



THE TREASURY

Kaitohutohu Kaupapa Rawa

12 July 2016

AC-4-5-14

Mr John Stanford
The Technical Director
International Public Sector Accounting Standards Board
International Federation of Accountants
529 Fifth Avenue, 6th Floor
New York, NY 10017 United States of America

Dear John

ED 60: Public Sector Combinations

The New Zealand Treasury welcomes the opportunity to provide comments to the International Public Sector Accounting Standards Board on ED 60 *Public Sector Combinations*.

We are pleased that the IPSASB is addressing this issue and are supportive of an approach that differentiates between amalgamations and acquisitions. However, we do have some concerns with the modified pooling of interest method of accounting for amalgamations in relation to the:

- proposed treatment of a single residual amount, and
- lack of flexibility around prior-year comparatives.

We have attached our responses to the specified matters for comment.

Yours sincerely

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ATTACHMENT

Specific Matter for Comment 1:

Do you agree with the scope of the Exposure Draft? If not, what changes to the scope would you make?

We agree with the scope of the standard applying to transactions or other events that meet the definition of a public sector combination.

Specific Matter for Comment 2:

Do you agree with the approach to classifying public sector combinations adopted in this Exposure Draft (see paragraphs 7–14 and AG10–AG50)? If not, how would you change the approach to classifying public sector combinations?

We agree that the classification of a public sector combination should reflect the economic substance of the combination and that it is appropriate to consider them as either amalgamations or acquisitions.

However the approach to determining the classification seems overly complicated to us and we are not convinced that the question about gaining control "*did one party to the combination gain control of one or more of the operations?*" needs to be included as the first step in the decision process. We are particularly uneasy that ED 60 requires an assessment of control being gained in a combination based on IPSAS 35 *Consolidated Financial Statements*, which focuses on whether control exists at a point. We note that in order to use the guidance in IPSAS 35, ED 60 requires that the words in IPSAS 35 "the entity controls" should be read as the "entity gains control" and "another entity" is to be read as "an operation". We think that this may lead to interpretation difficulties in practice.

Although there may be interpretation difficulties, we think that combination transactions in the public sector, particularly under common control, will be appropriately classified as amalgamations. In our experience one entity often gains control of another in a restructure of entities under common control, but the presumption that it is an acquisition is expected to be rebutted by working through the indicators relating to decision-making and consideration. For this reason we are cautiously supportive of the classification approach in ED 60.

We also support the ISASB's "belt and braces" approach by including paragraph 11 which states that if after applying the indicators related to consideration and decision making, the results are inconclusive as to whether it's an acquisition or amalgamation, an entity also considers which classification would provide information that best meets the objectives of financial reporting and that best satisfies the qualitative characteristics. Having this guidance at a standards level for borderline combinations in terms of classification is a welcome addition.

We suggest the IPSASB consider a post implementation review of this standard when it has been effective for an appropriate period of time. With the possibility of interpretation difficulties, varied feedback from constituents through the due process up to the development of ED 60 and the changing debate during development of the classification approach (as described in the Basis of Conclusion, paragraph BC 15 to 39) applying the approach developed in ED 60 may not be as straight forward as the IPSASB intends.

Specific Matter for Comment 3:

Do you agree that the modified pooling of interests method of accounting should be used in accounting for amalgamations? If not, what method of accounting should be used?

We support the modified pooling of interest method of accounting, but with two further proposed modifications:

- A different approach to accounting for the residual amount as noted in our response to Specific Matter for Comment 4 below, and
- An option to include prior comparatives, particularly for combinations under common control.

We support the IPSASB's view that the requirement to restate the prior year comparative information might be onerous and unnecessary. However, we believe that the option to include comparatives of one of the combining entities, or restate comparatives of the newly combined entities should be included in the standard, particularly for entities under common control.

In our jurisdiction there are regular restructures of entities within the New Zealand Government and these can range from very small restructures (where a small operation is subsumed into a large department) to complex mergers of several large entities into one new department.

In a situation where a small operation is subsumed into a large department, the resulting department often has the economic substance of a continuing business rather than the economic substance of a new organisation as at the combination date. In certain cases user needs may be better served by showing the incoming operation as a "movement" in the existing departments financial statements, and including the prior year comparatives of the original department with an explanatory footnote or note that the comparatives do not include the new operations transactions and balances. This would be particularly useful where the small operation is subsumed part way through a financial year and the resulting department carries on largely unchanged.

If the small operation is subsumed from the beginning of the department's financial year, the resulting department could take one step further and restate the prior year comparatives to include the new operation. Such a step may better meet user needs.

Providing options in accounting standards is sometimes considered suboptimal because it leads to less comparable information, between years and/or between different reporting entities. We think that providing options in this instance would improve comparable information, at least year on year, rather than obstruct it.

We therefore propose flexibility around presenting prior year comparatives should be provided under the modified pooling of interest method.

Specific Matter for Comment 4:

Do you agree to adjustments being made to the residual amount rather than other components of net assets/equity, for example the revaluation surplus? If not, where should adjustments be recognized?

Do you agree that the residual amount arising from an amalgamation should be recognized:

- (a) In the case of an amalgamation under common control, as an ownership contribution or ownership distribution; and
- (b) In the case of an amalgamation not under common control, directly in net assets/equity? If not, where should the residual amount be recognized?

In BC 57 the IPSASB noted that the modified pooling of interest method of accounting recognises an amalgamation as giving rise to, in substance, a new entity on the date the amalgamation takes place. As the new entity would not have generated other components of net assets/equity such as accumulated surplus or deficit, or revaluation surplus, all items with net assets/equity would be included as part of the residual amount.

We noted that in coming to this view, the IPSASB accepted this approach may have consequences for some entities where future revaluation decreases are more likely to be recognised in surplus or deficit.

We disagree with this proposal and believe users' needs are better served when individual reserves at amalgamation date are carried forward into the net assets/equity of the resulting entity.

While the IPSASB has highlighted the impact on property, plant and equipment revaluation reserve, we note this would also impact cash flow hedging reserves and reserves arising from the re-measurement of defined benefit schemes (when the proposals in ED 59 Employee Benefits becomes effective). There may also be reserves held by an entity prior to the amalgamation that are restricted by legislation or contract where it would be important to carry over to the resulting entity in an amalgamation.

These separate reserves are typically re-measurements of specific assets and liabilities inherited at amalgamation date. Where the resulting entity intends to, or is required to, continue re-measuring relevant assets (and liabilities) under its accounting policies, in our view, the reserves should be carried forward separately and utilised where appropriate. In particular, the resulting entity should be able to utilise the revaluation reserve in the event of a subsequent devaluation within a class of asset, which would otherwise be a loss in the statement of financial performance if the revaluation reserve had been eradicated at amalgamation date. Such reserves differ from accumulated surplus and deficits generated through the entity's operation. The resulting entity, in inheriting the carrying value of a revalued asset, also inherited the underlying price and other valuation changes captured in the revaluation reserve. We think visibility of those accumulated valuation changes from inception of the asset (or liability), rather than just from amalgamation date, are important for users in holding the resulting entity to account.

We also note that the IPSASB consider the visibility of separate reserves inherited in the amalgamation is important for users. ED 60 requires analysis of the residual amount, including significant adjustments such as revaluation surplus or deficits to be disclosed in the notes of the resulting entity's accounts [paragraph 52(f)]. In our view it would be more helpful to users to

have inherited reserves separately shown within net assets/equity of the resulting entity rather than looking for that information in an additional note disclosure.

The IPSASB also noted the other consequence of a single residual amount relates to amalgamations that take place under common control. The resulting entity will recognise a residual amount but the controlling entity will continue to recognise the previous components of net assets/equity in its consolidated financial statements, giving rise to ongoing consolidation adjustments. The IPSASB noted they did not consider that these consequences outweighed the benefits of adopting the conceptual approach [BC 66]

We disagree with the IPSASB's conclusion in BC 66 on the benefits and costs in relation to the consequence of ongoing consolidation adjustments.

As noted above we think the eradication of separate reserves in the resulting entity is not a benefit to users. We also believe that it can be confusing for users where a resulting entity under common control has a different treatment for reserves than the controlling entity. In our jurisdiction users such as parliament select committees and government ministers (who are responsible for both the resulting entity and the controlling entity) may be puzzled by this situation and raise questions about which one is showing the "right answer".

This is particularly relevant where any write-down of a previously revalued asset is recognised in surplus or deficit in the resulting entity, but leads to a reduction in the revaluation reserve in the controlling entity. The resulting entity will have the need to explain why a loss on revaluation needs to be reflected in their statement of financial performance, but this is not a factor in the financial performance for the controlling entity.

The Treasury notes that the IASB considered a similar issue in determining if goodwill and fair value impairments in different currencies should be translated at the closing rate or the historical transaction rate (IAS 21 BC 26 – 40 refers). The IASB Board agreed that conceptually the correct treatment depends on whether the goodwill and fair value adjustments are part of the assets and liabilities of the acquired entity or the assets and liabilities of the parent. It determined that the goodwill and fair value adjustments should be treated no differently from other assets of the acquired entity and therefore agreed that goodwill should be 'pushed down' to the level of each functional currency.

Similarly the Treasury would argue that the revaluation reserves relate to the assets of the amalgamated entity rather than those of the parent entity and that 'push down' accounting should therefore apply, consistent with this precedent.

Controlling entities in the public sector (such as a state or whole of government), typically include numerous subsidiaries of variable sizes. In our jurisdiction the government regularly reviews the way it is organised and as a result, entities under common control are regularly restructured. As noted above these can range from very small restructures (where a small operation is subsumed into a large department) to complex mergers of several large entities into one department. The IPSASB's proposals for a single residual amount on amalgamation may lead to the controlling entity maintaining a reasonably large number of ongoing consolidation adjustments to separate these.

In our view, consolidations are most efficient and cost effective where the subsidiary's results are rolled up, unadjusted, with consolidation adjustments focused on eliminating inter-entity transactions and balances at each reporting date. Permanent ongoing consolidation adjustments which are required to change a view of a transaction or balance at the controlling entity from the view at the subsidiary at each reporting date are more onerous to manage over time.

We urge the IPSASB to reconsider their conclusion in BC 66 on the benefits and costs for amalgamations under common control. We think there is limited benefit to users in presenting a single residual amount in the resulting entity under common control and believe ongoing consolidation adjustments for reversing the single residual reserve on consolidation, both at interim and annual reporting dates, are costly.

In the case of an amalgamation under common control, we agree that accumulated surplus and deficits should be treated as an ownership contribution or ownership distribution.

Specific Matter for Comment 5:

Do you agree that the acquisition method of accounting (as set out in IFRS 3, *Business Combinations*) should be used in accounting for acquisitions? If not, what method of accounting should be used?

We agree with the acquisition method of accounting as set out in IFRS 3, *Business Combinations*.

