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International Public Sector Accounting Standards Board
International Federation of Accountants
277 Wellington Street West
Toronto Ontario Canada M5V 3H2

Subject: International Public Sector Accounting Standards Board *Consolidated Financial Statements* Exposure Draft 49

This letter provides the U.S. Government Accountability Office's (GAO) comments on the International Public Sector Accounting Standards Board (IPSASB or the Board) Exposure Draft (ED) 49 entitled *Consolidated Financial Statements* which relates to the establishment of principles for the presentation and preparation of consolidated financial statements when an entity controls one or more entities. Our general comments follow.

The *Consolidated Financial Statements* ED 49 is drawn primarily from the International Financial Reporting Standards (IFRS) 10 *Consolidated Financial Statements* issued by the International Accounting Standards Board. Once approved, ED 49 will supersede International Public Sector Accounting Standard (IPSAS) 6 entitled *Consolidated and Separate Financial Statements* which was developed specifically to address public sector issues or circumstances surrounding consolidations. It is our view that certain key aspects of IPSAS 6 should be retained, with some modifications, in the IPSASB's new standard for *Consolidated Financial Statements* as there are unique considerations and transactions that occur exclusively in the public sector which warrant a different accounting treatment to accurately portray the economic substance of these transactions.

The ED proposes to withdraw the current exemption for temporarily controlled entities in IPSAS 6 paragraphs 20 -22 which states that:

> 20. Consolidated financial statements shall include all controlled entities of the controlling entity, except those referred to in paragraph 21.
> 21. A controlled entity shall be excluded from consolidation when there is evidence that (a) control is intended to be temporary because the controlled entity is acquired and held exclusively with a view to its disposal within twelve months from acquisition, and (b) management is actively seeking a buyer.
> 22. Such controlled entities are classified and accounted for as financial instruments...

We believe that the IPSAS for *Consolidated Financial Statements* should exempt certain temporarily controlled entities from consolidation to appropriately provide for economic transactions which uniquely occur in the public sector that are not necessarily included in IFRS

10. Our views consider experiences in the United States over the last several years. Our rationale for the exemption of certain temporary controlled entities from consolidation is that:

(1) there are exceptional circumstances where a public sector entity may exercise regulatory or other sovereign power and intervene in private sector entities and the standard should provide for these circumstances;
(2) consolidating financial information related to entities where the public sector entity has less than permanent control provides misleading information in the public sector entity's financial statements;
(3) with respect to such non-permanent interventions, the principal users of the public sector entity's financial statements are concerned with the investment recoverability and identification of further risks associated with the intervention activity;
(4) note disclosures can provide a comprehensive understanding of the nature, benefits, and risks associated with the intervention activity that articulate the economic substance of the intervention activity without obscuring the public sector entity's finances;
(5) there are significant costs to the public sector entity for the preparation and audit of the financial information of the private sector entity using IPSASB standards; and,
(6) consistent and sufficient criteria can be developed to identify categories of private sector entities which should not be consolidated can be developed.

Exceptional Public Sector Interventions in the Private Sector

In response to exceptional circumstances, such as economic instability or security concerns, a public sector entity may exercise regulatory or other sovereign powers and intervene in private sector entities. Some of these interventions may result in control over a private sector entity, while others do not. Such interventions arise because of the public sector entity's broad responsibility for the well-being of its jurisdiction, rather than routine public sector activities. Such intervention actions may relate broadly to entire markets, to key industries, or specific entities. Control may be obtained for a variety of reasons, such as ensuring that the public sector entity will optimize the recovery of its investment, enhancing the likelihood that the entity will continue to operate, and preventing other investors from unfairly profiting from the intervention. Moreover, in recent years, an increasing number of public sector entities have experienced such unusual temporary intervention transactions and we believe that the standard should provide sufficient latitude to appropriately account for these types of circumstances.

Control Is Not Expected To Be Permanent And Consolidating Such Information Provides Misleading Financial Information

For many interventions carried out by the public sector entity, it is clear at the time of the acquisition of a controlling interest in a private sector entity that the public sector entity intends to dispose of its interest as soon as economically practicable and that control of the private sector entity is not expected to be permanent, but rather is expected to be temporary. Such expectations may be made clear through legislation or other actions of the public sector entity. In some instances, interventions of private sector entities may be controlled through specific legal structures, such as receiverships and conservatorships, which may indicate the intent of the public sector entity's actions. For example, receiverships or conservatorships are established to liquidate failing institutions or to guide such institutions back to safe and sound conditions, respectively. Generally, such private sector entities are under some form of economic duress and the intervention by the public sector entity provides temporary relief or liquidity to such entities.

While the public sector entity plans to dispose of its investments in the private sector entity as soon as economically practicable, the timing of the public sector entity's actions to dispose of its investments may be affected by its efforts to maximize the recovery of the public sector entity's investments in the intervention entities, as well as by the financial health of the intervention entities and market conditions. Because of the unique and often severe conditions leading to these public sector interventions, the exact period of control may not be known or estimable and may exceed one year, even though the public sector clearly intends control to be temporary. Consequently, the temporary nature of the control would need to be reconfirmed at the end of each reporting period.

It is our view that consolidating financial information related to entities where the public sector entity has less than permanent control provides misleading information in the public sector's financial statements by obscuring the public sector entity's liabilities or risks with respect to the temporarily-controlled entity (because balances between the entities would be eliminated). It also provides misleading information about the public sector entity's financial resources and obligations by including the private sector entity's:

- assets (such as inventory and production plant) that are not available for the ongoing operations of the public sector entity;
- liabilities that are not the responsibility of the public sector entity; and,
- revenues and expenses that do not reflect the public sector entity's operations.

Principal Users Of Financial Statements Seek Information On The Investment Recoverability And Identification Of Further Risks

Consistent with the public sector entity's intention to dispose of its interests as soon as economically practicable, the public sector entity's focus, which may be clearly indicated through laws or its actions, is on investment recovery and any further risks. Consequently, the principal user information needs relate to the public sector entity's accountability to the public regarding (1) the public sector entity's recoverability of its investments and any potential further public sector entity investments in the entity, and (2) minimizing loss of taxpayer funds. Accordingly, users' needs are best met through information about amounts invested, the market value or fair value of the investment (consistent with IPSAS 29 *Financial Instruments*), any additional liabilities or contingencies for further investments in such entities (in accordance with existing reporting standards), and disclosure of any additional risks that could result in future losses through additional disclosure requirements. In addition, such reporting should be consistent with other interventions for which control was not obtained or which are no longer controlled by the public sector entity. Contrary to meeting such user needs, consolidation of intervention entities meeting the above characteristics would fail to provide useful information on the recoverability of investments in such temporarily controlled entities. Further, it is our view that disclosure of recoverability information would not be an effective substitute for proper recognition. In addition, consolidation and deconsolidation within a relatively short period of time (e.g., 2-3 years) could lead to user confusion and significant costs.

Note Disclosures Can Provide a Comprehensive Understanding of the Nature, Benefits, And Risks Associated with the Intervention without Obscuring the Public Sector Entity's Finances

It is our view that note disclosures can provide a more comprehensive understanding of the nature, benefits, and risks associated with intervention activities than would be provided through the consolidation of certain temporarily controlled private sector entities. These disclosures could reveal the nature of the relationship of the temporarily controlled entity to the public sector entity, provide relevant activity that occurred during the reporting period, and describe any financial and non-financial risks and potential benefits to the public sector entity. We believe that the development of principles for comprehensive note disclosures related to the intervention activity would more appropriately reflect the economic substance of the intervention activity without obscuring the public sector entity's finances.

Costs to Prepare and Audit the Intervention Entities Could Be Significant

If such intervention entities were consolidated, the overall cost to the public sector entity to prepare and audit the financial information of such private sector entities could be significant. These entities may be required to continue to file audited financial statements on a private sector GAAP basis with security regulators. The financial statements would need to be analyzed and converted, as necessary, to IPSAS standards and the public sector entity would likely directly bear the additional costs of the audit.

Sufficient Criteria Can Be Developed For Identifying Such Entities

We believe that sufficient criteria can be developed for consistently identifying entities that are temporarily controlled. For example, the following characteristics could be used to identify such entities: (1) control results from exceptional interventions in the private sector, (2) control over the entity is not expected to be permanent, and (3) investment recoverability and identification of further risks are the principal user information needs, all of which we have previously discussed.

Other Considerations For Excluding Certain Temporarily Controlled Entities from Consolidation

Our experience in the United States provides an illustrative example of such intervention activities. In 2009, the federal government carried out significant activities to stabilize the financial markets and to promote economic recovery. These activities included making material investments in certain private sector entities--some of which represented majority ownership. Many such activities were carried out through the Troubled Asset Relief Program (TARP). It was clear from the onset of the TARP that such private sector entity investments were not intended to be permanent. The legislation authorizing TARP contained specific requirements that TARP:

- hold the private sector entity assets it had acquired until such time when market conditions were optimal for selling such assets, in order to maximize the value for taxpayers; and,
- sell such assets at a price that, based on available financial analysis, would maximize its return on investment for the federal government.

In the Unites States Consolidated Financial Report, TARP investments--both those of controlled entities and of non-controlled entities--were valued at fair value and supplemented with disclosures that provided information on the nature of the arrangements, relevant activity during the period, and the identification of further risks associated with such activities. Looking back, as TARP has liquidated most of its investments, it is clear that federal government decision makers and taxpayers were primarily interested in financial information concerning the extent to which the federal government's TARP investments would be recovered and that the reported financial information was used to help financial statement users assess the TARPs activities and provide accountability over U.S. taxpayer provided resources.

Currently, the Federal Accounting Standards Advisory Board (FASAB) is reconsidering the criteria used to determine entities that should be consolidated. In its Exposure Draft entitled *Reporting Entity,* the Board proposed that a controlled entity may be excluded from consolidation if it is an intervention activity and the relationship with the federal government is not expected to be permanent. The FASAB is currently considering comment letters on the exposure draft. The exposure draft also would require disclosures related to the relationships, activity, and risks associated with intervention activities.

We appreciate the opportunity to provide comments on this important work. Please contact me at (202) 512 – 2600, or sebastians@gao.gov if you have questions on GAO's perspectives.

Sincerely yours,

Steven J. Sebastian

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