

AASB ISSUES CONSOLIDATION GUIDANCE FOR NOT-FOR-PROFIT ENTITIES

Background

The Australian Accounting Standards Board (AASB) recently issued AASB 2013-8 *Amendments to Australian Accounting Standards – Australian Implementation Guidance for Not-for-Profit Entities – Control and Structured Entities* which adds an Appendix, Appendix E, to AASB 10 *Consolidated Financial Statements* to explain and illustrate how the principles in AASB 10 apply to not-for-profit entities in the private and public sectors, particularly where the for-profit perspective does not readily translate to a not-for-profit perspective.

AASB 2013-8 also adds implementation guidance to AASB 12 *Disclosure of Interests in Other Entities* to explain and illustrate the definition of 'structured entity' from a not-for-profit perspective.

Not-for-profit guidance

Appendix E, added to AASB 10, follows the order of AASB 10 and provides guidance from a not-for-profit perspective for:

- Control
- Power
- Returns
- Link between power and returns
- Implementation examples.

Additional guidance for structured entities in the not-for-profit environment has also been added via an Appendix, Appendix E, to AASB 12.

Guidance added to AASB 10

The table below summarises the main issues included in the implementation guidance for AASB 10 by comparing principles contained in the text of AASB 10 and Appendix B (as applying to for-profit entities) with Appendix E (as applying to not-for-profit entities).



AASB 10 PRINCIPLES – FOR-PROFIT ENTITIES	IMPLEMENTATION GUIDANCE – NOT-FOR-PROFIT ENTITIES
<p>Control (Paragraph 11) Obtained by voting rights on shares and contractual arrangements.</p>	<p>Control (Appendix E, IG4) Investor need not have a financial investment in the investee. Investor and investee are merely entities that have a relationship in which control of one entity (the investee) by another entity (the investor) may arise.</p>
<p>Power (Paragraph 10) Investor has power over investee when investor has existing rights that give it the current ability to direct the relevant activities (activities that most significantly affect returns).</p>	<p>Power (Appendix E, IG5) Investor has power over investee when investor can require investee to deploy its assets or incur liabilities in a way which affects the investee's returns. Example: Providing goods or services to investor or other parties to assist in achieving or furthering investee's objectives.</p>
<p>Power (Paragraph 11) Power arises from voting rights and contractual arrangements.</p> <p>Power (Paragraph B10) Consider rights of the investor and other parties with respect to the investee.</p>	<p>Power (Appendix E, IG6) Rights from administrative arrangements or statutory provisions can be the source of power. Investee constitutions giving the investor rights to direct operating and financing activities do not necessarily mean that investor has power. Need to consider whether others direct the relevant activities.</p>
<p>Rights that give investor power (Paragraph B15) Include:</p> <ul style="list-style-type: none"> • Voting rights • Rights to appoint or remove investee's KMPs who have ability to direct relevant activities • Rights to appoint or remove another entity that directs relevant activities • Rights to direct investee to enter into, or veto, changes to transactions for benefit of investor • Other contractual rights that give holder the right to direct relevant activities. 	<p>Rights that give investor power (Appendix E, IG9) Additional examples for not-for-profit entities include:</p> <ul style="list-style-type: none"> • Rights to give policy directions to governing body of investee that enable holder to direct relevant activities • Rights to approve or veto operating and capital budgets relating to relevant activities.
<p>Rights that give investor power (Paragraph B19 and B40) Operations of investee being dependent upon investor is an indicator, but does not necessarily mean, that investor controls an investee. Economic dependence alone does not lead to investor having power over an investee.</p>	<p>Rights that give investor power (Appendix E, IG11 and IG12) Government may not have the current ability to direct the relevant activities of entities such as private schools, private hospitals, private aged-care providers and universities that are dependent on government funding were the governing bodies of these entities have the ability to decide whether to accept the funding, and have discretion about how resources are to be deployed. This may be the case even where the grants are subject to specific conditions, such as being for capital construction and operating costs, subject to specified service standards or restrictions on user fees.</p>
<p>Substantive rights (Paragraph B22) To determine whether rights are substantive, we need to consider barriers that prevent the holder from exercising those rights.</p>	<p>Substantive rights (Appendix E, IG13) Barriers include political, cultural, social or similar barriers that make it difficult for investors to exercise rights, but rights would still be substantive if holder could choose to exercise them.</p>

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<p>Substantive rights (Paragraph B24) To be substantive, rights need to be exercisable when decisions about relevant activities need to be made (currently exercisable).</p>	<p>Substantive rights (Appendix E, IG14) Power may be obtained from existing statutory arrangements. Rights specified in substantively enacted legislation would be substantive if they will be able to be exercised when decisions about directing relevant activities need to be made.</p>
<p>Protective rights (Appendix A) Rights that protect the interest of a party without giving power to the party.</p>	<p>Protective rights (Appendix E, IG15) Protective rights include rights of government or other entities to protect (not enhance) the interests of government, beneficiaries of an entity, and the public at large.</p>
<p>Protective rights (Paragraph B28) Examples include, but are not limited to:</p> <ul style="list-style-type: none"> • Lender's right to restrict a borrower from undertaking certain activities, e.g. paying dividends • Right of non-controlling interest to approve capital expenditure above a certain threshold • Right of a lender to seize assets in case of default. 	<p>Protective rights (Appendix E, IG17) Additional examples include:</p> <ul style="list-style-type: none"> • Rights of a regulator to curtail or close operations for non-compliance with regulations • Right to remove/appoint members of governing body in certain restricted cases • Right of government to remove tax deductibility for contributions to a not-for-profit entity if objectives of entity change significantly • Philanthropic trust providing resources to a charity on condition that net assets are distributed to a similar organisation, undertaking similar activities, if the charity is liquidated.
<p>Variable returns (Paragraph B57(c)) Returns can include combining operating functions with investee to achieve economies of scale, cost savings, sourcing scarce products, gaining access to proprietary knowledge or limiting some operations or assets to enhance the value of the investor's other assets.</p>	<p>Variable returns (Appendix E, IG18-19) Broad scope of nature of returns includes financial, non-financial, direct and indirect benefits, whether positive or negative, including the achievement or furtherance of the investor's objectives.</p> <p>Example: Investee providing goods or services to its beneficiaries may affect extent to which investor's social policy objectives are furthered, such as efficiency and effectiveness of delivery of goods or services and changes in the outcomes for beneficiaries.</p>
<p>Link between power and returns (Paragraph 7) For an investor to have control, they must have the ability to use their power to affect the amount of their returns.</p>	<p>Link between power and returns (Appendix E, IG20) Investor could have ability to use power when it can direct investee to work with investor to further the investor's objectives.</p> <p>However, the existence of congruent objectives alone is not enough for an investor to conclude that it controls an investee.</p>
<p>Agent vs. principal (Paragraph B60 and B61) Decision maker must consider all of the following to determine whether they are acting as agent or principal, unless a single party has kick-out rights:</p> <ul style="list-style-type: none"> • Scope of decision-making authority over investee • Rights held by other parties • Remuneration entitlements • Exposure to variability of returns from other interests it holds in investee. 	<p>Agent vs. principal (Appendix E, IG21-22) Example 1 (extracted from IG 22): Charity establishes a trust fund to construct village dams, bores and other water structures in a developing country.</p> <p>Trustee receives remuneration from the trust commensurate with services provided, plus a performance bonus upon successful completion of the project.</p> <p>Charity can replace trustee at its discretion. Trustee is therefore an agent.</p>

Examples

Appendix E of AASB 10 also includes various implementation examples to illustrate how the control principles can be applied in practice to not-for-profit entities. We have extracted a few of these below. Please refer to Appendix E for the remaining examples.

Example IG1

A religious organisation, ABC, established a community housing program that provides low-cost housing. The program is operated by an incorporated association. The association's constitution states that its objective is to manage the community housing facility to meet the need for low-cost housing. The association has not issued any equity instruments.

The relevant activities of the association comprise:

- Reviewing and selecting applicants for housing
- The day-to-day operation of the housing program
- Maintaining the houses and common facilities
- Improving and extending the housing facilities.

The board of governors of the association has 16 members, with eight appointed by (and subject to removal by) the religious organisation. The chair is appointed by the board from amongst the appointees of the religious organisation, and has a casting vote that is rarely exercised. The board meets regularly and reviews reports received from the association's management. Based on these reports, the board may confirm or override management decisions. In addition, the board makes decisions on major issues such as significant maintenance and investing further capital to build additional housing, after reviewing vacancy levels and the demand for housing.

The religious organisation owns the land on which the housing facilities stand and has contributed capital and operating funds to the association since it was established. The association owns the housing facilities.

The association retains any surplus resulting from the operation of the facilities and under its constitution is unable to provide a direct financial return to the religious organisation.

Example IG1A

Based on the facts and circumstances outlined above, the religious organisation controls the association.

The religious organisation appoints eight members of the board of governors, one of whom will become the chair, who has a casting vote. As a result, the religious organisation has power over the association through substantive rights that give it the current ability to direct the relevant activities of the association, regardless of whether the religious organisation chooses to exercise those substantive rights.

The religious organisation also has exposure or rights to variable returns from its involvement with the association. The religious organisation obtains non-financial returns through the association furthering its social objective of meeting the need for low-cost community housing. Although not able to receive direct financial returns, the religious organisation obtains indirect returns through its ability to direct how the financial returns are to be employed in the community housing program.

The religious organisation also satisfies the final control criterion. Through its appointees on the board, the religious organisation has the ability to use its power to affect the nature and amount of its returns from the association.

The religious organisation satisfies all three criteria for control and therefore the religious organisation controls the association.

Example IG1B

In this example, the facts of Example IG1A apply, except that:

- The association's board of governors is elected through a public nomination and voting process that does not give rights to the religious organisation to appoint board members
- Decisions made by the association's board are reviewed by the religious organisation, which may offer advice to the association.

Based on the revised facts and circumstances outlined above, the religious organisation does not have substantive rights relating to the association and therefore does not have power over the association.

The religious organisation's social objectives in relation to low-cost community housing are still being achieved and therefore it will still obtain indirect non-financial returns. However, congruence of objectives alone is insufficient to conclude that one entity controls another (see paragraph IG20).

The religious organisation does not have power and consequently does not have the ability to use power to affect the amount of the organisation's returns. The religious organisation is unable to satisfy two of the three control criteria and therefore the religious organisation does not control the association.

Example IG1C

In this example, the facts of Example IG1B apply, except that the association's constitution allows the religious organisation to change the manner in which the board of governors is determined, as it sees fit.

For example, the religious organisation has the unilateral ability to amend the constitution of the association to enable the religious organisation to appoint a majority of the board of governors, thus giving the religious organisation substantive rights that give it the current ability to direct the relevant activities of the association. Therefore, the religious organisation has power over the association through those substantive rights, regardless of whether the religious organisation chooses to exercise those rights.

Since the religious organisation has the ability to determine the composition of the board of governors and thus direct the relevant activities of the association, the religious organisation has exposure or rights to the same variable returns from its involvement with the association as set out for Example IG1A.

The religious organisation also satisfies the final control criterion. Through its ability to determine the composition of the board of governors, the religious organisation can use its power to affect the amount of its returns from the activities of the association.

The religious organisation satisfies all three of the control criteria and therefore the religious organisation controls the association. In this example, the design of the association, as set out in its constitution, indicates that the religious organisation has the ability to direct the relevant activities of the association even though a publicly elected board of governors has been established. This design reflects the special relationship between the religious organisation and the association.

Example IG2

FGH Charity is a private sector not-for-profit organisation. Its objectives are to protect and serve the community by providing emergency first aid and increasing the first aid skills of the community. The charity provides first aid at sporting events and when natural disasters occur. The charity is funded via donations and the sale of first aid supplies (bandages, first aid kits, etc.). The board of the charity has 10 members.

The charity established TUV First Aid Training Ltd (TUV or the company) some years ago. The purpose of TUV is to provide first aid training courses to the general public for a fee. TUV has an eight-member board, with all members appointed by the board of FGH Charity.

The charity has the right to receive distributions of profits made by TUV.

The management of TUV is responsible for the day-to-day operations of the company. TUV's management is also responsible for developing the company's policies, including:

- The scope of the training courses, such as the type of courses and the maximum number of participants for each course
- Marketing plans for the courses, including the fee structure
- The frequency and location of courses
- The use of in-house or off-the-shelf training materials.

These policies address the relevant activities of TUV, i.e. the activities that significantly affect the company's returns.

The board of TUV meets regularly to review reports from TUV management in order to assess the performance of the company. The board makes decisions about the company's activities and policies so as to optimise its outcomes. For example, the board might modify the scope or frequency of courses or revise the fee structure.

The TUV board also considers whether any profits should be distributed to the charity (FGH) as a financial return or used to improve or expand the company's activities.

Example IG2A

Based on the facts and circumstances outlined above, the charity controls TUV.

The charity has power over TUV because its board appoints the board members of TUV, thus giving the charity the current ability to direct the relevant activities of the company.

The charity is exposed to variable returns from its involvement with TUV, both financial returns (the right to receive distributions of profits from TUV) and non-financial returns (the furtherance of its objective of improving community first aid skills).

Finally, the charity can use its power over TUV (via the board) to affect the nature and amount of returns it obtains through TUV.

Example IG2B

In this example, the facts of Example IG2A apply, except that:

- The charity does not have the right to receive distributions of profits from TUV since the constitution of the company prohibits distributions to its members, and
- All profits of TUV are to be reinvested into first aid training programs.

Based on the revised facts and circumstances, the charity controls TUV.

The charity has power over TUV because it appoints the board of the company.

Although it does not receive any financial returns, the charity obtains non-financial returns because TUV is fulfilling one of its objectives by increasing the first aid skills of the community.

The charity is able to use its power over TUV to affect the nature and amount of its returns. Therefore, the three control criteria are satisfied.

Example IG2C

This example has the same facts as Example IG2B, except that:

- The charity cannot appoint the board members of TUV, except for the Chair, who must be a board member of the charity
- The charity has the right to veto appointments to the board of TUV, but only in exceptional circumstances – that is, when a potential board member is deemed unsuitable. This right has only been enforced once, when a proposed board member was found to have a history of fraudulent activities.

Based on these facts and circumstances, the charity does not control TUV.

This is because the charity does not have the requisite power to direct the relevant activities of TUV – it appoints only one of the eight members of the board of TUV.

Even though the charity has the right of veto over TUV board appointments, this is only a **protective right** because it is a safeguard against having board members who could potentially interfere with the operations of the company and adversely affect its outcomes.

The charity had the opportunity and incentive when establishing TUV to obtain rights that would give it the ability to direct the relevant activities of TUV, but it did not do so. Being involved in the design of an investee is not sufficient to give an investor control (see paragraph B51 of the Standard).



Example IG2D

In this example, the facts of Example IG2C apply, except that:

- TUV's constitution permits its board to make financial distributions to other parties as decided by the board
- Although the charity does not have any right to distributions of profits from TUV, to date TUV has always distributed its profits to the charity.

Based on these facts and circumstances, the charity does not control TUV because, as in Example IG2C, the charity does not have power over TUV to direct the relevant activities.

Even though TUV was established by the charity in order to further its objective regarding community first aid skills, and despite the charity historically receiving financial returns from TUV, the design of TUV does not give the charity power over TUV.

The board of TUV is independent of the charity, there is no requirement for TUV to make distributions to the charity (or to any other party), and the charity has no right to demand financial returns.

Guidance added to AASB 12 on structured entities

AASB 12 requires extensive new disclosures about structured entities that have **not** been consolidated. Additional guidance has been added to AASB 12 (Appendix E) to explain what a structured entity is from a not-for-profit perspective, so that we can determine whether this additional disclosure is required for not-for-profit entities.

A 'structured entity' is defined in Appendix A of AASB 12 as:

"An entity that has been designed so that voting or similar rights are not the dominant factor in deciding who controls the entity, such as when any voting rights relate to administrative tasks only and the relevant activities are directed by means of contractual arrangements."

Voting rights are often the dominant factor in deciding who controls a **for-profit entity**. The definition of 'structured entity' therefore limits the scope of structured entities to entities that are controlled through **less conventional means**, for example, securitisation vehicles, asset-backed financings and some investment funds.

Not-for-profit entities are often established by **administrative arrangements or legislation**, especially in the public sector, and these are therefore the dominant factors in deciding who controls the not-for-profit entity. This means that not-for-profit entities established by administrative arrangements or legislation **are not structured entities** because they are not controlled through less conventional means.

The AASB 12 disclosures regarding structured entities, such as the provision of financial support without a contractual obligation, are not particularly relevant to such entities, given the expectation of on going government funding through appropriations to supplement any other revenue sources.

So what is a structured entity in a not-for-profit context?

A structured entity in the not-for-profit context must be controlled through less conventional means, so **this rules out** the following as being structured entities:

- Voting or similar rights are the dominant factor when assessing control
- Administrative arrangements or statutory provisions are the dominant factor in assessing control.

Therefore not-for-profit entities where control is assessed based on the above points being the dominant factor in assessing control **are not structured entities**.

This means that we are only likely to see not-for-profit structured entities when **contractual arrangements are the dominant factor** in assessing control.

Examples

Appendix E to AASB 12 includes two examples of structured entities in the not-for-profit space.

One is a partnership between a government and a private sector entity, being a partnership established and directed by contractual arrangements. On that basis, the partnership is a structured entity, regardless of the rights (if any) that the government and the entity have in relation to the partnership. If the government guarantees a certain level of revenue for its private sector partner, for example, the AASB 12 disclosures concerning the provision of financial support would be particularly relevant, whether the partnership is a consolidated or an unconsolidated structured entity for the government. However, the mere fact that a government provides funding to another entity does not make that entity a structured entity.

Another example is a not-for-profit private sector entity that may have established or sponsored a community service organisation whose relevant activities are directed by means of contractual arrangements. Those arrangements might require the not-for-profit private sector entity to provide financial support in specified circumstances to the community service organisation, or alternatively the entity might choose to provide financial or other support to the organisation without the contractual obligation to do so (e.g. due to the economic dependency of the organisation upon the entity).

The AASB 12 disclosure requirements would be relevant in both circumstances as the community service organisation is a structured entity. AASB 12, paragraph 31, for example, would require the not-for-profit private sector entity to disclose any current intentions to provide support to an unconsolidated structured entity.

Summary

AASB 10 applies to not-for-profit entities for years beginning on or after 1 January 2014. Now that the implementation guidance on how to apply the control principles have finally been released for not-for-profit entities, we recommend that you start assessing whether any control decisions will change under the new standards.