International Financial Reporting for Non Profit Organizations

Technical Advisory Group

AGENDA ITEM: TAGCP03-02
December 2, 2019 – Virtual Meeting

Definition of control (including the treatment of branches)

Summary	Definition of control has been identified as a specific issue for the not-for profit sector. This paper brings together material gathered from national and international standard setters.
Purpose/Objective of the paper	To allow TAG members to consider the nature of the issue, potential ways forward and text for inclusion in the Consultation Paper.
Other supporting items	None
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Actions for this meeting	Advise on: • The description of the issue • The list of alternatives to address the issue • Links to other international standard development, national standards or other guidance • The need for any further input

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Definition of control (including branches)

1. Consultation Paper Draft

1.1 At the TAG meeting on November 4, the TAG agreed that the definition of control and in particular how this relates to branches should be included in the short list of issues to be included in the Consultation Paper.

1.2 Part 2 of this paper has been drafted for discussion, with the aim that the text is capable of being inserted directly into the Consultation Paper, subject to any drafting comments.

1.3 The document proposes two overarching alternatives; a principles based approach to defining control and a more rules based approach. The Secretariat considered a third alternative of following a principles based approach for larger entities and a rules based approach for smaller entities. Given that IFRS for SMEs follows a more rules based approach and that small and medium sized entities are the anticipated coverage of the Guidance, Secretariat's view was that it wasn't appropriate to effectively sub-divide this further.

1.4 The paper refers to issues around definition of a reporting entity, which has a relationship to branches. With the focus on control, the definition of a reporting entity is not explored in detail.

Question 1: What comments does the TAG have on Sections 1 and 2?

Question 2: Does the summary of current international guidance in Section 3, together with Annex A, accurately reflect the current international standards/guidance?

Question 3: Does the summary of national-level guidance in Section 4, together with Annex A, accurately reflect the current national standards/guidance? Is the TAG aware of any other guidance on the definition of control issued by national standard setters or other regulatory bodies that should be included in the Consultation Paper?

Question 4: Does the TAG agree with the descriptions of the alternatives, their respective advantages and disadvantages, and that they should be included in the Consultation Paper?

Question 5: Does the TAG agree that there are no further alternatives that should be considered for inclusion in the Consultation Paper?

Question 6: What comments does the TAG have on the standard SMCs in relation to this topic and are there other specific SMCs that could be raised?

2. Next steps

2.1 The text drafted below will be included in the Consultation Paper subject to any further comments from the TAG.

2.2 The PAG will be consulted on any specific issues raised by the TAG further to this discussion. For example, the PAG could be asked if there are jurisdictional considerations in the ability to define control.

Question 7: Is there specific input to be sought from the PAG?

November 2019

International Financial Reporting for Non Profit Organizations

Part 2 - Draft Consultation Paper Text

Definition of control (including branches)

1. Description of the issue

1.1 NPOs often operate across many geographical areas. These different geographical areas can be country wide, as in supplying a similar service to different areas of the same jurisdiction, or international, supplying services to other jurisdictions.

1.2 Activities undertaken across a range of locations may be organised through a series of separate offices, rather than via the head office. They may be organised through differing legal structures, by sharing with partner NPOs or associates or by partnering with existing services within the geographical area.

1.3 These structures may involve separate legal bodies, partnerships with another entity in that location or may be an allocation of entity assets, staff and resources. In addition, beneficiaries or supporters of the NPO may also form entities to partner with and/or support the NPO.

1.4 It may be difficult to determine whether a body/activity is controlled by another entity given the nature and complexities of the relationship between them. For example, a legal structure managed by an NPO is more likely to be controlled, whereas it might be difficult to establish whether there is control for an association of local supporters.

1.5 It is important to address this issue to ensure that there is full transparency and accountability over the assets and liabilities of NPOs, particularly where there are complex structures supporting operational delivery. Addressing this issue will also improve comparability between similar types of NPOs.

2. Financial reporting challenges

2.1 NPOs operate under differing regulatory frameworks which may influence the control and resulting consolidation arrangements. Different regulatory frameworks can exist within national jurisdictions for different types of NPOs as well as between them. For example, a UK charity registered as a company follows requirements specified by the Companies Act 2006 while a social enterprise charity will follow the Charities SORP. The different frameworks may lead to financial reporting outcomes for similar activities (although arguably in the UK these control frameworks will lead to similar results for the majority of cases).

2.2 It is likely to be difficult to be able to distinguish between relationships which are substantially affiliation/membership for services and those of a reporting entity within a control structure. For example, local structures may be affiliated with a national brand in order to benefit from using a NPO's logos on its website, or its insurance etc., but maintain distinctly differing financial and governance arrangements. Alternatively an NPO could bring in its own governance and insist on uniform activities and funding structures. Both can appear to the public to be very similar operations but may require very different reporting structures.

2.3 NPOs are also faced with practical issues, for example, difficulties can exist in situations where there is legal power over the operations but there may be resistance in practice to the control that the legal power provides. For example, branches may resist the governance structures by not submitting financial returns or other information requirements. It is also the case that individual branches can be immaterial to the parent NPOs accounts.

2.4 NPOs may therefore find it difficult to determine what degree of control is sufficient to recognise the assets and liabilities (and other resources) of a separate activity or reporting entity into the financial statements of an NPO. NPOs will need to ensure that its decisions relating to control are consistent, using the same the definition of control. An NPO may require substantial information and analysis to ensure a consistent approach.

2.5 In some situations there may be severe long-term restrictions on the ability to exercise rights of one NPO over another and so hinder control, or an entity may be being held exclusively with a view to its subsequent resale. The identification of severe long-term restrictions requires a highly subjective assessment and may fluctuate wildly over relatively short periods of time.

3. Current international guidance

3.1 The definition of control in IFRS 10 *Consolidated Financial Statements* focuses on the substance of transactions and not their legal form. In accordance with this standard an entity (investor) is deemed to control another entity (investee) when the investor is exposed, or has rights, to variable returns from its involvement with the investee and has the ability to affect those returns through its power over the investee.

3.2 The key principle in IFRS 10 is that an investor controls an investee, if and only if, the investor has:

- power over the investee;
- exposure, or rights, to variable returns from its involvement with the investee; and
- the ability to use its power over the investee to affect the amount of the investor's returns.

3.3 IPSAS 35 accords with IFRS 10 and uses the definition of control in that standard. However, IPSASB included a number of amendments to reflect public sector circumstances. Those relevant include:

- removal of references to 'investor';
- use of the term 'benefits' instead of 'returns';
- modification of IFRS 10 to highlight the range of relevant activities that could occur in the public sector and stress that control of financial and operating policies can demonstrate power over relevant activities; and
- clarification that regulatory control and economic dependence do not give rise to power for the purposes of the standard(s).

3.4 Both IFRS and IPSAS state that to have power over another entity, an entity must have existing rights that give it the current ability to direct the relevant activities. The relevant activities are those activities that significantly affect the nature or amount of the benefits from its involvement with the other entity.

3.5 IFRS for SMEs uses a different (but narrower) definition of control which is supported by provisions which are more rules based. It defines control as the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities.

3.6 Under this standard control is presumed to exist when the parent owns, directly or indirectly through subsidiaries, more than half of the voting power of an entity. IFRS for SME's states that this presumption may be overcome in exceptional circumstances if it can be clearly demonstrated that such ownership does not constitute control.

4. **National-level guidance**

4.1 In national level guidance gathered there are essentially two approaches being adopted, which reflect the international standards available. Some countries follow the international standards for the private and public sectors, and so require NPOs to determine control based on principles that relate to the substance of the relationship between entities. At a national level this can be supported by additional guidance specific to NPOs.

4.2 In other jurisdictions there is a closer relationship to the international standard for small and medium sized entities. In these jurisdictions, although there is a principles based definition of control, it is narrower and the focus of the supporting provisions is on the voting or operational control of the entity. Guidance is also provided about the sets of circumstances that would suggest control.

4.3 In addition some jurisdictions have provided additional guidance about branches. In one jurisdiction there is specific guidance about branches which it notes include, special trusts, linked or connected charities and certain joint ventures of charities but that do not involve a separate joint venture. Branches are deemed to be the legal property of a charity and are as covering a charity's administrative arrangements whereby its internal operating structure is arranged according to function, location or other factor designed to facilitate its administration.

4.4 Some jurisdictions provide additional guidance on accounting for branches. One provides indicators that an organisation may be a branch and/or whether a branch is a separate reporting entity. The indicators that an organisation may be a branch can relate to the branding of the organisation (naming, registrations, websites) and financial support.

5. Alternative financial reporting treatments

5.1 The alternative treatments that could be adopted based on both the national and international treatments have been set out below together with the advantages and disadvantages of these alternatives.

5.2 Guidance on branches would follow either of the control definitions preferred from the alternative treatments set out in the table below. Under these definitions NPOs will need to establish:

- whether a branch is a separate reporting entity which they control; or
- whether a branch or network of branches and the assets/liabilities and resources are part of the single entity financial statements of the NPO.

Both arrangements would be within the reporting boundary of the NPO if the definition of control is met.

	Description	Advantages	Disadvantages
Alternative 1 **Define control using the principles based approach of substance over form.**	• Use the definition of control in IFRS 10 and IPSAS 35 i.e. based on the three principles: – power over the entity; – exposure, or rights, to variable returns/benefits from its involvement with the other entity; and – the ability to use its power over the other entity to vary the returns/benefits • Under this control model there is a need to specify relevant activities i.e. those activities that significantly affect the parent NPO's returns on a public benefits basis. • Require consolidation of a subsidiary when a reporting NPO controls another NPO or reporting entity, where the entity is material to the group.	• This will accord with both IPSAS and IFRS and will be broadly consistent with IFRS for SMEs. • The specifications of benefits and relevant activities are better suited to the determination of control for NPOs. • Allows for comparability with other NPOs and entities in the public benefit and public sectors. • Using principles provides flexibility to allow for variations in local environments.	• The cost of determining whether control exists may outweigh the benefits, particularly for smaller entities. • Only marginal decisions are likely to have different results.
Alternative 2 **Define control using the principles based approach of substance over form with**	• As alterative 1, with additional guidance about how to identify and then account for branches.	• Addresses gaps where current literature that does not address the type of relationships and arrangements prevalent in the NPO sector.	• Additional guidance may have the effect of turning a principles based approach into a rules based approach. • As above.

	Description	Advantages	Disadvantages
additional guidance on branches.		• As above	
Alternative 3 **Define control taking an approach where the supporting provisions are more rules based**	• Control is defined as the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities. Control is presumed when the parent owns, directly or indirectly through subsidiaries, more than half of the voting power of an entity. • Establish supporting guidance based on a rules based approach to identify circumstances for consolidation (which include some substantive judgments i.e. control of financial and operating policies but are also form based 'bright lines' tests i.e. voting rights) and materiality. • Require consolidation of a subsidiary when a reporting NPO controls another NPO or reporting entity.	• A rules based approach: – is easier to apply – is easier for some users to understand – is able to be applied more consistently – is less resource intensive. • Is consistent with IFRS for SMEs.	• A rules based approach risks being unable to properly reflect the economic circumstances relating to a NPO's interests in other reporting entities. • Is not consistent with IFRS or IPSAS approaches which focus on an entity having power, exposure to variable returns/benefits and the ability to use that power to affect its returns/benefits from the entity it has an interest in • Might be difficult to arrive at a single set of rules that adequately fit the broad range of NPOs in the sector.

Alternative 4 **Define control taking an approach where the supporting provisions are more rules based with specific guidance on branches.**	• As alterative 3, with additional guidance about how to identify and then account for branches.	• Addresses gaps in IFRS for SMEs where it does not address the type of relationships and arrangements prevalent in the NPO sector. • As above	• Additional guidance may have the effect of furthering a rules based approach. • As above.

Specific Matters for Comment

Do you agree that the list of alternative treatments that should be considered is exhaustive? If not, please describe your additional proposed alternatives, and explain why they should be considered.

Do you agree with the advantages and disadvantages articulated for each alternative accounting treatment? If you do not agree, please set out the changes you propose, and why these should be made.

Please identify the alternative treatment that you favour, and the reasons for your view.

[Draft generic questions for further discussion]

Annex A – Definition of Control - Analysis to support alternatives

	IFRS and IPSAS	UK	Australia	New Zealand	Canada	USA	Colombia
Alternative 1 **Define control using the principles based approach of substance over form.**	IFRS and IPSAS define control as when the entity is exposed, or has rights, to variable returns (IFRS10)/benefits (IPSAS 35) from its involvement and has the ability to affect the nature or amount of those benefits through the power it holds.		Follows IFRS with an Annex including application guidance for not for profit entities.				
Alternative 2 **Define control using the principles based approach of substance over form with additional guidance on branches**				PBE IPSAS – Follows the IPSAS definition of control, and provides additional guidance on branches.			
Alternative 3:	IFRS for SMEs defines control as the power to				One organization is presumed to	The direct or indirect ability to determine	Follows IFRS for SMEs.

	IFRS and IPSAS	UK	Australia	New Zealand	Canada	USA	Colombia
Define control taking an approach where the supporting provisions are more rules based approach	govern the financial and operating policies of an entity to obtain the benefits from its activities. Control is presumed when half of the voting power of an entity is owned, directly or indirectly. The standard also sets out when control may exist where ownership is less than 50 per cent.				control another entity when it has the right to appoint the majority of the voting members of the other entity's board of directors. Additional guidance on indicators of control are also provided.	the direction of management and policies through ownership, contract, or otherwise. Consolidation is required when there is both and economic interest and control.	
Alternative 4: **Define control taking an approach where the supporting provisions are more rules based approach with additional guidance on branches.**		FRS 102 defines control as being the power to govern the financial and operating policy of an entity so as to obtain benefit from its activities. Section 9 of FRS 102 includes five situations					

	IFRS and IPSAS	UK	Australia	New Zealand	Canada	USA	Colombia
		where a parent has control over another entity. The Charities SORP includes specifications on how to account for branches.					
Standards References	IFRS 10 paragraphs 6 & 7. IPSAS 35 paragraphs 19 & 20. IFRS for SMEs 9.4 &9.5.	FRS 102, paragraph 9.4 & 9.5 Charities SORP, Section 25 provides guidance on branches	AASB 10, Paragraphs 6 and 7 and Appendix E, Australian implementation guidance for not-for-profit entities	PBE IPSAS 35, Paragraphs 18 – 20 *Explanatory Guide A8 Financial Reporting by Not-for-Profit Entities: The Reporting Entity* (EG A8), provides additional guidance on branches	Reference- CPA Canada Handbook – Accounting: Section 4450, *Reporting controlled and related entities by not-for-profit organizations*; and CPA Canada Public Sector Accounting Handbook: PS 4250, *Reporting controlled and related entities by not-for-profit organizations*)	FASB ASC 958-810-25-1 – 5, Glossary definition 958-810-20.	