

## ***Guidelines for identifying public sector control – Responses from TFHPSA members***

Drafted by TEAM A of the TFHPSA  
(draft of 6 January 2005)

### **Nature of this document**

This document collates information requested by Team A concerning the criteria or guidelines currently used by TFHPSA members to identify public sector control. It is intended as a temporary working document rather than a self-contained standalone work-piece. For a full understanding of the background and the issues involved it needs to be read in conjunction with the paper ‘Government/Public sector/Private Sector – Delineation Issues’, discussed at the September 2004 meeting of the TFHPSA held in Washington DC, as well as the minutes of that meeting.

In addition to collating the responses, the document also includes suggestions for the inclusion of some of these criteria into the revised SNA. Once there is consensus within TFHPSA members, the relevant details in this document, as well as those in the paper ‘Government/Public sector/Private Sector – Delineation Issues’, could be incorporated into a paper for the AEG. At that stage, the task would be considerably more editorial in nature.

TFHPSA members were also requested to provide guidelines currently used by them to determine ESPs. These responses are being collated in a separate working document, with the intention of transferring the relevant details into the AEG paper once some consensus has been reached within the group.

### **Responses received**

Eight responses were received. They are included in Attachment A. In some cases, large manuals or publications were provided as responses and only selected extracts relating to public sector control have been included whilst in other cases, the original responses have been reproduced in their entirety.

As the number of responses is relatively small no attempt has been made to summarise them. However, on the basis on these responses and the minutes of the September 2004 meeting of the TFHPSA held in Washington DC, some suggestions for improving the current SNA definition of government control of corporations and non-market NPIs have been made. These suggestions are represented as *italicised text* below so that the substance of what is being proposed for the revised SNA is clear.

## **Government control of a corporation**

### **Background and current definition**

A corporation is in the public sector if a government unit or a public corporation controls the entity; otherwise it is in the private sector. The SNA defines this control ‘as the ability to determine the entity’s general corporate policy, by appointing directors if necessary’ [SNA para 4.30].

### **Proposed revised definition and supporting text**

It is proposed that the above ‘basic’ definition be amended so that *control is defined ‘as the ability to determine the general corporate policy of the corporation’*.

It is further proposed that the existing reference to ‘the appointment of directors, if necessary’ (and other additional explanatory text as outlined below) be incorporated into the SNA so as to improve the basic definition and make it operationally similar to the equivalent concept in the public sector accounting standards. The conceptual basis of the current definition is therefore not changed in any material way by the supporting text outlined below.

#### **Supporting text:**

*Government units and or public corporations may be able to determine the ‘general corporate policy’ of a corporation in a variety of different ways depending on the institutional arrangements in place. The expression “general corporate policy” as used here is understood in a broad sense to mean the key financial and operating policies relating to the corporation’s strategic objectives as a market producer.*

*Since governments exercise sovereign powers through legislation, regulations, orders and the like, care needs to be applied in determining whether the exercise of such powers amounts to a determination of the general corporate policy of a particular corporation and therefore control of the corporation. The laws or regulations applicable generally to all units as a class or in a particular industry should not be viewed as amounting to control of these units. Government authority to determine the general policy of a corporation usually comes from legislation or other instrument that is specific to the individual corporation over which control is exercised.*

*The ability to determine the general corporate policy does not necessarily include the direct control of the day-to-day activities or operations of a particular corporation. The officers of such corporations would normally be expected to manage these in a manner consistent with and in support of the overall objectives of the particular corporation.*

*The ability to determine the general corporate policy of a corporation also would not include the direct control over any professional, technical or scientific judgements, as these would normally be viewed as part of the core competency of the corporation itself. Thus, the professional or technical judgement exercised by a corporation set up to certify aircraft airworthiness would not be considered controlled in respect of individual approvals and disapprovals, though its broader operating and financial*

*policies, including the airworthiness criteria, may well be determined by a government unit as part of the corporation's corporate policy.*

*Following on from the above, the determination of the general corporate policy of a corporation acting as a bona-fide trustee would not amount to control of the trustee's execution of its professional functions as a fiduciary. In such instances, the institutional units typically involved would be the trustee (say in the form of a particular corporation in question), the trust property or activity (say in the form of another corporation) and the beneficiaries (say individuals or householders). If a government unit (or another public corporation) did determine the general corporate policy of the corporation in question, then this would not amount to control of the trust property or activity. This is because the trustee, in executing its fiduciary obligations, would be obliged to act strictly in accordance with the trust deed. The trustee would act in the interests of the beneficiaries and not at the behest of its controlling entity (in matters subject to the trust of course). Accordingly, the public corporation in question would not be viewed as controlling the trust property or activity and the latter would therefore be classified to the private sector.*

*In the above case, if the beneficiaries were public sectors entities then a classification of the trust property or activity to the public sector would be appropriate. The general principles described here in relation to a public corporation performing as a bona-fide trustee would also apply if the unit in question were of a different type (e.g. a government unit or an NPI controlled by government).*

*When governments control corporations in the manner discussed here they would generally do so for reasons that can broadly be described as being for public policy purposes. Governments therefore benefit in the process. Although all such benefits can ultimately be linked to public policy (given that this is fundamentally the reason for government's existence), it is also possible to view a subset of them in a financial or monetary sense (such as entitlement to dividend income or exposure to financial loss). A determination of the existence of government control over a corporation can be done independently of the benefits involved.*

*Since the arrangements for the control of corporations can vary considerably it is neither desirable nor feasible to prescribe a definitive list of factors to be taken into account; however, the following indicators could be taken as a guide:*

***Some indicators of control:***

***Indicator 1 – ownership of the majority of the voting interest***

*The ownership of the majority of shares if decisions are made on a one-share one-vote basis needs to be considered. The shares may be held directly or indirectly and the aggregate ownership of the whole public sector needs to be considered as a number of different public sector entities may hold shares. Such a situation could be relevant temporarily in cases when the government has taken control of a private company in difficulty.*

*In cases where decisions are not made on a one-share one-vote basis (i.e. the ownership is on a different basis to control), the classification to the public sector would be based on whether the control provides a majority voice.*

### ***Indicator 2 – control of the board or other governing body***

*The controlling entity may have the ability to appoint or remove a majority of the board or other governing body as a result of existing legislation, regulation, contractual, or other arrangements. This may be determined by examining the arrangements and considering, where necessary, the total public sector influence. There may be appointees of different levels of government and of different public corporations that need to be aggregated to assess the overall situation.*

*Even when the public sector does not control the appointment of directors, they may have the right to veto proposed appointments. This can be seen as a form of control if it influences the choices that can be made. This right of veto may also be relevant to indicators 3 and 4 below.*

*Another body, including a subset of the board itself, may be responsible for appointing the directors. In these cases it is necessary to look at the composition of these other bodies to see whether these are majority public sector or not. There may also be timing issues if the government (or the public sector more widely) appoints the first set of directors but does not control the appointment of replacement directors. The body would then be public sector until the initial appointments had expired, provided there was no control of the next set of appointments.*

*There may also be circumstances where the key financial and operation policies of the entity are actually established and limited by existing legislation, regulation or other instrument, thereby making the issue of board appointments less critical or even irrelevant.*

### ***Indicator 3 – control of the appointment and removal of key personnel***

*In cases where control of the board or other governing body appears marginal or inconclusive, the appointment of key executives, including the chief executive, chairperson and finance director may be considered. Non-executive directors may also be relevant if they sit on key committees such as the remuneration committee determining the pay of senior staff.*

### ***Indicator 4 – control of key committees of the entity***

*Sub-committees of the board or the governing body could determine the key operating and financial policies of the entity. These sub-committees could be examined to establish whether any have a majority public sector membership. This can happen under the constitution or enabling instrument if it specifies that some public sector members of the board must be on the sub-committee.*

### ***Indicator 5 – golden shares***

*The government may own a “golden share” in some companies, particularly those which have been privatised. This share gives the government some residual rights to protect the interests of the public and, for example, prevent the company selling off some categories of assets. The share may confer the right to appoint a special director who has strong powers in certain circumstances. The government would have indicated that they do not expect to exercise the power of the golden share in normal circumstances and the companies’ owners/shareholders accept the existence of the golden share voluntarily. Thus the power covered by such a golden share is seen as contingent and not indicative of control. However, if the powers were ever used then the entity would need to be reclassified to the public sector from the date in question.*

*As a general principle, the public/private determination of an entity’s status should be based on the existing power to determine corporate policy exercised under normal conditions rather than in exceptional economic or other circumstances such as wars, civil disorders or natural disasters. Any power to control an entity in such circumstances should be viewed as contingent nature. However, when abnormal circumstances arise and the contingency is activated then a reclassification would be justified during the period of such abnormality.*

#### **Indicator 6 – regulation**

*The borderline between general regulation (of a kind that would normally apply to all entities within say a whole class or industry group) and the control (of an individual corporation as discussed here) can be difficult to judge sometimes. There are many examples of government involvement through regulation, particularly in areas such as monopolies and privatised utilities, but regulatory involvement itself is not necessarily control. Therefore, it is possible for regulatory involvement to exist in important areas, such as in price setting, without the entity ceding control of its general corporate policy.*

*Where regulations are accepted by the entity (i.e. the entity chooses to enter into or continue to operate in a highly regulated environment) this suggests that they are not equivalent to control. However, when the regulation is so tight as to effectively dictate how the entity performs its business, then this could amount to a form of control. Fundamentally, if an entity retains unilateral discretion as to whether it will take funding from, interact commercially with or otherwise deal with a public sector entity, other than abide by laws and regulations applicable generally, then the entity has the ultimate ability to determine its own corporate policy and is therefore not controlled by the public sector entity.*

#### **Indicator 7 – control by a dominant customer**

*If 100% of sales are to one public sector customer there is clear scope for dominant influence. This can also apply when slightly less than 100% of sales are to one customer, although the presence of a minority customer usually implies an element of independent decision-making.*

#### **Indicator 8 – controls attached to borrowing from the government**

*Lenders often impose controls as conditions of making loans. If they are more than would be typical when a healthy private sector entity borrows from a bank, they indicate control.*

***Indicator 9 – other controls associated with the entities constitution and other rules***

*There are often a number of formal legal documents underpinning an entity. These need to be examined for indications of control although it is difficult to cover all eventualities. The following list suggests points to watch for to check whether under the existing arrangements the government can:*

- *determine aspects of how the body delivers its outputs*
- *have a final say in the disposal or acquisition of fixed assets*
- *be entitled to share of proceeds of asset disposals that goes beyond the repayment of previous government support for capital formation*
- *close or restructure the body*
- *prevent the body from ending its relationship with government*
- *change the constitution of the body*
- *decide what sort of financial transactions the body can undertake, or limit them*
- *prevent the body from receiving certain types of income from other sources*
- *exert numerous minor controls over how the body is run*
- *exert financial control as part of a system of controlling public expenditure (this may require more frequent and more detailed financial reporting than would be the case more generally)*
- *control dividend or other distribution policy*
- *set pay or remuneration rates*
- *approve mergers or acquisitions (other than for regulatory reasons provided for under existing arrangements).*

***Indicator 10 – totality of all indicators***

*In many cases, a single indicator alone could be sufficient to establish the existence of control beyond doubt. In other cases, a number of separate indicators could each be indicative of control, but lack conclusiveness as individual indicators. In these instances, the total impact of all such indicators should be taken into account to establish whether overall control effectively exists, even when none of them provide such an indication on their own.*

*A decision based on the totality of all indicators as described here must necessarily be judgemental in nature, rather than one based on the principles of exact science.*

## **Government control of non-market NPIs**

### **Background and Current definition**

NPIs controlled and mainly financed by government are allocated to the general government sector. In this context, control is defined ‘as the ability to determine the general policy or programme of the NPI by having the right to appoint the officers managing the NPI’ [SNA para 4.62].

### **Proposed revised definition and supporting text**

It is proposed that the reference to ‘and mainly financed by government’ be replaced with the term ‘non-market’ (or perhaps even ‘mainly non-market’)<sup>1</sup> and that the reference to ‘the right to appoint the officers managing the NPI’ be repositioned under a new ‘indicators of control’ sub-heading.

The amendment does not change the conceptual basis of the current definition but it does make it operationally more consistent with that used in the accounting standards. As a result of these changes the paragraph above would read as follows:

*Non-market NPIs controlled by government are allocated to the general government sector. In this context, control is defined as the ability to determine the general policy or programme of the NPI.*

In addition, further text could be added in the revised SNA so as to provide guidance on the factors that may indicate control of NPIs. The following is suggested:

#### ***Some indicators of control:***

##### ***Indicator 1 – appointment of officers***

*Under the provisions of the NPIs constitution, articles of association or other enabling instrument, the government may have the right to appoint the officers managing the NPI.*

##### ***Indicator 2 – other provisions of enabling instrument***

*Even though government may not have the right to appoint the officers managing the NPI, the enabling instrument may contain other provisions that effectively allow government determine the general policy or programme of the NPI.*

##### ***Indicator 3 – existence of contractual agreements***

*The existence of any contractual agreement between a government and an NPI for, say, the provision of goods or services may contain clauses indicative of the NPI effectively allowing government to determine aspects of its general policy or programme. However, so long as the NPI is ultimately able to determine its policy or programme to a significant extent (for example by being able to change its*

---

<sup>1</sup> In drawing up its recommendations on the criteria for determining ESPs, the Team would need to ensure that NPIs mainly financed governments (i.e. by transfers rather than purchases of goods and services) are in fact designated non-market NPIs. The expression ‘mainly financed by government’ may therefore remain in the revised SNA, partly for reasons of continuity, but it needs to be included only in the context of a discussion on ESPs (which determines the market and non-market distinction) and not control (which determines the public and private sector distinction).

*constitution or dissolve itself without requiring government approval other than that required under the general regulations), then it would not be considered controlled by government.*

***Indicator 4 – Totality of all indicators***

*Where individual indicators are inconclusive in their right, the totality of all indicators may be taken into account in determining whether government control effectively exists.*



<b>Guidelines for identifying public sector control Responses @ 11 November 2004</b>	
<b>Respondent<sup>2</sup></b>	<b>Summary of responses<sup>3</sup></b>
Australia (statistical guidelines)	<p>the public sector includes resident units that are part of the general government sector or are controlled by units of the general government sector and all other resident units are in the private sector.</p> <p>The public sector therefore comprises:</p> <ul style="list-style-type: none"> <li>- all resident units that are classified to the general government sector, including all government units and non-market NPIs that are controlled and mainly financed by government</li> <li>- all resident units that are classified to the non-financial corporations sector and are controlled by government units (<i>public non-financial corporations</i>)</li> <li>- all units that are classified to the financial corporations sector and are controlled by government units (<i>public financial corporations</i>).</li> </ul> <p>The criterion for recognising government-controlled corporations and quasi-corporations is based on the SNA93 definition of control, which is 'the ability to determine general corporate policy by appointing appropriate directors, if necessary. Owning more than half the shares of a corporation is evidently a sufficient, but not a necessary, condition for control'. Thus, government controls a corporation when a government unit owns more than 50% of the shares in the corporation. However, in some cases, government control can also exist when a government unit owns 50% or less of the shares of a corporation. For example, government control can exist where special legislation or regulations empower a government to determine corporate policy or to appoint the directors of a corporation. Corporations controlled by other government-controlled corporations are considered to be government controlled.</p> <p>For the purposes of the public/private classification, government control of corporations does not include a government's ability to exercise general legislative or regulatory powers over corporations as a group. Government authority to determine the general policy of a corporation usually comes from legislation that is specific to the individual corporation over which control is exercised.</p> <p>In some cases, the existence of government control may not be clear. In Australia, such is the case with superannuation funds that governments</p>

<sup>2</sup> The information provided has been designated as either 'statistical' or 'accounting' to reflect its usage or application.

<sup>3</sup> Where large manuals or publications were provided as responses, only selected extracts relating to public sector control have been included here whilst in other cases, the original responses have been reproduced in their entirety.

	<p>have established for the benefit of their employees. Legislation places responsibility for the day-to-day operation of the superannuation funds with a board of trustees that is created as a separate legal entity. The establishing governments generally receive no monetary benefits from the funds, which are accordingly treated as NPIs. Because the costs of the funds' operations are recovered from the pool of contributions, the funds are treated as market NPIs and are included in the financial corporations institutional sector. Although the establishing government has the power, under the legislation, to appoint and dismiss some or all of the trustees, the boards of trustees are typically not under the direction of government and are required to act in the beneficiaries' interests, and not those of the government. Accordingly, the funds are not considered to be under government control. Although the circumstances of individual funds may vary, in the interest of uniformity, all superannuation funds with arrangements broadly similar to those described are included in the private sector.</p> <p>Non-market NPIs that are controlled and mainly financed by government are classified to the general government sector. SNA93 defines government control of NPIs as 'the ability to determine the general policy or programme of the NPI by having the right to appoint the officers managing the NPI '.</p> <p>In some cases, the SNA93 criteria for including NPIs in the general government sector are not sufficiently definitive, and other factors have to be taken into account. Such factors can include:</p> <ul style="list-style-type: none"> <li>- the proportion of government appointees to NPI management boards</li> <li>- the extent to which control and majority financing lies with one government or is divided among different governments and non-government sources</li> <li>- whether government control exists without predominant government financing or predominant government financing exists without government control</li> <li>- the degree of independence from government influence able to be exercised by the NPI in day-to-day management of its affairs.</li> </ul> <p>All other non-market NPIs (i.e. those that are not controlled and mainly financed by government) are classified to the NPISH sector.</p>
Canada (statistical guidelines)	<p>- public sector contains all institutional units controlled by government</p> <ul style="list-style-type: none"> <li>• four criteria are used in classifying an entity to the government component of the public</li> </ul> <p>(1) entity is non-commercial in nature (not having a view to a profit)  (2) the non-commercial entity is entirely owned by a government  (3) the non-commercial entity is controlled by a government:  control is determined by examining proportion of financing provided</p>

	<p>by government and degree of accountability for its use (expenditures primarily financed, &gt; 50%, by public funds and accountable to the public or to a government for use of funds). Any one of the following indicates such accountability:</p> <ul style="list-style-type: none"> <li>- the entity's budget is approved by a government or one of its institutions</li> <li>- the entity must undergo official audits and report to a government</li> <li>- the entity's results of operations and use of resources are reflected in the government's financial accounts</li> <li>- the entity's financial accounts are subject to examination by the auditor general</li> <li>- the entity's employees negotiate collective agreements with a government; and</li> </ul> <p>(4) the non-commercial entity's activities are intrinsically governmental</p> <ul style="list-style-type: none"> <li>• One of the following three conditions must be evident for a business enterprise to be publicly controlled:</li> </ul> <p>(1) Direct control</p> <ul style="list-style-type: none"> <li>(a) this implies existence of actual or potential majority voting ownership by a government</li> <li>(b) existence of irrevocable options or the right to acquire shares, or convertible debt or equity, exercisable at the discretion of a government, is taken as if the option had been exercised for the purposes of calculating voting equity</li> <li>(c) a corporation is directly controlled by a government if more than 50% of the voting equity is held directly, other than by way of security only, by or for the benefit of that government</li> </ul> <p>(2) Effective control – if one of the following is met</p> <ul style="list-style-type: none"> <li>(a) the government holds a significant voting ownership in a public enterprise where significant is taken to mean the holding of the largest block of voting equity, the holding exceeds 33.3% of the voting equity and the block is larger than the combined percentage of the next two largest blocks</li> <li>(b) the business enterprise declares that it is effectively controlled by a government</li> <li>(c) there exists a method or a variety of methods that yield effective control (eg significant voting ownership of the enterprise, technological agreements, supply controls or contracts, management contracts, interlocking directorships, debt, or convertible debt or equity). In rare instances, where these factors are inconclusive, related information such as historical precedent may be used</li> </ul> <p>(3) Indirect control</p> <p>A business enterprise is indirectly controlled by a government if that government directly or effectively controls a government business enterprise that in turn directly or effectively controls that enterprise</p> <p>Associated factors:</p>
--	--

	<p>In addition to direct, effective and indirect control criteria above, the following other associated factors may be taken into account when determining if an entity belongs to the government business enterprise component</p> <ul style="list-style-type: none"> <li>- if revenues are not primarily financed by government (not &gt; 50%)</li> <li>- if the entity finances its own capital formation</li> <li>- if the entity provides goods and or services to other than government</li> <li>- if the net operating surplus is not transferred to government</li> </ul> <p>Resistance rule: Classification changes are only performed when there is evidence of a permanent shift over a number of years to prevent 'sector hopping'.</p>
Denmark (statistical guidelines)	<ul style="list-style-type: none"> <li>• Public/Private Sector delineation is based on ESA95 criteria, as below:</li> </ul> <p>First of all the unit must be an institutional unit to be placed outside general government. The criteria for a unit to be considered an institutional are the following:</p> <ol style="list-style-type: none"> <li>1) decision-making autonomy</li> <li>2) keep a complete set of accounts or it would be possible</li> <li>3) be entitled to own assets in its own right and incur liabilities on its own behalf</li> <li>4) have an economic and financial behaviour different from that of their owners and similar to that of corporations</li> </ol> <p>Furthermore the unit must sell at significant prices to be placed outside general government. This means applying the 50% criterion.</p> <ul style="list-style-type: none"> <li>• Both criteria must be fulfilled for the unit to be placed outside general government.</li> <li>• The crucial point in many cases is the question whether or not the unit can invest/own assets in its own right. Therefore we think that this criterion should have/keep its central position in the delineation decision.</li> <li>• The concept of significant prices or the 50% criterion (which in my interpretation of ESA95 is the same) is too easy to fulfil. In situations where e.g. central government decides to simulate marked prices in units providing rental services for other central government units. The only reason for using marked like prices</li> </ul>

	<p>is to make the use of rental services in central government more efficient. In most cases the 50% criterion is easily fulfilled and combined with sufficient autonomy the unit must be classified outside general government.</p>
Eurostat (statistical guidelines)	<ul style="list-style-type: none"> <li>• ESA95 manual on government deficit and debt, in relation to general government control of a non-profit institution, suggests on page 12 that one should use a more operational definition of control whenever the criteria set in national accounts is not formally satisfied or when special legislation is lacking. Public intervention in the form of general regulations applicable to all units working in the same activity should not be considered as relevant when deciding whether the government controls an individual unit.</li> <li>• ESA95 manual states that: ‘government secures the control of a unit when it influences its management of this specific unit, independently of general supervision exercised on all similar units’. The example of schools is given: GG controls it if its approval is needed for creating new classes, making significant investments in gross fixed capital formation or borrowing; or if it can prevent the school from ending its relationship with government.</li> <li>• GG does not control the unit if it just finances the school or supervises the quality of education the school has to provide (example: by fixing general programmes or the maximum number of pupils per class).</li> <li>• There is a need for more guidance.</li> </ul>
IFAC-PSC (accounting guidelines)	<p>Extract from IPSAS 6</p> <p><b>Establishing Control of another Entity for Financial Reporting Purposes</b></p> <p>26. Whether an entity controls another entity for financial reporting purposes is a matter of judgment based on the definition of control in this Standard and the particular circumstances of each case. That is, consideration needs to be given to the nature of the relationship between the two entities. In particular, the two elements of the definition of control in this Standard need to be considered. These are the power element (the power to govern the financial and operating policies of another entity) and the benefit element (which represents the ability of the controlling entity to benefit from the activities of the other entity).</p> <p>27. For the purposes of establishing control, the controlling entity needs to benefit from the activities of the other entity. For example, an entity may benefit from the activities of another entity in terms of a distribution of its surpluses (such as a dividend) and is exposed to the risk of a potential loss. In other cases, an entity may not obtain any financial benefits from the other entity but may benefit from its ability to direct the other entity to work with it to achieve its objectives. It may</p>

	<p>also be possible for an entity to derive both financial and nonfinancial benefits from the activities of another entity. For example, a GBE may provide a controlling entity with a dividend and also enable it to achieve some of its social policy objectives.</p> <p><b><i>Control for Financial Reporting Purposes</i></b></p> <p>28. For the purposes of financial reporting, control stems from an entity's power to govern the financial and operating policies of another entity and does not necessarily require an entity to hold a majority shareholding or other equity interest in the other entity. The power to control must be presently exercisable. That is, the entity must already have had this power conferred upon it by legislation or some formal agreement. The power to control is not presently exercisable if it requires changing legislation or renegotiating agreements in order to be effective. This should be distinguished from the fact that the existence of the power to control another entity is not dependent upon the probability or likelihood of that power being exercised.</p> <p>29. Similarly, the existence of control does not require an entity to have responsibility for the management of (or involvement in) the day-to-day operations of the other entity. In many cases, an entity may only exercise its power to control another entity where there is a breach or revocation of an agreement between the controlled entity and its controlling entity.</p> <p>30. For example, a government department may have an ownership interest in a rail authority, which operates as a GBE. The rail authority is allowed to operate autonomously and does not rely on the government for funding but has raised capital through significant borrowings that are guaranteed by the government. The rail authority has not returned a dividend to government for several years. The government has the power to appoint and remove a majority of the members of the governing body of the rail authority. The government has never exercised the power to remove members of the governing body and would be reluctant to do so because of sensitivity in the electorate regarding the previous government's involvement in the operation of the rail network. In this case, the power to control is presently exercisable but under the existing relationship between the controlled entity and controlling entity, an event has not occurred to warrant the controlling entity exercising its powers over the controlled entity. Accordingly, control exists because the power to control is sufficient even though the controlling entity may choose not to exercise that power.</p> <p>31. The existence of separate legislative powers does not, of itself, preclude an entity from being controlled by another entity. For example, the Office of the Government Statistician usually has statutory powers to operate independently of the government. That is, the Office of the Government Statistician may have the power to obtain information and report on its findings without recourse to government</p>
--	---

	<p>or any other body. The existence of control does not require an entity to have responsibility over the day-to-day operations of another entity or the manner in which professional functions are performed by the entity.</p> <p>32. The power of one entity to govern decision-making in relation to the financial and operating policies of another entity is insufficient, in itself, to ensure the existence of control as defined in this Standard. The controlling entity needs to be able to govern decision-making so as to be able to benefit from its activities, for example by enabling the other entity to operate with it as part of an economic entity in pursuing its objectives. This will have the effect of excluding from the definitions of a “controlling entity” and “controlled entity” relationships which do not extend beyond, for instance, that of a liquidator and the entity being liquidated, and would normally exclude a lender and borrower relationship. Similarly, a trustee whose relationship with a trust does not extend beyond the normal responsibilities of a trustee would not be considered to control the trust for the purposes of this Standard.</p> <p><b><i>Regulatory and Purchase Power</i></b></p> <p>33. Governments and their agencies have the power to regulate the behavior of many entities by use of their sovereign or legislative powers. Regulatory and purchase powers do not constitute control for the purposes of financial reporting. To ensure that the financial statements of public sector entities include only those resources that they control and can benefit from, the meaning of control for the purposes of this Standard does not extend to:</p> <p>(a) The power of the legislature to establish the regulatory framework within which entities operate and to impose conditions or sanctions on their operations. Such power does not constitute control by a public sector entity of the assets deployed by these entities. For example, a pollution control authority may have the power to close down the operations of entities that are not complying with environmental regulations. However, this power does not constitute control because the pollution control authority only has the power to regulate; or</p> <p>(b) Entities that are economically dependent on a public sector entity. That is, where an entity retains discretion as to whether it will take funding from, or do business with, a public sector entity, that entity has the ultimate power to govern its own financial or operating policies, and accordingly is not controlled by the public sector entity. For example, a government department may be able to influence the financial and operating policies of an entity which is dependent on it for funding (such as a charity) or a profit-orientated entity that is economically dependent on business from it. Accordingly, the government department has some power as a purchaser but not to govern the entity’s financial and operating policies.</p> <p><b><i>Determining Whether Control Exists for Financial Reporting Purposes</i></b></p> <p>34. Public sector entities may create other entities to achieve some of their objectives. In some cases it may be clear that an entity is</p>
--	---

	<p>controlled, and hence should be consolidated. In other cases it may not be clear. Paragraphs 35 and 36 provide guidance to help determine whether or not control exists for financial reporting purposes.</p> <p>35. In examining the relationship between two entities, control is presumed to exist when at least one of the following power conditions and one of the following benefit conditions exists, unless there is clear evidence of control being held by another entity.</p> <p><i>Power conditions</i></p> <p>(a) The entity has, directly or indirectly through controlled entities, ownership of a majority voting interest in the other entity.</p> <p>(b) The entity has the power, either granted by or exercised within existing legislation, to appoint or remove a majority of the members of the governing body of the other entity.</p> <p>(c) The entity has the power to cast, or regulate the casting of, a majority of the votes that are likely to be cast at a general meeting of the other entity.</p> <p>(d) The entity has the power to cast the majority of votes at meetings of the board of directors or equivalent governing body.</p> <p><i>Benefit conditions</i></p> <p>(a) The entity has the power to dissolve the other entity and obtain a significant level of the residual economic benefits or bear significant obligations. For example the benefit condition may be met if an entity had responsibility for the residual liabilities of another entity.</p> <p>(b) The entity has the power to extract distributions of assets from the other entity, and/or may be liable for certain obligations of the other entity.</p> <p>36. When one or more of the circumstances listed in paragraph 35 does not exist, the following factors are likely, either individually or collectively, to be indicative of the existence of control.</p> <p><i>Power indicators</i></p> <p>(a) The entity has the ability to veto operating and capital budgets of the other entity.</p> <p>(b) The entity has the ability to veto, overrule, or modify governing body decisions of the other entity.</p> <p>(c) The entity has the ability to approve the hiring, reassignment and removal of key personnel of the other entity.</p> <p>(d) The mandate of the other entity is established and limited by, legislation.</p> <p>(e) The entity holds a “golden share”<sup>1</sup> (or equivalent) in the other entity that confers rights to govern the financial and operating policies of that other entity.</p> <p><i>Benefit indicators</i></p> <p>(a) The entity holds direct or indirect title to the net assets/equity of the other entity with an ongoing right to access these.</p> <p>(b) The entity has a right to a significant level of the net assets/equity of</p>
--	---



	<p>the other entity in the event of a liquidation or in a distribution other than a liquidation.</p> <p>(c) The entity is able to direct the other entity to co-operate with it in achieving its objectives.</p> <p>(d) The entity is exposed to the residual liabilities of the other entity.</p> <p><sup>1</sup> “Golden share” refers to a class of share that entitles the holder to specified powers or rights generally exceeding those normally associated with the holder’s ownership interest or representation on the governing body.</p>
New Zealand (accounting guidelines)	<p><b>EXTRACTS FROM FRS-37: CONSOLIDATING INVESTMENTS IN SUBSIDIARIES</b></p> <p><i>Paragraphs re control</i></p> <p><b>STANDARD</b></p> <p><b>4.13 “Control” by one entity over another entity exists in circumstances where the following parts (a) and (b) are both satisfied:</b></p> <p><b>(a) the first entity has the capacity to determine the financing and operating policies that guide the activities of the second entity, except in the following circumstances where such capacity is not required:</b></p> <p style="padding-left: 40px;">(i) where such policies have been irreversibly predetermined by the first entity or its agent; or</p> <p style="padding-left: 40px;">(ii) where the determination of such policies is unable to materially impact the level of potential ownership benefits that arise from the activities of the second entity.</p> <p><b>(b) the first entity has an entitlement to a significant level of current or future ownership benefits, including the reduction of ownership losses, which arise from the activities of the second entity.</b></p> <p><b>COMMENTARY</b></p> <p><b>Control Requiring Two Elements</b></p> <p>4.14 For control to exist for the purposes of this Standard, both parts (a) and (b) of paragraph 4.13 must be satisfied. Part (a) will be satisfied where either the capacity to determine the financing and operating policies as stated in part (a) exists, or one of the exceptions provided in items (i) and (ii) of part (a) exists. Subject to those exceptions, the definition of control requires both a power element (i.e. part (a)) and a benefit element (i.e. part (b)). It is implicit that both the power element and the benefit element are linked because ownership benefits are, by nature, benefits that arise from the determination of the relevant entity's financing and operating policies.</p> <p><b>Ownership Form of Control</b></p> <p><i>Limitation to an Ownership Form of Control</i></p> <p>4.15 The definition of control represents control of an ownership form. An ownership form of control has been adopted as the criterion for the preparation of consolidated financial statements because owners</p>

	<p>are the primary users of financial statements and owners primarily rely on financial statements to meet their financial information needs. Other forms of control that exist, but which are outside this definition, include:</p> <ul style="list-style-type: none"> <li>• Control of a regulatory form that exists when there is a specific authority under regulation to impose a specified form of compliance on the regulated entity's operation.</li> <li>• Control of a purchase form that exists when there is a power, held as a consequence of a relationship involving the purchase of goods or services, to compel a provider entity into a certain course of action.</li> <li>• Control of a lending form that exists when there is a power, held as a consequence of a lending relationship, to compel a borrower into a certain course of action.</li> </ul> <p><i>In-substance vs Legal Ownership</i></p> <p>4.16 Control of an ownership form represents in-substance ownership. It includes in-substance ownership created under any scheme, arrangement, or device and is therefore not restricted to relationships that arise through the legal ownership of equity instruments. It includes all control relationships arising from any mechanism that establishes an ownership relationship between two entities including such a relationship established directly under legislation.</p> <p><i>Regulatory vs Ownership Form of Control</i></p> <p>4.17 Both ownership and regulatory forms of control can arise under legislation. As with ownership control, regulatory control arising under legislation establishes entitlements to benefits. However, legislation will lead to an ownership form of control only where it establishes, in favour of one entity over another, both the power to determine financing and operating policies and an entitlement to ownership benefits. The critical distinction between ownership and regulatory forms of control established under legislation is that, under the ownership form of control the entitlement to benefit arises from the power to determine financing and operating policies; whereas under the regulatory form of control, the entitlement to benefit instead arises directly from the legislation.</p> <p>4.18 Regulatory forms of control are not limited to requirements currently in place. They also include the ability to enact regulation to impose future requirements. For the purposes of this Standard, the Crown's sovereign power to enact legislation is to be regarded as a regulatory form of control even though, through this power, the Crown has the capacity to establish ownership relationships as well as regulatory relationships.</p> <p><i>Ownership vs Fiduciary Relationships</i></p> <p>4.19 Fiduciary relationships, such as those involving trustees and</p>
--	---

	<p>beneficiaries of trusts, might appear to be ownership relationships that satisfy the definition of control in this Standard. However, they can be distinguished in two ways:</p> <ul style="list-style-type: none"> <li>• The decision-making power of a trustee does not meet the power element of the definition of control. While a trustee may have the ability to make decisions concerning the financing and operating activities of the trust, this ability is governed by the trustee's fiduciary responsibility at law to act in the best interests of the beneficiaries of the trust.</li> <li>• A trustee's entitlement to benefits does not meet the benefit element of the definition of control. Any link between the decision-making powers of a trustee and the trustee's entitlement to benefits is different in nature to the link between the power and ownership benefit elements that exist in an ownership relationship giving rise to control. In a fiduciary relationship, the trust deed will specifically preclude a trustee from using its decision-making powers to direct the trust to engage in activities designed to increase its own fees or other benefits. Furthermore, the fee that a trustee receives will be in the nature of recompense for the services it provides as trustee, and is not a benefit attributable to the holding of an ownership interest.</li> </ul> <p><b>Power Element</b></p> <p><i>Capacity to Exercise Power through Governance</i></p> <p>4.20 The power element refers to the capacity to determine the financing and operating policies of another entity. In most cases, with regard to entities in both the private and public sectors, such capacity exists through an ability of one entity to select and terminate those parties responsible for determining the financing and operating policies of the other entity. In the public sector, this ability is often specified by legislative authority. In the private sector, this ability mostly arises from holding a majority interest in the voting rights of the investee. The critical factor is capacity. As a consequence, where the holding of a majority interest in the voting rights of the investee determines the power element and there are favourable unexercised instruments exclusively held by the investor that will give the investor a majority interest when exercised, such interest may need to be determined on the basis that the unexercised instruments have been exercised. In the particular circumstances where such instruments exist and they are currently exercisable, such interest will need to be determined on the basis that the instruments have been exercised.</p> <p><i>Unilateral Power</i></p> <p>4.21 The decision-making capacity that satisfies the power element of control must be unilateral. The capacity cannot be shared or divided such that it enables power to be exercised jointly by two or more partners or co-owners. The ability to participate with others in making decisions that guide the activities of another entity usually characterises joint venture relationships, which are covered under a separate financial</p>
--	---

	<p>reporting standard. Thus, Entity A will not have a unilateral decision-making capacity with regard to Entity B if Entity A requires the ongoing consent of other parties to set or change the policies or management that guide the activities of Entity B. On the other hand, a unilateral decision-making capacity may still exist despite there being a requirement to consult before a corresponding power can be exercised.</p> <p><i>Restrictions on Activities</i></p> <p>4.22 While the power element of control cannot be shared, usually it is limited to some degree by law, regulations, fiduciary responsibilities, and contractual rights of other parties. For example, provisions under the Companies Act 1993 restrict the ability of an investor in a less than wholly owned subsidiary to direct its subsidiary to engage in certain specified transactions or activities without the consent of minority shareholders. Also, contractual agreements with lenders may impose limits on an entity's ability to pay dividends. However, these forms of restrictions usually establish protective limits on, rather than participatory rights in, the decision-making capacity of the parent. Such protective limits do not usually give a minority shareholder, regulatory agency or contracting party the ability to make or participate in a parent's decisions that guide the subsidiary's activities. It is only where participatory rights are affected in addition to protective limits being placed on the entity that the power element of control may cease to be satisfied. Rights are participatory if they enable investors (majority and minority owners) to participate in decisions that involve setting and modifying the financing and operating policies that guide the activities of the entity.</p> <p><i>Power of Veto</i></p> <p>4.23 In some circumstances, the power element of control may appear to be satisfied where there is an ability to restrict others from directing significant policies. However, a power of veto will not of itself satisfy the power element of control unless its effect is that significant policy decisions are taken in accordance with the wishes of the entity holding that power. One entity will not have decision-making capacity with regard to another where there is a third party that has the ability to determine all significant financing and operating policies.</p> <p><i>Delegated Power</i></p> <p>4.24 The power element rests with the party having the ultimate decision-making capacity, regardless of whether or not the party actively exercises that capacity. The fact that decision-making ability may be delegated by one party to another party such that the second party determines the day-to-day operations of the entity does not undermine the ultimate decision-making capacity of the first party. Delegation of decision-making ability while retaining the ultimate decision-making capacity may occur in several ways, including delegation of such ability within the governance structure of the entity</p>
--	--

	<p>and delegation of such ability to an external party under a contractual arrangement.</p> <p>4.25 Delegation within the governance structure of the entity includes the appointment or retention by shareholders of directors to exercise decision-making ability on the shareholders' behalf. In such case, the ultimate decision-making capacity of the shareholders continues to exist regardless of whether that capacity is exercised. For example, when a parent obtains control of a subsidiary it may choose to retain the subsidiary's existing policies, directors, officers and other personnel without affecting its ability to change any of that subsidiary's policies or personnel responsible for carrying out those policies. In the public sector, the Crown may exercise power over an entity through legislation which establishes the entity and requires the operation of that entity to have regard to the Government's policies, even though the Crown may not have day-to-day responsibility for the activities of that entity.</p> <p>4.26 Delegation under a contractual arrangement includes relationships established under management agreements and franchise agreements. Under a typical management agreement, an external party is contracted to manage an entity in return for a management fee. This involves a transfer by the owner of the entity to the external party of a decision-making ability in respect of the entity. However, the ultimate decision-making capacity is retained by the owner of the entity through the ability to terminate the contract and reacquire the decision-making ability previously transferred. In a franchise agreement, the owner of a franchisee might or might not have transferred to the franchisor its decision-making ability over the franchisee. This position depends on whether, by virtue of the terms of the agreement, the franchisor is able to determine all significant financing and operating decisions affecting the franchisee. However, in all cases the ultimate decision-making capacity is retained by the owner of the franchisee through its ability to withdraw from the franchise agreement, reacquire any decision-making ability previously held by the franchisor, and continue operating in business.</p> <p><i>Exceptions to Need for Power Element</i></p> <p>4.27 Part (a) of paragraph 4.13 identifies two circumstances where the existence of a power element is not necessary to satisfy the definition of control. The first circumstance is where all significant policies concerning an entity have been predetermined and are unable to be modified. In such cases, even although a power element does not exist, a power element is not necessary because the party that stands to gain the ownership benefits will have been irreversibly specified in advance as part of the significant predetermined policies. Control will therefore arise in favour of any party that has established such an entity in circumstances where that party is entitled to a significant or greater level of the entity's ownership benefits. These arrangements are sometimes described as “autopilots”.</p>
--	--

	<p>4.28 The second circumstance covered by part (a) of paragraph 4.13 is where the determination of significant policies is unable to materially impact the level of potential benefits to be realised. In such cases, a power element is not necessary because, although the policies may not be irreversibly predetermined, the nature of the activities of the entity is such that any exercise of decision-making power will have no material influence on the level of ownership benefits to be realised from those activities. For example, consider the case of a special purpose entity (SPE) established to securitise a mortgage portfolio in circumstances where the activities of the SPE are effectively limited to collecting interest income from mortgagors, paying interest income to the SPE debt holders, and paying insurance premiums to cover the risk of mortgagor default. Any party having decision-making ability concerning the SPE's activities will be unable to materially influence the net surplus or deficit of the SPE. This will instead depend substantially on factors outside the control of the manager, such as prevailing market interest rates and the cost of insurance cover. Control will therefore arise in favour of a party that is entitled to a significant or greater level of the SPE's ownership benefits, irrespective of whether that party has the ultimate decision-making capacity regarding the SPE. Entities having financial assets securitised through an SPE vehicle in this manner will commonly have control over the SPE in terms of this Standard.</p> <p><b>Benefit Element</b></p> <p><i>Entitlement to Significant Ownership Benefits</i></p> <p>4.29 The benefit element refers to an entitlement to a significant or greater level of ownership benefits. Ownership benefits are benefits equivalent to returns to an investor on or of an investment. Where a capacity to determine the financing and operating policies of another entity exists and is relevant, ownership benefits will be directly attributable to the exercise of decisions concerning the financing and operating policies of that other entity. Types of ownership benefits are discussed in paragraphs 4.32 to 4.35 below.</p> <p>4.30 A key component of the benefit element is that there be an entitlement to ownership benefits. To hold such an entitlement does not require it to be probable that ownership benefits will arise. The critical factor is that, in the event such benefits do arise, the entitled party has the ability to realise those benefits. However, a substance approach needs to be taken in assessing this factor and such an entitlement will exist only where the entitled party has a realistic ability to obtain those benefits. Entitlements to ownership benefits that are established nominally but that are never able to be obtained do not enable the benefit element to be met.</p> <p>4.31 Another key component of the benefit element is that the entitlement to ownership benefits must relate to at least a significant</p>
--	---

	<p>level of such benefits. Whether a level of ownership benefits is significant often depends on the type of ownership benefits and the ability of other parties to participate in such benefits. It is not necessarily a question of meeting a predetermined percentage threshold. In cases where percentages are an important determinant, the spread of entitlement percentages is relevant. For example, an entitlement to a level of 20% may be significant where no other parties are each entitled to more than 5%; whereas an entitlement to a level of 40% may be necessary to be significant where one or more other parties are each entitled to 20%.</p> <p><i>Benefits from Distributions of Earnings or Net Assets</i></p> <p>4.32 An entitlement to ownership benefits will usually arise through a residual interest in an entity that establishes an ability to participate in current or future distributions of earnings or net assets. In identifying residual interests, access to the whole of the benefit inflows arising from gross assets is not a key consideration. A parent will not have access to benefit inflows of an amount equal to those gross assets, as the creditors have a prior claim. For this reason, it is necessary to focus on the benefit flows associated with the net assets of the entity. Often evidence as to who is entitled to these benefits is given by who stands to suffer or gain from the financial performance of the entity.</p> <p><i>Receipt of Benefits by Parent Not Required</i></p> <p>4.33 A parent's entitlement to distributions of earnings or distributions of net assets is not dependent on whether the parent is the actual recipient of a distribution that has been made. The entitlement depends on a parent's ability to obtain the proceeds of a distribution and apply those proceeds as it determines. Therefore an entitlement to ownership benefits will continue to be held by a parent where distributions are made by a subsidiary to third parties in circumstances where the parent has the ability to claim those resources for its own purposes. Usually such circumstances will arise where the parent has expressly directed, through its capacity to determine the financing and operating policies of the subsidiary, that the transfer be made to third parties.</p> <p><i>Other Benefits from Control over Net Assets</i></p> <p>4.34 Ownership benefits may also comprise benefits from net assets other than residual distributions. A parent's entitlement to other ownership benefits depends on whether the power element held by the parent has been exercised to ensure that, should such other ownership benefits emerge, the benefits will flow to the parent. For example, a parent will be entitled to any synergistic benefits arising as a result of the parent using its decision-making power to combine certain functions of the parent and the subsidiary to create economies of scale.</p> <p><i>Benefits from Complementary Activities</i></p> <p>4.35 A parent's entitlement to other ownership benefits may also</p>
--	--

	<p>arise in circumstances where there is a supply of goods or services to a third party by the possible subsidiary, which meets an operating objective of the parent. For example, it is common for special entities such as trusts to be established to provide certain services to support the operating objectives of another entity. In such circumstances, a parent may benefit from complementary activities. Because it can be difficult to identify clearly whether a given circumstance establishes an entitlement to receive the benefits resulting from complementary activities, this Standard takes the position that such entitlement arises when all three of the following conditions apply:</p> <ul style="list-style-type: none"> <li>• the supply of goods or services by the possible subsidiary is directly consistent with, and is likely to enhance, the operating objectives of the parent, and</li> <li>• determination of the nature of the goods or services to be supplied is a direct consequence of the exercise of the parent's decision-making ability over the activities of the possible subsidiary, and</li> <li>• the parent is relieved, as a result of the activity of the possible subsidiary, of an actual or constructive obligation to provide such supply; or the parent has a right to receive a future service delivery from the possible subsidiary which is not subject to additional funding to be provided by the parent.</li> </ul> <p><i>Responsibility for loss with or without entitlement to benefit</i></p> <p>4.36 The term “ownership benefits” requires that a favourable result can be obtained by a parent from its ability to exercise power over the activities of another entity in order to satisfy the benefit element of control. A favourable result will include reduced deficits, in addition to increased surpluses. An entitlement to ownership benefits may exist where there is both an ability to share in any surplus and a requirement to bear any loss, but such entitlement will not exist where there is only a requirement to bear any loss. A requirement to bear any loss does not in itself diminish its entitlement to benefits from that other entity at some future point. It will only be where the requirement to bear any loss exists on its own, without a corresponding entitlement to share in any gain, that the benefit element of control will not be satisfied. The effect of entitlement to ownership benefits and a requirement to bear any loss on the benefit element of control can be summarised as follows:</p> <p>(i) entitlement to significant benefits with no exposure to loss = benefit element satisfied</p> <p>(ii) entitlement to significant benefits with exposure to loss = benefit element satisfied</p> <p>(iii) exposure to loss but no entitlement to significant benefits = benefit element not satisfied</p> <p>4.37 The guarantee of liabilities or other obligations of an entity without any other interest or involvement in the entity is an example of a requirement to bear any loss without any entitlement to share in any</p>
--	--



	<p>surplus. The same situation will apply in the case of a securitisation arrangement that exposes the transferor to recourse from the financier with regard to certain financial instruments, while not providing the possibility of a further benefit accruing to the transferor. Although a prior benefit may have accrued to the transferor, once transferred there can be no current or future entitlement to benefits but only a continuing requirement to bear any resulting loss that might occur. While control, and therefore consolidation, will not be applicable in such cases, the obligation to meet any such loss will need to be recognised as a provision or, unless the possibility of such loss is remote, disclosed as a contingent liability, in accordance with FRS-15: <i>Provisions, Contingent Liabilities and Contingent Assets</i>.<sup>4</sup></p> <p><b>Assessing the Existence of Control</b></p> <p><i>COMMENTARY</i></p> <p><i>Application of Judgement</i></p> <p>5.9 The existence of control as defined in this Standard is a question of fact. The determination of the fact that control exists will, however, often require the application of judgement. This is because control of an entity can be attained in a variety of ways, and the underlying circumstances will vary between differing situations. Paragraph 5.10 sets out a number of rebuttable presumptions, which, in the absence of any evidence to the contrary, will indicate the existence of control. Where a given situation does not apparently match one or more of the rebuttable presumptions, the lists of indicators of both ownership powers and ownership benefits in paragraph 5.11 may still be sufficient to establish the existence of control. The decision tree in Appendix 2 of this Standard indicates how these rebuttable presumptions and indicators are to be applied in determining whether control exists in any given situation.</p> <p><i>Rebuttable Presumptions</i></p> <p>5.10 The definition of control under this Standard requires, subject to two limited exceptions, that there be both a power element and a benefit element. The circumstances listed in this paragraph establish a rebuttable presumption that control exists. A rebuttable presumption is only rebutted when there is clear evidence of control not being held by the entity in question. This evidence is likely to arise through the existence of other rebuttable presumptions, or indicators listed in paragraph 5.11, being applicable to another entity. All the circumstances listed in this paragraph should be assessed with regard to each situation.</p> <ol style="list-style-type: none"> <li>(1) A beneficial ownership of a majority voting interest in an entity.</li> <li>(2) A unilateral power to obtain a majority voting interest through ownership of securities or other rights that are currently convertible into a majority voting interest at the option of the holder where conversion is favourable to the holder.</li> <li>(3) A unilateral power to appoint or remove a majority of the members</li> </ol>
--	---

<sup>4</sup> Extracted from ICANZ Members' Handbook, November 2001, FRS-37.

	<p>of the governing body of an entity.</p> <p>(4) A unilateral power, through any form of mechanism, to set or modify the financing and operating policies that guide the activities of an entity.</p> <p>(5) A unilateral power to extract distributions of economic benefits from an entity.</p> <p>(6) A right that is directly attributable to the ownership interest in another entity, to a majority of the economic benefits arising from that entity, irrespective of the timing or the mode of distribution of the benefits.</p> <p>(7) A unilateral power to dissolve an entity and obtain a significant level of the residual economic benefits.</p> <p>The use of the word “unilateral” in describing the power elements in presumptions (2), (3), (4), (5) and (7), is to be read as a discretion to exercise the particular power in the ordinary operating circumstances of the entity. As explained in paragraph 4.21, a unilateral power arises from a decision-making capacity that cannot be shared or divided. Essentially it refers to a power of a participatory nature rather than a power of a protective nature in the context of the discussion on “restrictions on activities” in paragraph 4.22.</p> <p><i>Indicators</i></p> <p>5.11 Where a rebuttable presumption is not apparent, the following indicators may still be sufficient to establish the existence of control. In some circumstances any one or more of these may confirm the existence of one of the rebuttable presumptions listed in paragraph 5.10, and control will then be presumed to exist. When this is not the case, an identification of control will require the existence of both a power element indicator from the first group (A) and a benefit element indicator from the second group (B). Ordinarily, for control to be evidenced in such manner, such indicators will be linked. In other words, the benefit element indicator will ordinarily either be established by a power mechanism or result from the exercise of a decision-making power attributable to the substance of a particular power element indicator. In circumstances when both power element and benefit element indicators exist in favour of more than one entity, judgement will be needed, based on all the relevant indicators and other circumstances, as to which entity is the most likely parent or whether control does not exist.</p> <p><b>(A) Indicators of Power Element</b></p> <p>(1) Ownership of a large minority voting interest and no other entity or organised group of entities has a significant interest.</p> <p>(2) Retention of a significant minority voting interest after previously holding a majority voting interest.</p> <p>(3) The holding of direct or indirect title to instruments entitling</p>
--	---

<sup>5</sup> Extracted from ICANZ Members' Handbook, November 2001, FRS-37.

	<p>appointment of a majority of the members of the governing body of an entity.</p> <p>(4) An ability demonstrated by a recent election to dominate the process of nominating candidates for the governing body of an entity and to cast a majority of the votes cast in an election of members of that governing body.</p> <p>(5) An ability to cast a majority of the votes usually cast in an election of members of the governing body of an entity.</p> <p>(6) An ability to use the resources of an entity to dominate the process of nominating members of the governing body of the entity and to solicit proxies from other holders of voting power.</p> <p>(7) A right to appoint members of the governing body of an entity to fill vacancies until the next election.</p> <p>(8) A continuing ability to appoint a significant number of the members of the governing body of an entity for which majority appointment or election powers were previously held.</p> <p>(9) An ability to determine the casting of a majority of the votes cast at a meeting of the governing body.</p> <p>(10) A direct or indirect ability to determine the revenue-raising, expenditure and resource-allocation policies of another entity, including an ability to modify or approve the entity's budget or an ability to modify or approve rate or fee changes affecting revenues of the entity.</p> <p>(11) A direct or indirect ability to veto, overrule or modify decisions of the governing body other than for the purpose of protecting existing legal or contractual rights or restrictions.</p> <p>(12) A direct or indirect ability to appoint, hire, reassign or dismiss key management personnel of the entity.</p> <p>(13) A unilateral ability to dissolve an entity and redirect the use of its individual assets, subject to claims against those assets, without assuming economic costs in excess of the expected benefits from redirection of the assets.</p> <p><b>(B) Indicators of Benefit Element</b></p> <p>(1) The holding of direct or indirect title to the net assets of an entity with an ongoing right to access those assets.</p> <p>(2) Ability under existing regulation or other instrument to access resources of an entity for purposes determined by the entity holding such ability.</p> <p>(3) A right to a significant level of the net assets of an entity in liquidation or in a distribution other than liquidation.</p> <p>(4) A right to a significant level of the distributed or undistributed surpluses attributable to holders of an ownership interest.</p> <p>(5) A right to a significant level of the distributed or undistributed surpluses attributable to holders of an ownership interest that would arise through the exercise of securities or other rights held that may be converted at the option of the holder without assuming risks or obligations in excess of the expected benefits from the conversion.</p>
--	---

	<p>(6) A right to a significant level of the change in the value of net assets or the rights thereto, excluding contributions and withdrawals of members of that entity, either periodically or cumulatively, and whether received in the form of management fees or distributions.</p> <p>(7) A right to derive net cash inflows or other economic benefits from an entity under an arrangement which limits that entity to activities consistent with the activities of the entity able to derive the economic benefits.</p> <p>(8) An ability to derive significant cash inflows, or other economic benefits, through an ability to use the assets of another entity.</p> <p>(9) An ability to reduce the risk of incurring losses or to limit other risks associated with ownership.</p> <p>(10) An ability to access cash flow synergies arising from a restructuring of the operations of either entity which occurs as a direct result of the acquisition of an ownership interest in one entity by another entity.</p> <p>(11) The undertaking, by an entity, of an activity involving the supply of goods or services that is directly consistent with, and is likely to enhance, the investor's operating objectives in circumstances where:</p> <ul style="list-style-type: none"> <li>• determination of the nature of the goods or services to be supplied is a direct consequence of the exercise by the investor of a decision-making ability over the activities of the entity; and</li> <li>• the investor is relieved, as a result of the activity of the entity, of an actual or constructive obligation to provide such supply; or the investor has a right to receive a future service delivery from the entity which is not subject to additional funding to be provided by the investor.<sup>5</sup></li> </ul> <p><b>Control Assessment Decision Tree (Appendix 2)</b></p>
--	--

	<div data-bbox="846 184 1351 331"> <p><b>Key</b>  RP rebuttable presumption under paragraph 5.10  PI power indicator under paragraph 5.11  BI benefit indicator under paragraph 5.11</p> </div> <pre> graph TD     START((START)) --&gt; D1{Is one or more RP apparent?}     D1 -- N --&gt; D2{Does either one PI or one BI exist?}     D1 -- Y --&gt; D3{Does one or more RP exist in favour of another party?}     D2 -- Y --&gt; D4{Does PI or BI establish existence of one or more RP?}     D2 -- N --&gt; D5{Does either a BI exist to complement the PI, or a PI exist to complement the BI?}     D3 -- Y --&gt; D6{Does other party control entity under consideration?}     D3 -- N --&gt; CE[Control exists]     D4 -- Y --&gt; D6     D4 -- N --&gt; D5     D5 -- Y --&gt; CE     D5 -- N --&gt; CNE[Control does not exist]     D6 -- Y --&gt; CE     D6 -- N --&gt; CNE   </pre>
United Kingdom (statistical guidelines)	<p><b>The distinction between public and private sector bodies.</b></p> <p>The UK bases its processes on the rules in the European System of Accounts (ESA95). On occasions reference may be made to SNA93, when the ESA does not provide the necessary precision but this is unusual.</p> <p><b>Process</b></p> <p>The UK operates a formal process for deciding on marginal, large or controversial classification cases. This is fully described on the ONS website.  <a href="http://www.statistics.gov.uk/about/Methodology_by_theme/bec/downloads/About_NACC.pdf">http://www.statistics.gov.uk/about/Methodology_by_theme/bec/downloads/About_NACC.pdf</a> These decisions are taken by a National</p>

	<p>Accounts Classifications Committee (NACC), which is a committee of national accounts experts chaired by the Director of National Accounts Group. Decisions are authorised at an appropriate level and published on the ONS website with detailed explanations as necessary. Decisions follow the principles of ESA and when necessary are quality assured by Eurostat.</p> <p>More straightforward cases are decided against a summary of the international rules by government departments, the UK Treasury or ONS officials. (See CLASS1 note attached separately.) They can still be referred to the NACC if any party wishes or the decision is challenged in any way.</p> <p><b>Background</b></p> <p>UK National Accounts classification decisions are consistent with the principles of the international statistical manuals, the <i>European System of Accounts 1995</i> (ESA95) and the <i>System of National Accounts 1993</i> (SNA93), and supporting manuals and case law.</p> <p>Paragraph 2.18 of ESA95 defines how units acting in the economy are grouped into institutional sectors:</p> <p><i>Each of the sectors and sub-sectors groups together the institutional units which have a similar type of economic behaviour.</i></p> <p><i>The institutional units are grouped into sectors on the basis of the type of producer they are and depending on of their principal activity and function, which are considered to be indicative of their economic behaviour. A sector is divided into sub-sectors according to the criteria relevant to that sector; this permits a more precise description of the economic behaviour of the units.</i></p> <p><i>The accounts for sectors and sub-sectors record all the activities, whether principal or secondary, of the institutional units covered.</i></p> <p><i>Each institutional unit belongs to only one sector or sub-sector.</i></p> <p>Chapter 2 of ESA95, which defines the institutional sectors in the National Accounting system, concentrates on control rather than ownership. For example, paragraph 2.28, which defines public non-financial corporations, states:</p> <p><i>The sub-sector public non-financial corporations consists of all non-financial corporations and quasi-corporations that are subject to control (see paragraph 2.26) by government units.</i></p> <p>The key paragraph in ESA95 for determining control is 2.26. Although this refers to corporations, it sets out general standards to follow. It is reproduced below:</p>
--	---

	<p><i>Control over a corporation is defined as the ability to determine general corporate policy by choosing appropriate directors, if necessary.</i></p> <p><i>A single institutional unit (another corporation, a household or a government unit) secures control over a corporation by owning more than half the voting shares or otherwise controlling more than half the shareholders' voting power. In addition, government secures control over a corporation as a result of special legislation decree or regulation which empowers the government to determine corporate policy or to appoint the directors.</i></p> <p>The approach to classification cases is to consider whether there:</p> <ul style="list-style-type: none"> <li>(i) is control or influence over an entity's directors through the appointment process; or</li> <li>(ii) any special factors that enable any part of the public sector to determine general corporate policy, either individually or collectively.</li> </ul> <p>In addition to securing control through power of appointment, ESA95 recognises that control over a corporation can result from legislation, decree or regulation. We therefore examine the situation to see whether any of these apply. The following sections discuss the indicators of control more fully. They are not comprehensive – each case needs examining on its merits.</p> <p><b>Detail</b></p> <p>Indicator 1 – ownership of the majority of shares if decisions are made on a one share / one vote basis (there are cases where ownership is on a different basis to control). Need to look at ownership of the whole public sector as a number of public sector entities may hold shareholdings which need to be aggregated. This is not relevant in all of the public sector as many UK public corporations do not have shares. Examples of cases where it has been relevant temporarily is when the government has taken control of a private company in difficulty.</p> <p>Indicator 2 – control of the board of directors through appointments. In many cases this is relatively easy to determine although again it is necessary to look at the total of public sector influence. There may be appointees of different levels of general government and of public corporations which need to be aggregated to assess the situation. Even when the public sector does not control the appointment of directors, they may have the right to veto proposed appointments. This can be seen as an indirect form of control if it influences the choices made. (This right of veto may also be relevant to indicators 3 and 4 below.) Another body, including a subset of the board itself, may be responsible for appointing the directors. In these cases it is necessary to look at the composition of these other bodies to see whether these are majority</p>
--	--

	<p>public sector or not. There may also be timing issues if the government (or the public sector more widely) appoints the first set of directors but does not control the appointment of replacement directors. The body would then be public sector until the initial appointments had expired, provided there was no control of the next set of appointments.</p> <p>Indicator 3 – control of the appointment of key directors. In cases where control of the board is marginal look at the appointment of key executives, including the chief executive, chairman and finance director. Non-executive directors may also be relevant if they sit on key committees such as the remuneration committee determining the pay of senior staff.</p> <p>Indicator 4 – control of key committees of the entity. Sometimes key policies of the entity are determined by sub-committees of the board. Examine whether any of these have a majority public sector membership. This can happen under the constitution if it specifies that some public sector members of the board must be on the committee.</p> <p>Indicator 5 – “Golden Shares”. In the UK the government owns a “golden share” in some companies, particularly those which have been privatised. This share gives the government some residual rights to protect the interests of the public and, for example, prevent the company selling off some categories of assets. The share may confer the right to appoint a special director who has strong powers in certain circumstances. The government has indicated that they do not expect to exercise the power of the “golden share” in normal circumstances and the companies’ owners/shareholders have accepted the existence of the “golden share” voluntarily. Thus the powers covered by such “golden shares” are seen as contingent and not indicative of control. However if the powers were ever used then the entity would be immediately reclassified to the public sector from that date.</p> <p>Indicator 6 – regulation. The borderline between regulation and control can be difficult to judge. There are many examples of government involvement through regulation, particularly in areas such as monopolies and privatised utilities, but regulatory involvement itself is not necessarily control. Therefore, it is possible for there to be regulatory involvement in important areas, such as setting prices, without the entity ceding control of general corporate policy. Where regulations are accepted by the entity (ie the entity chooses to operate in a highly regulated environment) this suggests that they are not equivalent to control. However, when the regulation is so tight as to effectively dictate how the entity performs its business, then this is recognised as a form of control.</p> <p>Indicator 7 – control by a dominant customer. If 100% of sales are to one public sector customer there is clear scope for dominant influence. This can also apply when slightly less than 100% of sales are to one customer, although the presence of a minority customer usually implies</p>
--	---



	<p>an element of independent decision making.</p> <p>Indicator 8 – controls attached to borrowing from the government. Lenders often impose controls as conditions of making loans. If they are more than would be typical when a healthy private sector entity borrows from a bank, they indicate control.</p> <p>Indicator 9 – other controls associated with the entities constitution and other rules. There are often a number of formal legal documents underpinning an entity. These need to be examined for indications of control although it is difficult to cover all eventualities. The following list suggests points to watch for to check whether government can:</p> <ul style="list-style-type: none"> <li>• determine aspects of how the body delivers its outputs</li> <li>• have a final say in sale/acquisition of fixed assets</li> <li>• be entitled to share of proceeds of asset disposals that goes beyond the repayment of previous government support for capital formation</li> <li>• close the body</li> <li>• prevent the body from ending its relationship with government</li> <li>• change the constitution of the body</li> <li>• decide what sort of financial transactions the body can undertake, or limit them</li> <li>• prevent the body from receiving certain types of income from other sources</li> <li>• exert numerous minor controls over how the body is run</li> <li>• exert financial control (n.b. this is different from funding) as part of a general system of controlling public expenditure</li> <li>• control dividend policy</li> <li>• set pay rates</li> <li>• (for non-regulatory reasons) approve acquisitions.</li> </ul> <p>Indicator 10 – look at the totality of the case to check whether the total impact of all indicators implies control, even when none of them does on its own.</p>
USA (statistical guidelines)	<p>This memorandum describes the current guidelines used by the Bureau of Economic Analysis to assign institutional units to the public sector for the U.S. national accounts. As discussed below, BEA prepares national accounts statistics for the public sector primarily using Federal Budget and U.S. Census Bureau <i>Government Finances</i> data, adjusted to meet national accounting conventions.</p> <p>Central government</p>

	<p>For the Federal (Central) Government, BEA relies substantially on Federal budget data to prepare national accounts statistics. The 1967 President's Commission on Budget Concepts developed important recommendations on classifying Federal Government institutional units.<sup>6</sup> These recommendations are used by the U.S. Office of Management and Budget to classify institutional units in the budget. The Commission concluded that the coverage of the budget should be comprehensive of the full range of Federal activities; borderline institutional units or transactions should be included unless there are exceptionally persuasive reasons to exclude them. The Commission suggested several questions to be asked when making decisions concerning whether institutional units should be included in the budget. As modified by experience, these questions are: (1) Who owns the unit? (2) Who supplies the unit's capital or other financial resources? (3) Who selects the unit's manager(s)? (4) Do the Congress and the President control the unit's program and budget or bear responsibility only in some broad ultimate sense? (5) Does the unit exercise sovereign powers? The Commission believed that the answer to no one of these questions is conclusive, and each answer is a matter of degree. Decisions on whether to include institutional units in the budget and, thereby, the Federal Government, should be made by a net weighing of as many relevant considerations as possible. Generally speaking, an institutional unit is more governmental and therefore the reason to include it in the budget is stronger to the extent that the answers to questions 1-3 are "the Federal Government," the answer to questions 4 is "Congressional and Presidential control," and the answer to questions 5 is "yes."</p> <p>The Federal Budget defines public enterprise funds as revolving funds that are authorized by law to conduct business-type activity, primarily with the public, in which the enterprises sell products or services and use the proceeds to finance operating expenses. Public enterprise funds are in the budget, and are included in the public sector. However, the budget does not define "business-type activity" explicitly; the implication is that enterprises cover a substantial portion of their operating costs with sales revenue.</p> <p>In general, BEA adopts the Federal Budget's classification of institutional units when preparing national accounts statistics. However, there are selected cases where BEA deviates from the budget's classifications, and imposes different classifications for institutional units.<sup>7</sup> In these cases, BEA relies upon <i>System of National Accounts, 1993</i> (SNA) guidance when classifying these units. A unique case is the U.S. Federal Reserve System, the nation's financial</p>
--	---

<sup>6</sup> See *Report of the President's Commission on Budget Concepts*, U.S. Government Printing Office, October 1967. Also see Chapter 25, "The Budget System and Concepts," in the *Analytical Perspectives Budget of the United States Government, Fiscal Year 2005* at <http://www.whitehouse.gov/omb/budget/fy2005/>.

<sup>7</sup> Examples of these cases include retirement programs/funds; the Universal Service Fund; thrift bailout agencies; credit accounts; and deposit funds and foreign currency accounts.

	<p>authority, where the system's Board of Governors is classified in the public sector, while the system of Federal Reserve Banks is classified in the private corporate sector.<sup>8</sup></p> <p>Regional governments</p> <p>For state and local (regional) governments, BEA relies substantially on Census Bureau data to prepare national accounts statistics. Part 3.12 of the Census Bureau's <i>Government Finance and Employment Classification Manual</i> provides a definition for "government":<sup>9</sup></p> <p style="padding-left: 40px;">A government is an organized entity which, in addition to having governmental character, has sufficient discretion in the management of its own affairs to distinguish it as separate from the administrative structure of any other governmental unit.</p> <p>This definition reflects a requirement that a government entity be autonomous (operating on its own and being separate from other units), which is consistent with the SNA. The Census Bureau manual describes the concept "having governmental character" using references to the methods used to select the entity's officers (popular election or appointment by public officials), performing governmental functions, and requirements for public accountability.</p> <p>Importantly, Part 3.13 of the manual also discusses entities that are "dependent" on government, and distinguishes between parent governments and sub-governmental units; all three types of entities (dependent, parent, and sub-governmental units) are classified within the public sector.</p> <p>The Census Bureau reflects four categories of governmental activities: General, utility, liquor stores, and insurance trusts. The utilities (water supply, electricity, gas supply, and transit) are classified as commercial-type activities by the Census Bureau.<sup>10</sup> BEA classifies the utilities plus the following types of institutional units as state and local government enterprises: Liquor stores, air and water terminals, toll facilities, housing and urban renewal, sewerage, and miscellaneous commercial activities (parking facilities, lotteries, off-track betting, and miscellaneous insurance trusts).<sup>11</sup> BEA classifies these institutional units as government enterprises because they produce goods or services for sale to the public, their sales cover a substantial portion of their operating costs, and because they maintain separate accounts.</p> <p>Notably, BEA classifies health, hospitals, and higher education</p>
--	--

<sup>8</sup> The Federal Reserve System is not reflected in the Federal Budget.

<sup>9</sup> See *Government Finance and Employment Classification Manual*, Chapter 3 – "Framework of Census Statistics on Government" at [http://www.census.gov/govs/www/class\\_ch3.html](http://www.census.gov/govs/www/class_ch3.html).

<sup>10</sup> The Census Bureau does not define "commercial-type."

<sup>11</sup> The Census Bureau classifies these units in general government.

	<p>institutions as part of general government, even though in some cases their sales of services may cover a substantial portion of their operating costs. This aspect of BEA's classification is part of BEA's research agenda.</p> <p>Please let us know if you have questions.</p> <p>BBR:11/05/04</p>
--	---