

Query No. 9

Subject: *Consolidation of the financial statements of a Section 8 Company with the Sponsor Company.*¹

A. Facts of the Case

1. A company incorporated under the Companies Act, 2013 as a Section 8 company limited by shares (hereinafter referred to as ‘the Section 8 Company’ or ‘the Sponsored Company’), has its equity contribution from a listed entity (hereinafter referred to as the ‘the Sponsor Company’ or ‘the Company’). The Section 8 Company was established in the year 2021 with its main objects being, inter alia, to undertake, promote, engage in, carry out, encourage, sponsor, aid, subsidise or assist by making donations, charities, contributions or providing financial or any other assistance, directly or indirectly in respect of the activities pertaining to various objects. The Directors of the Section 8 Company are:

- Mr. G (also Chief Executive Officer of the Sponsor Company)
- Mr. M

The operations of the Section 8 Company are carried on independently under the oversight of its Board of Directors. Till 31st March 2023, the Company (Sponsor Company) has consolidated the financial statements of this Section 8 Company while preparing its consolidated financial statements as per Indian Accounting Standards (Ind AS), notified under the Companies (Indian Accounting Standards Rules), 2015 (as amended).

2. The querist has informed that the Memorandum of Association (MoA) of the Section 8 Company clearly states that:

- (i) The profits, if any, or other income of the Section 8 Company, whatsoever derived, shall be applied solely for the promotion of its objects as set forth in this memorandum.
- (ii) No portion of its profits, other income or property aforesaid shall be paid or transferred, directly or indirectly, by way of dividend, bonus or otherwise by way of profit, to persons who, at any time are, or have been members of the Section 8 Company or any one or more of them or to any person claiming through any one or more of them.
- (iii) No remuneration or other benefit in money or money’s worth shall be given by the Section 8 Company to any of its members, whether officers or members of the company or not, except payment of out-of-pocket expenses, reasonable and proper interest on money lent, or reasonable and proper rent on premises let to the Section 8 Company.
- (iv) Nothing in this clause shall prevent the payment by the Section 8 Company in good faith of prudent remuneration to any of its officers or servants (not being members) or to any other person (not being member), in return for any services actually rendered to the Section 8 Company.

¹ Opinion finalised by the Committee on 24.4.2024.

- (v) Nothing in clause (iii) and (iv) shall prevent the payment by the Section 8 Company in good faith of prudent remuneration to any of its members in return for any services (not being services of a kind which are required to be rendered by a member), actually rendered to the Section 8 Company.

Keeping these facts in mind, the Company wishes to re-assess, whether the Section 8 Company needs to be consolidated with the Company (the Sponsor Company) for the purpose of preparation of consolidated financial statements under the Companies Act, 2013.

In this regard, the Company has assessed the following facts and wishes to put forth its following views; and seek clarification from the Expert Advisory Committee of the Institute of Chartered Accountants of India (ICAI).

3. *Control Evaluation as per Indian Accounting Standard (Ind AS) 110, 'Consolidated Financial Statements':*

As per Ind AS 110, an investor needs to determine whether it controls an investee and if yes, then the investor would be treated as parent and the investee would be treated as subsidiary of the parent. An investor controls an investee if and only if the investor has all of the following three elements:

- (a) Power over investee;
- (b) Exposure, or rights, to variable returns from investee; and
- (c) Ability to use power over investee to affect the investor's returns.

According to the querist, currently, the Company does not exercise any control over the Section 8 Company. The Company only contributes funds for the Corporate Social Responsibility (CSR) purposes to the Section 8 Company. Oversight, if any, is only to the extent of a sponsor having requirements and reporting from any NPO organisation to whom funds are given to.

Upon liquidation of this Section 8 Company, the proceeds should be given only to another NPO which is in same objects of philanthropy. Therefore, as per the querist, in the absence of any commercial benefit flowing from the Section 8 Company, the Company cannot consider it as a control.

4. The querist has further shared the management views as follows:

The Company is engaged with the Section 8 Company through its equity holding only. However, due to the Section 8 Company's registration framework, it is explicitly prohibited from allocating any rights over its profits to its members. Consequently, there is neither exposure nor entitlement to any returns from the investee. In addition, the Company lacks rights to variable returns, as there are no such entitlements specified. Given the absence of these rights, the Company is unable to leverage its influence over the investee to influence returns.

5. The querist has informed the following objectives of the Section 8 Company:

- (i) eradicating hunger, poverty and malnutrition, promoting health care including preventive health care and sanitation including contribution to the schemes set-up by the Central Government.
- (ii) education, including special education and employment enhancing vocational skills, livelihood enhancement projects, especially among children, women, elderly and the differently abled.
- (iii) gender equality, empowering women, setting up homes and hostels for women and orphans; setting up old age homes, day care centres and such other facilities for senior citizens and measures for reducing inequalities faced by socially and economically backward groups.
- (iv) ensuring environmental sustainability, ecological balance, protection of flora and fauna, animal welfare, agroforestry, conservation of natural resources and maintaining quality of soil, air and water and making available safe drinking water, promotion of sanitation.
- (v) protection of national heritage, art and culture including restoration of buildings and sites of historical importance and works of art; setting up public libraries; promotion and development of traditional art and handicrafts.
- (vi) benefiting armed forces, war widows and their dependents.
- (vii) rural sports, nationally recognised sports, paralympic sports, and Olympic sports.
- (viii) socio economic development for the welfare and benefit of the schedule caste, tribes, other backward classes, minorities, women in villages, rural areas and semi-urban areas and encouraging and assisting them in setting up self-help groups, for carrying on socio economic development programmes.
- (ix) public funded universities, government recognised institution(s) or private entities engaged in research and development or promoting projects, in the fields of science, commerce, legal laws, technology, engineering and medicine, ayurveda, unani, siddha, homeopathy.
- (x) rural development projects, slum area development and disaster management, including relief, rehabilitation, and reconstruction activities.
- (xi) literacy, culture and social awareness programmes, lectures on savings and investments, health, life and general insurance, family planning, in the interest of and for benefit of the society at large.
- (xii) stimulation and facilitation of exchange of experiences and ideas between corporate leaders, policy makers, regulators, law enforcing agencies, non – government organisations and voluntary agencies with a view to developing a framework for corporate governance reforms in the context of liberalisation and globalisation; providing financial or any other assistance directly or indirectly for activities which seek to promote corporate governance including research and training; conducting National, Regional & International Conferences, seminars, Round tables and lecture series to discuss and debate the current issues of corporate governance and sustainability, keeping in mind the unique / specific needs of each of the different commercial and non-commercial sectors of the Country etc.

B. Query

6. Considering the above facts, the querist has sought the opinion of the Expert Advisory Committee as to whether the Company, which is a listed entity is required to consolidate the financial statements of its sponsored company which is a Section 8 Company registered under the Companies Act, 2013. If the answer to the above is in negative, whether it can change the position taken for the preparation of its financial statements till March 2023.

C. Points considered by the Committee

7. The Committee notes that the basic issue raised in the query relates to whether the Company, which is a listed entity, is required to consolidate the financial statements of a 100% owned company, which is a Section 8 Company registered under the Companies Act, 2013. The Committee has, therefore, considered only this issue and has not considered any other issue that may arise from the Facts of the Case, such as, accounting for transactions between the Section 8 Company and the Company, accounting and disclosures for CSR activities, accounting in the books of the Section 8 Company, manner of consolidation in the books of the Company including accounting for rights and obligations, if any, of the Section 8 Company in the consolidated financial statements of the Company, etc. Further, the Committee has opined purely from accounting perspective and not from any legal perspective, such as, legal interpretation of Memorandum of Association or Articles of Association of the Section 8 Company or compliance with the requirements of Companies Act, Income-tax Act, etc.

8. The Committee notes from the Facts of the Case that the Sponsored or Section 8 Company was established under Section 8 of the Companies Act, 2013 in the year 2021 and is wholly owned by the Company (the Sponsor Company). Further, being a listed company, the financial statements of the Company are prepared as per the requirements of Indian Accounting Standards. The Committee further notes that paragraph 1 of Ind AS 110, 'Consolidated Financial Statements' states that the objective of this Standard is to establish principles for the presentation and preparation of consolidated financial statements when an entity controls one or more other entities. Paragraph 2(a) further states that this Ind AS requires an entity (*the Parent*) that *controls* one or more other entities (*subsidiaries*) to present consolidated financial statements. The Committee also notes that no specific exemption is available under the Companies Act or Indian Accounting Standards from consolidation on the basis that the subsidiary company is a not-for-profit organisation or a Section 8 Company.

9. With regard to the assessment of 'control', the Committee notes the following paragraphs of Ind AS 110, 'Consolidated Financial Statements' and Basis for Conclusions (BC) to International Financial Reporting Standard (IFRS) 10 (which is corresponding international standard to Ind AS 110), issued by the International Accounting Standards Board (IASB):

- “5 An investor, regardless of the nature of its involvement with an entity (the investee), shall determine whether it is a parent by assessing whether it controls the investee.**
- 6 An investor controls an investee when it is exposed, or has rights, to variable returns from its involvement with the investee and has the ability to affect those returns through its power over the investee.**

7 **Thus, an investor controls an investee if and only if the investor has all the following:**

- (a) **power over the investee (see paragraphs 10–14);**
- (b) **exposure, or rights, to variable returns from its involvement with the investee (see paragraphs 15 and 16); and**
- (c) **the ability to use its power over the investee to affect the amount of the investor’s returns (see paragraphs 17 and 18).**

8 An investor shall consider all facts and circumstances when assessing whether it controls an investee. The investor shall reassess whether it controls an investee if facts and circumstances indicate that there are changes to one or more of the three elements of control listed in paragraph 7 (see paragraphs B80–B85).”

“Power

10 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.”

“Returns

15 An investor is exposed, or has rights, to variable returns from its involvement with the investee when the investor’s returns from its involvement have the potential to vary as a result of the investee’s performance. The investor’s returns can be only positive, only negative or both positive and negative.”

“Assessing control

B2 To determine whether it controls an investee an investor shall assess whether it 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.

B3 Consideration of the following factors may assist in making that determination:

- (a) the purpose and design of the investee (see paragraphs B5-B8);
- (b) what the relevant activities are and how decisions about those activities are made (see paragraphs B11-B13);
- (c) whether the rights of the investor give it the current ability to direct the relevant activities (see paragraphs B14-B54);

- (d) whether the investor is exposed, or has rights, to variable returns from its involvement with the investee (see paragraphs B55-B57); and
 - (e) whether the investor has the ability to use its power over the investee to affect the amount of the investor's return (see paragraphs B58-B72)."
- "B5 When assessing control of an investee, an investor shall consider the purpose and design of the investee in order to identify the relevant activities, how decisions about the relevant activities are made, who has the current ability to direct those activities and who receives returns from those activities."
- "B9 To have power over an investee, an investor must have existing rights that give it the current ability to direct the relevant activities. For the purpose of assessing power, only substantive rights and rights that are not protective shall be considered (see paragraphs B22–B28)."
- B12 Examples of decisions about relevant activities include but are not limited to:
- (a) establishing operating and capital decisions of the investee, including budgets; and
 - (b) appointing and remunerating an investee's key management personnel or service providers and terminating their services or employment."
- B14 Power arises from rights. To have power over an investee, an investor must have existing rights that give the investor the current ability to direct the relevant activities. The rights that may give an investor power can differ between investees.
- B15 Examples of rights that, either individually or in combination, can give an investor power include but are not limited to:
- (a) rights in the form of voting rights (or potential voting rights) of an investee (see paragraphs B34–B50);
 - (b) rights to appoint, reassign or remove members of an investee's key management personnel who have the ability to direct the relevant activities;
 - (c) rights to appoint or remove another entity that directs the relevant activities;
 - (d) rights to direct the investee to enter into, or veto any changes to, transactions for the benefit of the investor; and
 - (e) other rights (such as decision-making rights specified in a management contract) that give the holder the ability to direct the relevant activities."
- "B51 In assessing the purpose and design of an investee (see paragraphs B5–B8), an investor shall consider the involvement and decisions made at the investee's

inception as part of its design and evaluate whether the transaction terms and features of the involvement provide the investor with rights that are sufficient to give it power. Being involved in the design of an investee alone is not sufficient to give an investor control. However, involvement in the design may indicate that the investor had the opportunity to obtain rights that are sufficient to give it power over the investee.”

“B54 An investor may have an explicit or implicit commitment to ensure that an investee continues to operate as designed. Such a commitment may increase the investor’s exposure to variability of returns and thus increase the incentive for the investor to obtain rights sufficient to give it power. Therefore a commitment to ensure that an investee operates as designed may be an indicator that the investor has power, but does not, by itself, give an investor power, nor does it prevent another party from having power.

Exposure, or rights, to variable returns from an investee

B55 When assessing whether an investor has control of an investee, the investor determines whether it is exposed, or has rights, to variable returns from its involvement with the investee.

B56 Variable returns are returns that are not fixed and have the potential to vary as a result of the performance of an investee. Variable returns can be only positive, only negative or both positive and negative (see paragraph 15). An investor assesses whether returns from an investee are variable and how variable those returns are on the basis of the substance of the arrangement and regardless of the legal form of the returns. For example, an investor can hold a bond with fixed interest payments. The fixed interest payments are variable returns for the purpose of this Ind AS because they are subject to default risk and they expose the investor to the credit risk of the issuer of the bond. The amount of variability (ie how variable those returns are) depends on the credit risk of the bond. Similarly, fixed performance fees for managing an investee’s assets are variable returns because they expose the investor to the performance risk of the investee. The amount of variability depends on the investee’s ability to generate sufficient income to pay the fee.

B57 Examples of returns include:

- (a) dividends, other distributions of economic benefits from an investee (eg interest from debt securities issued by the investee) and changes in the value of the investor’s investment in that investee.
- (b) remuneration for servicing an investee’s assets or liabilities, fees and exposure to loss from providing credit or liquidity support, residual interests in the investee’s assets and liabilities on liquidation of that investee, tax benefits, and access to future liquidity that an investor has from its involvement with an investee.
- (c) 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.*”

(Emphasis supplied by the Committee)

“BC39 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.”

“BC62 ... ED 10 used the term ‘returns’ rather than ‘benefits’ because ‘benefits’ are often interpreted as implying only positive returns.

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.”

From the above, the Committee notes that the assessment of ‘control’ is a matter of judgement and requires continuous assessment over time, which should be evaluated in the particular facts and circumstances and considering the requirements of any specific contractual arrangement between the parties concerned. In the context of the current fact pattern, the Committee notes that whilst there are three elements of control, viz., (i) power, (ii) exposure to variable return, and (iii) linkage between the power and variable return, the querist has primarily made arguments related to variable return to re-evaluate control. Accordingly, the Committee has examined the issue in greater detail from the variable return perspective which is dealt with in below paragraphs. However, for completeness, with regard to power, the Committee notes that the purpose of establishing the Section 8 Company by the Company is to meet its CSR obligations since the CSR Rules, inter alia, provide that a Company’s Board shall ensure that the CSR activities are undertaken by the Company itself or through a company established under section 8 of the Act, established by the Company, either singly or along with any other company. Also, in such case, the CSR amount may be spent by the Company for creation or acquisition of a capital asset, which can be held by the company established under section 8 of the Act. Further, in the instant case, the Section 8 Company is 100% owned and established by the Company with active involvement in its design and determining the purpose thereof pursuant to its CSR obligations. The Committee also notes that, the Section 8 Company has only two directors and one of them is the CEO of the

Company. Further, all the powers to take decisions about the activities of the Section 8 company, like all the decisions to fulfil objectives of the Section 8 Company given in paragraph 5 above, increase in share capital, reduction of share capital, borrowings decisions, making investment decisions, issue of debentures, etc. are either with the members/ shareholders (i.e., the Company) or with the board of directors of the Section 8 Company. The Company being a 100% shareholder should have the right to appoint and remove all board members of the Section 8 Company. Thus, in fact and in substance, the Company has power as well as the ability to direct the relevant activities of the Section 8 Company.

With regard to exposure or rights to variable returns from the Section 8 Company, the Committee believes that the Company is exposed to variable returns arising from activities of Section 8 Company for the following key reasons:

- (i) In accordance with the requirements of Ind AS 110, returns include not only positive returns, but negative returns also. Under Ind AS 110, variable return is a wide notion that also encompasses non-financial returns, such as, exposure to loss or expenses from providing funds, donation, credit or liquidity support and intangible benefits of reputation and image from good governance practices, synergistic returns that are not available to other interest holders, such as, combining operating functions to achieve economies of scale, impact on market capitalisation, etc.
- (ii) The Company contributes funds for the CSR purposes to the Section 8 Company and the objective of the Section 8 Company is to implement the CSR activities of the Donor Company (primarily, Sponsor Company). Thus, the Section 8 Company is apparently dependent on and carries out or manages CSR activities on behalf of the Company.
- (iii) The Company has an exposure to variable returns in the form of exposure to statutory penalties for non-compliance with the Company's CSR obligations, loss from funding or providing liquidity support for running the CSR entity (Section 8 Company). In addition, there will be intangible/ non-financial returns by way of enhancement or damage to reputation and image including, being a listed company its market capitalisation. Therefore, it can be construed that such Section 8 Company engaged in CRS activity of the Company has the ability to affect the Company's returns.
- (iv) The Company does the charity with administrative support, and associates itself with the Section 8 Company which also indicates that it has an exposure to variable returns from that company. This is also supported by paragraph B57(c) of Ind AS 110 which states that an investor might use its assets, with the investee's assets, to enhance the value of its other assets. From the Company's perspective, this could include the intangible benefit of being associated with the Section 8 Company and providing it with a support function.

Thus, the Committee is of the view that in the extant case, the Company has power over Section 8 Company as well as exposure to variable returns associated with the activities of the Section 8 Company. Accordingly, the Committee is of the view that the Company exercises control over the Section 8 Company and as per Ind AS 110, the Company is required to consolidate the financial statements of its Sponsored Company, which is a section 8 Company, with its financial statements.

D. Opinion

10. On the basis of the above, the Committee is of the opinion on the issues raised in paragraph 6 above that since the Company exercises control over the Section 8 Company and no specific exemption is provided to any company from consolidating a section 8 Company as per Ind AS 110 and/or the Companies Act, 2013, the Company is required to consolidate the financial statements of its Sponsored Company, which is a section 8 Company, with its financial statements, as discussed in paragraph 9 above.
