Practitioner Advisory Group
Issue Paper

AGENDA ITEM: PAGED06-03
15 June 2022 – Online

Issues around NPO consolidation

Summary	The paper provides an update on development of material for the exposure draft on Consolidation
Purpose/Objective of the paper	This paper notes that some respondents to the Consultation Paper had concerns over the essentially universal requirement to provide consolidated financial statements under IFRS for SMEs where control exists, and that Secretariat is seeking to explore the principles for other reporting in some cases .
Other supporting items	N/A
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Actions for this meeting	<u>Provide advice on:</u> • The conceptual basis for consolidation of NPOs in financial statements • Whether other forms of presentation might, in some cases, be appropriate

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Issues around NPO consolidation

1. Background

Approaches outlined in the Consultation Paper

1.1 The Consultation Paper offered two main alternatives in relation to the topic of the reporting entity which impact on consideration of consolidation:

- Alternative 1: this proposed using the substance over form principles included in IFRS Standards and IPSAS (IFRS 10/IPSAS 35 *Consolidated Financial Statements*). Additional NPO-specific guidance would also be developed, using a principles-based approach to determine whether one entity has control over another.
- Alternative 2: this proposed using pragmatic methods of assessment such as the power to govern financial and operating policies to define control as required by the IFRS for SMEs Standard. The focus would be on key characteristics that define NPO relationships and use the control principles set out in IFRS 10 and IPSAS 35 to develop tests to determine control.

1.2 Responses to the consultation generally supported Alternative 2. However, regard needs to be had to developments in the IFRS for SMEs Standard which based on the tentative decisions by the IASB, we understand is very likely to be reframed and aligned with IFRS 10.

1.3 As reported to the March PAG, consideration of the issues around reporting entity and control was also informed by a focus group that was set up after the consultation paper responses. On balance this group supported approaches based on IFRS 10.

1.4 The March PAG considered these factors and noted that, having regard to the NPO specific issues in this area, the PAG would nevertheless be inclined to support Alternative 2.

1.5 In addition to the above, three respondents to the Consultation Paper <u>did not support either Alternative 1 or Alternative 2</u>, because of the related suggestion that entities included in the group reporting entity would necessarily be consolidated. They suggested, for example, that consolidation would be either too complex or too onerous for smaller NPOs.

2. TAG Advice and Requests

2.1 The TAG reviewed Secretariat submissions on responses to the Consultation Paper which encompass discussions with the focus group and PAG, and provided the following relevant feedback:

Advice

- There should generally be as few differences as possible to the IFRS for SMEs Standard. It is anticipated that the revised *IFRS for SMEs* Standard will present an IFRS 10 aligned approach to control and a general requirement to provide consolidated financial statements for a group.

- While consolidation may have a different purpose for the private sector compared to non-profit organisations, describing the relationship between entities is important.

Requests

- Secretariat should articulate the conceptual basis of why to consolidate and the purpose of consolidation to consider what that means for control and application of IFRS 10, particularly in the more nuanced relationships and legal forms operated by NPOs.

- Secretariat should be clear on the principles used in IFRS10 and in developing application guidance keep to principles and avoid a 'rules based' approach.

- Secretariat should test what goes in the application guidance by reviewing different sets of guidance available in a number of jurisdictions.

3. Further consideration being undertaken on this issue

3.1 It has been suggested consolidated financial statements are difficult to understand and do not provide the information which readers of NPO financial statements are interested in.

3.2 It may also be that some, or the primary readers of NPO financial statements are more interested in specific entities, and the interactions of those entities with other (group) entities.

3.3 The Secretariat have discussed these and other issues around control with a PAG member. That discussion noted that one approach to providing information of the sort described in para 3.4 above is through additional disclosure within the consolidated financial statements. This does not of course address the suggestions of onerousness at 1.5, or understandability at 3.3.

3.4 The discussion noted that reporting on a consolidated basis is beneficial in the private sector in that it provides a consistent basis for reporting, and provides a better metric for the economic volume of group transactions and balances. These factors may also be important for some readers of NPO financial statements, perhaps including institutional funders, but may be less relevant to other readers.

3.5 The Secretariat has arranged a further focus group in order to gather information on this matter, setting out the purpose of the group as follows:.

This second focus group on the topic of the reporting entity looks at the consolidation of entities controlled by an NPO. Stakeholder feedback raises concerns that users of NPO financial statements find consolidated accounts confusing. However, these users want to understand the relationships between entities that are under common control so that there is transparency over how they operate. The benefits from consolidated information need to be considered in the light of the associated costs, particularly for smaller entities. This focus group explores the conceptual basis for consolidation of NPOs.

Question 1: Based on the experience of PAG members, what advice do PAG members have on the circumstances when they would deem consolidation inappropriate? Are there any circumstances?

3.6 Apart from observations on the cost and effort required to produce the financial statements, the main arguments against consolidation presented thus far are suggestions that consolidated financial statements are less understandable. This might be because there is information they are not providing, or perhaps because they are providing more information than is needed to the extent that key information is obscured.

3.7 Secretariat notes that consolidation is the default treatment under IFRS for SMEs, while also noting some concern that this approach may not be appropriate for all NPOs. Consolidation may increase consistency and thereby support neutrality in reporting through the removal of intra-group transactions and balances. This benefit would be pertinent to the NPO context unless there are other reasons why consolidation is not helpful

3.8 If it is considered that elimination of intra-group items means that information is less complete in a way which matters for NPOs, then this could in principle be addressed by additional disclosure attached to consolidated statements, rather than not producing the consolidated financial statements.

3.9 By contrast, if it can be determined that more information is being provided than is needed and this has a detrimental effect on the understandability of the financial statements then this will require further consideration. This will most likely be considered in subsequent phases of the Guidance development.

3.10 For this phase of the Guidance development, in line with TAGs requests, Secretariat is exploring how it can use the existing conceptual framework to articulate the conceptual basis of consolidation to take account of NPO specific considerations.

3.11 Insofar as there might be a conceptual basis for alternative forms of presentation, the Secretariat view is that these could be grounded in consideration of whether the reporting provided faithful representation or sufficiently relevant information.

3.12 Relevance and faithful representation are the fundamental characteristics of financial information under the Conceptual Framework for Financial Reporting for full IFRS, and drive standard-setting decisions on what to include in financial statements..

3.13 'Relevance' hinges on whether information can make a difference in decision making by users of financial statements. 'Faithful representation' aims to make sure that information which has been deemed relevant is of adequate quality for decision making. To achieve 'faithful representation', a depiction should seek to be complete, neutral and free from error.

3.14 It is possible to provide application guidance that explains how preparers could review the implications for faithful representation and relevance when considering consolidation.

Question 2: Based on experience, do PAG members consider that application guidance that explains how faithful representation and relevance informs NPO decisions on whether to consolidate, would be useful? Do PAG members see any risks or unintended consequences?

3.15 In line with the above we do not anticipate being able to consult on an alternative form of presentation in the Exposure Draft. It would however be possible to consult on whether an alternative presentation would be welcomed by stakeholders, and the conceptual basis for adopting a different treatment.

Question 3: Do PAG members consider that it would be helpful to consult on whether an alternative presentation would be welcomed?

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