Agenda paper 10

CONSOLIDATION OF NOT-FOR-PROFIT ENTITIES UNDER IFRS 10

FIFTEENTH MEETING OF THE IASB EMERGING ECONOMIES GROUP (EEG)

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AGENDA

Topic
1. Background
2. General Governance Structure of CSR Foundations
3. Excerpts of CSR Foundations from Annual Reports
4. CFS - Key consolidation principles
5. Issues to address
6. Analysis of ‘Control’
7. Whether to consolidate CSR Foundations under IFRS 10

BACKGROUND

- ✓ Many companies in India form Special Purpose Vehicles (SPVs) to undertake Corporate Social Responsibility (CSR) initiatives on their behalf.
- ✓ Legal structure of such SPVs is predominantly registered trusts or registered societies or companies established under section 8 of the Companies Act.
- ✓ Companies Act 2013 recently introduced a requirement for companies to spend a fixed percentage of their profits on CSR activities.
- ✓ For this purpose, Companies Act 2013 provides that a company may decide to undertake its CSR activities through a registered trust or a registered society or a company established under section 8 of the Act by the company, either singly or along with its holding or subsidiary or associate company , etc.
- ✓ Since the companies benefits from SPVs, the issue arises whether such SPVs should be consolidated by the companies.

GENERAL GOVERNANCE STRUCTURE OF CSR FOUNDATION

- ✓ Company is the sole sponsor/joint sponsor to the CSR Foundation.
- ✓ Power to appoint/ remove the members of governing body (trustees/directors) who take decisions regarding the relevant activities of the Foundation is with the company itself. Director/Trustees are generally the employees of company.
- ✓ Relevant activities of the CSR Foundation include deciding what CSR projects should be supported, decisions with respect to acquisition of assets, carrying out activities for beneficiaries as per the purpose for which the entity has been formed and investment decisions related to surplus cash, if any.
- ✓ No portion of surplus or other income can be transferred during the tenure of the Foundation to the owners.
- ✓ At the time of winding up, the remains are required to be transferred to any entity with similar objectives.

Note: *The term 'CSR Foundation' has been used for the* ***company*** *established under section 8 of the Companies Act, 2013/***registered trust** (registered under the State Public Trust Act)*/* **registered society** *(registered under Societies Registration Act)for undertaking CSR initiatives.*

EXCERPTS OF CSR FOUNDATION FROM ANNUAL REPORTS

TATA STEEL FOUNDATION

In order to strengthen our CSR deployment and governance system, the Board of Directors, on December 16, 2015, approved the formation of a Section 8 Company. On August 16, 2016, Tata Steel Foundation (**'TSF'**), a Section 8 Company, was incorporated under the Companies Act, 2013. The Board of Directors of TSF comprises of Mr. Ishaat Hussain, Mr. T.V. Narendran and Mr. Koushik Chatterjee.

The broad objectives of TSF are as follows:

1. To undertake various developmental and CSR programmes, including those provided in Schedule VII of Section 135 of the Companies Act, 2013, either on its own or on behalf of any other person or organization
2. To undertake CSR projects jointly with other companies including foreign companies
3. To borrow or raise money and garner support from national and international agencies
4. To make contributions to any non-profit organization with objectives similar to those of the Company
5. To apply the profits solely towards the promotion of its objectives

EXCERPTS OF CSR FOUNDATION FROM ANNUAL REPORTS

Reliance Industries Ltd.

"Reliance Foundation (RF), established in 2010, is an umbrella organisation for the Company's social development initiatives. Most of the CSR activities of the Company are carried out under the aegis of the Reliance Foundation. These initiatives are aligned with the objectives defined by the Sustainable Development Goals (SDGs), outlined in the United Nations 2030 Agenda for Sustainable Development."

CFS - KEY CONSOLIDATION PRINCIPLES

- **When 'control' is established, investor is required to consolidate the investee under IFRS 10, *Consolidated Financial Statements*.**

- ***As per IFRS 10, an investor controls an investee if and only if the investor has all the following:***

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

- In order to establish that an investor has control over the investee, all the above conditions needs to be satisfied.

- All the above conditions are analysed in subsequent slides.

ISSUES TO ADDRESS

Before analysing the three conditions of control under IFRS 10, following issues need consideration:

- Whether investor-investee relationship exists in the extant case.
- ‘Reputation risk’, and its significance in determining exposure to returns.

ANALYSIS OF 'CONTROL'

(a) Power over the investee

An investor has power over an investee when the investor has existing rights that give it the current ability to direct the relevant activities, ie the activities that significantly affect the investee's returns. (Para 10)

In the extant case,

- all the relevant activities are directed by the Directors/Trustees who are generally employees of the company
- company has the ability to appoint and remove the Directors/Trustees of the CSR Foundation
- Significant portion of the funding of CSR Foundation is contributed by the company

Accordingly, the investor has a power over the investee.

(Contd..)

ANALYSIS OF 'CONTROL'

(Contd..)

(b) Exposure, or rights, to variable returns from its involvement with the investee

View 1: No right to variable returns

- ✓ Company can have only non-financial returns from CSR Foundation and non-financial returns are not sufficient to conclude on control.
- ✓ It is difficult to evaluate 'returns' in the context of a CSR Foundation as unlike a profit making entity there is no real economic benefits in financial terms arising from the charitable entity.
- ✓ The financial benefits accrue to the beneficiaries of the CSR Foundation that are different than the sponsoring entity.
- ✓ Non-financial returns are only one of the factors to consider i.e. reputational risk is a factor to consider along with other facts and circumstances, it is not an indicator of power in its own right

(Contd..)

ANALYSIS OF 'CONTROL'

(Contd..)

BC39 of IFRS 10
The Board believes that reputational risk is part of an investor's exposure to risks and rewards, albeit a risk that arises from non-contractual sources. For that reason, the Board concluded that when assessing control, reputational risk is a factor to consider along with other facts and circumstances. It is not an indicator of power in its own right, but may increase an investor's incentive to secure rights that give the investor power over an investee.

(b) Exposure, or rights, to variable returns from its involvement with the investee

View 2: Rights to variable returns

- ✓ Company gets non-financial returns from CSR Foundation (good corporate image and reputational risk) along with satisfaction of conditions (a) and (c) of control are sufficient to conclude on control. (Contd..)

ANALYSIS OF 'CONTROL'

(Contd..)

B57(c) of IFRS 10

Examples of returns include returns that are not available to other interest holders. For example, an investor might use its assets in combination with the assets of the investee, such as combining operating functions 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.

(b) Exposure, or rights, to variable returns from its involvement with the investee

View 2: Rights to variable returns

- ✓ ***Intangible Assets:*** Though the value of the assets is not enhanced, arguably it enhances the public image of company's normal business activities, consequently resulting in intangible benefit of being associated with the foundation.
- ✓ ***Savings in expenses:*** For example, if the company establishes a foundation for the education of the children (including education of the children of employees), then benefit is that the company would save the amount that it may otherwise spend on the education of employee's children.

(Contd..)

ANALYSIS OF 'CONTROL'

(Contd..)

BC 63 & BC 64 of IFRS 10

BC63. The Board confirmed its intention to have a broad definition of 'returns' that would include synergistic returns as well as more direct returns, for example, dividends or changes in the value of an investment. In practice, an investor can benefit from controlling an investee in a variety of ways. The Board concluded that to narrow the definition of returns would artificially restrict those ways of benefiting.

BC64. Although some respondents to ED 10 commented that 'returns' could be interpreted narrowly to refer only to financial returns such as dividends, the Board believed that the broad description of returns included in the IFRS should ensure that the Board's intention to have a broad definition is clear. The Board also confirmed that an investor's returns could have the potential to be wholly positive, wholly negative or both positive and negative.

(b) Exposure, or rights, to variable returns from its involvement with the investee

View 2: Rights, to variable returns

- ✓ Paragraphs BC 63-64 of IFRS 10 elaborate on the IASB's intention to have a broad definition of 'returns'.

(Contd..)

ANALYSIS OF ‘CONTROL’

(Contd..)

(c) ***Ability to use power to affect returns***

An investor controls an investee if the investor not only has power over the investee and exposure or rights to variable returns from its involvement with the investee, but also has the ability to use its power to affect the investor’s returns from its involvement with the investee. (Para 17)

If, there is an exposure to returns from the CSR foundation under condition (b)

- Ability to use power over the foundation to affect the amount of the investor’s returns is there though the power is being exercised only in a fiduciary capacity to undertake CSR activities in the interest of the general public.

(Contd..)

WHETHER TO CONSOLIDATE OR NOT UNDER IFRS 10

View 1-No consolidation of CSR Foundation

- ✓ No financial returns
- ✓ Non-financial returns (e.g. reputational risk or positive image) alone would not be sufficient.
- ✓ On consolidation of CSR Foundation, the net worth of the company will increase which does not belong its own shareholders because the surplus will not be transferred to the company even in case of winding up of the CSR Foundation. Therefore, consolidation may not present true and fair view.

The amount of contribution to the CSR foundation shall continue to be recognized as an expense as incurred and appropriate disclosures to be made in the financial statements.

View 2-Consolidation of CSR Foundation

- ✓ Good corporate image and reputational risk along with satisfaction of conditions (a) and (c) of control are sufficient to conclude on control.
- ✓ Additionally, returns should be considered from a broader perspective, therefore, good corporate governance, reputation, savings in expenses (in some cases) may be considered as significant factors even if there are no financial returns.

Thank You

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