to be the most significant factor in determining the economic substance of the combination.

Accounting for Amalgamations

The resulting entity accounts for each amalgamation by applying the **modified pooling of interests** method of accounting.

The resulting entity is the entity that is the result of two or more operations combining in an amalgamation.

The **resulting entity** accounts for each amalgamation by applying the modified pooling of interests method of accounting.

The resulting entity is defined as “the entity that is the result of two or more operations combining in an amalgamation.”

The modified pooling of interests method of accounting is a variation of the pooling of interests method of accounting (sometimes referred to as “merger accounting”) in which the amalgamation is recognized on the date it takes place.

Modified Pooling of Interests Method

- Identify the resulting entity
- Determine the amalgamation date
- Recognize and measure the assets received, the liabilities assumed and any non-controlling interest in the combining operations; and
- Recognize and measure components of net assets/equity and other adjustments.

Applying the modified pooling of interests method of accounting requires:

- Identifying the resulting entity;
- Determining the amalgamation date;
- Recognizing and measuring the assets received, the liabilities assumed and any non-controlling interest in the combining operations; and
- Recognizing and measuring components of net assets/equity and other adjustments.

The resulting entity:

- Recognizes the assets, liabilities and any non-controlling interests that are recognized in the financial statements of the combining operations as at the amalgamation date; and
- Measures them at their carrying amounts in the financial statements of the combining operations.

The carrying amounts are adjusted to conform to the resulting entity's accounting policies (and in other limited circumstances, for example tax forgiveness). An example of where this would be necessary is where one combining operation previously measured land and buildings under the historical cost model, while another combining operation used the current value model. After the amalgamation, the same accounting policy has to be applied by the resulting entity.

The modified pooling of interests method of accounting recognizes the amalgamation on the date it takes place. As a consequence, no comparative information is required.

Components of net assets/equity

The resulting entity recognizes the difference between the assets and liabilities assumed in an amalgamation as one or more components of net assets/equity. IPSAS 40 does not specify which components of net assets/equity should be used; this is a matter for the professional judgment of the reporting entity.

In determining which components of net assets/equity should be reported, a reporting entity will take into account issues such as:

- What information will be most relevant to the users of the financial statements;
- Whether the reporting entity is, in substance, a new entity; and
- Whether existing reserves of the combining operations (for example, hedging reserves) are required to comply with other IPSAS.

Prior period information

IPSAS 40 permits, but does not require, a reporting entity to present prior period information. Where a reporting entity elects to present prior period information, this information is not restated. The reporting entity explains the basis on which this information is presented.

Accounting for Acquisitions

- The acquirer accounts for each acquisition by applying the **acquisition method** of accounting.
- The acquirer is the entity that gains control of one or more operations in an acquisition.

Acquisition Method

- Identify the acquirer;
- Determine the acquisition date;
- Recognize and measure the identifiable assets acquired, the liabilities assumed and any non-controlling interest in the acquired operation; and
- Recognize and measure goodwill, a gain or a loss from an acquisition.

The acquisition method of accounting adopted in IPSAS 40 is that set out in IFRS 3, *Business Combinations*, supplemented by additional guidance for public sector specific circumstances.

The acquirer recognizes, separately from any goodwill recognized, the identifiable assets acquired, the liabilities assumed and any non-controlling interest in the acquired operation. This may include items not previously recognized by the acquired operation.

Goodwill is defined as "an asset representing the future economic benefits arising from other assets acquired in an acquisition that are not individually identified and separately recognized."

The acquirer measures the identifiable assets acquired and the liabilities assumed at their acquisition-date fair values (as defined in IPSAS 46, *Measurement*). IPSAS 46 provides guidance on measuring assets and liabilities at fair value (see Module 10 for further details).

IPSAS 40 provides limited exceptions to these recognition and measurement principles. For example, contrary to IPSAS 19, *Provisions, Contingent Liabilities and Contingent Assets*, the acquirer recognizes a contingent liability assumed in an acquisition where consideration is transferred.

Goodwill, loss or gain from a bargain purchase

Goodwill is usually recognized only where consideration is transferred (or there is an exchange of equity instruments, which is not common in the public sector).

Goodwill is measured as the excess of:

- The aggregate of:
  - The consideration transferred;
  - The amount of any non-controlling interest in the acquired operation; and
  - In an acquisition achieved in stages, the fair value of the acquirer's previously held equity interest.

  over
- The net of the amounts of the identifiable assets acquired and the liabilities assumed.

Goodwill is only recognized to the extent that the acquisition will result in the generation of cash inflows or a reduction in the net cash outflows of the acquirer. Any additional excess is recognized as a loss.

In a bargain purchase, the net of the amounts of the identifiable assets acquired and the liabilities assumed may exceed any consideration paid. The acquirer recognizes the resulting gain in surplus or deficit.

Disclosures

- The resulting entity discloses information that enables users of its financial statements to evaluate the nature and financial effect of an amalgamation
- The acquirer discloses information that enables users of its financial statements to evaluate the nature and financial effect of an acquisition that occurs either:
    - During the current reporting period; or
    - After the end of the reporting period but before the financial statements are authorized for issue

IPSAS 40 includes detailed disclosure requirements to enable users of the financial statements to evaluate the nature and financial effect of a public sector combination.

The requirements are too detailed for this training module; if further detail is required, please refer directly to IPSAS 40.

Questions and Discussion

Visit the IPSASB webpage

http://www.ipsasb.org

That concludes our module on public sector combinations. Participants should refer to the review questions to test themselves on their knowledge.

Review Questions

Question 1

On 30 June 20X5 Resulting Entity (RE) is formed by an amalgamation of two municipalities, Combining Operation A (COA) and Combining Operation B (COB). Four years previously, COA had provided COB with a ten-year, fixed interest rate loan of CU250. Interest on the loan is payable annually, with the principal repayable on maturity.

COB has recently experienced financial difficulties, and at the amalgamation date was in arrears on making the interest payments. The carrying amount of the financial liability (the amortized cost of the loan) in its financial statements at the amalgamation date is CU260.

Because of the arrears and the fact that COB was experiencing financial difficulties, COA had impaired the loan. The carrying amount of the financial asset (the loan) in its financial statements at the amalgamation date is CU200.

At the amalgamation date, the statements of financial position of COA and COB contained the following line items:

	COA	COB
Financial assets	4,957	2,256
Financial liablities	(3,085)	(1,921)
Net asset/equity	1,209	(2,883)

What amount should RE report in its opening statement of financial position in respect of these line items?

Question 2

A government defense agency acquires a defense company for CU1,800,000. The carrying amounts reported in the company's statement of financial position at the acquisition date, and the fair value of the items at that date, are shown below.

	Carrying Amount CU (000s)	Fair Value CU (000s)
Cash	200	200
Receivables	350	350
Financial assets	1,241	1,241
Land and buildings	2,994	4,019
Intangible assets	100	100
Payables	(545)	(545)
Financial liabilities	(3,962)	(3,962)
Provisions	(35)	(35)

In addition, the company is developing new software. The software is currently in the research phase and consequently the company has expensed all expenditure. The carrying amount of the software is zero; its fair value is CU 140,000

What goodwill does the agency recognize on acquiring the company?

Answers to Review Questions

Question 1

At the amalgamation date, RE eliminates the financial asset received from COA and the financial liability assumed from COB and credits components of net assets/equity with CU60, the difference between the carrying amounts of the financial asset and the financial liability associated with the loan.

The amounts for each of the line items reported are as follows:

	COA	COB	Adjustments	RE
Financial assets	4,957	2,256	-200	7,013
Financial liabilities	-3,085	-1,921	260	-4,746
Net asset/equity	-1,209	2,883	-60	1,614

Question 2

The agency recognizes the identifiable assets acquired, and liabilities assumed, and measures them at fair value. This includes an intangible asset for the software not previously recognized by the company.

Goodwill is defined as "an asset representing the future economic benefits arising from other assets acquired in an acquisition that are not individually identified and separately recognized." Goodwill is measured as the difference between the consideration paid and the net assets recognized:

The agency recognizes goodwill of 292,000, calculated as follows:

	Fair Value of Items Recognized by Company CU (000s)	Fair Value of Items not Recognized by Company CU (000s)	Fair Value of Items Recognized by Agency CU (000s)
Cash	200		200
Receivables	350		350
Financial assets	1,241		1,241
Land and buildings	4,019		4,019
Intangible assets	100	140	240
Payables	(545)		(545)
Financial liabilities	(3,962)		(3,962)
Provisions	(35)		(35)
Net Assets			**1,508**
Consideration Paid			**(1,800)**
Goodwill			**292**