

# Technical Advisory Group

## Issue Paper

AGENDA ITEM: TAGED07-05

28 June 2022 – Online

### Section 9 - Consolidated and separate financial statements

Summary	This paper sets out the proposals for revisions to INPAG Section 9 - Consolidated and separate financial statements as a result of the advice and requests received at the April 2022 meeting.
Purpose/Objective of the paper	To provide the TAG with proposals for the direction of travel on a number of technical areas for INPAG Section 9 Consolidated and separate financial statements and to gain feedback on these proposals.
Other supporting items	N/A
Prepared by	Steven Cain
Actions for this meeting	For the TAG to: <ul style="list-style-type: none"><li>• <b><u>Advise</u></b> on the proposed direction of travel for a number of technical areas following previous discussion with the TAG</li><li>• <b><u>Comment</u></b> on the proposed drafting to date</li></ul>

## Technical Advisory Group

### Section 9 - Consolidated and separate financial statements

#### 1. Background

- 1.1 The TAG was provided with feedback from the Consultation Paper associated with Section 9 - Consolidated and separate financial statements of the INPAG at its April 2022 meetings.
- 1.2 In responding to the Consultation Paper, there was not a clear view from respondents on the alternative to progress. There was a fairly even response in terms of alignment with IFRS 10 and with continuing with the pragmatic approach in IFRS for SMEs. Whilst the proposal is for the IFRS for SMEs Standard to be aligned with IFRS 10, the simplifications that currently exist that provide a more pragmatic approach may continue.
- 1.3 The TAG in their feedback supported alignment with IFRS 10 and the PAG supported a pragmatic approach but also saw value in a principles based approach that supported the use of judgement.
- 1.4 In the previous TAG paper, the Secretariat raised a question about the rebuttable presumption in the *IFRS for SMEs* Standard and whether this should carry forward or be different in INPAG. Further work will be carried out once it is clear whether a rebuttable presumption will continue, and the form of this in the revised *IFRS for SMEs* Standard.
- 1.5 In preparing the first drafts of the INPAG text, the Secretariat has had regard to two aspects highlighted in previous discussions with the TAG. Firstly, the conceptual basis of why NPOs consolidate and the purpose of consolidation to consider what that means for control. Secondly, the application of IFRS 10, particularly in the more nuanced relationships and legal forms operated by NPOs.
- 1.6 In considering the first of these, the conceptual basis of consolidation, the TAG is reminded that consolidation is not part of Phase 1 of IFR4NPO. Whilst considering the points raised, the Secretariat is intending to maintain focus on what is necessary in the context of matters relating to the reporting entity as part of this phase of the project.

## 2. Technical issues and proposed direction of travel

- 2.1 In the context of for-profits, the purpose of acquiring control over another entity or establishing another entity as part of an economic group of undertakings is to ultimately generate a financial return for distribution to the providers of risk capital. Similar contextual issues may arise for NPOs, where they are trading to generate cash flows that support the ability to undertake activities for social benefit.
- 2.2 Both for-profits and non-profits may invest in other undertakings to generate a return or have a participating interest in joint activities or hold a minority interest in an undertaking. Such collaborative activities in a for-profit context are associated with equity stakes and a formal contractual relationship. By way of contrast, NPOs due to their wider purposes often collaborate with other NPOs in a co-operative and non-contractual way to further their purposes. These more informal collaborative arrangements, which may not be defined by formal contracts or equity stakes, may not readily fall within the approach set out in IFRS10 –*Consolidated financial statements*.
- 2.3 Also, in the case of NPOs, not all transactions that give rise to cash flows (income) are contractual and not all contractual obligations are carried out at market value. Goods or services in some cases are supplied at below market consideration or for nominal consideration. This is because an NPO is focused on generating a public benefit rather than to generate a market return or profit. These considerations can apply to the interest that an NPO may have in a for-profit entity where that interest is not primarily for a financial return but for example to further a social purpose for the public benefit.
- 2.4 Stewardship in the context of NPOs should therefore not be defined in the same manner as for-profits, since the consideration of the return to providers of risk capital may be either missing or only one aspect of the NPOs activities. Instead, stewardship should arguably be framed around the capacity of the NPO to carry out its non-profit activities, the sustainability of those activities, the nature of those activities and the difference or effect that those activities make for the public benefit.

### *The application of the control concepts*

- 2.5 INPAG will draw on the control principles in IFRS 10, such that a parent NPO will control another entity if, and only if, it has all the following:
- a. power over the entity (power);
  - b. exposure, or rights, to variable returns from its involvement with the entity (returns); and

- c. the ability to use its power over the entity to affect the amount of the parent NPO's returns (link between power and returns).
- 2.6 Power, returns and the linkage between power and returns have wider aspects and nuances for NPOs which do not apply to for-profit organisations. Control, power and return all need to be interpreted in the context of benefit to the public and activities that further the purposes of the NPO parent for the benefit of the public. IPSAS 35 considers these issues from a government perspective and the application guidance in IPSAS 35 will be used in developing guidance for NPOs.
- 2.7 Some of the key issues are highlighted in the paragraphs below. For NPOs delivering activities for the benefit of the public, including making social investments in entities to deliver benefits to the public, the notion of financial returns is not always appropriate. For many parent NPOs, making money from a controlled entity to distribute to the providers of risk capital, by way of financial return, is not the motive.
- 2.8 It is proposed that INPAG will state that control exists where an NPO has the ability to direct the activities of or the use of funds of an entity. It will have power where it:
  - a. has the right to appoint the majority of the governing body (be that trustees or board members) of the entity; or
  - b. has the right to appoint the majority of the key management personnel; or
  - c. can exercise the majority of voting rights (which could be from contracts or other arrangements); or
  - d. has a right to veto any or all of the activities of the entity; or
  - e. has a right to veto any or all of the uses to which the funds of the entity may be put.
- 2.9 However, the Guidance will make clear that some rights to direct the use of funds do not give rise to control. For example, where an NPO makes grants to other entities, grant agreements may set out conditions that a grant recipient only uses the funds provided to undertake the activities for which the grant was made and for no other purpose. The agreement though is only relating to one aspect of the recipient entity's purposes and activities and does not provide a general right to the grant-making NPO to direct all the activities of the grant receiving entity and so the recipient is not in substance an entity controlled by the grant-making NPO.
- 2.10 It is proposed that the Guidance makes clear that a return from an interest in another entity is not necessarily a matter of obtaining funds from the entity. Rather the return is the benefit the parent NPO derives in exercising its control to fulfil one or more of the purposes of the parent NPO. A focus on benefit allows for non-financial as well as financial benefits.

2.11 It will make clear that the ability to control does not result from a voluntary collaboration, a coincidence of activities or through a joint venture or similar arrangement where the other entity has discretion as to the nature and extent of any benefit the parent NPO might obtain. The Application Guidance will build on the thinking in paragraphs 2.5-2.11 supported by use of existing internationally available guidance.

**Question 1:** Does the TAG consider that this approach to the control principles is appropriate?

2.12 In the *IFRS for SMEs* Standard reference is frequently made to an 'investee', when referring to the entity that might be consolidated. This language may be less appropriate to NPOs. Instead, the terms 'interest' or 'beneficial interest' could be used. The Secretariat propose to use the terminology 'beneficial interest'.

**Question 2:** Does the TAG agree with the term 'beneficial interest'?

### *The benefits of consolidation*

2.13 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.

2.14 Consolidation may increase consistency and thereby support neutrality in reporting through the removal of intra-group transactions and balances. This benefit could be pertinent to the NPO context unless there are other reasons why consolidation is not helpful.

2.15 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 by user or to the extent that key information is obscured.

2.16 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.

- 2.17 Reports that have researched the users of NPO financial statements have concluded that users can find consolidated information difficult to understand. Users have an interest in understanding operating flows and relationships and governance arrangements and how entities work together to deliver the NPO's mission.
- 2.18 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.
- 2.19 The Secretariat has arranged a focus group in order to explore the conceptual basis for consolidation of NPOs. Focus group participants will be asked to reflect on the benefits from consolidated information and how it can contribute to transparency over how NPOs operate. They will also be asked to consider and elaborate upon any circumstances where consolidation may not be appropriate. Feedback from the focus group will further inform the development of the INPAG and related Application Guidance.

**Question 3:** Do TAG have any further advice on the circumstances when consolidation might be inappropriate?

#### *Basis of consolidation*

- 2.20 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 provides faithful representation or sufficiently relevant information.
- 2.21 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.
- 2.22 '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.

- 2.23 It would be possible to provide application guidance that explains how preparers could review the implications for faithful representation and relevance when considering consolidation. Where an NPO does not consolidate a controlled entity, INPAG would require disclosure of the reasons why consolidation is not appropriate, the nature of the relationship between the entities, including governance and the value and nature of goods and services transacted between the entities. If the TAG is of the view that this could be helpful, it will be developed as part of the application guidance.

**Question 4:** Do TAG consider that 'faithful representation and 'relevance' should be considered in the context of consolidation is appropriate? Do TAG members agree there should be additional disclosures if entities are not consolidated? Do TAG members see any risks or unintended consequences?

- 2.24 The current version of the *IFRS for SMEs* Standard provides an exception to the provision of consolidated financial statements where the parent is itself a subsidiary and the ultimate parent produces financial statements based on IFRS or *IFRS for SMEs*. This approach could be carried forward into INPAG and broadened to allow the ultimate parent to comply with other forms of GAAP e.g. US GAAP. This would follow the spirit of the *IFRS for SMEs* Standard but with wider flexibility.

**Question 5:** Do TAG have views on whether allowing the ultimate parent to comply with other forms of GAAP would be appropriate?

- 2.25 In line with the scope of Phase 1 of the Guidance and the agreed prioritised topics, Secretariat do not anticipate being able to consult on an alternative form of presentation in the Exposure Drafts. It would however be possible to ask a specific matter for comment on whether an alternative presentation would be welcomed by stakeholders, and the conceptual basis for adopting a different treatment.

**Question 6:** Do TAG consider it beneficial to include a specific matter for comment at this point?

### 3. Developing the exposure draft

- 3.1 As TAG is aware, the *IFRS for SMEs* Standard is currently subject to comprehensive review. This section of the Standard is likely to be updated as part of the current revision, given the IASB's tentative decision to align this revision with IFRS 10 – *Consolidated financial statements*. Given the potential extent of these revisions limited changes have been made to the drafting of this Section.
- 3.2 As indicated above the application guidance has not been fully drafted, pending TAG comments on the direction of travel. Indicative content is included at present.
- 3.3 In line with the other Sections being drafted for INPAG, drafting changes have been colour coded to identify the source of any new text proposed for INPAG.

Text colour	Explanation
Black	Original IFRS for SMEs Standard text
<del>Red strikethrough</del>	Deletion of text within original IFRS for SMEs Standard text
Green	Change of terminology only
Purple	Text originated from IFRS Standards
Blue	Original INPAG text
<u>Blue underlined</u>	Text originated from IPSAS Standards

June 2022



## Annex A

### Log of Advice and Requests

Date	Requests	Status	Notes
06/04/2022	Articulate the conceptual base on 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.	In progress	Update at June 2022 TAG
06/04/2022	Be clear on the principles used in IFRS10 and in developing application guidance keep to principles and avoid a 'rules based' approach. Test what goes in the application guidance by reviewing different sets of guidance available in a number of jurisdictions.	In progress	Being developed in drafting

Date	Advice	Notes (if any)
06/04/2022	The update to the <i>IFRS for SMEs</i> Standard will follow the same definition of control as IFRS 10 and guidance about the reporting entity aligned with this definition.	Agreed
06/04/2022	Control may not be seen in the same way for NPOs and may need to be thought about in a different way to make sense for NPOs. Different forms of joint arrangement that involve NPOs also need to be considered.	Will be reflected in drafting
06/04/2022	It may not be appropriate in all circumstances to consolidate – it may be better to have a set of summary information instead. Whilst control is a factual position, the need to consolidate may need to be thought about differently. Combined financial statements may be better than consolidated financial statements.	Address in request above
06/04/2022	Consolidation may have a different purpose for the private sector compared to non-profit organisations, but describing the relationship between entities is important.	Agreed
06/04/2022	The combination of IFRS10 definition of control, a rebuttable presumption and additional guidance could be very useful for the sector. There is a question about how to adopt the rebuttable presumption currently in the <i>IFRS for SMEs</i> Standard.	To be updated once the IFRS for SMEs Exposure Draft is available
06/04/2022	Create as few differences as possible to the IFRS for SMEs Standard, draw on existing guidance and use the application guidance to address NPO specific differences.	Agreed