# Not for profit groups – when to consolidate

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## Assessing control of another entity can be tricky for NFPs

Not for profit entities (NFPs) are often entering increasingly complex arrangements as they explore ways to secure funding and deliver services. Some NFPs have considered the potential benefits and pitfalls of reorganising their legal and operating structure to improve service delivery.

While potential tax and legal implications may be top of mind in these decisions, management and those charged with governance should also consider the effect on financial reporting obligations. Accounting outcomes are not always consistent with tax or legal outcomes and so must be considered early.

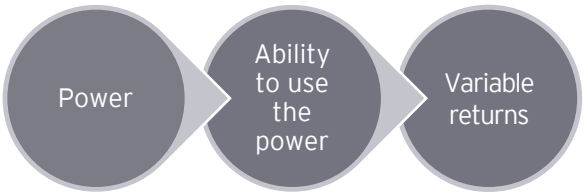
NFPs should not underestimate the complexities associated with the control assessment.

In this publication, we highlight the key principles for assessments of accounting control and explain situations which lead to a requirement to produce consolidated (group) accounts.

## Control & consolidate

The rules[1] for when one entity controls another (leading to a requirement for consolidated accounts) were written from the perspective of for-profit entities (FPs). In order to help NFPs make this decision, the Australian Accounting Standards Board (AASB) issued extra guidance[2].

Broadly, one entity (investor) controls another entity (investee) when it has all of the following:




- Power
  - over relevant activities
  - how decisions about those activities are made
- Ability to use the power
  - whether the investor could use its power to affect the returns from the investee
- Variable returns
  - whether the investor will be exposed to variable returns from the investee

**Substance over form**

The assessment also considers:

- Purpose and design
- Rights outside of contractual arrangements
- Related party relationships

The accounting assessment is based on the substance of the relationship, rather than its legal form, and could result in a different conclusion to that for legal or taxation purposes.

## Power

An investor has power when it has existing rights that give it the current ability to direct the activities that significantly affect the returns.

For NFPs, this power will often arise through rights resulting from administrative and other contractual arrangements rather than ownership of equity as for FPs.

[1] *AASB 10- Consolidated Financial Statements*

[2] *Implementation Guidance for Not-for-Profit Entities – Control and Structured Entities (Appendix E to AASB 10)*

**Example 1: Rights without equity ownership**

A religious organisation established an incorporated association to run its community housing program. The association has not issued any equity instruments. As per the deed of association:

- The board of governors consist of 16 members, and a simple majority has ability to confirm or override all management decisions
- The religious organisation can appoint and remove 8 members to the board of governance
- The chair is appointed by the board – but only from amongst the 8 appointees of the religious organisation, and he has a casting vote.

In this situation, the religious organisation has power through its ability to appoint and remove 8 board members directly, and the chairman (with a casting vote).

## Substantive vs. protective rights

**Substantive rights** are those that confer power on an investor and are typically exercisable without cause.

**Protective rights** are usually designed to protect an investor's interest, and do not confer power.

**Substantive rights vs. Protective rights**

| Substantive | Protective |
|---|---|
| Appoint or dismiss members of the governing body at own discretion | Remove members of the governing body only under restricted circumstances (e.g. a lack of probity) |
| Direct the relevant activities of the investee | Restrict operations when not complying with regulations (e.g. pollution, health and safety requirements) |
| Approve or reject budgets relating to those activities | Reject budgets when not complying with a specific spending requirement |

**Example 2: Research trusts of a university**

A university, in order to carry out one of its main objectives of undertaking research for the advancement of knowledge and the benefit and well-being of communities, establishes two research trusts and appoints trustees.

The trustees are responsible for making decisions about the financing and operating activities of the trusts in accordance with the trust deed.

- For Trust # 1, the university can only replace the trustee for misconduct.
- For trust # 2, the university can replace the trustee at any time and appoint another trustee.

In this example, the university is not deemed to have power over the trust # 1 as its ability to remove the trustee for misconduct can only be considered a protective right.

However, the university's ability to remove the trustee of trust # 2 at any time is considered substantive and confers power over the trust.

## Variable returns

In order to have control, an investor should have an exposure or right to variable returns from its involvement with the investee. In many cases returns will be financial (e.g., quasi-equity) in nature, however "returns" is a wide notion that also encompasses non-financial returns such as the achievement or furtherance of objectives. In effect, this broad notion of returns means that entities set up by an NFP with similar objectives will be assumed to contribute some form of returns to the NFP.

**Example 3: Exposure to variable returns**

A university has a goal to undertake research for the advancement of knowledge and the benefit and well-being of communities.

It sets up a trust with similar research objectives. The trustee of the trust receives remuneration for their service.

The trust assists the university to achieve its overall objectives. That might be in the form of papers that further its research objectives. As a result, the university would be deemed to be exposed to (by obtaining) variable returns from the trust. On other hand, the trustee itself would not be deemed to have sufficient exposure or rights to variable returns from its involvement in the trust, because the trustee's remuneration is its only return and is consistent with that of a service provider along with being insignificant in relation to the total returns from the trust.

## Ability to use the power (Linkage of power and returns)

The third aspect of control assessment is an investor's ability to exercise its power to affect the returns from the investee.

An investor needs to consider whether they are a principal acting in their own right or an agent with delegated power.

**Example 4: Delegated power & linkage of power and return**

A university establishes a trust to achieve its research objectives. It appoints a trustee to oversee the work of the trust. The trustee:

- Receives remuneration for the service
- Receives performance bonus upon the successful completion of individual projects
- Can be replaced by the university at its discretion

Situation 1: All decisions on the relevant activities are made by a management committee, appointed by the university. The trustee provides only an oversight role to the management committee.

Situation 2: The trustee is responsible for making decisions about the financing and operating activities in accordance with the trust deed.

In these examples, as the university can replace the trustee at its discretion, the trustee is an agent of the university and so the trustee cannot control the trust. The university then needs to assess whether it controls the trust (through the trustee).

In situation 1, the university has power over the relevant activities through its ability to appoint the management committee. In situation 2, the university controls the trust as;

- It can direct all relevant activities (through its ability to replace the trustee), and
- It is exposed to non-financial variable returns (as the trust furthers the university's objectives).

## Key considerations

NFPs should consider the following in determining whether control over another entity exists.

**Power**

- What are the relevant activities of an investee and does the NFP have power over them?
- Are there any rights arising from administrative or other contractual arrangements?
- Are rights substantive or protective in nature?
- Are rights presently exercisable, or exercisable when decisions about relevant activities are to be made?

**Variable returns**

- What exposure or rights to financial (or non-financial) returns, including direct or indirect returns, does the NFP obtain from its involvement with the investee?

**Ability to use the power**

- Is the NFP exercising its decision-making abilities as a principal or as an agent with delegated power?

To discuss further, please contact your local EY adviser.

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