

Public Audit Act 2001: Explanation of the “Control Test” for the Purposes of Section 5(2)

Introduction

- 1 The Public Audit Act 2001 (the “Act”) came into force on 1 July 2001.
- 2 Under section 14 of the Act, the Auditor-General is the auditor of every public entity.
- 3 Under section 15 of the Act, the Auditor-General must audit the financial statements, accounts, and other information that a public entity is required to have audited.
- 4 Section 5 of the Act defines “public entity” as follows:
 - (1) *In this Act, **public entity** means each of the following entities:*
 - (a) *the Crown;*
 - (b) *each office of Parliament, except where another auditor has been appointed for that office under section 40(b) of the Public Finance Act 1989;*
 - (c) *an entity of a class described in Schedule 1;*
 - (d) *an entity listed in Schedule 2;*
 - (e) *an entity in respect of which the Auditor-General is the auditor under any other enactment (other than section 19);*
 - (f) *an entity which is controlled by 1 or more entities of the kinds referred to in paragraphs (a) to (e).*
 - (2) *For the purposes of subsection (1)(f), an entity is controlled by 1 or more public entities if—*
 - (a) *the entity is a subsidiary of any of those other entities; or*
 - (b) *the other entity or entities together control the entity within the meaning of any relevant approved financial reporting standard; or*
 - (c) *the other entity or entities can together control directly or indirectly the composition of the board of the entity within the meaning of sections 7 and 8 of the Companies Act 1993 (which, for the purposes of this paragraph, are to be read with all necessary modifications.).*
- 5 The relevant approved financial reporting standard for the purposes of section 5(2)(b) is FRS-37 *Consolidating Investments in Subsidiaries* (FRS-37).

The “Control” Test

- 6 Paragraphs (a) (b) and (c) of section 5(2) are alternatives, so an entity need only be covered by one of those paragraphs to be a public entity. The three limbs of the control test do overlap in some respects – so that it is possible for an entity to be controlled under more than one limb of the test.

One or More Public Entities

- 7 The “control” test is wider than that normally applied (in, for example, the Companies Act 1993) to determine whether one entity has control of another. Under the Act, an entity is also a public entity if it is controlled by one *or more* public entities (section 5(1)(f)). Therefore, the control test covers an entity where *two or more public entities together exercise control over it*.
- 8 For example, a 50:50 joint venture company co-owned by two public entities is also a public entity, even though it is not a subsidiary of either entity for the purposes of the Companies Act. Likewise, an incorporated society in which public entities together appoint the majority of the governing body (but individually cannot appoint a majority) is a public entity.

Offshore Entities

- 9 The control test also extends to entities based overseas if they are controlled by one or more public entities.

First Limb of the Control Test – Section 5(2)(a)

- 10 An entity that is a “subsidiary” of any public entity is a public entity.
- 11 The definition of “subsidiary” set out in section 4 of the Act refers to:
- ◆ a subsidiary within the meaning of sections 5 to 8 of the Companies Act 1993; and
 - ◆ an entity that is classified as a subsidiary in any relevant approved financial reporting standard.

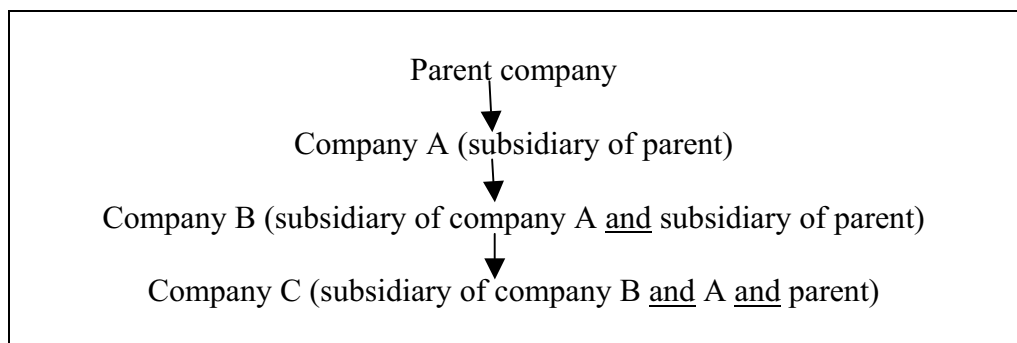
A Subsidiary under the Companies Act

- 12 In summary, sections 5 to 8 of the Companies Act provide that a company is a subsidiary of another company if that other company:

- ◆ controls the composition of the board of the company (i.e. can appoint or remove all or a majority of directors, exercising a power by itself or with the consent of another person); or
- ◆ may exercise or control the exercise of more than 50% of the maximum number of votes that can be exercised at a meeting of the company; or
- ◆ holds more than 50% of the issued shares of the company¹; or
- ◆ is entitled to receive more than 50% of every dividend paid on shares issued by the company¹.

A Subsidiary of a Subsidiary

- 13 Under section 5(2) of the Companies Act, the subsidiary of a company which itself is a subsidiary, is also a subsidiary of that subsidiary’s parent company. It is therefore possible, in a company group situation, for a company to be a subsidiary of more than one company. The diagram below illustrates this extended meaning of “subsidiary”.



Other Features of Companies Act Definition

- 14 In sections 5, 7 and 8 of the Companies Act, the expression “company” includes any body corporate – such as an incorporated society, statutory body corporate, or incorporated trust.
- 15 Section 8 sets out certain matters to be disregarded in determining whether a company is a subsidiary of another company. Such matters include shares held in a fiduciary or nominee capacity, or shares held or a power exercisable under a debenture.

¹ Other than shares that carry no right to participate beyond a specified amount in a distribution of either profits or capital.

A Subsidiary under any Relevant Approved FRS

- 16 The definition of subsidiary in the Act includes a subsidiary under any relevant approved financial reporting standard (FRS). This would cover any subsidiary not covered by the Companies Act definition, such as an overseas subsidiary. The relevant approved FRS for the purpose of determining a “subsidiary” is also FRS-37, so section 5(2)(a) and 5(2)(b) overlap in this respect.

Second Limb of the Control Test – Section 5(2)(b)

- 17 An entity is a public entity if one or more public entities together control the entity within the meaning of any relevant approved financial reporting standard.
- 18 FRS-37 applies to periods ending on or after 31 December 2002 for financial reporting purposes. However, for the purposes of the control test in the Act, it applies now since the Accounting Standards Review Board approved it on 9 October 2001.
- 19 “Control” is defined in paragraph 4.13 of FRS-37 as:

Control by one entity over another entity exists in circumstances where the following parts (a) and (b) are both satisfied:

- (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:*
- (i) *where such policies have been irreversibly predetermined by the first entity or its agent; or*
 - (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.*
- (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.*

- 20 Paragraphs 4.14 to 4.37 of FRS-37 set out commentary guidance, which explains the nature of control and identifies relevant factors which evidence control. Paragraphs 5.9 to 5.11 of FRS-37 provide a structured approach using rebuttable presumptions and indicators to show the likely existence of control.
- 21 FRS-37 defines control for the purposes of consolidating investments in subsidiaries. Therefore, control is discussed as control by **one** entity over another. However, for the purposes of section 5(2)(b) of the Act, control must be considered in the context of **one or more public entities together** controlling another entity (refer paragraphs 7 and 8). Therefore, even if the

entity does not need to consolidate another entity under FRS-37, the other entity may still be a public entity if it is controlled by one or more public entities.

- 22 The diagram at the end of this document provides a decision tree to use in determining whether, on the face of it, one or more public entities together control an entity and, therefore, whether the entity is a public entity.

Third Limb of the Control Test – Section 5(2)(c)

- 23 Section 5(2)(c) is designed to cover related entities such as trusts, which do not meet the FRS-37 control definition because the “benefit” element of control is missing, as well as to address the situation where the control by one or more public entities is indirect.
- 24 Under section 5(2)(c), the Auditor-General is the auditor of any entity where one or more public entities can together control, directly or indirectly, the composition of the board of the entity, within the meaning of sections 7 and 8 of the Companies Act 1993.
- 25 Control of the composition of the board of an entity will exist where the controlling entity can appoint or remove all or a majority of the governing body. For the purposes of section 5(2)(c), sections 7 and 8 are to be read with all necessary modifications, meaning they can be read to apply to entities such as trusts and incorporated societies, as well as companies.
- 26 Section 5(2)(c) overlaps significantly with section 5(2)(a) and 5(2)(b). The key differences include:
- ◆ section 5(2)(c) applies where two or more public entities together control the composition of an entity’s governing body (compare section 5(2)(a)) – which concerns control by one public entity);
 - ◆ control can exist under section 5(2)(c) regardless of whether there is a benefit to the controlling entities (compare section 5(2)(b)); and
 - ◆ section 5(2)(c) applies to situations where the control is indirect (compare section 5(2)(a)).

Indirect Control

- 27 An example is useful to illustrate the effect of the “indirect control” aspect of section 5(2)(c).
- 28 Consider a trust settled by an incorporated society controlled by a number of public entities, where the society has the right to appoint or remove a majority of trustees of the trust. The public entities together appoint the

governing body of the society, so the society is a public entity under the control test (section 5(1)(f) and 5(2)(c)). While the trust is controlled by the society, that does not make the trust a public entity as it is the trust's relationship with the public entities that is relevant for the purposes of the control test.²

- 29 The public entities together *indirectly* control the composition of the governing body of the trust (through direct control of the governing body of the society). The trust would therefore be a public entity because of section 5(1)(f) and 5(2)(c), being indirectly controlled by one or more public entities.
- 30 The trust could also be a public entity under section 5(2)(b), as FRS-37 also covers situations where control is indirect.

² For an entity to be controlled under section 5(1)(f), it must be controlled by one or more entities of the kinds referred to in paragraphs (a) to (e) of section 5.