

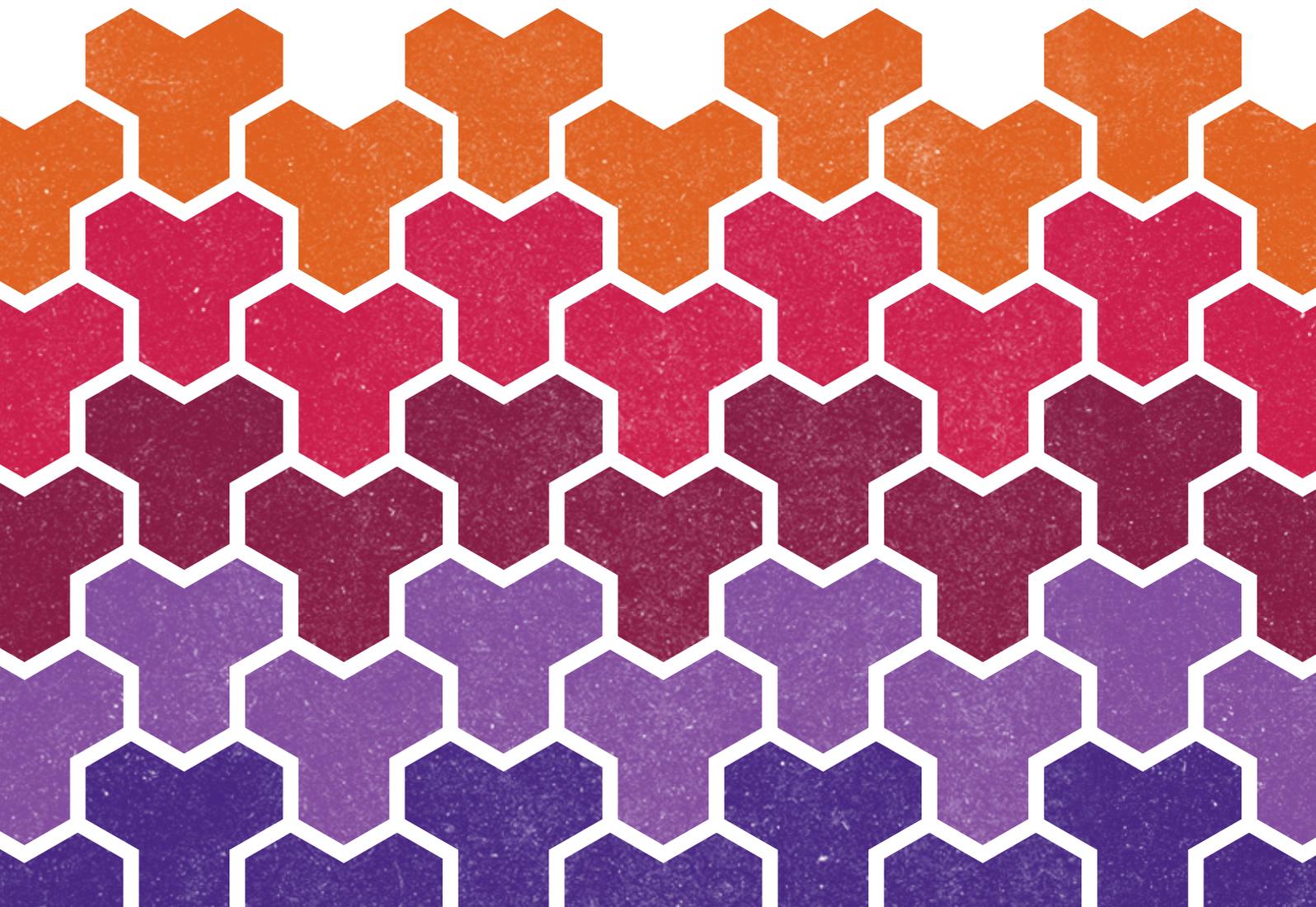


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Under control?

A practical guide to applying IFRS 10 consolidated financial statements
August 2012



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Introduction

Assessing control

Assessing when one entity controls another (in other words, when a parent-subsiary relationship exists) is essential to the preparation of financial statements in accordance with International Financial Reporting Standards (IFRS). The control assessment determines which entities are consolidated in a parent's financial statements and therefore affects a group's reported results, cash flows and financial position – and the activities that are 'on' and 'off' the group's balance sheet.

In May 2011, the IASB introduced new requirements on assessing control by issuing IFRS 10 'Consolidated Financial Statements' (IFRS 10) – part of a package of changes addressing different levels of involvement with other entities. IFRS 10 redefines 'control' and provides extensive new guidance on applying the new definition. IFRS 10 applies both to traditional entities and to special purpose (or structured) entities and replaces the corresponding requirements of both IAS 27 'Consolidated and Separate Financial Statements' (IAS 27) and SIC-12 'Consolidation – Special Purpose Entities' (SIC-12).

IFRS 10 is unlikely to affect the scope of consolidation in simple situations involving control through ownership of a majority of the voting power in an investee. However, more complex and borderline control assessments will need to be reviewed – and some will need to be revised.

Fortunately, the member firms within Grant Thornton International Ltd (Grant Thornton International) – one of the world's leading organisations of independently owned and managed accounting and consulting firms – have gained extensive insights into the application of IFRS 10. Grant Thornton International, through its IFRS team, develops general guidance that supports its member firms' commitment to high quality, consistent application of IFRS. We are pleased to share these insights by publishing 'Under Control? A Practical Guide to Applying IFRS 10 Consolidated Financial Statements' (the Guide).

Important note

References to IFRS 10 and IAS 27

References in the Guide to IFRS 10 'Consolidated Financial Statements' (IFRS 10) are to the May 2011 version as amended by revised transition requirements published in June 2012.

References to IAS 27 'Consolidated and Separate Financial Statements' (IAS 27) are to the revised version of that standard published in 2008, except where otherwise stated.

Investment entities

At the time of writing the IASB has an active project on investment entities. This may lead to new requirements under which investment entities that meet defined criteria are required to account for their controlled investments at fair value instead of consolidating them. The current status of the project is summarised in Appendix B.

Using the Guide

The Guide has been written to assist management in transitioning to and applying IFRS 10. More specifically it aims to assist in:

- understanding IFRS 10's requirements and how they differ from IAS 27's and SIC-12's
- identifying situations in which IFRS 10 is more likely to affect control assessments
- identifying and addressing the key practical application issues and judgements.

The Guide is organised as follows:

- **Section A** provides an overview of IFRS 10, a comparison with IAS 27 and SIC-12 and indications of the situations in which the new requirements are most likely to change current practice. It also explains how IFRS 10 fits into the overall package of new and amended standards on involvement with other entities.
- **Section B** explains the scope of IFRS 10 from an investor and investee perspective, and the situations in which a parent entity is exempt from presenting consolidated financial statements.
- **Section C** sets out IFRS 10's new control definition and its key elements, and identifies key practical issues in applying this new guidance.
- **Section D** discusses the specific situations and types of investee for which IFRS 10 is most likely to affect control conclusions and the scope of consolidation in practice.

- **Section E** discusses consolidation procedures and the requirements on changes in ownership and loss of control.
- **Section F** explains the effective date of IFRS 10 and the transitional issues when first moving from IAS 27 and SIC-12 to the new standard.
- **Appendix A** summarises the new disclosure requirements in IFRS 12 and provides selected application examples.
- **Appendix B** summarises the current status of the IASB's project on a possible consolidation exemption for investment entities.

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A. Overview

This Section provides:

- an ‘at a glance’ overview of IFRS 10
- a summary of key changes from previous requirements
- insights into areas where IFRS 10 will most often affect consolidation assessments
- an explanation of how IFRS 10 fits into the broader ‘consolidation package’.

1 IFRS 10 at a glance

IFRS 10 ‘Consolidated Financial Statements’ (IFRS 10) establishes a single, control-based model for assessing control and determining the scope of consolidation. It replaces the corresponding requirements of both IAS 27 ‘Consolidated and Separate Financial Statements’ (IAS 27) and SIC-12 ‘Consolidation – Special Purpose Entities’ (SIC-12). Although SIC-12 is an interpretation of IAS 27, some commentators believe that it established a somewhat different model for assessing control over special purpose entities.

Terminology – ‘special purpose entities’ (SPEs) and ‘structured entities’

The Guide makes extensive references to ‘special purpose entities’ (SPEs). These references are used here to describe entities that would be considered to be within the scope of SIC-12. SIC-12 describes SPEs only in general terms, so deciding whether a particular entity is an SPE can require judgement.

IFRS 10 does not refer to SPEs, but instead refers to entities that have been designed so that voting or similar rights are not the dominant factor in assessing control. These are described as ‘structured entities’ (in IFRS 12 ‘Disclosure of Interests in Other Entities’). IFRS 10 includes application guidance for assessing control over such entities.

In practice we expect that most (but not all) entities previously regarded as SPEs under SIC-12 would be structured entities under IFRS 10.

This is explained in more detail in Section D.4.1.

Figure A.1 below summarises IFRS 10's main requirements:

Figure A.1 – Summary of IFRS 10's main requirements



2 Headline changes in IFRS 10

Key differences and similarities between IFRS 10 and IAS 27 and SIC-12 are summarised below:

Accounting topic	IAS 27 (2008) and SIC-12	IFRS 10
Scope	<ul style="list-style-type: none"> IAS 27 applies to all control assessments but is interpreted by SIC-12 for Special Purpose Entities (SPEs) IAS 27 applies to both consolidated and separate financial statements 	<ul style="list-style-type: none"> IFRS 10 is the single source of consolidation guidance for all types of investee, including those to which SIC-12 applied IFRS 10 applies only to consolidated financial statements. Requirements on preparing separate financial statements are retained in IAS 27
Consolidation exemptions	<ul style="list-style-type: none"> IAS 27 provides an exemption for a parent that is itself a subsidiary and meets strict conditions 	<ul style="list-style-type: none"> no change in IFRS 10
Control definition	<ul style="list-style-type: none"> under IAS 27 control is the power to govern the financial and operating policies of another entity so as to obtain benefits from its activities 	<ul style="list-style-type: none"> IFRS 10's new control definition retains a 'power + returns' concept but focuses on the ability to direct the activities that most affect the returns
Consolidation procedures	<ul style="list-style-type: none"> IAS 27 sets out procedures such as elimination of intragroup balances as transactions in order to achieve a 'single economic entity' presentation IAS 27 includes requirements on changes of ownership without loss of control, and loss of control 	<ul style="list-style-type: none"> no change in IFRS 10
Control with voting rights/de facto control	<ul style="list-style-type: none"> IAS 27 includes a presumption that ownership of more than 50% of an investee's voting power gives control IAS 27 has no explicit guidance on control via a large minority holding ('de facto control') 	<ul style="list-style-type: none"> under IFRS 10 control is conferred by more than 50% of voting rights if substantive and the investee's relevant activities are directed by voting rights IFRS 10 includes explicit guidance that a large minority holding may confer control where other shareholdings are widely dispersed
Special Purpose Entities (SPEs)	<ul style="list-style-type: none"> SIC-12 defines SPEs and provides specific interpretive guidance SIC-12's indicators of control include 'risks and rewards' and 'autopilot' 	<ul style="list-style-type: none"> SPEs are not defined in IFRS 10 IFRS 10's general principles apply to entities previously covered by SIC-12 IFRS 10 does include guidance on situations in which voting or similar rights are not the dominant factor in deciding who controls the investee
Potential voting rights (PVRs)	<ul style="list-style-type: none"> under IAS 27 PVRs may convey or contribute to control if currently exercisable IAS 27's guidance is very restrictive as to when PVRs lack substance (eg when exercise price precludes conversion in any feasible scenario) 	<ul style="list-style-type: none"> under IFRS 10 PVRs may convey or contribute to control if 'substantive' IFRS 10 has a broader range of indicators to assess whether PVRs are substantive
Delegated power (principal-agent situations)	<ul style="list-style-type: none"> IAS 27 has no guidance 	<ul style="list-style-type: none"> IFRS 10 includes extensive guidance on whether an investor is a principal or an agent. An investor engaged primarily to act on behalf of other parties (ie an agent) does not control the investee.

3 Areas where IFRS 10 may affect the scope of consolidation

IFRS 10 is unlikely to affect the scope of consolidation in straightforward situations involving control through majority ownership of voting power. However, more complex and borderline control assessments will need to be reviewed – and some will need to be revised.

The table below summarises the main situations and types of investee in which IFRS 10 has the greatest potential to change control assessments and the resulting scope of consolidation:

Situations/type of investee	Potential impact of IFRS 10
Special purpose entities (SPEs) and structured entities	<ul style="list-style-type: none"> consolidation outcomes for entities that were previously within the scope of SIC-12 may change because: <ul style="list-style-type: none"> exposure to risks and rewards is only an indicator of control under IFRS 10 and is not determinative of control on its own IFRS 10 places less emphasis on ‘autopilot’ and instead requires a more specific identification of the future activities and decisions that can affect returns.
Large minority holdings	<ul style="list-style-type: none"> control may exist where other shareholdings are widely dispersed and an investor holds significantly more voting rights than any other shareholder or group of shareholders.
Potential voting rights (PVRs)	<ul style="list-style-type: none"> PVRs can affect consolidation conclusions under both IAS 27 and IFRS 10 but the analysis differs: <ul style="list-style-type: none"> under IAS 27 only currently exercisable PVRs are considered. Under IFRS 10 PVRs are relevant if they can be exercised in time to affect decisions on relevant activities (which may be a future date) IFRS 10 takes a broader approach to assessing whether PVRs are substantive.
Delegated power (principal-agent situations)	<ul style="list-style-type: none"> the new guidance in IFRS 10 on principal-agent may impact on consolidation decisions investment and asset managers in particular may be affected.

4 IFRS 10 in the context of the overall ‘consolidation package’

IFRS 10 was issued in May 2011 as part of a package of three new and two amended standards, sometimes referred to as the consolidation package. The other pronouncements are:

Other pronouncements in the ‘consolidation package’

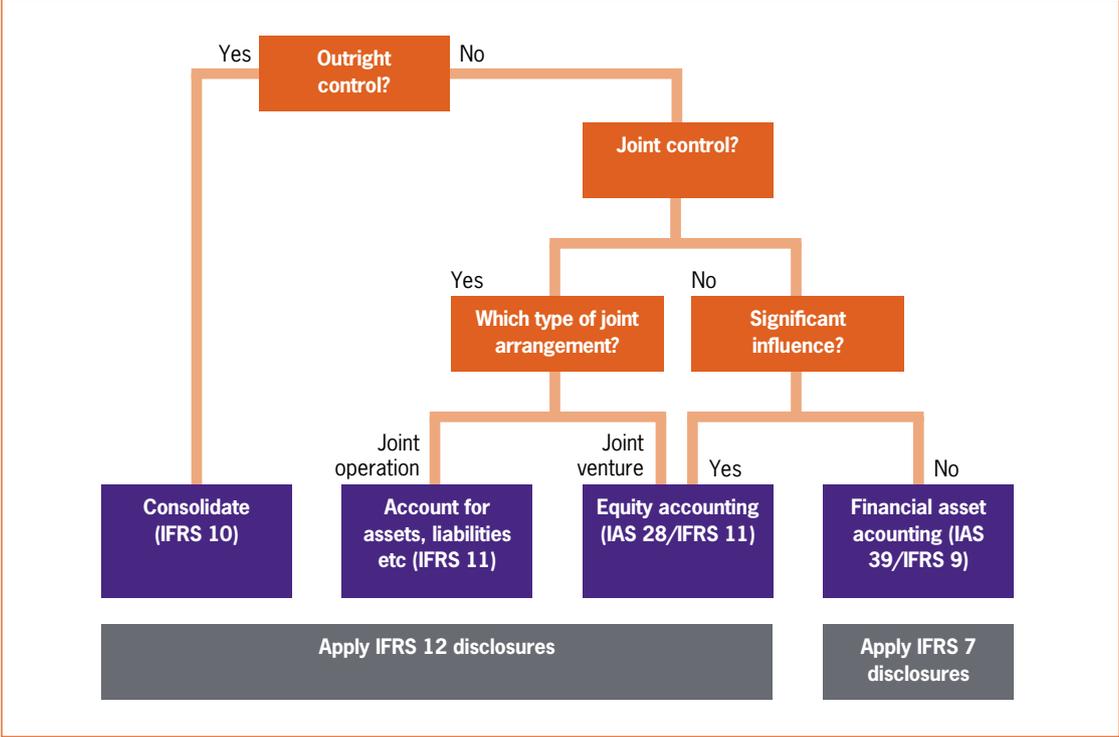
In addition to IFRS 10, the package of standards and amendments published in May 2011 includes:

- IFRS 11 ‘Joint Arrangements’, which replaces IAS 31 ‘Interests in Joint Ventures’ and SIC-13 ‘Jointly Controlled Entities – Non-Monetary Contributions by Venturers’
- IFRS 12 ‘Disclosure of Interests in Other Entities’
- an amended version of IAS 27, which is renamed IAS 27 ‘Separate Financial Statements’ and now addresses only separate financial statements
- an amended version of IAS 28, now renamed IAS 28 ‘Investments in Associates and Joint Ventures’, but substantively the same as the previous version.

This Guide focuses on IFRS 10, although the related disclosure requirements in IFRS 12 are summarised in Appendix A.

The flowchart below summarises the interactions between IFRSs 10, 11 and 12 and IAS 28 for different levels of involvement with an investee:

Figure A.2 – Interactions between pronouncements in the ‘consolidation package’



B. Scope and consolidation exemptions

This Section discusses:

- the scope of IFRS 10 and associated practical issues
- exemptions from preparing consolidated financial statements.

1 Scope of IFRS 10

IFRS 10 addresses the scope of consolidated financial statements and the procedures for their preparation. The requirements on separate financial statements are retained in a revised version of IAS 27 (now re-named IAS 27 ‘Separate Financial Statements’).

The scope of IFRS 10 covers:

- the reporting entities that are required to assess control of their investees – see Section B.1.1 below
- the investees that the control assessment is applied to – see Section B.1.2 below
- circumstances in which parent entities are exempt from presenting consolidated financial statements – see Section B.2 below.

Terminology – ‘investor’ and ‘investee’

IFRS 10 does not define ‘investors’ and ‘investees’ but uses these terms extensively.

In practice, **‘investor’** refers to the reporting entity (or potential parent) and **‘investee’** refers to an entity that might be a subsidiary. An investor therefore assesses whether it controls an investee to determine whether a parent-subsidiary relationship exists.

1.1 Which reporting entities are required to assess control of their investees?

IFRS 10 applies to all reporting entities that prepare IFRS financial statements, except post-employment benefit plans or other long-term employee benefit plans to which IAS 19 ‘Employee Benefits’ applies. Accordingly, subject to this narrow scope exception, every reporting entity is required to apply IFRS 10 to determine whether it is a parent and, if so, the entities it controls (its subsidiaries).

Definition of parent, subsidiary and group [IFRS 10.Appendix A]

A **parent** is an entity that controls one or more entities.

A **subsidiary** is an entity that is controlled by another entity.

A **group** is a parent and its subsidiaries.

1.2 Which investees is the control assessment applied to?

IFRS 10 generally requires the control assessment to be made at the level of each investee entity. However, in some circumstances the assessment is made for a portion of an entity (a deemed separate entity). This is the case if, and only if, all the assets, liabilities and equity of that part of the investee entity are ring-fenced from the overall investee (often described as a ‘silo’) [IFRS 10.B77-B79].

Silos most often exist within special purpose vehicles in the financial services and real estate sectors (eg some so-called ‘multi-seller conduits’ and captive insurance entities). However, the conditions for a silo to be a deemed separate entity for IFRS 10 purposes are strict. Example B.1 illustrates the silo concept:

Example B.1 – Silos and deemed separate entities

Bank A establishes and administers a special purpose vehicle that enables two corporate clients – Companies A and B – to sell trade receivables in exchange for cash and rights to deferred consideration. The vehicle issues loan notes to outside investors to fund the purchases. Each company remains responsible for managing collection of its own transferred receivables. Bank A provides credit enhancements in exchange for a fee. The terms of the loan notes and contractual document establish how cash collected from each pool of receivables is allocated to meet payments of the loan notes. Cash collected in excess of the specified allocation is paid to the originators.

Analysis:

A portion of an entity is treated as a silo if, and only if, the following conditions are met:

- specified assets of the investee (and related credit enhancements) are the only source of payment for specified liabilities
- parties other than those with the specified liability do not have rights or obligations related to the specified assets or to residual cash flows from those assets.
- in substance, none of the returns from the specified assets can be used by the remaining investee and none of the liabilities of the deemed separate entity are payable from the assets of the remaining investee.

In this case further analysis will be required to determine whether the allocation provisions create a situation in which each pool of assets is viewed as the only source of payment for specified liabilities.

The term ‘entity’ is widely used in IFRS and is usually well-understood. Entities are generally arrangements with separate legal personalities in accordance with law (such as companies, corporations, trusts, partnerships and unincorporated associations). However, entities are not defined and questions sometimes arise as to whether an arrangement is an ‘entity’. Example B.2 illustrates one such situation:

Example B.2 – Co-ownership agreement

The law in Country X provides a mechanism for two or more investors to own undivided shares in the same property. Two entities – Investor A and Investor B – acquire undivided shares in a plot of land of 60% and 40% and establish a co-ownership agreement setting out their intention to develop and operate a retail park on the site. The co-ownership agreement establishes the decision-making rights of each Investor, their respective obligations and the basis for allocation of profits from the venture.

Analysis:

Based on these limited facts, judgement is required to decide whether the property, combined with the co-ownership agreement, is an ‘entity’. One view, based on the IASB’s Exposure Draft of a Conceptual Framework chapter on the ‘Reporting entity’, is that an entity is any circumscribed area of economic activity for which discrete financial information exists. Under this definition the arrangement described would be an entity. However, this definition is not authoritative.

If an entity exists, Investors A and B should apply IFRS 10 to assess which (if either) has control. If, for example, A has control it would consolidate the investee and recognises a 40% non-controlling interest. Alternatively, A and B might conclude they have joint control and that IFRS 11 applies.

If the arrangement is not an entity:

- if it is jointly controlled it will be in the scope of IFRS 11, which applies to ‘joint arrangements’ whether or not structured through an entity
- if it is not jointly controlled, each investor applies other applicable IFRSs. For example, Investor A might recognise its 60% share of the property as an asset, without recording any non-controlling interest.

2 Consolidation exemptions

IFRS 10 requires all parent entities to present consolidated financial statements, other than intermediate parent entities that meet the strict conditions for exemption. These conditions are unchanged from IAS 27:

Conditions for a parent entity to be exempt from consolidation [IFRS 10.4]

A parent is not required to present consolidated financial statements if it meets all the following conditions:

- it is a wholly-owned subsidiary or is a partially-owned subsidiary of another entity and all its other owners, including those not otherwise entitled to vote, have been informed about, and do not object to, the parent not presenting consolidated financial statements.
- its debt or equity instruments are not traded in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local and regional markets)
- it did not file, nor is it in the process of filing, its financial statements with a securities commission or other regulatory organisation for the purpose of issuing any class of instruments in a public market; and
- its ultimate or any intermediate parent produces consolidated financial statements that are available for public use and comply with IFRSs.

Although these criteria are identical to IAS 27's, questions do arise on whether the consolidation exemption is available in particular circumstances. The following examples provide guidance on three common issues:

Example B.3 – Ultimate parent with different year-end

Entity IP1 is an intermediate parent company, wholly owned by Entity UP1 (the ultimate parent entity). Entity IP1's reporting date is 30 September and Entity UP1's is 31 December. Assuming the stated conditions in IFRS 10.4 are met, does the difference in reporting date preclude use of the consolidation exemption?

Analysis:

No. The consolidation exemption does not require the ultimate or higher level parent to have the same reporting date as the reporting entity seeking to apply the exemption. Accordingly, Entity IP1 meets the conditions for exemption from presenting consolidated financial statements if the other stated conditions in IFRS 10.4 are met.

Example B.4 – Immaterial intermediate parent

Entity IP2 is an intermediate parent company, wholly owned by Entity UP2 (the ultimate parent entity). From Entity UP2's perspective, Entity IP2 and its subsidiaries are immaterial. For this reason, Entity UP2 does not actually consolidate these entities. Is use of the consolidation exemption by Entity IP2 possible in this situation?

Analysis:

In our view, the consolidation exemption is still available in these circumstances (assuming the stated conditions in IFRS 10.4 are met). This is because Entity UP2's consolidated financial statements can still assert compliance with IFRSs if genuinely immaterial subsidiaries have been omitted from the consolidation. However, great care should be taken in assessing whether the effect of not consolidating really is immaterial.

Example B.5 – Ultimate parent's financial statements not yet available

Entity IP3 (domiciled in Country X) is an intermediate parent company, wholly owned by Entity UP3 (which is domiciled in Country Y). Both have a reporting date of 31 December. However, Entity IP3's filing deadline (in accordance with the law in Country X) is three months after year-end, and Entity UP3's (in accordance with the law in Country Y) is six months. Both entities file financial statements on the legal deadline, so Entity UP3's consolidated financial statements are not available for public use when Entity IP3's are filed. Does this preclude use of the consolidation exemption by Entity IP3?

Analysis:

In our view, the consolidation exemption is not dependent on the higher level consolidated financial statements for the same accounting period being available on or before the date of approval or filing of the intermediate parent's financial statements. The requirement is instead that the higher level parent produces consolidated financial statements that will be publicly available in due course.

C. New control definition and guidance

This Section:

- explains IFRS 10's definition of control
- compares the new definition to IAS 27's and the guidance in SIC-12
- explains the three key elements of control.

1 New control definition

IFRS 10 defines control as follows:

New definition of control [IFRS 10.6]

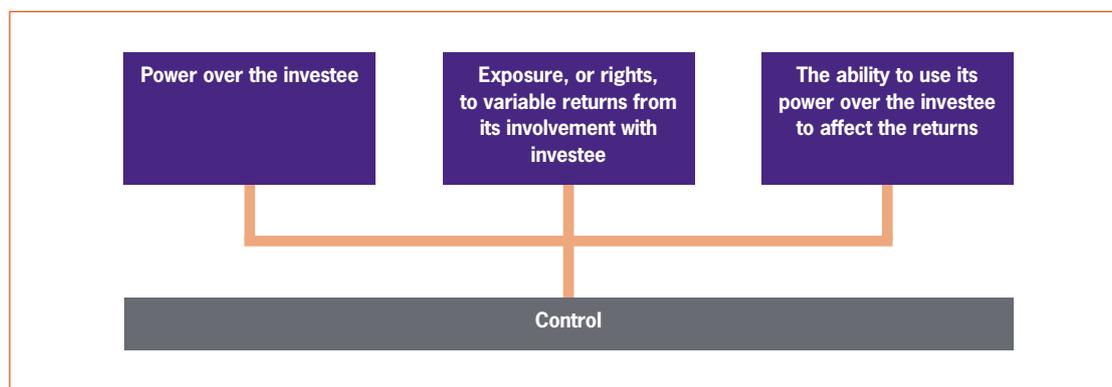
An investor controls an investee when it is exposed, or has rights, to variable returns from its involvement with the investee and has the ability to affect those returns through its power over the investee.

An investor therefore controls an investee if, and only if, the investor has:

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

These key elements of control are considered in more detail later in this Section.

Figure C.1 – Three elements of control



2 The new and old definitions compared

IAS 27's and IFRS 10's control definitions use different terminology but are similar in substance. Under both standards control requires both power over an investee entity, and some form of benefits or returns from that investee.

However, comparing the basic definitions alone is insufficient. This is because IAS 27 is supplemented by SIC-12, which provides additional indicators for making consolidation assessments for special purpose entities (SPEs).

The table below compares IFRS 10's definition with IAS 27's and with SIC-12's additional indicators:

New and previous definitions of control [IFRS 10.6, IAS 27.4 and SIC-12.10]

IFRS 10	IAS 27
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.	Control is the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities.
	SIC-12 (extract) The following circumstances, for example, may indicate a relationship in which an entity controls an SPE: <ul style="list-style-type: none"> (a) in substance, the activities of the SPE are being conducted on behalf of the entity according to its specific business needs so that the entity obtains benefits from the SPE's operation; (b) in substance, the entity has the decision-making powers to obtain the majority of the benefits of the activities of the SPE or, by setting up an 'autopilot' mechanism, the entity has delegated these decision-making powers; (c) in substance, the entity has rights to obtain the majority of the benefits of the SPE and therefore may be exposed to risks incident to the activities of the SPE; or (d) in substance, the entity retains the majority of the residual or ownership risks related to the SPE or its assets in order to obtain benefits from its activities.

2.1 Practical implications of new definition

The changes to the definition and accompanying guidance will have little or no practical effect on control assessments when a single investor owns a majority of the voting rights of an investee with a conventional governance and ownership structure. Under IAS 27 direct or indirect ownership of a majority of the voting rights presumptively results in control. This type of relationship will result in control under IFRS 10 in most cases, although IFRS 10 has more guidance on situations in which this is not the case – see Section D.1.

However, the revised definition does include changes that will affect the control assessment in more complex and judgemental situations. Figure C. 2 summarises some of the key practical implications:

Figure C.2 – Practical implications of revised control definition

Change in control definition	Practical implications
<p>IAS 27 refers to ‘power’ but IFRS 10 refers to ‘rights’ and ‘ability’</p>	<ul style="list-style-type: none"> the revised definition and guidance clarify that owning a majority of the voting or other rights is not always necessary to have control control instead requires that the investor’s power/rights are sufficient for it to unilaterally direct the activities that most affect the investee’s returns more analysis and judgement will now be required to determine whether an investor with a significant minority of voting or other rights has control
<p>IAS 27 refers to governing the financial and operating policies but IFRS 10 refers to the ability to affect returns</p>	<ul style="list-style-type: none"> the new definition reflects the fact that IFRS 10 applies to special purpose or structured entities as well as more conventional entities in more complex control assessments IFRS 10 requires identification of the activities that most affect the investee’s returns (the ‘relevant activities’), and how they are directed, at a more granular level in simpler assessments involving conventional entities it will continue to be sufficient to consider activities at the financial and policy level
<p>IAS 27 refers to obtaining ‘benefits’ while IFRS 10 requires ‘exposure or rights to variable returns’</p>	<ul style="list-style-type: none"> ‘benefits’ and ‘returns’ are similar in substance although returns is probably a broader concept IFRS 10 clarifies that: <ul style="list-style-type: none"> returns should be interpreted broadly eg to include synergy benefits as well as financial returns returns can be negative or positive a right to returns that is fixed is not consistent with control (although returns that are contractually-fixed are often still variable in substance – see Section C.3.2)
<p>SIC-12 includes specific control indicators for special purpose entities (SPEs) while IFRS 10 does not</p>	<ul style="list-style-type: none"> SPE control assessments are in the scope of IFRS 10’s single model IFRS 10 includes guidance on investees for which voting rights cannot significantly affect the returns and contractual rights determine the direction of the relevant activities SIC-12 has been applied in different ways by different entities and some approaches will no longer be sufficient eg assessments based only on: <ul style="list-style-type: none"> quantitative analysis of risks and rewards qualitative consideration of whether an SPE’s activities are conducted on behalf of the investor and is on ‘autopilot’

3 The three key elements of control in more detail

IFRS 10 includes guidance on each of the three key control elements summarised above. This guidance is broad. Considering the guidance on the elements separately can give the impression that almost any ‘involvement’ with another entity requires a detailed control assessment. However, it is important to note that the three elements are inter-related and that all three must be present to confer control.

The following paragraphs provide an overview of this guidance and explain the main practical implications.

3.1 Power

IFRS 10 explains that power arises from rights. Rights confer power when they are sufficient to give the investor the current ability to direct the ‘relevant activities’ (see below) unilaterally. In this context ‘current ability’ does not necessarily require the rights to be exercisable immediately. Instead, the key factor is whether the rights can be exercised before decisions about relevant activities need to be taken (see discussion of substantive and protective rights later in this Section).

Practical insight – assessing power in straightforward situations

Assessing power is straightforward for conventional investees where voting rights (normally conferred by share ownership) are the key factor [IFRS 10.11]. In such cases, ownership of a majority of the voting rights confers power and control (in the absence of other relevant factors) [IFRS 10.B6].

An investor evaluates all of the following factors to determine if it has power over the investee:

- relevant activities
- how the relevant activities are directed
- the rights that the investor and other parties have in relation to the investee [IFRS 10.B10].

An investor also considers the purpose and design of the investee (see Section C.4 below).

Relevant activities [IFRS 10.B11-B13]

IFRS 10 introduces the concept of ‘relevant activities’. This is a critical part of the model. This concept clarifies which aspects of an investee’s activities must be under the direction of an investor for that investor to have control for consolidation purposes.

Definition of relevant activities [IFRS 10.Appendix A]

Relevant activities are activities of the investee that significantly affect the investee’s returns.

IFRS 10 provides some non-exhaustive examples of possible relevant activities:

Examples of relevant activities [IFRS 10.B11]

Examples of activities that, depending on the circumstances, can be relevant activities include:

- selling and purchasing of goods or services
- managing financial assets during their life (including upon default)
- selecting, acquiring or disposing of assets
- researching and developing new products or processes
- determining a funding structure or obtaining funding.

Questions sometimes arise as to whether an investee whose activities are largely pre-determined (such as some special purpose and structured entities) really has any relevant activities. As discussed in Section D.4, in our view it is very rare (although not impossible) that an investee has no relevant activities at all.

Assessing relevant activities is critical when an investor has the current ability to direct only some of an investee’s activities (and decisions about other activities are taken by other parties, or through shared decision-making). If two or more investors have rights to direct different relevant activities, the investor with current ability to direct the activities that most significantly affect the returns has power [IFRS 10.13]. Example C.1 illustrates this concept:

Example C.1 – Rights to direct different relevant activities

Investors A and B establish Entity C and each holds 50% of the voting rights. The shareholders' agreement between A and B specifies that:

- Entity C's purpose is to generate capital gains from investing in commercial property. Its activities are limited to buying, managing and selling properties that meet pre-determined investment criteria
- all decisions concerning major capital activities, including buying and selling properties, and associated financing activities, require the agreement of both investors
- Investor A is responsible for other day-to-day management activities, including marketing to prospective tenants, negotiating rental agreements, rent collection and property maintenance, security and insurance. Investor A is paid for these services on the basis of costs incurred plus a fixed margin.

Analysis:

It is likely that the major capital activities and day-to-day management activities will both affect Entity C's returns to a significant extent. Investors A and B should therefore evaluate which set of activities has the greatest effect on returns.

In making this evaluation, the investors should consider the purpose and design of Entity C. Given that its stated objective is to achieve capital gains, this may indicate the capital activities have the most significant impact. If so, the conclusion would be that Investors A and B have joint control of Entity C because these activities are directed by joint decision-making. If however the day-to-day management activities are considered more significant, the conclusion would be that Investor A has control of Entity C because it directs these activities unilaterally.

Fortunately, in practice, it is normally unnecessary to identify the relevant activities in detail in simple situations involving conventional ownership structures and business entities:

Practical insight – relevant activities for conventional business entities

For many investees, returns depend on a wide range of financial and operating activities. Most entities with traditional ownership and governance structures that operate a business are in this category. In such cases it is not normally necessary to identify the relevant activities in detail. This is because directing the investee's financial and operating policies (either directly or by appointing the majority of the Board of Directors or other senior management body) encompasses all or most of the underlying activities – and therefore confers power.

However, a more specific and detailed analysis of relevant activities is required in less straightforward situations. This will often be the case for special purpose or structured entities, including entities that would be considered as on 'autopilot' under SIC-12. Example C.2 illustrates one such situation:

Example C.2 – Specific relevant activity

Bank A establishes Entity B – a limited life entity with a narrow and well-defined purpose to acquire a portfolio of Bank A's originated mortgage loans. Entity B funds the purchase by issuing loan notes to various third party investors. Once these initial transactions have been completed, Entity B will not undertake any further investing or financing activities. The only continuing activities relate to:

- managing the loans, including collecting the amounts due and management of any defaults
- basic administrative functions.

Analysis:

The set-up activities that occurred in the past are not directly relevant since no further decisions are to be taken about them. However, in assessing Entity B's purpose and design, Bank A should consider its involvement and decisions made at inception. This may indicate Bank had the opportunity to obtain rights that confer power, such as rights to manage the loans (including on default). In this case, Entity B's relevant activity is likely to be managing the loans. Bank A should therefore consider:

- how decisions about managing the loans are directed
- whether it has rights or exposure to variable returns.

Some investees are structured such that two or more investors have the current ability to direct relevant activities but those activities occur at different times. In this situation the investors again determine which investor is able to direct the activities that most significantly affect the returns. This assessment is re-evaluated if relevant facts or circumstances change. Example C.3 illustrates two situations in which different relevant activities are directed by different investors:

Example C.3 – Different relevant activities at different times

Scenario 1 – research and development

An entity with two investors (A and B) is designed to research, develop, and produce a new drug. In this entity, Investor A will make the significant decisions until a new drug candidate receives regulatory approval, and Investor B will make all decisions on manufacturing, marketing, and distribution of that drug.

Analysis:

The production and sales period may be expected to be longer than the research phase of the entity, which could be an indicator that the manufacturing, marketing, and distribution activities would have a more significant effect on the investee's returns over the life of the entity. However, significant uncertainty about the ultimate outcome of the research might indicate that the research activities are more significant to the investee's returns until that uncertainty is reduced or eliminated.

Over time, the investors would need to reconsider this assessment as the manufacturing and marketing activities become more significant. Once regulatory approval is obtained (and no further drugs are developed) then there are no further activities or decisions associated with this phase. The only activities then relate to manufacturing and marketing activities so these must now be the relevant activities.

In this type of situation a change of control (from one investor to another) is possible, following reassessment of the investee's relevant activities. This is consistent with IFRS 10's continuous assessment requirement (see Section C.7).

Scenario 2 – construction of a facility

In contrast to the research and development example, consider an entity designed to construct and operate a facility. For this entity, Investor A has the ability to make the significant decisions only during the construction of the entity's operating facility; thereafter, Investor B manages all operating activities of the entity. Over the expected life of the entity, the operating period is expected to be significantly longer than the initial construction period. In addition, there may be little uncertainty about the entity's ability to complete the construction and begin operations.

Analysis:

The operating activities of the entity may be determined to have the most significant impact on the investee's returns over the life of the entity, even during the construction period. If so, then we consider that Investor B has power from the outset.

In our view relevant activities can include future activities, and are not necessarily limited to current activities. However, once a one-off activity (such as the construction phase in this example) has been completed it can no longer be a relevant activity.

Directing relevant activities

Having identified an investee's relevant activities, the next step is to determine how those activities are directed. IFRS 10 breaks this down into the following two steps (although in practice we expect these steps would be combined with the identification of relevant activities):

- understanding the decisions about relevant activities [IFRS 10.B12]
- identifying rights that confer ability to direct those decisions [IFRS 10.B14-B17].

Practical insight – decisions about relevant activities

Decisions about relevant activities include but are not limited to:

- establishing operating and capital decisions of the investee, including budgets
- appointing and remunerating an investee's key management personnel or service providers and terminating their services or employment [IFRS 10.B12].

These decisions are broad-based and relate to high level direction of the investee. For conventional investees where the relevant activities comprise a wide range of financial and operating activities, direction is generally through these broad-based decisions. In other words there is usually no need to identify relevant activities at a specific or detailed level.

In more complex situations where the relevant activities are identified at a more specific level, such as Example C.2 above, direction might be through a more specific contractual right or process.

IFRS 10 envisages two types of rights that may confer ability to direct these decisions (ie power):

- voting rights granted by equity instruments eg ordinary shares
- contractual rights [IFRS 10.B16-B17].

The previous steps – identification of the investee's relevant activities and how they are directed – determine the applicable category. The control assessment will typically be more straightforward when power is conferred through voting rights. In most cases involving conventional operating entities and governance structures, power is conferred by voting rights. For investees that would have been considered special purpose entities and analysed in accordance with SIC-12, however, power arises from more specific contractual rights.

Figure C.3 below illustrates how the direction of relevant activities differs for conventional and special purpose entities:

Figure C.3 – Direction of relevant activities for conventional and special purpose entities



In some cases voting rights might exist but, in practice, confer an ability to direct only administrative-type tasks with little or no effect on returns. Example C.4 below illustrates one such situation:

Example C.4 – Voting versus contractual rights

Bank A establishes a special purpose vehicle, Entity B, and owns 100% of its shares. Entity B simultaneously enters into a trade receivables factoring agreement with Company C. The agreement sets out the terms on which Entity B will purchase Company C's receivables, and the terms of financing provided by Bank A for that purpose. The agreement provides that Company C will continue to be responsible for collecting and managing the receivables, including in the event of default. Company C is also required to provide a guarantee that losses on the transferred receivables will not exceed a specified percentage.

Entity B's articles of association restrict its activities to this specific factoring programme.

The shares held by Bank A confer the general range of voting rights associated with shares but cannot override the restriction on Entity B's activities, or invalidate the contract with Company C.

Analysis:

Although Bank A owns 100% of the shares of Entity B, it is unlikely that the associated voting rights confer the ability to direct the relevant activities. This is due to the combined effect of:

- the restrictions placed on Entity B's activities; and
- the factoring agreement, which provides that Company C will manage the receivables (which is likely to be the activity with the greatest impact on Entity B's returns).

Substantive and protective rights [IFRS 10.B22-B28]

In assessing whether it has power, an investor does not consider rights that it holds, or rights held by others, if those rights are:

- not 'substantive'; or
- purely 'protective'.

Definition of substantive rights [IFRS 10.B22]

For a right to be substantive, the holder must have the practical ability to exercise that right.

Definition of protective rights [IFRS 10.Appendix A and B26-B27]

Protective rights are rights designed to protect the interest of the party holding those rights without giving that party power over the entity to which those rights relate.

Protective rights relate to fundamental changes to the activities of an investee or apply in exceptional circumstances. However, not all rights that apply in exceptional circumstances or are contingent on events are protective. Because protective rights are designed to protect the interests of their holder without giving that party power over the investee to which those rights relate, an investor that holds only protective rights cannot have power or prevent another party from having power over an investee.

Therefore, an investor cannot have control if its only rights are non-substantive or protective. Likewise, rights held by other parties cannot prevent an investor from having control if they are non-substantive or protective. This is illustrated in Figure C.4 below:

Figure C.4 – Effect of substantive and non-substantive or protective rights

Type of rights held by investor		Type of rights held by other parties		Does the investor have control?
Substantive	+	Non-substantive or protective	▶	Yes
Non-substantive or protective	+	Substantive	▶	No
Substantive	+	Substantive	▶	Further analysis required

Assessing whether rights are substantive can require judgement, taking into account all facts and circumstances. Examples of factors to consider include:

Factors to consider [IFRS 10.B23–B24]	Examples
<p>Whether barriers to exercise exist, for example:</p> <ul style="list-style-type: none"> penalties and incentives exercise or conversion price that creates a financial barrier or deterrent terms and conditions that make exercise unlikely absence of an explicit, reasonable mechanism for exercise lack of information to exercise operational barriers legal or regulatory barriers 	<ul style="list-style-type: none"> if an investor has some or all of its decision-making rights via a management contract, the terms on which other investors are able to cancel that contract ('kick-out rights') should be evaluated. The kick-out rights might be less substantive if, for example: <ul style="list-style-type: none"> a substantial penalty is payable on exercise they are held by a many other investors and exercisable only by unanimous consent other suitable service providers are not available in the applicable market in assessing whether an investor's voting rights are sufficient to give it power, the investor considers actual and potential voting rights (PVRs) held by itself and by others. PVRs might be considered non-substantive if exercise: <ul style="list-style-type: none"> is at a price that is significantly out-of-the-money is permitted only in a very narrow timeframe is permitted only on a contingent event such as proposed change of control would remove power from an investor with essential skills or resources that would be difficult to replace would breach laws and regulations eg on foreign ownership or competition an investor holds majority voting rights in an investee but relevant activities are subject to direction by a government, court, administrator, receiver, liquidator or regulator
<p>Whether exercise requires the agreement of more than one party or, when rights are held by various parties, whether a mechanism exists to enable collective action</p>	<ul style="list-style-type: none"> the more parties that are required to agree to exercise the rights, the less likely it is that those rights are substantive however, a board of directors whose members are independent of the decision-maker may serve as a mechanism for numerous investors to act collectively in exercising their rights
<p>Whether investor would benefit from exercise</p>	<ul style="list-style-type: none"> an investor's PVRs are more likely to be substantive if: <ul style="list-style-type: none"> the exercise price is in-the-money the investor would realise synergy benefits
<p>Timing of exercisability</p>	<ul style="list-style-type: none"> an investor's PVRs that are exercisable in the future are more likely to be substantive if the exercise date is before a date when significant decisions about relevant activities are made eg the next annual general meeting

As with the assessment of whether rights are substantive, determining whether rights are purely protective involves judgement and consideration of all the facts and circumstances. Some examples of the types of rights that might be protective include:

Practical insight – examples of possible protective rights

Examples of rights that may be protective include:

- rights held by a lender that can be used to prevent borrower from undertaking activities that could significantly change the credit risk of the borrower
- rights held by a lender to seize assets in the event of default
- the right of a party holding a non-controlling interest in an investee to approve capital expenditure above set limits or to approve the issue of equity or debt instruments
- blocking rights over matters such as foreign takeovers or changes to an investee's founding charter held by a governments or founding party via a 'golden share'
- rights held by a franchisor to protect the franchise brand against adverse actions by a franchisee.

Practical insight – is a right to veto the budget a 'protective right'?

Rights of veto over an investee's operating budget could be substantive in some cases and protective in others. The assessment should consider matters such as:

- whether the budget-setting process significantly affects the investee's returns (in other words whether it is a relevant activity), considering matters such as:
 - the level of detail in the budget
 - the extent to which the budget determines management's actions
 - what happens next if the right of veto is used
- the purpose and design of investee
- the purpose and design of the veto right, including its underlying intent and whether it can be used in all circumstances or only in particular circumstances.

Common situations in which the substantive/protective assessment is relevant are:

- assessing potential voting rights – see Section D.3
- assessing control over a franchise – see Section D.6
- determining the acquisition date in a business combination – see Example C.5 below.

Example C.5 – Acquisition date in a business combination

Acquirer A is in negotiation with Vendor V to acquire 100% of the share capital of Entity B (the acquiree). Entity B is currently wholly-owned by Vendor V and operates a business (as defined in IFRS 3). Legal completion of the transaction (ie transfer of legal title to the shares in Entity B and payment of the consideration) is subject to approval by both Acquirer A's shareholders and the jurisdictional competition authority.

Acquirer A and Vendor V enter into an agreement that:

- commits both parties to legal completion subject to obtaining the required approvals
- commits both parties to use best endeavours to obtain these approvals
- specifies the purchase price, subject to adjustment for working capital movements between the agreement date and completion date
- specifies that the following decisions and actions can be undertaken by Vendor V only with the consent of Acquirer A:
 - changes in the management of Entity B
 - dividend payments
 - constitution amendments
 - new contracts or charges in excess of a specified value
 - ceasing any business or starting a new business
 - changes to employee and directors remuneration in excess of 5%.

Does Acquirer A obtain control over Entity B on the date of this agreement (or only on the completion date)?

Analysis:

A determination should be made as to whether Acquirer A's various rights of approval are substantive rights, or merely protective rights. The assessment should include the intent of these rights. Typically, this is to protect the interests of the future acquirer but without delivering control before the law permits it. In this case legal ownership of the voting rights remains with the current owners, Vendor V, until completion. Acquirer A can block some important decisions before that date but is not able to initiate new activities or strategies. Accordingly, it is likely that Acquirer A's rights are protective and do not confer control.

Approval procedures and their effect on the acquisition date differ extensively so each case must be considered based on its specific facts and circumstances.

Other factors in assessing whether an investor has power [IFRS 10.12-14]

IFRS 10 includes a number of other clarifications as to whether an investor's rights confer power:

Other factors in assessing whether an investor has power [IFRS 10.12-14]

IFRS 10 explains that:

- current ability to direct the relevant activities confers power even if the rights to direct have yet to be exercised
- evidence that the investor has been directing relevant activities can help determine whether the investor has power, but such evidence is not, in itself, conclusive in determining whether the investor has power
- if two or more investors each have existing rights that give them the unilateral ability to direct different relevant activities, the investor that has the current ability to direct the activities that most significantly affect the returns of the investee has power over the investee
- an investor can have power over an investee even if other entities have existing rights that give them the current ability to participate in the direction of the relevant activities, for example when another entity has significant influence.

3.2 Exposure, or rights, to variable returns

For an investor to have control it must have exposure, or rights, to variable returns from the investee.

Definition of variable returns [IFRS 10.15 and 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.

IFRS 10 provides the following examples of variable returns:

Examples of variable returns [IFRS 10.B57]

Variable returns could include:

- dividends
- other distributions of economic benefits (eg interest from debt securities)
- changes in value of an investment
- 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
- tax benefits
- access to future liquidity
- returns that are not available to other interest holders such as:
 - use of own assets in combination with investee's assets
 - combining operating functions to achieve economies of scale
 - cost savings
 - gaining access to proprietary knowledge.

IFRS 10 also makes it clear that returns that are ‘fixed’ in contractual terms are nonetheless regarded as variable for the purposes of the control assessment. For example:

- a bond with fixed interest payments still exposes its holder to default risk and credit risk
- fixed performance fees for managing an investee’s assets are variable returns because they expose the investor to the performance risk of the investee [IFRS 10.B56].

Variable returns are therefore defined very broadly and extend well beyond the ownership benefits obtained through equity shares. Example C.6 illustrates one type of less conventional variable return:

Example C.6 – Outsourcing arrangement

Entity B is a bank in the US and Entity S is an information technology (IT) outsourcing company in India. Entities B and S form a new Entity C, with the sole activity of providing IT services to B on an outsourced basis. Some key facts relating to the arrangement are as follows:

- Entity B owns 51 ‘class A’ shares and Entity S owns 49 ‘class B’ shares in Entity C, representing 100% of each class
- the two classes of shares each confer one vote per share, such that Entity B holds 51% of the total votes
- all residual profits or losses of the venture, and rights to receive more than the nominal value on liquidation, accrue to the ‘class B’ shares owned by Entity S
- Entity B pays for services received on the basis of a partly fixed fee, and a variable element that results in the sharing of operational efficiencies between B and C
- Entity C’s Board of Directors has 5 members, three appointed by Entity B and two by Entity S. The Board controls most significant decisions, which are taken by simple majority vote. The CEO is nominated by Entity S but reports to and functions under the direction of the Board
- most middle management staff are former employees of Entity S who bring in the operational expertise
- the service delivery management of the venture is the most relevant activity, and this is managed on a day-to-day basis by Entity S under the overall oversight of the Board
- operations of the venture are carried out from premises of Entity S.

Analysis:

This fact pattern raises two main issues:

- **Which investor(s) has rights or exposure to variable returns?** It is clear that Entity S has rights to variable returns through its ownership of ‘class B’ shares, which enable it to participate in net profits. However, Entity B also has a variable return that relates to Entity S’s performance. This is because the pricing mechanism results in Entity B sharing in any efficiency benefits achieved by Entity S. These benefits vary depending on Entity S’s performance.
- **Which investor(s) directs the relevant activities?** There are some mixed indicators on this question. Entity B appoints the majority of the Board but Entity S nominates the CEO, has more day-to-day involvement in the operations, and provides most of the staff with expertise. However, Entity C’s Board oversees both the CEO and day-to-day operations and is empowered to direct these activities. Accordingly, it is likely that Entity B has the ability to direct the relevant activities and therefore controls Entity C.

3.3 Ability to use power to affect returns

The third element of control is that an investor is able to use its power to affect its returns (sometimes referred to as ‘linkage’). This linkage depends on whether the investor has the current ability to direct the relevant activities (decision-making rights):

- on its own account (in other words, as principal); or
- on behalf of other investors that have delegated their power to it (in other words, as agent).

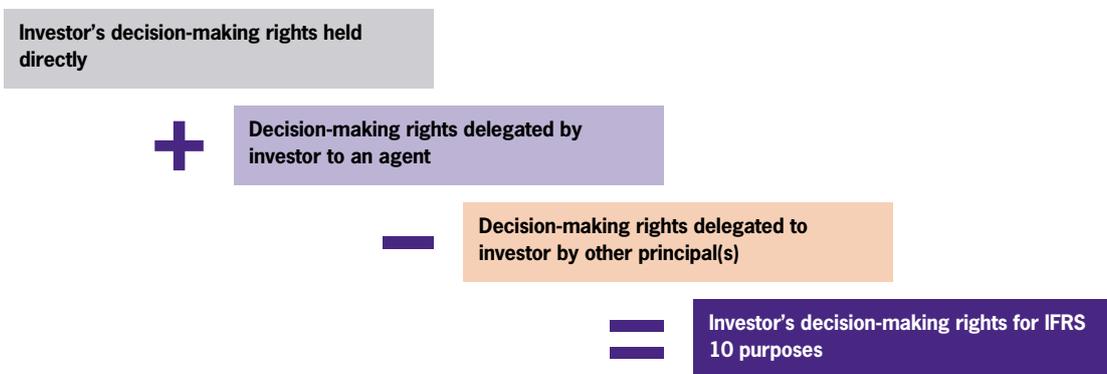
Definition of agent [IFRS 10.B58]

An agent is a party primarily engaged to act on behalf and for the benefit of another party or parties (the principal(s)) and therefore does not control the investee when it exercises its decision-making authority.

This link between power and returns clearly exists in a normal parent-subsidiary relationship based on majority share ownership. Accordingly, in such cases a detailed analysis is not needed. However, this third element of control is important when an investor holds decision-making rights as a result of a management contract or similar arrangement – such as a fund or asset manager.

If an investor has some or all of its decision-making rights in the capacity of agent, those rights do not count towards the assessment of whether it controls the investee. Conversely, if the investor has delegated some or all of its decision-making rights to an agent, those rights are treated as the investor's rights for IFRS 10 purposes. Figure C.5 below illustrates this concept:

Figure C.5 – Decision-making rights as principal or agent



IFRS 10 also includes the concept of a de facto agent ie an entity that acts on the investor's behalf even though there is no contractual arrangement that obliges it to do so.

Definition of de facto agent [IFRS 10.B74]

A party is a de facto agent when the investor has, or those that direct the activities of the investor have, the ability to direct that party to act on the investor's behalf.

Examples of the types of entity or other party that might act as a de facto agent include:

Examples of other parties that might act as de facto agent [IFRS 10.B75]

The following are examples of parties that, by the nature of their relationship, might act as de facto agents for the investee:

- the investor's related parties
- a party that received its interest in the investee as a contribution or loan from the investor
- a party that has agreed not to sell, transfer or encumber its interests in the investee without the investor's prior approval
- a party that cannot finance its operations without subordinated financial support from the investor
- an investee for which the majority of the members of its governing body or for which its key management personnel are the same as the investor's
- a party that has a close business relationship with the investor such as the relationship between a professional service provider and one of its significant clients.

The guidance on de facto agents is not intended to imply that parties listed above would always act for the investor. The assessment requires judgement, including careful consideration of the nature of the relationship and the way that the parties interact with each other. To some extent this guidance appears to be designed as an ‘anti-abuse’ provision, intended to ensure that control cannot be disguised by the informal delegation of power to other parties.

To determine whether a decision-maker is a principal or an agent, IFRS 10 requires an assessment of a range of indicators aimed at identifying the decision-maker’s primary role. The indicators consider the nature of the decision-maker’s rights and its incentives to act primarily on its own behalf or on behalf of others. The indicators are summarised in Figure C.6 and discussed in more detail in Section D.5:

Figure C.6 – Indicators of whether investor is principal or agent [IFRS 10.B60-B72]:



4 Purpose and design of investee

IFRS 10 refers to assessing the ‘purpose and design’ of an investee in several different contexts. The IASB’s intention appears to be that, in assessing control, an investor considers all facts and circumstances, including the substance and intended purpose of specific structures and arrangements. In summary, IFRS 10’s various references to purpose and design are:

Assessing purpose and design [IFRS 10.B5-B8, B48, B51, B63]

The assessment of the investee’s ‘purpose and design’ is carried out in order to identify:

- the **relevant activities**
- how **decisions** about the relevant activities are made
- who has the **current ability** to direct those activities
- who receives **returns** from those activities.

In addition purpose and design is considered in assessing :

- whether **potential voting rights are substantive** [IFRS 10.B48]
- control when voting rights are not the dominant factor including consideration of:
 - the **risks** to which the investee was designed to be exposed, the risks it was designed to pass on to the parties involved with the investee and whether the investor is exposed to some or all of those risks [IFRS 10.B8]
 - the involvement and **decisions made at the investee’s inception** as part of its design and evaluation of whether the transaction terms and features of the involvement provide the investor with rights that are sufficient to give it power [IFRS 10.B51]
- whether an investor is a **principal** or an **agent** [IFRS 10.B63].

5 Situations where the control assessment is unclear

IFRS 10 recognises that the control assessment process described above will not always yield a clear conclusion. To assist in reaching a conclusion in marginal situations, the standard includes guidance on:

- evidence of possible power
- indicators of possible power
- incentives to obtain power.

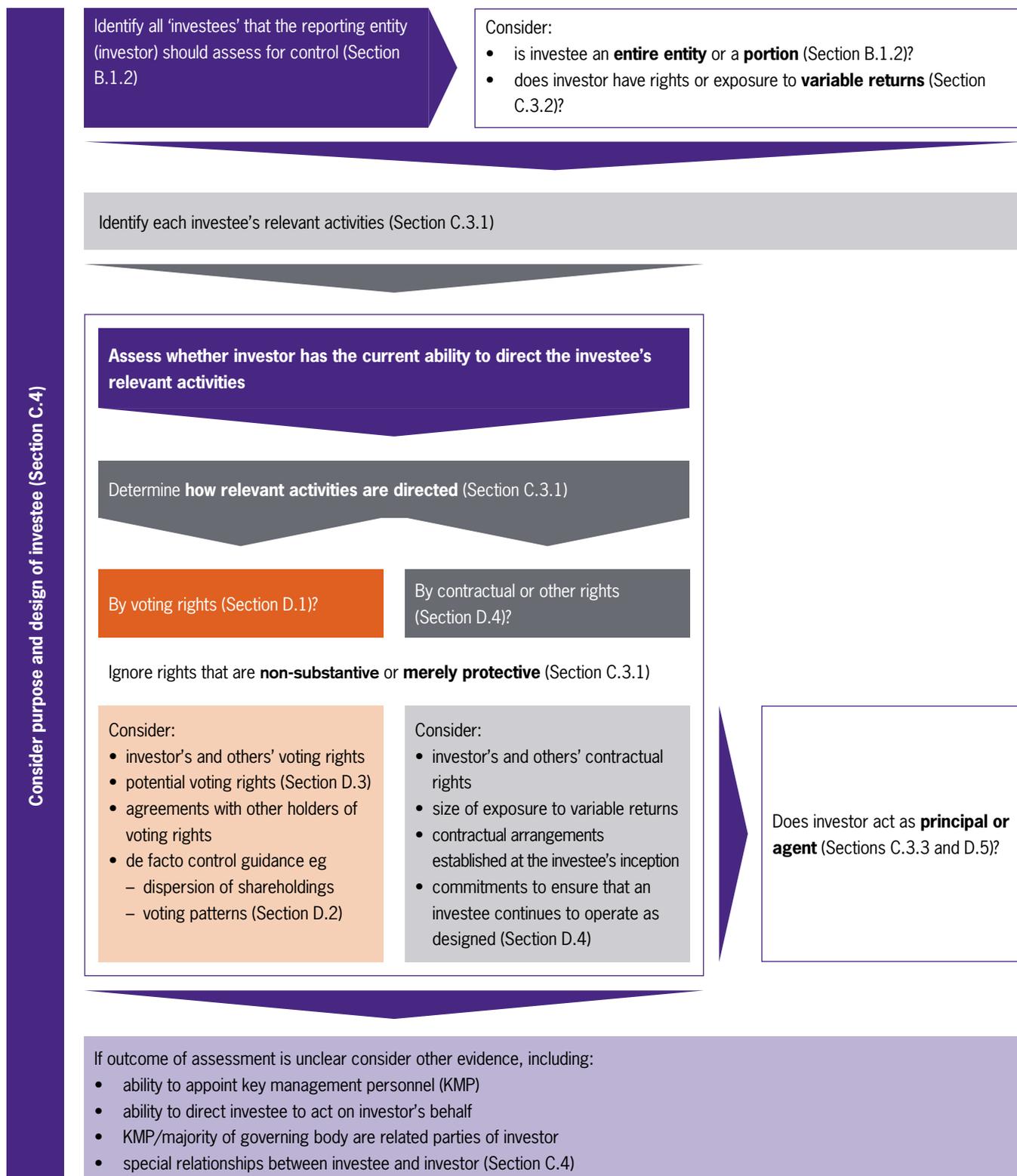
This guidance, set out in IFRS 10.B18-B21, is summarised below:

Factors to consider	Description
Evidence that investor's rights may be sufficient to confer power [IFRS 10.B18]	<ul style="list-style-type: none"> • investor can, without having the contractual right: <ul style="list-style-type: none"> – appoint/approve the investee's key management personnel – direct the investee to enter into, or can veto any changes to, significant transactions for the benefit of the investor • investor can dominate either the nominations process for electing members of the investee's governing body or the obtaining of proxies from other holders of voting rights • investee's key management personnel, or majority of members of governing body, are related parties of the investor
Indicators that the investor has more than a passive interest in the investee that, in combination with other rights, may indicate power [IFRS 10.B19]	<ul style="list-style-type: none"> • investee's key management personnel are current or previous employees of investor • investee's operations are dependent on the investor eg <ul style="list-style-type: none"> – investee depends on the investor to fund a significant portion of its operations. – investor guarantees significant portion of investee's obligations – investee depends on the investor for critical services, technology, supplies or raw materials. – investor controls critical assets such as licences or trademarks – investee depends on the investor for key management personnel, such as when the investor's personnel have specialised knowledge. • significant portion of the investee's activities either involve or are conducted on behalf of the investor • investor's exposure, or rights, to returns from its involvement with the investee is disproportionately greater than its voting or other similar rights
Incentives to obtain power – extent of variable returns	<ul style="list-style-type: none"> • more exposure, or rights, to variability of returns increases the investor's incentive to obtain power and is therefore an indicator that the investor may have power. • however, the extent of the investor's exposure does not, in itself, determine whether an investor has power
Weighting of factors	<ul style="list-style-type: none"> • the list is not exhaustive • all factors may need to be considered • when different factors are considered more weight is given to the evidence in the first row above

6 Summary of the control assessment process

In summary, applying the IFRS 10 control model requires the investor to assess a range of factors. Figure C.7 below provides a high-level summary of the key assessments required to apply the new control model, along with cross-references to the relevant sections of the Guide:

Figure C.7 – Key assessments in applying the single control model



7 Continuous assessment

IFRS 10 clarifies that control over another entity is reassessed if facts and circumstances indicate that there are changes to one or more of the three elements control discussed above [IFRS 10.B80]. A continuous assessment approach was perhaps implied in IAS 27 but was not an explicit requirement.

The principle of continuous assessment is broad. Put simply, a reassessment of control should be carried out whenever a change that could affect the outcome of the assessment takes place. This could naturally include a very wide variety of circumstances.

Some examples of situations when a reassessment of control could or would be appropriate include:

Examples of situations that would lead to reassessment [IFRS 10.B80–B85]

Situations that could trigger a reassessment of whether an investor controls an investee could include:

- changes to the investor's decision-making rights
- lapse of decision-making rights held by other parties
- investor becomes or ceases to be entitled to variable returns
- changes resulting in reassessment of whether an investor acts as agent or principal.

In our view reassessment may also be required when different investors have rights over activities that take place at different times – see Example C.3 above.

D. Applying the control model in specific circumstances

This Section provides guidance on the consolidation assessment in accordance with IFRS 10 in the following specific circumstances:

- majority holdings in an investee
- large minority holdings in an investee
- potential voting rights in an investee
- special purpose and structured entities
- principal-agent situations
- franchises.

1 Majority holdings in an investee

Consistent with IAS 27, IFRS 10 provides that an investor with the majority of an investee's voting rights controls an investee in most circumstances. In the absence of other relevant factors the majority vote holder has control if:

- the investee's relevant activities are directed by the holder of the majority of the voting rights; or
- the majority of the members of the governing body that directs the relevant activities is appointed by a vote of the holder of the majority of voting rights [IFRS 10.B35].

IAS 27 provided that ownership of more than half the voting power of an entity constitutes control unless 'in exceptional circumstances it can be clearly demonstrated that such ownership does not constitute control'. IFRS 10 has more specific guidance on when the majority owner does not have control as follows:

Situation	Examples
Another entity that is not an agent has rights to direct relevant activities	<ul style="list-style-type: none">• another investor's voting rights, plus its substantive potential voting rights, represent an overall majority of voting power (see Sections C.3 and D.2) [IFRS 10.B36]
Voting rights are not substantive	<ul style="list-style-type: none">• investee's relevant activities are subject to direction by:<ul style="list-style-type: none">– government– court– administrator, receiver or liquidator– regulator [IFRS 10.B37]

Involvement of a government, court, administrator (or similar) or regulator in an investee's decision-making process does not necessarily mean that a majority owner does not have control. Careful consideration of all facts and circumstances is necessary and judgement may be required.

The following example describes one such scenario and the required analysis:

Example D.1 – Scheme of protection from creditors

In country X, a legislative mechanism exists whereby a 'sick' company is able to seek statutory protection from its creditors in order to provide a period of time for restructuring and rehabilitation. Key features of Country X's applicable law are that:

- a 'sick' company is one which operates in certain industries, has incurred losses in consecutive years and has liabilities that exceed assets by more than a specified ratio
- the directors of a sick company are required to make an application to a government-appointed Restructuring Board
- the Restructuring Board reviews the application. If it considers that the company meets the criteria, and can feasibly be restructured, it appoints an operating agent (often a lead lender)
- the operating agent has a set period to review the business and prepare a restructuring scheme proposal for approval by the Restructuring Board. If approved, this scheme is binding on the directors and owners
- throughout this process the company's board of directors continues to be appointed by vote of the owners, and remains responsible for day-to-day operations. However, the operating agent is able to veto certain large transactions such as asset disposals.
- during the application and review period, creditors are unable to take legal action to recover their debts.

Analysis:

In this situation a majority owner retains the right to appoint the majority of the board of directors, but the board's powers are constrained by the Restructuring Board's and operating agent's ability to:

- veto certain large transactions; and
- determine and enforce a restructuring plan.

Deciding whether a majority owner has retained or loses control involves determining which activities have the greatest expected effect on returns. For a company in financial distress, the restructuring activity might affect returns more than day-to-day operations. In particular, without such restructuring the company may be forced to enter liquidation in which case returns to shareholders are often zero. However, reaching a conclusion involves careful consideration of all facts and circumstances and may require judgement.

2 Large minority holdings in an investee

2.1 IFRS 10's approach

While IFRS 10 is unlikely to have widespread impact on control assessments involving majority ownership, the revised definition and guidance will require more focus on investees in which the investor holds a significant minority of voting rights. This is because, under IFRS 10, control exists when the investor has the practical ability to direct an investee's relevant activities.

IFRS 10's approach is often referred to as an effective (or de facto) control model. The IASB has publicly stated that, in its view, IAS 27 also contemplated effective control. However, IAS 27 itself made no direct reference to this and many commentators took the view that IAS 27 is based more on legal control. Either way, IFRS 10 is clear that minority voting rights are sometimes sufficient to confer control.

This Section discusses basic situations in which minority voting rights may confer control in isolation – ie in the absence of potential voting rights, other contractual rights or other relevant facts and circumstances. In practice, all these factors need to be considered collectively to reach a conclusion.

2.2 Practical application

To illustrate a de facto control approach, and how it differs from a legal control model, consider Example D.2 below:

Example D.2 – Large minority shareholding

An investor holds 47% of the ordinary shares in an investee with a conventional control and governance structure (in other words, an investee whose relevant activities are directed by voting rights conferred by ordinary shares).

The remaining 53% of the shares are owned by hundreds of other unrelated investors, none of whom own more than 1% individually. There are no arrangements for the other shareholders to consult one another or act collectively and past experience indicates that few of the other owners actually exercise their voting rights at all.

Analysis:

IFRS 10

Under the practical ability model in IFRS 10, the investor controls the investee. This is because its voting power is sufficient to provide the practical ability to direct. A large number of other shareholders would have to act collectively to outvote the investor. There are no mechanisms in place to facilitate collective action.

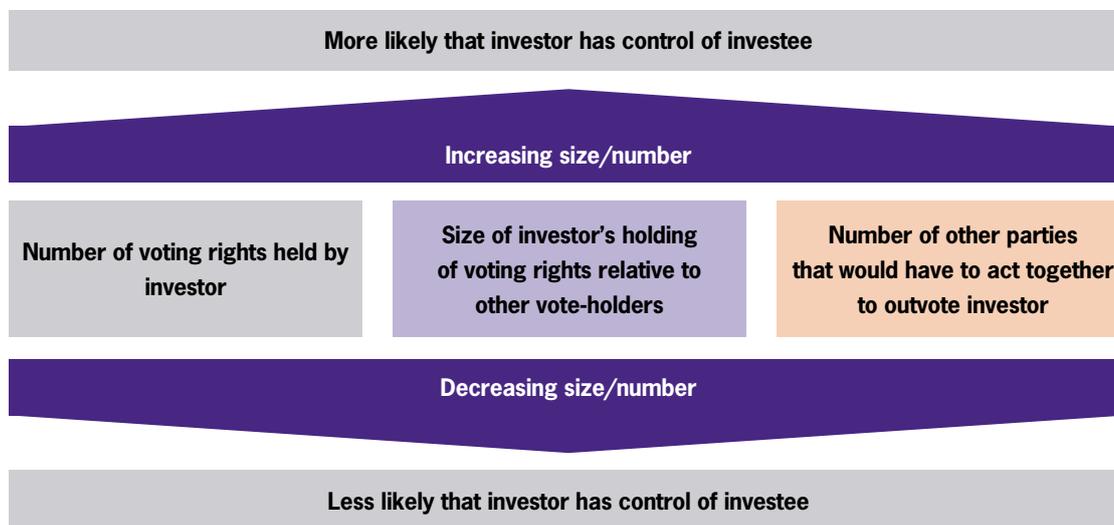
IAS 27

Under a legal control interpretation, more than half the voting power is required to confer control so the investor does not control the investee in this example. Under a de facto control interpretation the analysis would be the same as for IFRS 10.

Example D.2 is a relatively clear-cut situation in which a large minority shareholding confers control based solely on an analysis of the distribution of voting power. In assessing whether an investor's voting rights are sufficient to give it power an investor considers all facts and circumstances, including:

- the size of the investor's holding of voting rights relative to other vote holders, noting that:
 - the more voting rights an investor holds, the more likely the investor is to have power
 - the more voting rights an investor holds relative to other vote holders, the more likely it is to have power
 - the greater the number of other parties that would need to act together to outvote the investor, the greater the likelihood the investor has power
- potential voting rights held by the investor and other parties
- other contractual rights
- any additional facts and circumstances that indicate the investor has, or does not have, the current ability to direct the relevant activities at the time that decisions need to be made, including voting patterns at previous shareholders' meetings [IFRS 10.B42].

Figure D.1 – Assessing the size of the investor’s voting rights relative to other vote holders



Although IFRS 10 has no bright lines on when a particular distribution of voting power confers control, Examples D.2 above and D.3 -D.4 below are based on similar examples in IFRS 10 and therefore serve to illustrate the IASB’s thinking:

Example D.3 – Two other shareholders could outvote Investor

Investor A holds 45% of the voting rights of an investee. Two other investors each hold 26% of the voting rights of this investee. The remaining voting rights are held by three other shareholders, each holding 1%. There are no other arrangements that affect decision-making.

Analysis:

In this case, the absolute size of investor A’s voting interest, and its size relative to the other shareholdings, are sufficient to conclude that investor A does not have control. The two investors holding 26% could readily co-operate to outvote Investor A.

Example D.4 – Eleven other shareholders could outvote Investor

Investor A holds 45% of the voting rights of an investee. Eleven other shareholders each hold 5% of the voting rights of the investee. None of the shareholders has contractual arrangements to consult any of the others or make collective decisions.

Analysis:

Based on IFRS 10’s guidance, the distribution of voting rights is inconclusive. Other facts and circumstances should be considered to assess whether Investor A has control.

Accordingly IFRS 10 makes it clear that a large minority shareholder:

- has control when hundreds or thousands of other shareholders would have to act collectively to outvote it (and there is no mechanism to facilitate collective action)
- does not have control if only two other shareholders could act collectively to outvote it.

However, many situations are less clear-cut and an analysis of the distribution of voting rights (along with any other contractual rights and potential voting rights) is inconclusive. Example D.4 above shows one such case, in which eleven other shareholders could collectively outvote the investor. Additional facts and circumstances then need to be considered – and judgement may be required. IFRS 10 does not specify any bright lines or thresholds to determine when an analysis of distribution of voting rights is sufficient to reach a conclusion and when additional facts and circumstances must also be considered.

As noted above, one of the important other factors is the voting pattern of other shareholders at previous shareholders' meetings. This is illustrated in Example D.5 below:

Example D.5 – Shareholder participation

An investor holds 35% of the voting rights of an investee. Three other shareholders each hold 5% of the voting rights of the investee. The remaining 50% of the voting rights are held by numerous other shareholders, none individually holding more than 1%. None of the shareholders has arrangements to consult any of the others or make collective decisions. Decisions about the relevant activities are directed by a simple majority of the votes cast at shareholders' meetings. At recent meetings, 75% of the total voting rights have been cast (including the investor's votes).

Analysis:

Based on IFRS 10's guidance, the investor does not have control. The active participation of the other shareholders at recent shareholders' meetings indicates that the investor would not have the practical ability to direct the relevant activities unilaterally. The fact that other shareholders may have voted in the same way as the investor, with the effect that the investor's desired outcomes have been achieved, does not change the conclusion.

This example makes the important point that an ability to direct as a result of other vote-holders choosing to vote in the same way does not amount to control by itself. This is because the decisions are not being taken unilaterally by one investor. That said, although the above example might seem to set a clear threshold, some practical application questions can still be expected. These include:

- how far back an investor should look when assessing past voting behaviour
- whether it is appropriate to assume that past behaviour trends will continue (for example, it is possible that other shareholders' voting behaviour will be altered by another investor acquiring a major holding)
- situations in which past data is not available such as start-ups and some newly acquired holdings.

There is no single right answer to these questions that will apply in all situations. However, in our view the judgement required is essentially forward-looking. The key question for an investor with a large minority holding is whether, based on the best information available, it reasonably expects to have the practical ability to direct the investee's relevant activities unilaterally going forward.

Another practical application issue is the role of additional expertise and 'soft' influence in a de facto control assessment. This is illustrated in Example D.6:

Example D.6 – Different levels of knowledge and expertise

Investor A, an entity operating in a high technology industry, establishes a new venture in an overseas jurisdiction. The corporate law in this jurisdiction prohibits majority foreign ownership. Accordingly, Investor A identifies a local partner (B) to co-invest. Ownership and voting rights are split 49% and 51% between the investor and local partner. The new venture's Board comprises five directors of which Investor A is entitled to appoint two and local partner B three. All relevant activities are directed by the Board. However, because the Investor A has superior industry knowledge, the local investor agrees to an initial Board comprising four current employees of Investor A and only one representative of its own. Although the composition of the Board can be changed at future meetings, Investor A expects that it will in practice be able to continue to appoint the majority of the Board because of its superior industry knowledge and expertise.

Analysis:

IFRS 10 has no specific guidance on the ability to direct through additional knowledge and expertise.

IFRS 10 does however include various other 'indicators' and 'evidence' to assist in more difficult assessments. Some of this guidance may suggest that Investor A does have control in this example eg the following (non-conclusive) indicators:

- the investor can, without having the contractual right to do so, appoint or approve the investee's key management personnel [IFRS 10.B18(e)]
- the majority of the members of the investee's governing body are related parties of the investor [IFRS 10.B18(a)]
- the investee depends on the investor for critical services, knowledge and/or key management personnel, such as when the investor's personnel have specialised knowledge of the investee's operations [IFRS 10.B19(b)(iii)-(v)].

If it would be impractical for the local partner B to oppose the wishes of Investor A there is an argument that B's rights are not substantive. For example, depending on the type of technology involved and the local market, Investor A might be the only feasible source of suitably qualified people. In that case it is likely that Investor A has control.

However, if local partner B has the practical ability to exercise its rights then Investor A does not have control. This is because Investor A's past ability to appoint the majority of the Board is not unilateral, but exists only with the consent of local partner B. This consent can be withdrawn unilaterally. The first and second indicators above would not change the analysis because the basic voting arrangements lead to a clear conclusion.

Importantly, IFRS 10 states that if the assessment remains unclear having considered all the applicable guidance, the investor does not have control [IFRS 10.B46].

3 Potential voting rights

3.1 IFRS 10's approach

An investor may hold so-called potential voting rights, through ownership of the types of instrument listed below:

Practical insight – examples of instruments that include potential voting rights

Potential voting rights normally relate to an investor's holdings of an investee's:

- share options and warrants
- convertible bonds
- convertible preference shares.

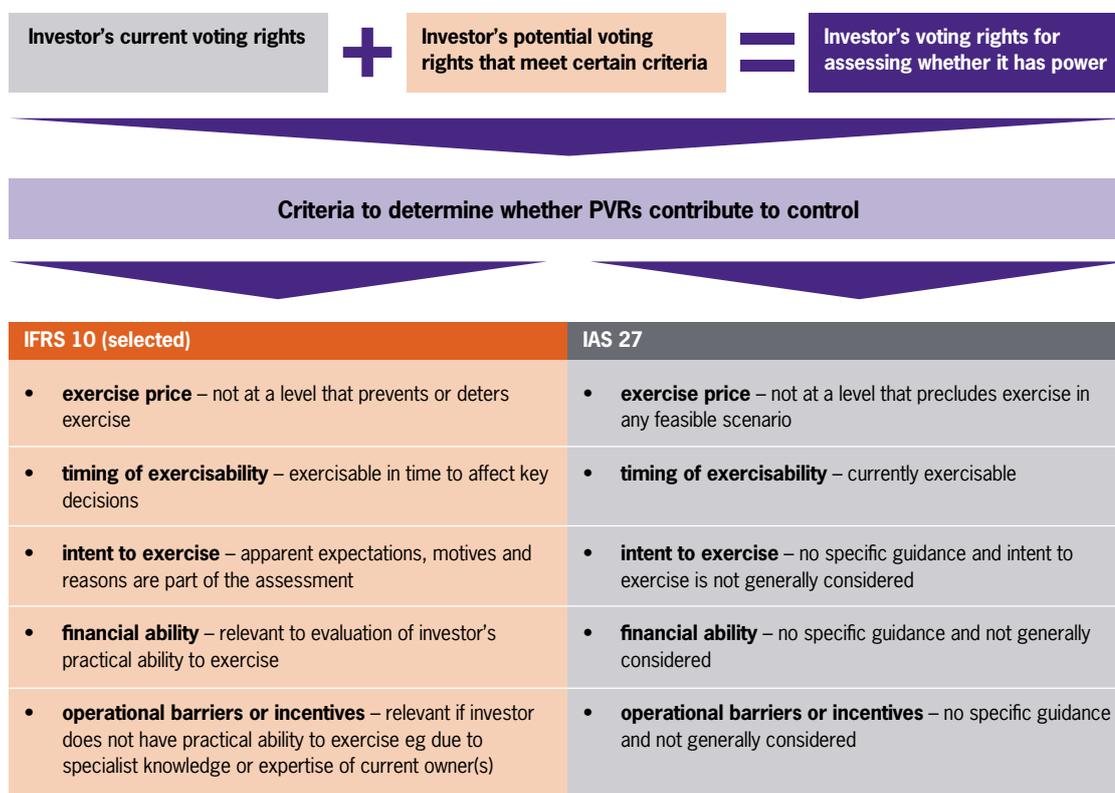
Potential voting rights can contribute to control of an investee in combination with current voting rights, or even confer control on their own. This is consistent with IAS 27. However, IFRS 10 requires a broader assessment to determine whether potential voting rights are substantive. Because the assessment is broader, and IFRS 10 has no bright lines, more judgement may be required.

IFRS 10's 'substantive' assessment takes into account both:

- the general guidance in IFRS 10.B22-B25 – summarised in Section C.3
- the purpose and design of the instrument – including its terms and conditions, and the investor's apparent expectations, motives and reasons for agreeing to them [IFRS 10.B48].

In our experience some of the factors referred to in IFRS 10.B22-B25 are normally more relevant than others, although any could be relevant in some situations. Figure D.2 summarises the factors that are most commonly of practical relevance, and compares IFRS 10's guidance with IAS 27's:

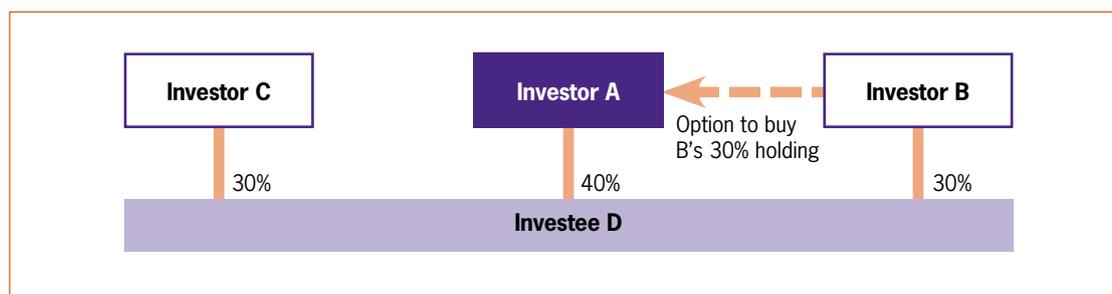
Figure D.2 – Potential voting rights



3.2 Practical application

The practical application of IFRS 10's approach is best illustrated using examples. The examples in this Section draw on the basic ownership structure in Figure D.3 below. Each example also assumes that Investee D is controlled by shareholder vote, and that there are no contractual or other non-voting rights that affect the analysis:

Figure D.3 – Basic ownership structure for Examples D.7 – D.9



The following examples are based on the general fact pattern above, with different specific detailed circumstances to illustrate the following different factors in the analysis. While each example focuses on one aspect of the analysis, it should be noted that IFRS 10 requires a broad assessment of whether a right is substantive. Accordingly, none of the individual factors discussed below is normally decisive in isolation.

Example D.7 – Exercise price somewhat out-of-the-money

Investor A's option has been acquired recently and is exercisable at any time in the next two years. The exercise price is fixed. The fixed price exceeds the current fair value of the underlying shares by 30%.

Analysis:

In accordance with IFRS 10 Investor A considers, among other things, whether the exercise price presents a barrier or deterrent. In this case, a 30% premium is not trivial. However, this premium may or may not prevent the option from being substantive in practice. Investor A should consider additional factors such as:

- whether a 30% premium is reasonable in the context of expected synergy benefits and a typical control premium
- if the premium is a substantial disincentive at present, whether the fair value of the underlying shares is nonetheless expected to increase, such that the premium reduces, within the timeframe for directing relevant activities (see Example D.8 below for a discussion of timing factors)
- management's intentions and motivations for purchasing an option on these terms.

IAS 27 comparison:

In accordance with IAS 27 the option would 'count' towards control such that Investor A has control overall. The option is currently exercisable and the price, although out-of-the-money, is not at a level that 'precludes exercise in any feasible scenario'.

Example D.8 – Option not yet exercisable

Investor A's option has been acquired recently and is exercisable in 30 days' time and then at any time in the following 12 months. The exercise price is based on a formula that is designed to approximate fair value of the underlying shares at each exercise date.

An annual shareholders' meeting is scheduled in six months' time. Any existing shareholder is also able to call a special meeting, on giving 45 days' notice to other shareholders. Members of the management committee (which directs Investee D's relevant activities) are elected or removed at these meetings by a simple majority of shareholder votes cast.

Analysis:

To be substantive in accordance with IFRS 10 a right must confer the current ability to direct relevant activities. However, while this normally requires the right to be currently exercisable, IFRS 10 explains that this is not always the case. Instead, the key question is whether the rights can be exercised by the time the decisions need to be taken. When direction is by shareholder voting, this means that potential voting rights must be convertible into current voting rights before the next voting opportunity.

In this case, the potential voting rights are convertible in time because Investor A can call a meeting in 45 days and exercise the option in 30 days. No other shareholder can force a vote before the option's earliest exercise date.

IAS 27 comparison:

In accordance with IAS 27 the option would not contribute towards control until it is currently exercisable.

Variation 1 – longer exercise date:

Assume instead that the option becomes exercisable 60 days after purchase. The notice period required for a shareholder vote is still 45 days.

In this case, for IFRS 10 purposes, the option would not be substantive on purchase. However, it may become so 15 days later. The IAS 27 analysis is the same as above (ie the option contributes towards control only when currently exercisable).

Variation 2 – staggered exercise dates:

Assume the option can be exercised only on fixed dates, at 90 day intervals, over the next 720 days. The notice period required for a shareholder vote is still 45 days.

This fact pattern presents a practical difficulty. Taking IFRS 10's guidance at face value would imply that Investor A could obtain control 45 days after acquiring the option, but then lose control in another 45 days (ie on day 90) if it doesn't exercise the option. This pattern is then repeated. Although it is of course possible to obtain and lose control of an investee repeatedly in a short period, this outcome is counter-intuitive and unlikely to represent the substance of the arrangement in this example.

In our view it is important to consider IFRS 10's guidance on timing of exercisability in the context of the broader principle and guidance on 'substantive', rather than take an entirely mechanistic approach. In this example, if Investor A does conclude that it has control of Investee D from day 45 we doubt it is appropriate to reverse this conclusion in the event of non-exercise on day 90 (provided the other relevant factors support the control conclusion). Although it may in theory be possible for Investors B and C to call a meeting in the next 45 days, and outvote Investor A, they may have little incentive to do this in the circumstances. In reaching a conclusion, assessing the purpose and design of the option, and the parties' intentions and motivations for agreeing to its terms, will be particularly important.

The standard itself includes some other examples illustrating its guidance on timing of exercisability [Examples 3 – 3D of IFRS 10.B24].

Example D.9 – Option held for defensive purposes

As in Example D.8, Investor A's option is exercisable at any time in the next two years at a fixed exercise price that exceeds the current estimated fair value of the underlying shares by 30%. However, Investor A's intention in purchasing this option was not to obtain control of Investee D, but instead to prevent Investor B from obtaining control by acquiring Investor C's shares. Investor A would be prepared to exercise, and pay the required premium, to block Investor B but is otherwise content to remain a long-term strategic (but non-controlling) investor.

Analysis:

In accordance with IFRS 10 Investor A considers, among other things 'the purpose and design' of the instrument, as well as the purpose and design of any other involvement the investor has with the investee. This includes an assessment of the various terms and conditions of the instrument as well as the investor's apparent expectations, motives and reasons for agreeing to those terms and conditions [IFRS 10.B48]. If the evidence supports Investor A's assertion that the potential voting rights are intended solely as a defensive mechanism, and would be exercised only in particular circumstances, it is reasonable to conclude that the rights are non-substantive.

IAS 27 comparison:

In accordance with IAS 27 the option would result in Investor A having control. IAS 27 does not permit management's intentions to be taken into consideration for the purpose of this assessment.

4 Special purpose and structured entities

4.1 IFRS 10's approach

As noted in Section A, IFRS 10 applies to both normal and structured or special purpose entities (SPEs). IFRS 10 has no specific guidance on SPEs. The reasons for referring to SPEs in this Guide are that:

- the term is widely-used in practice to describe certain types of entity (see below)
- many of the approaches used for assessing control of SPEs under SIC-12 are not sufficient or appropriate under IFRS 10.

Neither SIC-12 nor IFRS 10 define an SPE. SIC-12 simply notes that 'an entity may be created to accomplish a narrow and well-defined objective (eg to effect a lease, research and development activities or securitisation of financial assets)'. This lack of a clear definition (and consequent lack of a clear dividing line as to which entities SIC-12 applies to) is a perceived shortcoming of IAS 27 and SIC-12.

Despite the lack of a definition, entities typically considered to be SPEs in practice normally have some of the following characteristics:

Practical insight – typical features of SPEs

The most widespread use of SPEs is in the financial services industry, in connection with securitisation and other asset-backed financing arrangements. Other common uses include:

- financial engineering and tax optimisation schemes
- ring-fencing or sharing the risk of higher risk assets or activities
- holding or investing in assets, especially property, in a tax efficient manner
- regulatory compliance reasons, such as to achieve exposure to assets or activities in which direct participation is not permitted

Typically, an SPE has at least some of the following governance characteristics:

- mechanism to ensure SPE undertakes only a narrow and well-defined range of activities, including a limited life
- mechanism to ensure that ordinary shares (if any) do not confer ownership benefits eg:
 - majority of profits paid out in interest or fees
 - shares owned by a charitable trust
 - thinly capitalised
- use of a type of corporate vehicle other than a basic limited company
- professional directors provided by an administration company
- domiciled in offshore tax haven or financial centre.

Although IFRS 10 has no separate guidance on SPEs, it does have guidance on assessing control over entities for which voting rights do not have a significant effect on returns. This type of entity is described (in IFRS 12) as a 'structured entity'. In practice, we expect that most (but not all) SPEs previously within the scope of SIC-12 would be structured entities under the new definitions.

Definition of structured entity [IFRS 12 Appendix A]

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.

IFRS 10's guidance on assessing control over these types of entity is summarised in the table below [IFRS 10.B51-B54]:

Guidance	Details
Consider investor's involvement in 'purpose and design' of investee	<ul style="list-style-type: none"> consideration should include involvement and decisions made at investee's inception such involvement may indicate that the investor had opportunity to obtain rights sufficient for power involvement alone is insufficient to confer power
Consider contractual arrangements between investor and investee	<ul style="list-style-type: none"> example of such contractual arrangements include: <ul style="list-style-type: none"> – call and put rights – liquidation rights contractual arrangements involving activities closely related to investee are considered part of the investee's overall activities (even if outside its legal boundary)
Relevant activities may include activities that arise only in particular circumstances	<ul style="list-style-type: none"> investee's activities may be predetermined unless a particular event occurs, at which point one or more investors has decision-making rights (eg rights to manage receivables only if they default) in some circumstances 'contingent' activities can be the investee's only relevant activities and the investor with the related decision-making rights may have control
Consider implicit and explicit commitments to support investee	<ul style="list-style-type: none"> such commitments may increase an investor's exposure to variable returns this increases the incentive to obtain power without conferring power in itself

In overview, then, applying IFRS 10 to structured entities and SPEs will require a detailed and specific assessment of the investee's relevant activities and the investor's rights to make decisions about them.

Practical insight – link with financial asset derecognition rules

SPEs are often used in connection with securitisations and other transactions involving a transfer of financial assets. The financial reporting impact of these transactions depends on the derecognition requirements in IAS 39 'Financial Instruments: Recognition and Measurement' (or IFRS 9 'Financial Instruments') as well as the consolidation conclusion under IFRS 10. If the asset transfer 'fails' de-recognition because the transferor retains substantially all the risks and rewards of the transferred assets, the accounting effect is often very similar to consolidation of the SPE.

4.2 Practical application

The following guidance discusses the practical application of IFRS 10's control model to structured entities or SPEs and how it differs from SIC-12's approach. SPEs encompass a wide variety of often complex arrangements and the detailed control analysis, under both IFRS 10 and SIC-12, therefore differs from one arrangement to another. Reaching a conclusion may involve significant judgement. Also, SIC-12 lacks detailed application guidance or examples and its indicators are described only briefly. Accordingly, the practical application of SIC-12 has not always been consistent and different investors have developed their own detailed approaches.

Although SIC-12 is strictly an interpretation of IAS 27, its indicators have often been treated as separate criteria that form the basis of control assessments of SPEs by the sponsoring entity. Figure D.4 provides a broad overview of how SIC-12's indicator approach maps onto IFRS 10's approach:

Figure D.4 – SIC-12's indicator compared with IFRS 10

SIC-12 control indicators (summary)		IFRS 10 similarities and differences
<ul style="list-style-type: none"> activities conducted on behalf of reporting entity 	Consider purpose and design of investee	<ul style="list-style-type: none"> no direct equivalent in IFRS 10 principal-agent guidance may be relevant
<ul style="list-style-type: none"> exposure to risks and rewards (including residual benefits from scheduled distributions and/or on liquidation) 	Consider purpose and design of investee	<ul style="list-style-type: none"> rights or exposure to variable returns is necessary for control but not sufficient alone IFRS 10 notes that increased rights or exposure to variable returns increases the investor's incentive to obtain power
<ul style="list-style-type: none"> decision-making powers to obtain the majority of the benefits or has set up an 'autopilot' mechanism 	Consider purpose and design of investee	<ul style="list-style-type: none"> no direct reference to 'autopilot' involvement in the design of an investee indicates investor had opportunity to obtain rights in theory an investee with no current or future decisions affecting returns is not controlled by any investor in practice 'pure' autopilots are rare and a more specific analysis of relevant activities and decision-making rights is required (including decisions that arise only in particular circumstances)

Some of the challenges of applying the IFRS 10 approach include:

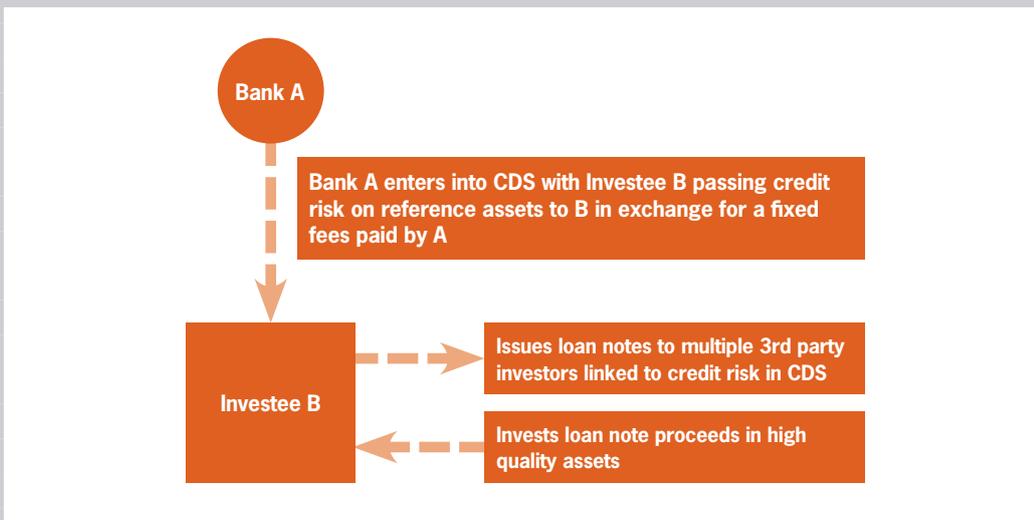
- identifying the investee's returns, which in turn involves identifying its assets and liabilities. This may appear straightforward but complications arise when the legal ownership of assets diverges from the accounting depiction (for example in financial asset transfers that 'fail' de-recognition, and in finance leases). In our view the assessment of the investee's assets and returns should be consistent with the accounting depiction in accordance with IFRS
- it may not always be clear whether contracts and other arrangements between an investor and an investee
 - create rights or exposure to a variable return from the investee's performance for the investor; or
 - transfer risk or variability from the investor to the investee
- the relevant activities of an SPE may not be obvious, especially when its activities have been narrowly specified in its purpose and design
- the rights to direct those activities might also be difficult to identify, because for example they arise only in particular circumstances or from contracts that are outside the legal boundary of the SPE (but closely related to its activities).

The following examples illustrate these issues.

Example D.10 – Investment vehicle

Bank A wishes to provide investment opportunities to outside investors wishing to assume credit risks associated with specific reference assets. It establishes an entity, Investee B, and passes the credit risk to it by writing a credit default swap (CDS). Investee B issues loan notes with payments that are contractually linked to the credit risk on these reference assets. The loan notes are purchased by multiple, unrelated investors. Investee B uses the proceeds to purchase high quality assets that will serve as collateral. Neither Bank A nor any of the note holders have voting rights in Investee B.

The structure can be summarised as follows:



Analysis:

Further analysis is required to determine whether or not Bank A controls Investee B in accordance with IFRS 10, including careful consideration of Investee B's purpose and design – in particular:

- whether Bank A has exposure to **variable returns**. If the assets held by Investee B are considered 'risk free' it is appropriate to conclude that Bank A does not have involvement that exposes it to variability of returns from the performance of Investee B. This is because the CDS transfers variability to Investee B rather than absorbing variability of returns from Investee B [IFRS 10.BC66]. However, if Investee B's assets are not risk free (even if they are high quality), Bank A does have at least some exposure to variable returns. This is because Bank A is entitled to payment from Investee B in the event of default (or other 'credit event') on the reference assets covered by the CDS. Investee B's ability to meet this (contingent) obligation will be affected at least to some extent by the performance of its asset portfolio
- whether Bank A has rights that give it the **current ability to affect its returns**. This in turn requires identification of Investee B's relevant activities. In this fact pattern the investee has relatively few activities/decisions. However, it is very rare for an investee to have no relevant activities at all. In this case, decisions need to be taken about managing the asset portfolio even if the investment criteria are narrowly specified. Management of the investments in the event of default may also be relevant (even if default is unlikely). Accordingly, if Bank A has substantive decision-making rights over Investee B's asset management activities Bank A may have control.

SIC-12 comparison:

The analysis of this arrangement under SIC-12 might differ depending on how the reporting entity interprets and applies that pronouncement. For example:

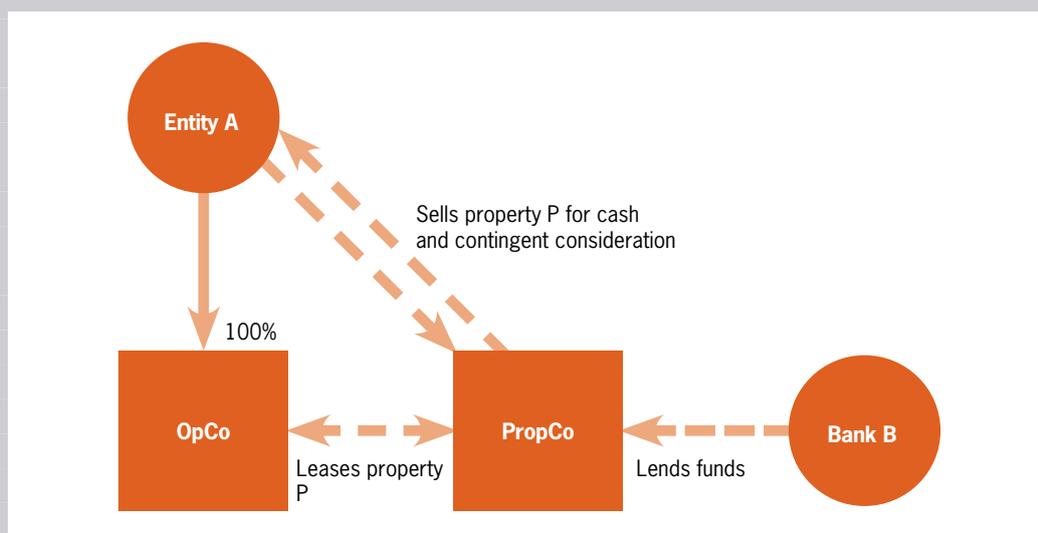
- some investors might take a qualitative approach. One view is that Bank A has set up Investee B on 'autopilot' to pursue an activity on its behalf, particularly if Bank A holds the underlying reference assets
- if Bank A does not hold the underlying reference assets some might alternatively conclude that Investee B's activities are not conducted on behalf of Bank A and that it does not therefore have control. Bank A would instead treat the CDS as a trading item
- some investors might take a quantitative approach, and analyse whether Bank A, or the loan note holders, are exposed to the majority of the risks and benefits relating to Investee B. The mechanics of such an assessment could vary according to specific investors' methodologies. The analysis of benefits should take account of any rights to residual interests (through scheduled residual distributions and/or in a liquidation).

The following example illustrates, among other points, a situation in which decision-making rights that are relevant to the analysis lie outside the legal boundary of an investee:

Example D.11 – 'OpCo/PropCo' structure

Entity A, a commercial business with extensive property holdings, wishes to reduce its property exposure and obtain finance on advantageous terms. It sets up an 'OpCo/PropCo' structure involving two new entities. The trade and operating assets of one of its businesses are transferred into 'OpCo', which is a conventional entity and is wholly-owned by Entity A. One property (P) used in this business is sold to 'PropCo'. PropCo pays cash and contingent consideration (see below). The cash payment is financed by a mortgage loan to PropCo from Bank B.

Property P is leased by OpCo under an operating lease. The lease requires OpCo to bear all of the property costs (including maintenance, capital expenditures, tax and insurance). PropCo's only role is to collect rent and pay the interest and principal on the debt. The arrangements made at set-up include options for OpCo to extend its lease and for Entity A to repurchase the property at market value. In the event of default or non-renewal/repurchase, Property P will be sold on the market to enable PropCo's loans to be repaid. Any excess funds are remitted to Entity A as additional consideration for the original sale.



Analysis:

In this fact pattern both Entity A's group (including its OpCo subsidiary) and Bank B have rights and exposure to variable returns from Property P. Entity A (including its OpCo subsidiary) has exclusive use of the property, as well as rights from the contingent consideration. Bank B has rights and exposure to variable returns as a result of the credit risk in its loan to PropCo.

Also, both Entity A and Bank B have some decision-making rights that are relevant to the analysis:

- Entity A has options to extend the lease and purchase the property that affect PropCo's returns. Although these decision rights lie outside the boundary of PropCo, they are closely related to its activities
- Bank B has rights in the event of default or non-renewal/repurchase.

It is likely in this scenario that Entity A controls PropCo. Entity A has more rights and exposure than Bank B (which is expected to receive a lender's return), and its decisions to renew the lease or purchase the asset are expected to have a greater impact on PropCo's returns. In addition, an evaluation of PropCo's purpose and design may indicate that PropCo is designed to enable Entity A to raise finance using Property P as security, retaining rights over the key decisions.

SIC-12 comparison:

Under SIC-12 it might be concluded that Entity A controls PropCo because PropCo:

- is considered to be on 'autopilot' in terms of SIC-12; and
- conducts an activity on behalf of Entity A.

An analysis of Entity A's risks and benefits from PropCo, including residual benefits, should also be performed (although the exact methodology may differ from one reporting entity to another).

The variation to this fact pattern below illustrates the importance of identifying the assets of an SPE in accordance with the substance and accounting depiction of an arrangement, rather than looking solely at legal ownership:

Example D.11A – 'OpCo/PropCo' structure – variation #1

The facts are similar to Example 11 except that:

- the lease between OpCo and PropCo is a finance lease
- OpCo/Entity A have options to extend the lease at market rents or re-purchase Property P at fair value at the end of the initial lease term
- there is no contingent consideration arrangement.

Analysis:

This changes the analysis primarily because PropCo's assets no longer include Property P (because, from an IFRS perspective, the property is leased to OpCo under a finance lease). PropCo's main asset is now a finance lease receivable. Entity A (including OpCo) has a finance lease obligation to PropCo. An obligation to an investee does not create rights or exposure to variable returns for the investor – instead this transfers variability to the investee. Accordingly, Entity A does not control PropCo.

Entity A would however include the property and finance lease liability in its financial statements in accordance with IAS 17 'Leases'.

SIC-12 comparison:

Under SIC-12 it might be concluded that Entity A controls PropCo because PropCo:

- is considered to be on 'autopilot' in terms of SIC-12; and
- conducts an activity on behalf of Entity A.

An analysis of Entity A's risks and benefits from PropCo is again required. However, the change in the arrangement will change the results of the analysis and might therefore affect the conclusion.

The second variation below introduces additional decision-making rights, some of which are shared rights and some unilateral. In this situation the identification of the relevant activities, and whether the related decisions are taken jointly or unilaterally, becomes critical:

Example D.11B – ‘OpCo/PropCo’ structure – variation #2

Facts are similar to Example 11 except that:

- Entity A co-invests a tranche of equity in PropCo along with an unrelated 3rd party Investor C
- PropCo is set up with the intent of acquiring multiple properties used in Entity A’s operations and will require new sources of finance in due course
- all decisions concerning the acquisition and disposal of properties, financing transactions, and the agreement of lease terms and variations thereto require the consent of both Entity A (including OpCo) and Investor C
- the leases are all operating leases and many include options for Entity A (including OpCo) to extend or repurchase the property.

Analysis:

In this variation Entity A (including OpCo), Investor C and Bank B have rights or exposure to variable returns. Entity A and Bank B hold some decision-making rights unilaterally (as in Example 11). However, PropCo now has a wider range of activities concerning future property deals and financings, and the related decisions are directed jointly by Entity A and Investor C. If these wider activities are determined to be the relevant activities (which is likely) then PropCo is a joint arrangement within the scope of IFRS 11 because Entity A and Investor C have joint control.

SIC-12 comparison:

Under SIC-12 it might be concluded that Entity A controls PropCo because PropCo:

- is considered to be on ‘autopilot’ in terms of SIC-12; and
- conducts an activity on behalf of Entity A.

An analysis of Entity A’s risks and benefits from PropCo is again required. However, the change in the arrangement will change the results of the analysis and might therefore affect the conclusion.

5 Principal-agent situations

5.1 IFRS 10’s approach

As explained in Section C.3.3, IFRS 10 includes extensive guidance on situations in which an entity with decision-making rights over an investee is an agent or a principal. An agent is an entity primarily engaged to act in the best interests of the other parties (ie the principals) in exercising its rights. An investor that has rights to direct an investee’s relevant activities as an agent does not meet the ‘linkage’ element of the control definition.

Practical insight – when is the principal-agent assessment relevant?

In practice the principal-agent assessment is relevant only when an investor:

- meets the ‘returns’ and ‘power’ elements of the control definition; and
- holds some or all of its decision-making ability as a result of contractual rights delegated by other parties.

Accordingly, an assessment is not needed when it is clear that:

- another entity has control; or
- the investor’s decision-making ability is not enough for it to have power even if held as a principal.

The examples in IFRS 10 discuss the role of an asset or fund manager in the fund management sector. However, the underlying principles are not industry-specific and could therefore be relevant to any situation in which decision-making ability is delegated under a management contract (or similar). Other sectors in which these types of contract are commonplace include:

- property and construction
- hospitality (eg hotels) and leisure
- outsourcing.

IFRS 10 also describes this concept as ‘delegated power’. This is because an agency situation arises when one or more principals delegate power to the agent. Other terminology is also used sometimes – such as ‘fiduciary control’. However, having fiduciary responsibilities to other parties is not enough to conclude that a decision-maker is an agent. IFRS 10 explains that an entity is not an agent simply because:

- others can benefit from its decisions [IFRS 10.B58]
- it is obliged by law or contract to act in others’ best interests [IFRS 10.BC130].

This guidance recognises the fact that fund managers (and similar) commonly have an ability and an incentive to act in their own interests as well in the interests of others. The terms of a fund manager’s remuneration typically include a performance-based element that aligns the fund manager’s interest with those of third party investors. Also, many fund managers hold direct interests in the underlying fund. Put another way, fund managers normally have a dual role. IFRS 10 therefore requires an assessment of a range of indicators in order to determine whether the decision-maker’s primary role is agent or principal. These indicators concern:

- scope of decision-making authority
- rights held by others (especially removal or ‘kick-out’ rights)
- remuneration
- other interests [IFRS 10.B60].

These indicators are described in more detail in the following table:

Indicator [IFRS 10.B62-72]	Description
The scope of decision-making authority	<ul style="list-style-type: none"> • the investor considers: <ul style="list-style-type: none"> – the activities permitted by the agreement and by law – the extent of its discretion – purpose and design of the investee – risks to which the investee was designed to be exposed – the risks it was designed to pass on to the parties involved – level of its involvement with the investee’s design • significant involvement in the investee’s design may indicate that the decision-maker had the opportunity and incentive to obtain rights that result in the ability to direct the relevant activities
Rights held by other parties (eg removal or ‘kick-out’ rights)	<ul style="list-style-type: none"> • substantive rights held by other parties may affect the decision-maker’s ability to direct relevant activities of an investee. • substantive removal or other rights may indicate that the decision-maker is an agent • if a single party can remove the decision-maker without cause the related decision-making rights are held as agent, with no further analysis required

Indicator [IFRS 10.B62-72]	Description
Decision-maker's remuneration	<ul style="list-style-type: none"> • the greater the magnitude and variability of the decision-maker's remuneration relative to the investee's overall expected returns the more likely the decision-maker is a principal • a decision-maker cannot be an agent unless: <ul style="list-style-type: none"> – its remuneration is commensurate with the services provided. – the remuneration agreement includes only terms, conditions or amounts that are customarily present in arrangements for similar services and level of skills negotiated on an arm's length basis
Exposure to variability of returns from other interests in the investee	<ul style="list-style-type: none"> • holding other interests in an investee (ie in addition to its management contract) indicates that the decision-maker may be a principal • in evaluating its exposure to variability of returns the decision-maker: <ul style="list-style-type: none"> – considers all its exposures (eg fees based on performance of a managed fund plus direct holdings in that fund) – considers both magnitude and variability associated with its total economic interests – assesses whether its exposure to variability of returns is different from that of the other investors and, if so, whether this might influence its actions. For example, this might be the case when a decision-maker holds subordinated interests in, or provides other forms of credit enhancement.

5.2 Practical application

An investor with delegated power is required to consider these indicators in reaching a conclusion as to whether its primary role is principal or agent. However, IFRS 10 does not specify any set levels at which one indicator, or a particular combination of indicators, leads to a definitive conclusion (except for removal rights held by a single party and exercisable without cause). Accordingly, reaching a conclusion will often involve judgment.

Despite this absence of bright lines, in our view some of these indicators will have greater practical significance than others. This is considered further below.

Scope of decision-making authority [IFRS 10.B62-B63]

IFRS 10's various examples (see below) clarify that decision-making authority only within narrowly defined parameters is an indicator of agent status. Conversely, extensive decision-making authority is an indicator of principal status.

In our view, however, this distinction will rarely be a decisive factor in most asset or fund management situations. This is because, for investment funds, decisions about buying, selling or holding investments (ie fund or asset management) will almost always be the activity that most significantly affects future returns (ie the relevant activity). IFRS 10 confirms that this is the case even when the fund manager is required to operate within the parameters set out in the investment mandate and in accordance with the regulatory requirements [see Example 13 of IFRS 10].

Example D.12 – Different investment mandates

Fund managers A and B have contracts to manage different funds (Funds A1 and B1). In both cases, remuneration is market-based and includes a stated percentage of net asset value. Each investor holds a significant direct interest in the respective fund. There are no kick-out rights.

Both fund managers are required to operate within defined parameters set out in the investment mandate and in accordance with strict local laws and regulations.

Fund A1 is an emerging markets equity fund and its manager has discretion to invest in a wide range of equities across different countries, sectors and companies. Fund B1 is a UK FTSE 100 tracker fund. Its manager must aim to track that index in the most efficient manner although it has some discretion in how to do so (eg through full replication or a sampling method, and through buying underlying shares or related derivatives).

Analysis:

Fund manager A has considerably more discretion than fund manager B and, all else being equal, is more likely to be a principal. However, both managers have rights to direct relevant activities and each has some discretion. Hence this might not be a strong differentiating factor.

That said, in practice it will probably be unusual for a tracker fund manager to be a principal for various other reasons. For example the remuneration for managing a tracker fund is likely to be at the low end of the scale and unlikely to include a performance-based element.

Rights held by other parties [IFRS 10.B64-B67]

Rights held by other parties, removal (or ‘kick-out’) rights in particular, will often be a very significant part of the analysis. Indeed the only situation in which a single indicator is conclusive in isolation is that a decision-maker is an agent if a single party can remove the decision-maker without cause [IFRS 10.B65].

Example D.13 – Kick-out rights held by one party

Investors A and B have set up a fund and hold direct investments of 40% and 60% respectively. Investor A has a fund management contract but can be removed by Investor B without cause at any time.

Analysis:

Investor A's rights to direct in the fund management contract are held as agent. There is no need for any further analysis of the other factors. Investor B therefore controls the fund.

When kick-out rights exist that do not meet the ‘single party, without cause’ criteria (which rarely apply in practice), they need to be assessed to determine how much weight is given to them. The general guidance on substantive rights, discussed in Section C.3.1, is relevant to this. However, in our view kick-out rights are not necessarily wholly substantive or wholly non-substantive. Instead, the assessment determines how much weight is given to these rights within the overall analysis.

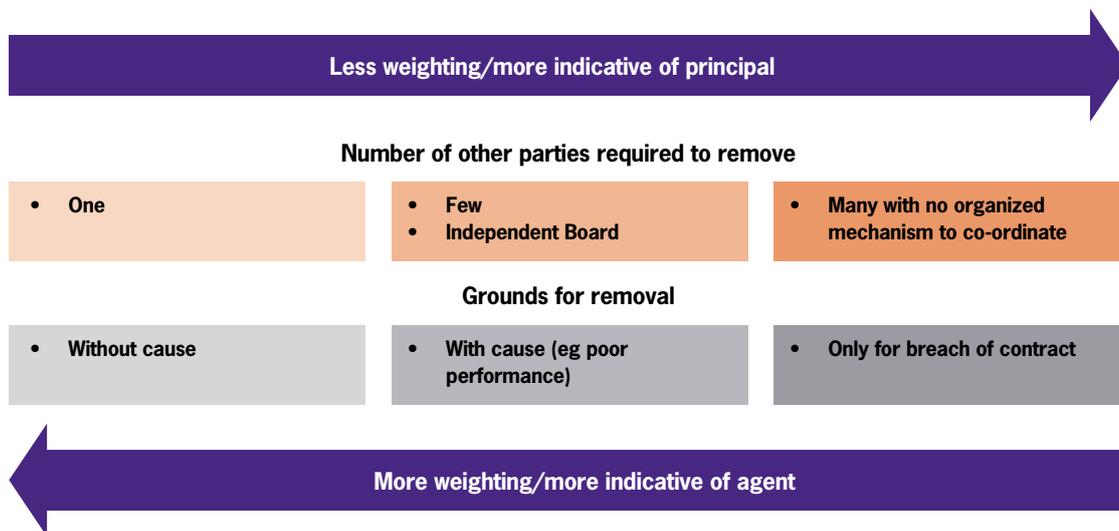
In assessing kick-out rights, the guidance in IFRS 10 suggests that two factors are particularly significant:

- the number of parties that need to act together to remove the decision-maker
- the contractual grounds on which the removal rights may be exercised (if any).

As shown in Figure D.4 below, the more parties must act together to remove a decision-maker the less substantive they are (ie less weight is given to them).

Also, a kick-out right that is exercisable without providing any reason (‘without cause’) carries more weight than one that is exercisable only in particular circumstances. A right that is exercisable only for breach of contract is protective in nature and is an indicator that the decision-maker is a principal [see Example 14B of IFRS 10].

Figure D.4 – Assessing removal rights



Kick-out rights that are exercisable by more than one party are not conclusive in isolation. The examples in IFRS 10 make it clear that:

- the absence of kick-out rights (or kick-out rights that are non-substantive) does not necessarily mean that the decision-maker is principal
- the existence of substantive kick-out rights (eg held by a small number of investors, or exercisable by an independent Board) does not necessarily mean that the decision-maker is an agent.

Examples D.14 and D.15 illustrate these points:

Example D.14 – No kick-out rights

Fund manager A sets up and markets a fund to a broad range of investors. It receives market-based remuneration, including a performance element. It holds a small (<5%) direct interest. It is required to operate within a defined investment mandate and in accordance with local law and regulation. There are no kick-out rights.

Analysis:

Although there are no kick-out rights it is likely that Fund manager A is agent when all the other factors are considered.

Example D.15 – Kick-out rights held by a few parties

Bank A sets up a fund along with three unrelated investors. Each holds a 25% direct interest. The fund management contract is awarded to Bank A's asset management subsidiary on terms that are considered 'at market'. The contract can be cancelled with one month's notice (without cause) by a vote of three out of four investors.

Analysis:

The kick-out rights are substantive (unless some other factor counters this – for example if Bank A has unique skills). However, this alone is not sufficient to conclude that Bank A is agent. Nonetheless, in our view kick-out rights that can be exercised by only a few parties and without cause are a strong indicator of agent status. Accordingly, it seems unlikely that Bank A has control in these circumstances as its rights to direct relevant activities could readily be removed.

Substantive rights held by other parties that restrict a decision-maker's discretion are assessed in a similar way. For example, a decision-maker that is required to obtain approval for its actions from a small number of other parties is generally an agent.

Decision-maker's remuneration [IFRS 10.B68-B70]

Practical insight – remuneration structures

Sectors in which the principal-agent analysis is often relevant include asset or fund management and hotel operation. In both cases the manager's or operator's fee structure usually creates rights to a variable return.

Asset or fund management

In the funds management industry an asset manager:

- typically receives a fee based on a stated percentage of the assets under management (IFRS 10 includes examples using 1% of net asset value)
- sometimes receives performance-based fees for 'out-performance' (IFRS 10 includes examples using 10% and 20% of fund profits if a target is achieved).

Hotel management

Typically, a hotel operator's fee structure includes:

- a base amount, calculated as a percentage of revenue from the hotel business
- an incentive element if gross operating profit exceeds an agreed threshold.

Assessing the decision-maker's remuneration and its basis is necessary for two main reasons:

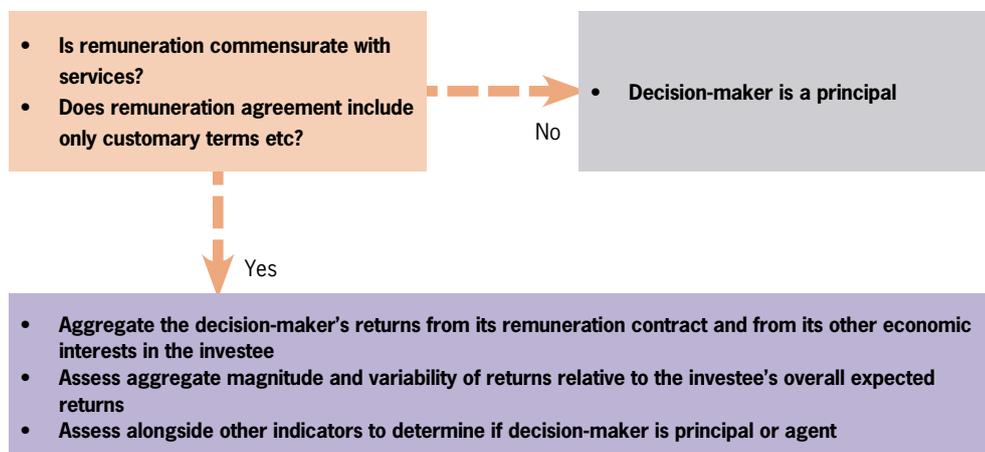
- the remuneration usually creates rights to a variable return
- as noted above, a decision-maker cannot be an agent unless remuneration:
 - is commensurate with the services provided; and
 - includes only terms, conditions or amounts that are customarily present in arrangements for similar services and level of skills negotiated on an arm's length basis [IFRS 10.B69].

For retail funds, and other funds marketed to unrelated investors, a fund manager's remuneration contract usually meets these 'market criteria'. Indeed, the examples in IFRS 10 (while not providing guidance on assessment) include a variety of structures all of which are described as meeting the market criteria. Levels and bases of remuneration will of course vary between markets, fund size, whether the fund is marketed at retail or institutional investors, and the type of investments under management.

Assuming the remuneration contract does meet the market criteria, the related rights to variable returns are assessed alongside the other three factors in reaching a conclusion. Variable returns from the remuneration contract are considered together with those from other interests in the investee (see below) in assessing the overall magnitude and variability of the decision-maker's returns relative to the investee's total returns.

The assessment of the decision-maker's remuneration is summarised in Figure D.5 below:

Figure D.5 – Assessing fee structure



In our view it is unlikely that a decision-maker would be considered a principal if the (market-based) remuneration is its only source of a variable return. This is the case even if there are no kick-out rights and the scope of decision-making authority is broad.

Exposure to variability of returns from other interests in the investee [IFRS 10.B71-B72]

In addition to its remuneration, a decision-maker may hold other interests that increase its overall rights or exposure to variable returns. IFRS 10 explains that holding other interests indicates the decision-maker may be a principal.

Practical insight – other interests in the investee

For the purpose of the principal agent analysis ‘other interests’ could be any type of involvement with the investee that creates rights or exposure to variable returns – see Section C.3.2. However, as a practical matter the most significant or commonplace types of interest are:

- equity interests in an entity such as an investment trust company
- units in a mutual fund, unit trust, real estate investment trust or similar investment vehicle
- debt holdings
- guarantees over an investee’s performance
- derivatives that absorb variability from the investee.

IFRS 10 requires such other interests to be assessed alongside the other indicators and does not specify any percentage ownership thresholds that are conclusive in isolation. However, the examples in the Standard at least provide some hints as to the IASB’s thinking. The examples in IFRS 10 (Examples 13 to 15) make it clear that direct interests are an important indicator.

More specifically, these examples suggest that:

- a decision-maker is unlikely to be principal if it has no other interests beyond (market-based) remuneration
- a direct interest of 10% or less is also unlikely to result in classification as principal, even if other indicators such as a lack of substantive kick-out rights, point in that direction
- a direct interest of 20% could result in classification as either agent or principal depending on other indicators.

Practical insight – is there a de minimis level of direct investment?

As a practical matter, some fund managers may wish to establish de minimis levels of direct investment, below which they can safely assume they are an agent without detailed analysis. Some may have used benchmarks in developing an accounting policy to apply existing requirements.

Unfortunately, IFRS 10 does not specify any benchmark or de minimis threshold. To do so would also be inconsistent with the general requirement to consider all relevant facts and circumstances. That said, the examples in IFRS 10 suggest that a manager with a market-based remuneration agreement and a direct holding of 10% or less is unlikely to be a principal.

Applying the indicators together

IFRS 10 includes a number of examples to illustrate the application of the four indicators in combination [Examples 13 to 16 of IFRS 10]. Some of the inferences that might be drawn from these examples have been discussed already in this Guide.

The key aspects of Examples 13 to 16 are summarised in the table below (although reference should be made to the full text of the examples in IFRS 10 for a complete explanation of the fact patterns and indicative conclusions):

Level of direct ownership /remuneration	Kick-out rights	Scope of decision-making authority	Implication
<ul style="list-style-type: none"> 10% or less direct interest market-based fees of 1% of assets 	None	Discretion within investment mandate	Likely to be an agent
<ul style="list-style-type: none"> 2% direct interest market-based fees of 1% of assets and 20% of fund profits if target return achieved 	Only for breach of contract	Wide scope	Likely to be an agent
<ul style="list-style-type: none"> 20% direct interest market-based fees of 1% of assets and 20% of fund profits if target return achieved 	Only for breach of contract	Wide scope	Likely to be a principal
<ul style="list-style-type: none"> 20% direct interest market-based fees of 1% of assets and 20% of fund profits if target return achieved 	Exercised via a Board, renewable annually	Wide scope	Likely to be an agent
<ul style="list-style-type: none"> 35% equity interest in a highly leveraged fund market-based fees of 1% of assets and 10% of fund profits if target return achieved 	Exercisable without cause but widely dispersed	Discretion within investment mandate	Likely to be a principal

Comparison with IAS 27 and SIC-12

IAS 27 and SIC-12 do not include specific guidance on the principal or agent issue. Accordingly, past practice in this area has been quite mixed.

One of the challenges in applying the previous control model to an investment fund is to decide whether it is an SPE within the scope of SIC-12. Under a SIC-12 analysis a fund manager might assess its overall exposure to the SPE's risks and rewards (taking into account both remuneration and direct interests) and conclude that it has control when the 50% level is reached.

If the fund is not considered an SPE, an IAS 27 analysis would be conducted. However, different approaches have been taken to applying IAS 27 in the absence of specific guidance. For example:

- it could be argued that an asset management mandate meets the ‘power’ criterion of IAS 27 and that almost any level of direct interest would confer benefits
- some have implemented accounting policies that are directionally consistent but set a de minimis threshold for a direct investment
- others have argued that, in some situations, the rights conferred by an asset management agreement are fiduciary in nature and would therefore only consolidate if a direct interest exceeds 50%
- still others have taken an approach that considers a range of factors and the overall relationship in a similar manner to IFRS 10’s requirements.

6 Franchises

In a franchise operation, both the franchisor and franchisee normally have some decision-making rights and some rights to variable returns from the franchise business. A question therefore arises as to whether the franchisee or franchisor has control (or whether control is shared).

Practical insight – franchises

In a franchise operation one party (the franchisee) pays another (the franchisor) for rights to operate a business using an established trade name and business model. The franchisee pays for rights to use the trade name and know-how for a period of time, and normally receives other services such as training and advertising. The franchisee typically pays the franchisor:

- an upfront fee
- fees for services provided
- a licence or royalty fee that may be linked to revenues or profits.

IFRS 10 also notes that a franchise agreement often gives the franchisor rights that are designed to protect the franchise brand and some decision-making rights with respect to the operations of the franchisee [IFRS 10.B29]. For example, the franchisee is commonly obliged to follow the franchisor’s requirements on matters such as staff uniforms and brand imagery and sometimes on pricing and sourcing of equipment and supplies.

A large part of the assessment in practice relates to whether the franchisor’s rights are protective or go beyond that. IFRS 10 provides some guidance on this assessment [IFRS 10.B30-B33]. The guidance emphasises that the franchisor’s rights are often protective and do not then prevent the franchisee from having control.

Key points are that:

- a franchisor’s rights that are designed to protect its brand are protective in nature and do not generally prevent others from having control
- other decision-making rights of the franchisor also do not necessarily prevent others from having control
- the lower the level of financial support provided by the franchisor and the lower the franchisor’s exposure to variability of returns from the franchisee the more likely it is that the franchisor has only protective rights
- by entering into the franchise agreement the franchisee has made a unilateral decision to operate its business in accordance with the terms of the franchise agreement, but for its own account.

Franchises do of course vary extensively and each needs to be assessed based on its specific facts and circumstances. Given that both parties have some decision-making the assessment of relevant activities is critical.

Example D.16 – Franchise

Franchisor A owns the trade name and business model-related IP for a fast food business. Franchisee B enters into an agreement giving it exclusive rights to operate the franchise business in a specified location for 5 years, renewable at B's option. Franchisee B pays an initial franchise fee, continuing royalties of 5% of revenues, and fees for advertising and other services. Franchisee B is entitled to all residual profits after paying these fees.

Under the terms of the agreement:

- Franchisor A sets the selling price for core products, determines branding requirements and determines a list of approved suppliers for key food supplies and negotiates the related prices
- Franchisee B is responsible for all other aspects of the operation including:
 - financing the franchise
 - fit-out (subject to A's approval of the design for brand compliance), equipment purchasing and negotiating the lease for premises
 - hiring management and employees and negotiating wages and other employment terms
 - determining detailed operating procedures
 - local advertising and promotion
 - renewing the franchise.

Analysis:

Both Franchisor A and Franchisee B have rights to variable returns and have decision-making rights over some activities. Franchisor A's decision-making rights may extend beyond simple brand protection (because, for example, they include rights over input and output prices). An assessment is therefore needed as to which activities have the greatest effect on returns. If it is determined that the most relevant activities are staffing, financing the franchise and renewal then Franchisee B would have control of the business.

E. Consolidation procedures

IFRS 10 retains IAS 27's requirements on consolidation procedures. This Section therefore provides a high level reminder of the key requirements, and identifies some common practical application issues, in the following areas:

- the consolidation process including:
 - uniform accounting policies
 - non-coterminous reporting dates
 - elimination of intra-group transactions
 - goodwill and other business combination-related adjustments
 - allocation to non-controlling interests
- changes in non-controlling interests
- losing control of a subsidiary.

1 The consolidation process

1.1 Summary

Consolidated financial statements present the financial position and results of a group (a parent and its subsidiaries) as those of a single economic entity. The key steps to achieve this are:

Summary of main steps for consolidation [IFRS 10.B86]:

Consolidated financial statements:

- combine like items of assets, liabilities, equity, income, expenses and cash flows from the financial statements of each group entity
- eliminate intragroup transactions and balances
- eliminate the parent's investment in each subsidiary and recognise goodwill and other business combination-related adjustments
- allocate comprehensive income and equity between the parent and any non-controlling interests.

The concept of a single economic entity is illustrated in Example E.1 below:

Example E.1 – Single economic entity concept

A subsidiary buys an asset from a third party for CU100. It subsequently sells the asset on to its parent for CU130. The subsidiary records a profit of CU30 and the parent records an asset of CU130 in its separate financial statements.

If the parent and subsidiary are viewed as being a single entity, all that has happened is that this single entity has bought an asset for CU100 from a third party. This is what would be shown in the parent's consolidated financial statements.

The detailed ‘mechanics’ of the consolidation process vary from one group to another, depending on the group’s structure, history and financial reporting systems. IFRS 10 and much of the literature on consolidation are based on a traditional approach to consolidation under which the financial statements (or, more commonly in practice, group ‘reporting packs’) of group entities are aggregated and then adjusted on each reporting date. Larger groups using enterprise reporting systems may prepare consolidated financial information in a more real time and automated manner. However, the traditional approach still serves to illustrate the underlying concepts.

Figure E.1 below summarises the key steps in a typical consolidation process and identifies the more common practical issues:

Figure E.1 – Key steps in a typical consolidation process

Keys steps	Common practical issues
Step 1 – combine financial statements of each group entity	<ul style="list-style-type: none"> • uniform accounting policies • non-coterminous reporting dates • overseas subsidiaries • immaterial subsidiaries • changes in group composition
Step 2 – eliminate intragroup transactions and balances	<ul style="list-style-type: none"> • intragroup losses • tax effects • intragroup arrangements that affect classification
Step 3 – eliminate the parent’s investment in each subsidiary and recognise goodwill and other business combination-related adjustments	<ul style="list-style-type: none"> • business combination adjustments • goodwill impairment
Step 4 – allocate comprehensive income and equity to non-controlling interests	<ul style="list-style-type: none"> • determining the effective ownership percentage • NCI valuation method

These steps are discussed in more detail below.

1.2 Combine financial statements of each group entity

In an ideal situation the financial information for each group entity used in the consolidation would be fully IFRS compliant, drawn up to the same reporting date and prepared using the parent’s or group’s accounting policies. In reality this is often not the case. The following paragraphs consider the most common practical issues.

Uniform accounting policies

If a group entity uses accounting policies other than those in the consolidated financial statements, appropriate adjustments should be made on consolidation [IFRS 10.B87]. The extent and complexity of this exercise depend on the nature of the group’s activities and the basis of preparation of individual group entities’ financial statements.

In carrying out this exercise a distinction should be made between accounting policies and:

- accounting estimates
- designations permitted or required in IFRSs on a transactional or item-by-item basis (eg hedge accounting and use of the fair value option in financial instruments accounting).

Example E.2 – Accounting policy alignment

Parent company P heads a property investment group that includes subsidiaries S1 and S2. P's group accounting policy for investment property is to apply the fair value model in accordance with IAS 40 'Investment Property'. In their individual financial statements S1 also applies the fair value model but S2 uses the cost model.

Both S1 and S2 use interest rate swaps to manage interest rate risk on floating rate borrowings. However, S1 applies hedge accounting and S2 does not.

Analysis:

On consolidation adjustments should be made to reflect S2's investment property at fair value (unless, in exceptional circumstances, it is impractical to reliably measure the fair value of the properties).

There is no need to make adjustments to remove the effects of hedge accounting for S1, or to apply hedge accounting for S2. IAS 39 'Financial Instruments: Recognition and Measurement' permits but does not require hedge accounting, on a case by case basis, if the applicable conditions are met.

Non-coterminous reporting dates

The basic requirement in IFRS 10 is that each group entity's financial statements are drawn up to the same reporting date for consolidation purposes. Where reporting dates differ, additional financial information is prepared for consolidation purposes, unless impractical [IFRS 10.B92].

IFRS 10 does allow some flexibility if it is impractical to obtain the additional information. In that situation the subsidiary's financial statements are used for consolidation purposes, with adjustments for significant transactions or events occurring outside the period covered by the consolidated financial statements. In this situation:

- the difference between the subsidiary's and parent's reporting date may not exceed three months
- the length of the subsidiary's reporting period and difference in dates must be the same from one period to the next.

Example E.3 – Non-coterminous year-end

Parent company P is preparing consolidated financial statements to 31 March 20X1. For this purpose, it uses statutory, IFRS-based financial statements for Subsidiary S. S has a year end of 31 December 20X0.

In February 20X1 Subsidiary S sold a property held at cost, realising a large profit that is material to the consolidated financial statements.

Analysis:

P should obtain additional information for S, such as a reporting pack or appropriately prepared management accounts, covering:

- the 3 month period from 1 January 20X1 to 31 March 20X1
- the comparative 3 month period from 1 January 20X0 to 31 March 20X0.

S's financial statements should be adjusted for consolidation purposes by adding its results for the current 3 month period and deducting those for the comparative period.

If this is impractical then S's financial statements may be used without including this comprehensive additional information. However, in that situation adjustments should still be made for the property sale in February 20X1 (and for any other significant transactions or events of Subsidiary S occurring in Parent P's annual period but outside S's annual period).

Overseas subsidiaries

The financial statements of foreign subsidiaries must be translated into the group's presentation currency (which is often, but not always, the parent's functional currency). The relevant requirements are in IAS 21 'The Effects of Changes in Foreign Exchange Rates'.

A detailed discussion of IAS 21's requirements is beyond the scope of this publication but, in summary, the process involves:

- translating assets and liabilities at closing rate
- translating income and expenses at transaction date rates
- recording resulting exchange differences in other comprehensive income [IAS 21.39].

In practice, income and expenses are usually translated at a rate that approximates the rate at the dates of the transactions, typically an average rate for the period. However, this is not appropriate if exchange rates have fluctuated significantly during the period [IAS 21.40].

Goodwill and other business combination-related adjustments (eg fair value adjustments) relating to an overseas subsidiary are treated as assets or liabilities of that subsidiary. Accordingly, they are translated at the closing rate in the same way as assets and liabilities recognised in the subsidiary's individual financial statements.

Immaterial subsidiaries

The question of whether a parent is required to consolidate immaterial subsidiaries arises frequently. IFRS 10 is silent on this question.

In our view the concept of materiality applies to consolidation in the same way as to any other requirement in IFRS. Accordingly a parent is not required to consolidate subsidiaries that are individually and collectively immaterial to the consolidated financial statements. However, care should be taken to ensure that materiality is:

- reassessed at each reporting date
- considered broadly such that it takes into account:
 - gross assets, liabilities, income and expense as well as the net position
 - items for potential disclosure even if not recognised in the primary statements (eg contingent liabilities and related party transactions).

Changes in group composition

Subsidiaries should be included in the consolidation from the date control is obtained to the date control is lost [IFRS 10.B88]. When these events occur part way through a group's reporting period it will be necessary to obtain additional information covering that part of the period for which the parent has control.

A transaction in which an entity obtains control over a business (including an entity that contains a business) is a business combination. Accounting for business combinations is discussed in detail in our publication 'Navigating the Accounting for Business Combinations – Applying IFRS 3 in Practice'.

Accounting for loss of control of a subsidiary is discussed below.

1.3 Eliminate intragroup transactions and balances

As noted in Section E.1.1 above, the single entity concept requires that a parent eliminates in full intragroup assets and liabilities, equity, income, expenses and cash flows relating to transactions between group entities. Profits or losses resulting from intragroup transactions that are included in the carrying amount of assets, such as inventory and property, plant and equipment, are also eliminated.

Intragroup losses may indicate an impairment that requires recognition in the consolidated financial statements [IFRS 10.B86].

Example E.4 – Elimination of intragroup loss

Parent company P acquired an item of property 8 years ago at a cost of CU200. P estimates the economic useful life to be 20 years and residual value to be zero. P has recorded accumulated depreciation of CU80 to 1 January 20X1 and carrying value at that date is CU120.

On 1 January 20X1 P sells the property to Subsidiary S for CU100, incurring a loss of CU20. S records the property at cost of CU100. S records depreciation of CU8.3 in the year to 31 December 20X1 (resulting in a carrying value of CU91.7).

Analysis:

On consolidation at 31 December 20X1 the following adjustments are required to adjust the carrying value and depreciation expense to the amounts they would have been if the intragroup sale had not occurred (ignoring tax effects):

	<u>Debit CU</u>	<u>Credit CU</u>
Property (110.0-91.7)	18.3	
Depreciation expense (10.0-8.3)	1.7	
Loss on sale of property		20.0

Because the intragroup sale incurred a loss, Parent P should consider whether the adjusted carrying value of CU110 exceeds the asset's recoverable amount.

The treatment of tax on consolidation requires care. IFRS 10 notes that IAS 12 'Income Taxes' applies to temporary differences that arise from the elimination of profits and losses resulting from intragroup transactions. The applicable tax base and tax rate for this purpose are determined based on the entity that holds the asset (the acquirer). However, an intragroup elimination changes the asset's carrying value in the consolidated financial statements. This creates or changes the amount of the temporary difference. This change needs to be 'tax effected', as shown in Example E.5:

Example E.5 – Tax effecting an intragroup elimination

The basic facts are the same as Example E.4 above. In addition:

- when S purchases the property for CU100 on 1 January 20X1 the tax base for S is equal to cost (ie also CU100)
- in the 12 months to 31 December S receives tax allowances of CU20, reducing the tax base to CU80
- S's tax rate is 25%.

Analysis:

In its individual financial statements S has a taxable temporary difference of CU11.7 (CU91.7 – CU80). S should therefore have already recognised a deferred tax liability of CU2.9 (CU11.7 * 25%) in its individual financial statements.

On consolidation the carrying value is increased by CU18.3 to CU110, resulting in a taxable temporary difference of CU30. Of this amount CU20 relates to the original intragroup sale.

The following further adjustment is required to 'tax effect' this elimination:

	<u>Debit CU</u>	<u>Credit CU</u>
Tax expense	4.6*	
Deferred tax liability		4.6**

* this is 25% of the taxable temporary difference that arose on the initial sale (CU20) less 25% of the extra depreciation recognised on consolidation (CU1.7)

** this increases the deferred tax liability to CU7.5 which is the taxable temporary difference after consolidation adjustment, of CU30, tax effected at S's tax rate of 25%

Another tax issue that often causes confusion in practice is the need to recognise deferred tax on some temporary differences associated with investments in subsidiaries (event though the investment is eliminated). Our guide 'Deferred Tax – A Chief Financial Officer's Guide to Avoiding the Pitfalls' explains the relevant requirements.

It should be noted that exchange gains or losses on intercompany loans and balances denominated in a foreign currency (from the perspective of one or more of the group entities involved) do not eliminate on consolidation:

Example E.6 – Intercompany loan between entities with different functional currencies

Parent company P has a functional currency of GBP and Subsidiary S has a functional currency of USD. During one financial period P makes a loan to S of USD60,000 at a time when spot rate is 1GBP = 1.5 USD. At year end the spot rate is 1GBP = 1.6 USD.

In its individual financial statements Parent P therefore retranslates the inter-company loan receivable from its initial carrying value of GBP40,000 (60,000/1.5) to GBP37,500 (60,000/1.6). P therefore records a loss of GBP2,500. Subsidiary S does not recognise any exchange difference as the loan is denominated in its own functional currency.

Analysis:

On consolidation Subsidiary S's assets and liabilities are translated into GBP at the year-end spot rate of 1.6. The resulting intercompany liability of GBP37,500 is eliminated against P's corresponding intercompany receivable. P's exchange loss of GBP2,500 is not eliminated and is therefore included in consolidated profit or loss.

If the loan is part of Parent P's net investment in Subsidiary S (ie settlement is neither planned nor likely in the foreseeable future – IAS 21.15), however, it is recognised in other comprehensive income on consolidation in accordance with IAS 21.32.

In addition to elimination requirements, some intragroup arrangements can cause particular transactions and arrangements to be classified and measured differently on consolidation. The table below summarises some of the more common examples:

Example	Details
Investment property	If a group entity holds property that is leased to another group entity, this property might meet the definition of investment property in the individual financial statements of the holder but would be considered 'owner occupied' at group level (see IAS 40 'Investment Property')
Debt-equity classification and parent company guarantees	When a subsidiary issues shares or other financial instruments and a parent or other group entity agrees additional terms directly with the holders (eg a guarantee), this may require reclassification of the instruments from equity to liability on consolidation (see paragraph AG29 of IAS 32 'Financial Instruments: Presentation')
Group share-based payment schemes	A subsidiary that enters into a share-based payment scheme that requires it to settle the obligation by providing shares in the parent company would classify the scheme as cash-settled in its individual financial statements. On consolidation the scheme would be treated as equity-settled (see paragraphs 43A – 43D of IFRS 2 'Share-based Payment')

1.4 Eliminate the parent's investment and recognise goodwill and other business combination-related adjustments

The single entity concept requires that the parent's investment in each subsidiary is eliminated on consolidation. In practice the following inter-related steps are usually combined:

- the investment is offset against the subsidiary's share capital and pre-acquisition reserves
- goodwill is recognised in accordance with IFRS 3 (for subsidiaries acquired in a business combination)
- fair value adjustments to assets, liabilities and contingent liabilities made in the business combination accounting are reflected
- non-controlling interests are recognised.

The basic process is illustrated in Example E.7 below:

Example E.7 – Elimination of parent's investment

Some years ago Parent P acquired 80% of the issued share capital of Subsidiary S for CU5,000. At that time S's balance sheet showed net assets of CU4,000. Fair value adjustments totalling CU800 were recognised in the business combination. P decides to recognise non-controlling interests using the proportionate share of net assets method rather than fair value (see paragraph 19 of IFRS 3 'Business Combinations').

S's summary balance sheet is therefore:

	Individual financial statements	Fair value adjustment	Total
	CU	CU	CU
Net assets	4,000	800	4,800
Share capital	2,500		
Other reserves	1,500		
	4,000		

Analysis:

Having added together P's and S's individual balance sheets, the entries to eliminate P's investment, reflect the fair value adjustments and to recognise goodwill and non-controlling interests, are as follows:

	Debit CU	Credit CU
Share capital	2,500	
Other reserves	1,500	
Goodwill (5,000 – 80%*4,800)	1,160	
Net assets	800	
P's investment in S		5,000
Non-controlling interests (20%*4,800)		960

In subsequent periods the consolidation eliminations and adjustments are updated to reflect :

- the income statement effects of fair value adjustments
- any goodwill impairment (goodwill identified in the business combination must be tested annually for impairment, by applying the requirements of IAS 36 'Impairment of Assets')
- changes in ownership without loss of control (see Section E.2 below).

Example E.8 – Updating consolidation entries to reflect fair value adjustments

Continuing the example above assume that:

- the acquisition took place at the start of P's annual period
- the CU800 fair value adjustment related entirely to property, plant and equipment with carrying value at the acquisition date of CU2,500 and fair value of CU3,300
- the remaining useful life after this date is 10 years
- in S's books the annual depreciation expense is CU250.

Analysis:

On consolidation the depreciation expense should be increased by CU80 to CU330. Of this excess depreciation, 20% is allocated to the non-controlling interest (CU16). Accordingly, after making the basic entry in Example E.7 above, the following catch-up entries are recorded:

First year-end after acquisition:	Debit CU	Credit CU
Depreciation expense	80	
PP&E		80
Non-controlling interest (equity)	16	
Retained profits (equity)		16
Second year-end after acquisition:		
Depreciation expense	80	
PP&E		160
Retained profits b/fwd	64	
Non-controlling interest b/fwd	16	
Non-controlling interest (equity)	16	
Retained profits (equity)		16

1.5 Allocate comprehensive income and equity to non-controlling interests

When a parent entity first obtains control over another entity, it recognises any non-controlling interest in the new subsidiary's net assets as illustrated in Example E.7 above. In subsequent periods the parent allocates to the non-controlling interest its proportion of:

- profit or loss
- each component of other comprehensive income [IFRS 10.B94].

Definition of non-controlling interests [IFRS 10.Appendix]

Non-controlling interest is the equity in a subsidiary not attributable, directly or indirectly, to a parent.

The proportion allocated to non-controlling interest is based on 'existing ownership interests' [IFRS 10.B89]. In our view ownership interests in this context are the parent's economic interests in the subsidiary rather than the voting rights. In most cases involving a traditional corporate structure these proportions will be the same and will reflect the ownership of ordinary shares. However, differences can arise as illustrated below:

Example E.9 – Different voting rights and economic interests

Parent company P owns all of the 100 'A' shares in an investee and another investor owns all the 100 'B' shares. There two types of share have equal rights to dividends and to available assets on a winding-up. However, each A share carries two votes and each B share only one vote.

Analysis:

Parent P owns two-thirds of the voting power (and therefore has control) but is entitled only to half the dividends and rights to net assets. Accordingly its economic interest is 50%. Equity and comprehensive income will be apportioned to the non-controlling interest based on 50%.

If a subsidiary has outstanding cumulative preference shares that are classified as equity and held by non-controlling interests, the parent deducts the preference dividends in arriving at the controlling interest's share of profit. The parent allocates the dividends to non-controlling interest, irrespective of whether they have been declared [IFRS 10.B95].

Other practical issues in determining the allocation percentage include:

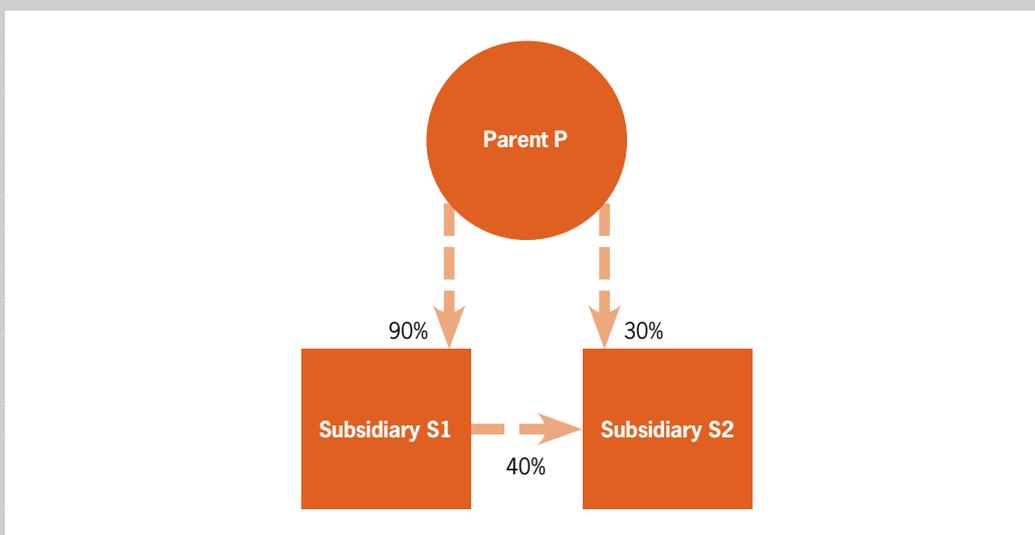
- indirect holdings
- potential voting rights and other derivatives.

Indirect holdings

If some of a parent's interests in a subsidiary are owned indirectly (through another subsidiary) the non-controlling interest is determined based on the parent's effective economic ownership. This is illustrated in Example E.10:

Example E.10 – Indirect holdings

Parent P controls two subsidiaries, S1 and S2, in the following group structure. Both subsidiaries were established as start-ups. Accordingly there is no goodwill and S1 and S2's retained earnings were all generated while P had control:



The summarised statements of financial position are as follows:

	Parent P	S1	S2	Total
	CU	CU	CU	CU
Investment in S1	810	–	–	810
Investment in S2	150	200	–	350
Other net assets	340	1,310	750	2,400
	<u>1,300</u>	<u>1,510</u>	<u>750</u>	<u>3,560</u>
Share capital	1,000	900	500	2,400
Retained earnings	300	610	250	1,160
	<u>1,300</u>	<u>1,510</u>	<u>750</u>	<u>3,560</u>

Analysis:

The effective controlling and non-controlling interest percentages are:

	S1	S1 *	S2 **	S2
	%	CU	%	CU
Controlling interests	90	1,179	66	495
Non-controlling	10	131	34	255
	<u>100</u>	<u>1,310</u>	<u>100</u>	<u>750</u>

* the NCI in S1 is calculated based on S1's net assets excluding the investment in S2, since NCI related to S2 is determined directly in this example

** the NCI in S2 is calculated as $100\% - 30\% - (90\% * 40\%)$

The consolidated statement of financial position is as follows:

Net assets	<u>CU</u> 2,400
Equity attributable to owners of P:	
– Share capital	1,000
– Retained profit	1,014
	<u>2,014</u>
Non-controlling interests:	
– In subsidiary S1	131
– In subsidiary S2	255
	<u>2,400</u>

Potential voting rights and other derivatives

If a parent holds potential voting rights in a subsidiary (such as share options, warrants and convertible instruments) the controlling and non-controlling percentages are normally based on existing ownership interests. In other words, the allocation does not reflect the possible exercise or conversion of potential voting rights [IFRS 10.B89].

However, as an exception to this general rule, an instrument that 'currently gives the entity access to the returns associated with an ownership interest' is regarded as an ownership interest in substance. In this case the allocation takes into account the eventual exercise of the potential voting rights [IFRS 10.B90].

The same analysis applies to other types of derivative that give a parent an additional economic interest in a subsidiary (for example a total return swap).

Determining whether potential voting rights do currently give access to the returns associated with an ownership interest can require considerable judgement. That said, in our view most potential voting rights and similar derivatives do not meet this condition because:

- options, warrants and forward contracts over shares do not normally convey a right to share in dividends until settled or exercised; and
- in the case of options, exercise is uncertain.

However, some instruments may meet the condition and therefore need further analysis:

Practical insight – instruments that might meet the IFRS 10.B90 conditions

Instruments that **might** currently give an investor access to the returns associated with an ownership interest include:

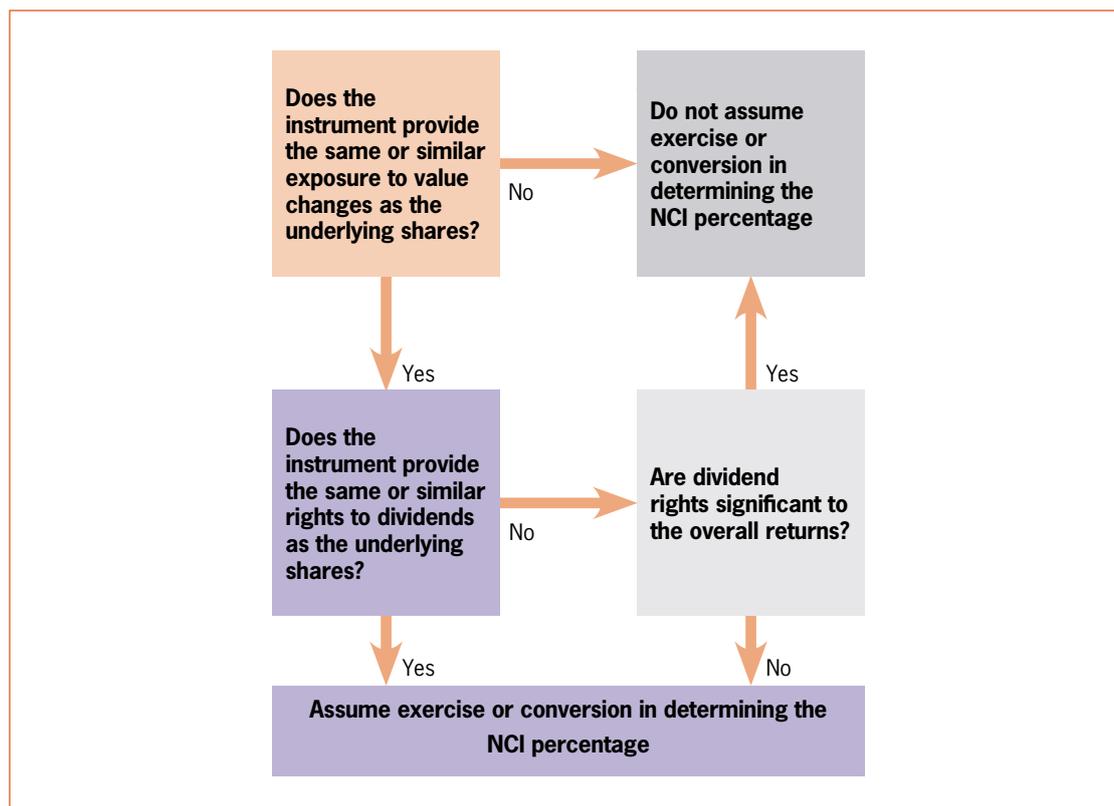
- a fixed price forward (ie non-option) contract between the parent and non-controlling interest to buy or sell shares in the subsidiary at a future date
- combined put and call options with a fixed exercise price
- a fixed price put or call option that is deeply in the money at inception such that exercise is virtually certain
- a total return swap.

In assessing such instruments it is necessary to first determine the returns associated with ownership of the underlying shares. Normally, the most important returns derive from:

- changes in the value of the shares
- dividends.

The broad approach to the assessment is summarised in Figure E.2 below:

Figure E.2 – Potential voting rights and ownership interests



In our view dividend rights must be considered in determining whether the parent or non-controlling interest has the rights to returns associated with the underlying shares. However, the effect of dividends may not be significant to the analysis in particular circumstances as discussed below:

Practical insight – are dividends significant to the overall returns?

Dividend rights are usually an important part of shareholders' returns, but may not be significant in the context of this analysis in all cases. Dividends may not be significant to the analysis when (for example):

- the terms of the contract prevent payment of dividends or restrict the amounts to a lender's return
- the exercise price of an option is adjusted if a dividend is paid
- payment of dividends prior to settlement of the derivative(s) is highly unlikely (for example due to the subsidiary's lack of profits or cash flows or because the parent can control the dividend policy).

The practical application of the analysis is illustrated by Examples E.11 and E.12:

Example E.11 – Purchased call option

Parent P owns 80% of the ordinary shares of Subsidiary S. Minority shareholder M owns the remaining 20%. P purchases an option to acquire the 20% holding owned by M for a fixed price in 12 months' time. The exercise price is based on the estimated fair value of the 20% holding at inception. Dividend rights are unaffected by the call option. Dividends are material and are paid regularly.

Analysis:

The purchased call option does not transfer the returns associated with ownership of the underlying shares to P. All else being equal, P will probably exercise its option if the value of shares in S has increased from inception to the exercise date, and allow the option to lapse if the value decreases. The option gives parent P the ability to share in an increase in value but it is not exposed to declines in value. Also, P does not receive dividends on the underlying shares prior to exercise of the call.

P therefore continues to allocate 20% of the results and net assets of S to M in its consolidated financial statements. If the call option meets the definition of an equity instrument in accordance with IAS 32 its purchase price is debited to equity. If not, it is measured at fair value in accordance with IAS 39.

Example E.12 – Combination of put and call options

The facts are similar to Example E.11 above except that Parent P and minority shareholder M negotiate both a call option for P to acquire M's shares, and a put option for M to sell its shares to P. The price in the put and call options is the same and is fixed at inception. Dividend rights are unaffected by the put and call options but dividends have not been paid in recent years.

Analysis:

The combined put and call option appear, in substance, to constitute a single financial instrument. Accordingly, a combined assessment is made as to whether the returns associated with ownership of the underlying shares are transferred to P. All else being equal, P should exercise its option if the value of shares in S increases and M should exercise its option if the value declines. In either case P will pay a fixed amount of cash and will therefore obtain the benefit of a value increase and bear the risk of a decrease.

The options do not transfer the proportionate interest in any dividends declared by S. However, P is likely to be in a position to control S's dividend declarations. If so, it may be irrational for P to decide that S should pay a dividend prior to acquiring M's shares (as that cash would leave the group). Accordingly, dividend rights may not be significant in this case.

If dividend rights are not considered significant, P should account for this arrangement as though the shares of M have been acquired at the date of entering into the put and call options. Accordingly, the non-controlling interest is derecognised and 100% of the results and net assets of S are allocated to P from that date. A liability is recognised for the present value of the exercise price in accordance with IAS 32.

2 Changes in non-controlling interests

Non-controlling interests (NCI) in a subsidiary are presented as a separate component of equity in the consolidated statement of financial position. Consequently, changes in a parent's ownership interest in a subsidiary that do not result in loss of control are accounted for as equity transactions.

Parent's accounting treatment [IFRS 10.23 and B96]

When the NCI in a subsidiary changes but the same parent retains control:

- no gain or loss is recognised when the parent sells shares (so increasing NCI)
- a parent's purchase of additional shares in the subsidiary (so reducing NCI) does not result in additional goodwill or other adjustments to the initial accounting for the business combination
- in both situations, the carrying amount of the parent's equity and NCI's share of equity is adjusted to reflect changes in their relative ownership interest in the subsidiary. Any difference between the amount of NCI adjustment and the fair value of the consideration received or paid is recognised in equity, attributed to the parent [IFRS 10.B96]
- the parent should also take the following into consideration:
 - the allocated amounts of accumulated OCI (including cumulative exchange differences relating to foreign operations) are adjusted to reflect the changed ownership interests of the parent and the NCI. The re-attribution of accumulated OCI is similarly treated as an equity transaction (ie a transfer between the parent and the NCI)
 - for a partial disposal of a subsidiary with foreign operations, the parent must re-attribute the proportionate share of cumulative exchange differences recognised in OCI to NCI in that foreign operation (IAS 21.48C)
 - IFRS 10 has no specific guidance for costs directly related to changes in ownership interests. In our view, costs that are incremental should be deducted from equity (consistent with IAS 32's rules on other types of transaction in the entity's own equity).

The accounting is illustrated in the following three examples:

Example E.13 – Parent sells shares in a subsidiary

Parent P acquired 80% of Subsidiary S1 in 20X6. On 1 January 20X9, P sells S1 shares equivalent to 20% of S1's outstanding shares for CU260. On that date, the carrying value of S1's net assets in the consolidated financial statements, excluding goodwill, amounted to CU900. Goodwill measured using the fair value and proportionate interest model amounts to CU230 and CU200, respectively. Parent P's recorded goodwill is not impaired. Subsidiary S1 has no accumulated OCI. After the sale, Parent P still has a 60% interest in Subsidiary S1 and retains control.

Analysis:

Parent P's adjustments to NCI and equity are as follows:

	NCI at fair value model	NCI at proportionate interest model
	CU	CU
Carrying value of S1's net assets	900	900
Goodwill recognised at acquisition	230	200
Carrying amount – 1 January 20X9	1,130	1,100
Cash consideration received	260	260
Less additional NCI to be recognised (20% of carrying amount)	226	220
Amount to be credited to parent's equity	34	40

- The choice of recording NCI either using the fair value or proportionate interest model only applies on the acquisition date. Adjustment to NCI is based on NCI's proportionate share of the subsidiary.

Example E.14 – Parent acquires additional shares in a subsidiary

Parent P has an 80% interest in Subsidiary S2. On the acquisition date, NCI measured using the fair value and proportionate interest model amounts to CU180 and CU150, respectively. On 1 January 20X9, Parent P purchases the remaining 20% interest in S2 for CU280. Parent P's recorded goodwill is not impaired. From the date of acquisition up to 1 January 20X9, the balance of NCI has increased by CU80 related to the NCI's share of S2's profits (CU70) and other comprehensive income (CU10).

Analysis:

Parent P's adjustments to NCI and equity are as follows:

	NCI at fair value model	NCI at proportionate interest model
	CU	CU
NCI recognised on acquisition date	180	150
NCI's accumulated share of profits	70	70
NCI's accumulated share of other comprehensive income	10	10
Carrying amount of NCI – 1 January 20X9	260	230
Cash consideration paid	280	280
Less amount debited to NCI (carrying amount)	260	230
Amount to be debited to parent's equity	20	50

The NCI's share of the accumulated other comprehensive income is re-attributed to P and will be included in the balance of accumulated other comprehensive income. Parent P will then record the following entry:

	Debit CU	Credit CU
Equity	10	
Accumulated other comprehensive income		10

Example E.15 – Subsidiary issues new shares

Parent P owns 90% of 100 outstanding shares of Subsidiary S3. On 1 January 20X9, S3 issued 20 new shares to an independent third party for CU200. This diluted Parent P's ownership interest from 90% to 75% ($90/(100+20)$). The carrying value of the identifiable net assets (excluding goodwill) of Subsidiary S3 in the consolidated accounts immediately before the new share issue is CU800, of which CU720 is attributable to the parent. The carrying value of the NCI at the same date is CU80.

Analysis:

Accounting for the change in ownership interest:

	Carrying Value		Parent's share		NCI's share	
	CU	%	CU	%	CU	
Net assets immediately before share issue	800	90	720	10	80	
Proceeds from share issue	200					
Net assets immediately after share issue	1,000	75	750	25	250	
Change in balances			30		170	

- Any subsequent adjustment to NCI is based on NCI's proportionate share of the subsidiary. The CU200 proceeds from the issuance of shares increases the net assets of S3 and also increases NCI's ownership interest from 10% to 25%. The increase in NCI is determined to be CU170 based on NCI's proportional interest in the adjusted net assets of S3.

- The difference between the increase in NCI of CU170 and the fair value of the consideration for such shares of CU200, amounting to CU30, is recorded as an adjustment to equity. No gain or loss is recognised.

In the consolidated financial statements of Parent P, the following entry will be recorded:

	<u>Debit CU</u>	<u>Credit CU</u>
Cash	200	
NCI		170
Equity attributable to the parent		30

3 Losing control of a subsidiary

3.1 Accounting for loss of control

The loss of control of a subsidiary usually occurs when the parent sells or otherwise transfers its controlling interest in a single transaction or as a result of multiple transactions. However, other events may also result in the loss of control, such as:

- expiration of a contractual agreement that conferred control of the subsidiary
- the subsidiary becomes subject to the control of a government, court, administrator or regulator (without any change in the ownership interest in the subsidiary) or
- the subsidiary issues shares that dilutes the parent's controlling interest.

Regardless of the nature of the transaction or event, the loss of control represents a significant economic event that requires the parent to stop consolidating the subsidiary and to recognise any gain or loss. IFRS 10's requirements are summarised below, along with an illustrative example of their application.

Accounting for the loss of control of a subsidiary [IFRS 10.25 and B97 – B99]

On losing control of a subsidiary the (former) parent:

- derecognises the assets (including goodwill) and liabilities of the subsidiary at their carrying amounts
- derecognises the NCI (including any components of OCI attributable to them)
- recognises the fair value of the consideration received, if any, and any shares distributed as dividends as part of the transaction that resulted in the loss of control
- recognises any investment retained in the former subsidiary at fair value
- reclassifies to profit or loss (if required by other IFRS) or transfers directly to retained earnings, any amounts included in OCI
- recognises any resulting gain or loss within profit or loss attributable to the parent.

Example E.16 – Disposal of a subsidiary while retaining an investment

Parent P acquired its wholly-owned subsidiary, Company R, for CU1,000 on 1 January 20X5. On 31 December 20X9, Parent P sold 90% of its interest in Company R for cash of CU1,440. On that date, the carrying value of the net assets of Company R is CU1,350. These net assets include goodwill and a financial asset classified as an available for sale investment with a fair value of CU200 and original cost of CU150. Company R applied the revaluation model of IAS 16 for its property, plant and equipment and has a revaluation reserve balance of CU60. For the purposes of this example, income tax on the gain on sale of Company R is ignored.

Analysis:

Accounting for the sale of the subsidiary:

	CU
Cash consideration	1,440
Fair value of retained investment (financial asset)	160
Subtotal	1,600
Carrying value of net assets	1,350
Gain	250
Add: available for sale reserve reclassified to profit or loss	50
Total gain	300

- In this example, the fair value of the retained investment is calculated with reference to the fair value of the consideration paid for the controlling interest (1,440 x 10% / 90%). In practice, the fair value of the retained interest may need to be separately determined to exclude any control premium included in the sale price of the controlling interest.
- IFRS 10.B98(c) requires reclassification of any gains or losses previously recognised in OCI (when required by other IFRSs) as though the entity had directly disposed of the assets and liabilities. Accordingly, the available for sale investment reserve is included in determining the loss or gain on sale.

Entry to record the sale:

	Debit CU	Credit CU
Cash	1,440	
Financial asset	160	
Available for sale investment reserve	50	
Identifiable net assets and goodwill		1,350
Gain (profit or loss)		300

Accounting for the subsidiary's revaluation reserve:

IFRS 10.B98(c) also applies to the subsidiary's revaluation reserve related to its property, plant and equipment. IAS 16 'Property, Plant and Equipment' requires that the revaluation surplus included in equity may be transferred directly to retained earnings when the asset is derecognised (IAS 16.41). Upon sale of the subsidiary, any revaluation reserve is then transferred directly to retained earnings and does not form part of the gain on sale of the subsidiary.

Entry to transfer the revaluation reserve to retained earnings:

	Debit CU	Credit CU
Revaluation reserve	60	
Retained earnings		60

Disclosure of the components of the gain on sale:

The CU300 gain calculated above comprises: (1) the gain on sale of the controlling interest; and (2) the gain on the retained investment. IFRS 12 requires disclosure about the consequences of losing control of a subsidiary, including separate disclosure of these two components, together with the line item in the income statement in which the gains or losses are recognised [IFRS 12.19].

This will require a separate calculation of the gain on the retained investment, as follows:

	CU
Fair value of the retained investment	160
Carrying value (10% of net carrying value of net identifiable asset of CU1,350)	135
Gain	25
Plus: share of the available for sale investment reserve reclassified to profit or loss (CU50 x 10%)	5
Gain on retained investment	30

The total gain recorded by Parent P comprises:	
	CU
Gain on disposal of subsidiary	270
Gain on retained investment	30
Total gain	300

3.2 Multiple transactions that result in loss of control

Transactions resulting in loss of control affect profit or loss while other transactions with NCI do not. In some situations, a single transaction that does not lead to loss of control in isolation may in fact be part of a series of linked transactions that will have this effect when considered together. IFRS 10 requires the parent to consider the terms and conditions of the transactions and their economic effects to determine whether two or more transactions should be considered as a single transaction for accounting purposes.

Factors that may indicate that multiple arrangements are accounted for as a single transaction [IFRS 10.B97]

One or more of the following indicate that the parent should account for multiple arrangements that result in loss of control:

- they are entered into at the same time or in contemplation of each other
- they form a single transaction designed to achieve an overall commercial effect
- the occurrence of one arrangement is dependent on the occurrence of at least one other arrangement
- one arrangement considered on its own is not economically justified, but it is economically justified when considered together with other arrangements (eg when one disposal of shares is priced below market and is compensated for by a subsequent disposal priced above market).

F. Effective date and transition

This Section provides guidance on:

- the effective date of IFRS 10
- transitioning from IAS 27 to IFRS 10 in different scenarios.

1 Effective date of IFRS 10

Latest version of transition provisions

In June 2012 the IASB published an amendment to IFRSs 10 and 12 in order to:

- clarify the transition requirements in some areas
- provide additional transition reliefs.

This Section is based on the revised requirements.

IFRS 10 is mandatory for annual periods beginning on or after 1 January 2013.

Earlier application is permitted. However, if an entity applies IFRS 10 before the mandatory effective date it must also:

- disclose that fact; and
- apply the other standards and amendments in the consolidation package at the same time – in particular IFRSs 11 and 12 [IFRS 10.C1].

Example F.1 – Effective date and early application

An entity has an annual reporting date of 30 September:

- when must it adopt IFRS 10?
- what are the implications of early adoption?

Analysis:

IFRS 10 becomes mandatorily effective for this entity in the annual period commencing on 1 October 2013 and ending on 30 September 2014.

The entity is also permitted to adopt IFRS 10 for earlier periods – say for the annual period commencing on 1 October 2012 and ending on 30 September 2013 – subject to any local jurisdictional endorsement or other restrictions. If it does so it must also adopt IFRSs 11 and 12 and the 2011 changes to IAS 27 (in respect of its separate financial statements) and IAS 28.

When an entity adopts the new standard it must provide the disclosures specified in paragraph 28 of IAS 8 'Accounting Policies, Changes in Accounting Estimates and Errors' on the effect of initial application of an IFRS. However, an entity need present the quantitative information required by IAS 8.28(f) only for the annual period immediately preceding the date of initial application of IFRS 10 (the 'immediately preceding period') [IFRS 10.C2A].

If the entity does not apply the new standard before its effective date it must provide the disclosures in IAS 8.30 on IFRSs issued but not yet effective.

2 The transition from IAS 27 (and SIC-12) to IFRS 10 in different scenarios

IFRS 10's transition provisions make extensive reference to the 'date of initial application', defined as follows:

Definition of date of initial application [IFRS 10.C2B]

The date of initial application is "the beginning of the annual reporting period in which this IFRS is applied for the first time."

Accordingly, for an entity with a calendar year-end that adopts IFRS 10 for the annual period from 1 January 2013 to 31 December 2013, the date of initial application is 1 January 2013.

The general approach to transition is retrospective application in accordance with IAS 8 'Accounting Policies, Changes in Accounting Estimates and Errors'. This is however subject to several important simplifications and reliefs [IFRS 10.C2]. The main simplifications are:

- relief from full retrospective application when the control assessment at the date of initial application under IFRS 10 differs from that under IAS 27 and SIC-12's but full retrospective application is impractical (as defined in IAS 8 – see below)
- relief from restatement when the control assessment at the date of initial application is the same under IFRS 10 as it was under IAS 27/SIC-12, even if the date on which control was obtained or lost differs.

These simplifications and reliefs are considered in Sections F.2.1 – 2.3 below.

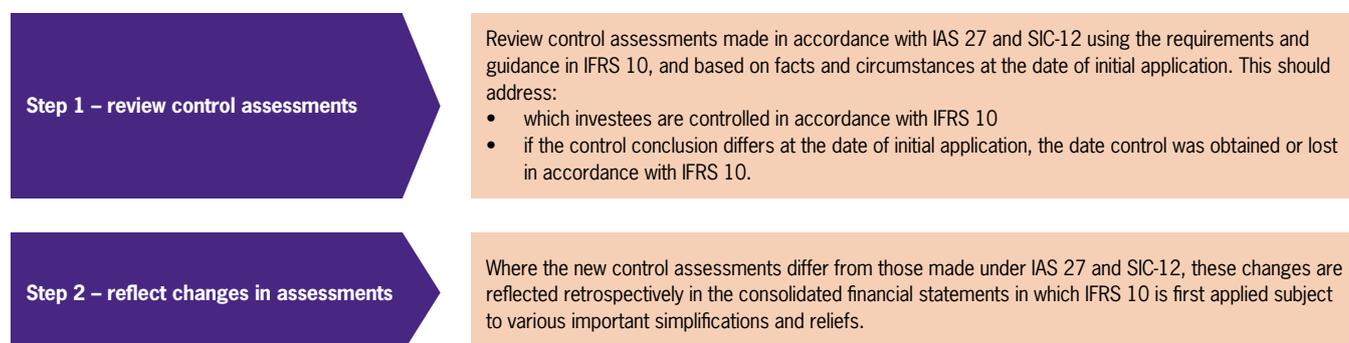
Definition of impractical [IAS 8.5]

Applying a requirement is impracticable when the entity cannot apply it after making every reasonable effort to do so. For a particular prior period, it is impracticable to apply a change in an accounting policy retrospectively or to make a retrospective restatement to correct an error if:

- (a) the effects of the retrospective application or retrospective restatement are not determinable;
- (b) the retrospective application or retrospective restatement requires assumptions about what management's intent would have been in that period; or
- (c) the retrospective application or retrospective restatement requires significant estimates of amounts and it is impossible to distinguish objectively information about those estimates that:
 - (i) provides evidence of circumstances that existed on the date(s) as at which those amounts are to be recognised, measured or disclosed; and
 - (ii) would have been available when the financial statements for that prior period were authorised for issue.

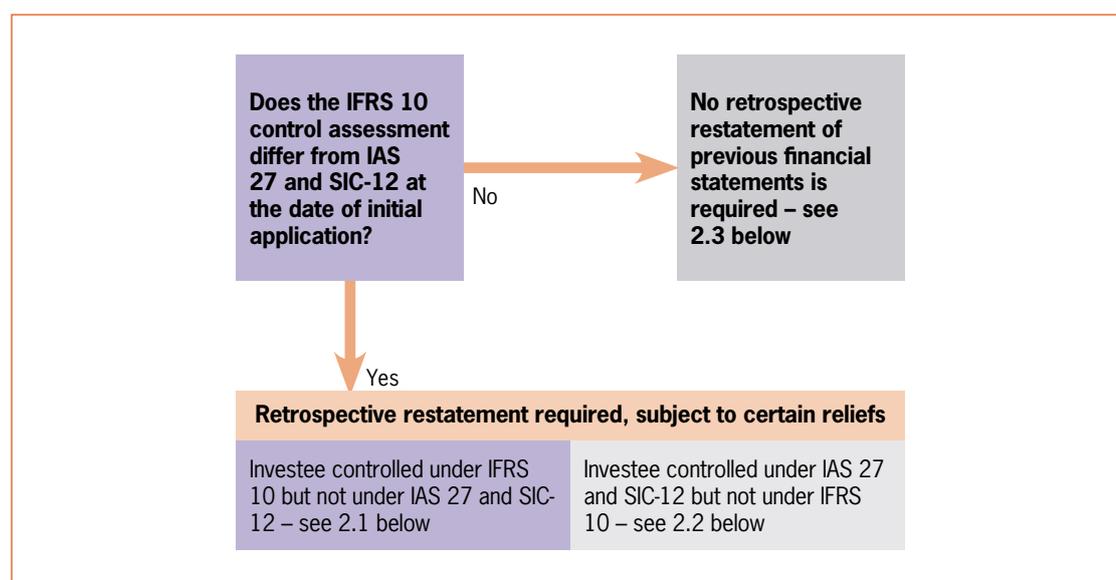
When IFRS 10 requires retrospective application, an investor is required to measure the investee's assets, liabilities, and non-controlling interests on the date of initial application as though the investee were consolidated from the date when the investor obtained control on the basis of the requirements in IFRS 10. In practice the transition from IAS 27/SIC-12 to IFRS 10 involves two main steps, summarised in Figure F.1 below:

Figure F.1 – Basic transition steps



The main ways in which IFRS 10 can affect the control assessments are summarised below, along with references to guidance on accounting for each scenario:

Figure F.2 – Control reassessments and retrospective restatement



2.1 Control under IFRS 10 but not under IAS 27 and SIC-12

For an investee consolidated under IFRS 10 that was not consolidated under IAS 27 and SIC-12, an investor is required to measure the investee’s assets, liabilities, and non-controlling interests on the date of initial application as though the investee were consolidated from the date when the investor obtained control on the basis of the requirements in IFRS 10.

If the investee is a business, acquisition accounting under IFRS 3 ‘Business Combinations’ is applied. If the investee is not a business, acquisition accounting under IFRS 3 is also applied but no goodwill is recognised [IFRS 10.C4].

The investor is required to adjust retrospectively the annual period immediately preceding the date of initial application. When the date that control was obtained is earlier than the beginning of the immediately preceding period, the consequent differences are recognised as an adjustment to equity at the opening date of the immediately preceding period (eg at 1 January 2012 for a reporting entity that applies IFRS 10 from 1 January 2013).

Put another way, restatement of comparative information is limited to the immediately preceding annual period. This will make a practical difference for reporting entities that are required (or choose) to present more than one comparative period. Such entities are nonetheless permitted to present adjusted comparative information for any earlier periods presented, but are not required to do so [IFRS 10.C6A].

If it is impracticable to measure the assets, liabilities, and non-controlling interests on the date the investor obtained control, the investor instead applies acquisition accounting as of a 'deemed acquisition date'. The deemed acquisition date is the beginning of the earliest period for which IFRS 10 is practicable, which may be the current period [IFRS 10.C4A].

Example F.2 – Investee consolidated under IFRS 10 but not under IAS 27

Entity P1 has an annual period end of 31 December and applies IFRS 10 for the first time for the annual period from 1 January to 31 December 2013.

On 1 March 2011 Entity P1 acquired a 45% shareholding in Entity A for cash consideration of CU900,000. Entity A operates a business*. In accordance with IAS 27 and IAS 28 Entity P1 concluded that it had significant influence, but not control, over Entity A on 1 March 2011 and subsequently. Accordingly, this investment was accounted for as an associate using the equity method.

On applying the guidance on control without a majority of voting rights in IFRS 10, Entity P1 concluded it controlled Entity A from 1 March 2011.

For the purpose of applying the equity method Entity P1 obtained information about the fair value of Entity A's underlying assets and liabilities as at 1 March 2011. The total fair value of its net assets was estimated to be CU1,800,000 (45% share = CU810,000).

Analysis:

Entity P1 should consolidate Entity A in its 31 December 2013 annual financial statements. Comparative information should be restated as though Entity A had been consolidated from 1 March 2011. P1 already has information about the fair value of Entity A's underlying assets and liabilities as at 1 March 2011. There is therefore no basis to apply 'impracticability' relief and use a later deemed acquisition date.

In practical terms restatement involves:

- including A's assets and liabilities in the consolidated statement of financial position at 31 December 2013 and in the comparative statements at 31 December 2011 and 2012, based on the fair values at 31 March 2011 (totalling CU1,800,000) and subsequent changes
- recognising a 55% non-controlling interest (NCI) in A's net assets in accordance with IFRS 3
- recognising goodwill of CU90,000 less any impairment (assuming that entity P1 applies IFRS 3's proportionate interest method for measuring NCI). Goodwill needs to be assessed for impairment in accordance with IAS 36 'Impairment of Assets'
- removing the related 'investment in associate' balance
- consolidating A's gross income and expenses, and allocating 55% to NCI from 1 March 2011
- removing the related 'share of income of associate' amounts from the statement of comprehensive income
- recognising any difference between the amount of assets, liabilities and NCI recognised and the previous carrying amount as an adjustment to equity at the beginning of the immediate comparative annual period.

* if Entity A is not a business then no goodwill would be recognised. In other respects the approach would be the same.

Practical insight – which versions of IFRS 3 and IAS 27 should be applied?

IFRS 3 (2008) is effective for business combinations in periods beginning on or after 1 July 2009. IFRS 3 (2008) differs from the previous version (IFRS 3 (2004)) in various important respects.

In addition, a revised version of IAS 27 (IAS 27 (2008)) was issued as part of the same package of changes and with the same effective date. The changes included new requirements on transactions with non-controlling interests (NCI) and loss of control. These requirements are carried forward into IFRS 10.

As noted above, an investor that is required to newly consolidate an investee on transition to IFRS 10 should apply IFRS 3 from the date it obtained control on the basis of IFRS 10 (the control date). If the control date is before the date IFRS 3 (2008) and IAS 27 (2008) became effective, which versions of these standards should be used for this purpose?

The IASB clarified this issue in the June 2012 amendment to IFRS 10. In summary the clarified rules state that:

- IFRS 3 (2008) must be used when the control date is after the effective date for that version of the standard
- for earlier control dates, the investor can choose which version of IFRS 3 to apply [IFRS 10.C4B]
- the IFRS 10 requirements on NCI transactions (etc) carried forward from IAS 27 (2008) must be applied to all comparative periods if the control date is after the effective date of IAS 27 (2008)
- for earlier control dates the investor can choose to:
 - apply the IFRS 10 requirements on NCI transactions (etc) to all comparative periods
 - apply the requirements of IAS 27 (2003) to periods before the effective date of IAS 27 (2008) and the IFRS 10 requirements to later periods [IFRS 10.C4C].

Example F.3 – Full retrospective application impractical

Entity P2 has a 31 December year-end and applies IFRS 10 for the first time for the annual period from 1 January to 31 December 2013. Entity P2 adopted IFRSs in 2005 and applied IFRS 1 'First-time Adoption of International Financial Reporting Standards' to its first IFRS financial statements.

In 2003, before its date of transition to IFRSs, Entity P2 acquired a 48% investment in Entity B (which operates a business). P2 treated Entity B as an associate in accordance with IAS 28. On adopting IFRSs in 2005 P2 took advantage of an exemption in IFRS 1 allowing it to use previous GAAP carrying values as the basis for accounting for pre-transition business combinations and investments in associates. Accordingly, P2 did not obtain comprehensive information about the fair value of Entity B's underlying assets and liabilities in 2003 (or on any later date).

The original cost of Entity P2's 48% investment in B was CU100,000. The carrying value of the investment at 1 January 2013 is CU250,000. Fair value as at this date is estimated to be CU300,000. The fair value of Entity B's underlying assets and liabilities (100%) is estimated to be CU700,000 at this date.

Entity P2's management determines that the earliest practical date to obtain information about the fair value of Entity B's underlying assets and liabilities is 1 January 2013.

On transition to IFRS 10 Entity P2 concludes that it obtained control of Entity B in 2003 on the basis of the revised guidance, and continues to have control on 1 January 2013. Entity P2 applies IFRS 3's proportionate interest method for measuring NCI.

Analysis:

In accordance with IFRS 10.C4(c) Entity P2 applies IFRS 3 from the beginning of the earliest period practical – 1 January 2013 in this case (the deemed acquisition date). To apply this approach P2:

- consolidates Entity B's assets and liabilities from 1 January 2013 based on fair values as of that date (totalling CU700,000)
- treats the fair value of its investment, of CU300,000, as the deemed consideration in accordance with IFRS 3. This results in negative goodwill of CU36,000 [(CU700,000 * 48%) – CU300,000]. However, unlike IFRS 3's normal approach, this is not reported as a gain. It is instead subsumed into the equity adjustment referred to below
- recognises a non-controlling interest of CU364,000
- reflects the difference between the revised carrying amount, net of NCI, and the previous carrying amount as an adjustment to equity on 1 January 2013*
- does not restate comparative information (ie continues to report Entity B as an associate in the comparative period)
- provides the disclosures required by IAS 28.28.

* In the consolidated financial statements of P2, the entry to be recorded at 1 January 2013 is:

	Debit CU	Credit CU
Net assets of B	700,000	
NCI (52%)		364,000
Investment in associate		250,000
Equity (difference)		86,000

Practical insight – when might full retrospective application be impractical?

We expect the availability (or non-availability) of adequate fair value information to be the most important factor in determining if full retrospective application is practical or impractical. If fair values were not obtained at the measurement date it is often challenging to obtain them retrospectively without introducing an inappropriate use of hindsight.

In many cases investees that are newly consolidated on applying IFRS 10 will previously have been accounted for as associates or joint ventures. In such cases some type of fair value exercise should have been performed when the investment was acquired (although Example F.3 above illustrates one scenario in which this may not be the case). This exercise will often be adequate to support acquisition accounting and consolidation on transition to IFRS 10. In certain cases, however, the fair value exercise might be insufficiently detailed. This could be because the investment was less material when treated as an associate or joint venture than it will be when consolidated (for example).

Other types of investees that may be affected by IFRS 10 include managed funds and many special purpose entities. In most such cases we would expect that fair value information will either be available or obtainable. However, this naturally depends on the specific facts and circumstances of each case.

2.2 Control under IAS 27 and SIC-12 but not under IFRS 10

For an investee that was consolidated under IAS 27 and SIC-12, but is no longer consolidated under IFRS 10, an investor is required to measure its interest on the date of initial application at the amount that would have been shown if the requirements of IFRS 10 had been effective when the investor first became involved with the investee [IFRS 10.C5].

Similar reliefs on retrospective adjustment of comparatives apply as for newly consolidated investees (see 2.1 above). Accordingly, the investor retrospectively adjusts only the annual period immediately preceding the date of initial application. When the date that the investor became involved with, or lost control of, the investee is earlier than the beginning of that annual period, consequent differences are recognised as an adjustment to equity at the opening date of that period (eg at 1 January 2012 for a reporting entity that applies IFRS 10 from 1 January 2013).

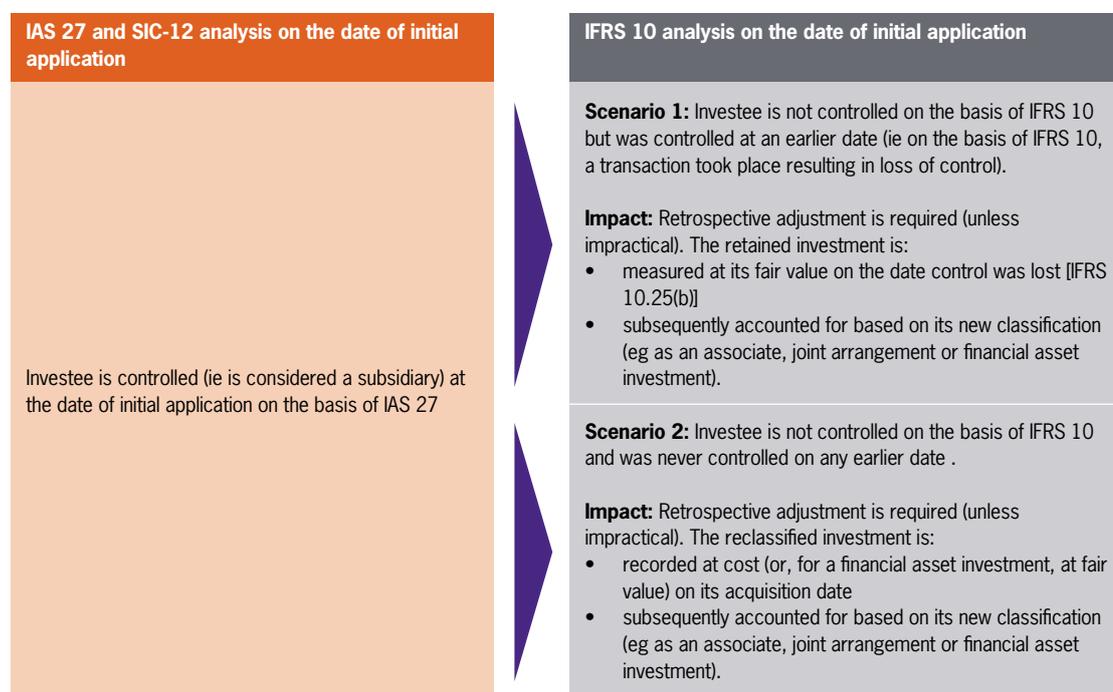
If it is impracticable to measure the retained interest on that date, the investor must apply the requirements for accounting for a loss of control under IFRS 10 at the beginning of the earliest period in which application of IFRS 10 is practicable, which may be the current period [IFRS 10.C5A].

When an investor concludes at the date of initial application that, under IFRS 10, it does not control an investee that was consolidated under IAS 27/SIC-12, it should also assess whether it:

- had control in the past on the basis of IFRS 10 but then lost control; or
- never had control.

This is because the practicalities of retrospective application differ in these two scenarios. This is described in Figure F.3 below:

Figure F.3 – Two different deconsolidation scenarios



IFRS 10.C5A’s relief for impracticability relates to both scenarios.

Practical insight – when might full retrospective application be impractical?

We expect that it will rarely be impractical to deconsolidate on a retrospective basis on transition to IFRS 10. This is because the investor already has extensive information about the investee from consolidating its results and net assets in previous periods. This information should enable the investor to account retrospectively for the investee’s revised classification (as an associate, joint arrangement or financial asset investment).

However, challenges to retrospective application may arise in the following situations:

- if an investor had control under IFRS 10 but then lost it (scenario 1 above) it will need to obtain fair value information about the retained investment on the date of loss of control. If loss of control arose from a market-based sale of shares to a third party, the transaction price should provide suitable fair value information. However, control could also be lost in other ways that do not involve a market-based sale
- if the revised classification is a financial asset within the scope of IAS 39 (or IFRS 9), fair value information will be needed at the beginning of the immediately preceding period and possibly at earlier dates. If fair values were not obtained at the measurement date it is often challenging to obtain them retrospectively without introducing an inappropriate use of hindsight. IAS 39’s impairment requirements for available-for-sale equity investments may also come into play.

Example F.4 – Deconsolidation on transition

Entity P3 has a year-end of 31 December and applies IFRS 10 for the first time for the annual period from 1 January to 31 December 2013.

On 1 June 2008, P3 acquired a 55% investment in Entity C from Investor D for CU800. Investor D retained 45% and also retained various rights to direct activities under a management contract. Entity P3 treated Entity C as a subsidiary in accordance with IAS 27. On transition to IFRS 10 P3 concluded that it has neither control nor significant influence/joint control (because of Investor D's rights under its management contract). P3 therefore reclassifies the investment as an available-for-sale (AFS) financial asset in accordance with IAS 39 'Financial Instruments: Recognition and Measurement'.

Selected financial data about Entity C:

	1 June 2008	31 Dec 2011	31 Dec 2012
	CU	CU	CU
Goodwill	140	140	140
Net assets	1,200	1,400	1,600
NCI (45%)	540	630	720
Fair value of 55% investment	800	900	950

Analysis:

In accordance with IFRS 10.C5 Entity P3 should deconsolidate its investment in Entity C retrospectively. The entries required to do this at 31 December 2012 and 2011 are:

At 31 December 2012:	Debit CU	Credit CU
AFS investment	950	
NCI (equity)	720	
Net assets of C		1,600
Goodwill		140
Retained profits (equity)	220	
AFS reserve (equity)		150
At 31 December 2011:	Debit CU	Credit CU
AFS investment	900	
NCI (equity)	630	
Net assets of C		1,400
Goodwill		140
Retained profits (equity)	110	
AFS reserve (equity)		100

Practical insight – complications with retrospective application

As noted above, retrospective deconsolidation of an investee that was consolidated under IAS 27/SIC-12 should be practical in most cases. This is because the investor already has extensive information about the investee as a result of consolidating it in previous periods.

That said, a number of complications will arise in specific situations. Examples include:

- **options over the investee:** if the investor has 'fixed-for-fixed' options to acquire more shares in the investee these would be classified as equity while the investee is a subsidiary. When the investee is reclassified the option would need to be treated as a derivative and measured at fair value though profit or loss.
- **impairment:** any goodwill impairments recognised while the investee was accounted for as a subsidiary will of course need to be reversed on reclassification. The investor will also then need to retrospectively apply the applicable impairment requirements based on the revised classification (such as the requirements on impairment of AFS financial assets in Example F.4 above).

- **deferred tax:** IAS 12 'Income Taxes' sets out some exemptions from recognising a deferred tax liability for a taxable temporary difference on an investment in a subsidiary (a so-called outside basis difference) [IAS 12.39]. Reclassification of an investee will normally affect the carrying value (and therefore the temporary difference under IAS 12). Also, the recognition exemption in IAS 12.39 may no longer apply if the investee is no longer a subsidiary.
- **hedging:** certain hedging arrangements entered into by the investor in respect of transactions of the investee will no longer qualify for hedge accounting when the investee is reclassified.

2.3 Same control assessment on date of initial application

When applying IFRS 10 for the first time, an entity is not required to make adjustments to the accounting for its involvement with either investees that were:

- previously consolidated in accordance with IAS 27 and SIC-12 and continue to be consolidated under IFRS 10; or
- previously unconsolidated in accordance with IAS 27 and SIC-12 and continue not to be consolidated [IFRS 10.C3].

This is an important relief. For example, it means an investor is not required to make any retrospective adjustments for situations in which, on the date of initial application:

- it no longer controls a former subsidiary under both IAS 27 and IFRS 10, but the date on which control was lost is different on the basis of the two standards
- it controls an investee in accordance with both IAS 27 and IFRS 10, but the date on which control was obtained differs
- it obtained then lost control over an investee prior to the date of initial application under one standard but never had control under the other standard.

Example F.5 – Effective date and early application

Entity P4 has a year-end of 31 December and applies IFRS 10 for the first time for the annual period from 1 January to 31 December 2013.

P4 acquires 48% of Company B on 22 December 2011 and has a substantive option to acquire the majority of the shares of Company B. Decisions about relevant activities of Company B are controlled by simple majority vote at general meetings of the shareholders. A minimum of 45-days' notice is required to hold such a meeting.

P4's option can be exercised only after giving 30-days' notice. In accordance with IAS 27, management determined that Company B was not controlled on 31 December 2011 as the option was not 'currently exercisable'. The option was exercised during January 2012 and Company B was consolidated from then.

When preparing the consolidated financial statement for the year-ended 31 December 2013 management determines that, if P4 had applied IFRS 10 in 2011, it would have consolidated Company B from 22 December 2011 on the grounds that it could have exercised the option before the next shareholder meeting at which decisions about relevant activities could be made.

Is P required to make any retrospective adjustments when it first applies IFRS 10?

Analysis:

No – retrospective adjustments are not required. At the date of initial application (1 January 2013 in this case), the control assessment is the same under both IFRS 10 and IAS 27. However, the date of obtaining control differs between IAS 27 and IFRS 10. IFRS 10.C3 provides relief from restatement in this situation.

However, because IFRS 10.C3 is a non-mandatory relief, P4 is nonetheless permitted to retrospectively consolidate Company B from 22 December 2011 if wishes to do so (for example to enhance the comparability of its financial statements for the two years ended 31 December 2013).

2.4 NCI transactions and loss of control on transition

IAS 27 was amended in 2008 (resulting in IAS 27(2008)). New or amended requirements, effective for annual periods commencing on or after 1 July 2009, were introduced covering:

- the allocation of losses to NCI when this results in a debit balance
- changes in the parent's ownership of a subsidiary that do not result in loss of control (NCI transactions)
- loss of control of a subsidiary.

These requirements are carried forward unchanged in IFRS 10 and are discussed in Section E.

IAS 27(2008) required these changes to be accounted for prospectively. IFRS 10 requires that those prospective changes continue to be dealt with prospectively (from the date the investor originally applied them) [IFRS 10.C6]. Put another way, an investor that previously transitioned from the former version of IAS 27 to IAS 27(2008) does not re-perform or revisit that exercise when it applies IFRS 10.

These requirements appear rather obscure and complex. However, they will rarely have a significant impact in practice because (as discussed above):

- IFRS 10.C5A allows some flexibility on which version of IAS 27 is applied in accounting for NCI transactions when an investee is newly consolidated on transition to IFRS 10; and
- IFRS 10.C3 provides relief from retrospective application when the control assessment is unchanged at the date of initial application.

Example F.6 below illustrates one situation in which there may be some impact.

Example F.6 – Past allocation of losses to NCI if investor chooses not to apply IFRS 10.C3

Entity P6 is applying IFRS 10 for the first time in the annual period from 1 January to 31 December 2013.

P6 has held a controlling interest in Subsidiary S (under both IAS 27 and IFRS 10) since 2006. Subsidiary S incurred losses between 2006 and 2009. P6 adopted the changes to IAS 27 (2008) for the annual period commencing 1 January 2010. However, the NCI balance at 1 January 2013 does not reflect the NCI's proportionate share of losses as a result of:

- the pre-2008 restrictions in IAS 27 on allocation of losses to NCI; and
- the prospective application of the changes in IAS 27(2008)

On transition to IFRS 10 Entity P6's management decide not to apply IFRS 10.C3 as they wish to make adjustments to 'true up' the allocation of past losses to NCI.

Is this acceptable?

Analysis:

No. IFRS 10.C6(a) states that: "an entity shall not restate any profit or loss attribution for reporting periods before it applied the amendment in paragraph B94 for the first time." In this case P6 applied paragraph B94 from 2010. P6 is therefore not permitted to make any restatements relating to the attribution of losses to NCI from 2006 to 2009.

Appendix A – Disclosures under IFRS 12: Understanding the requirements

1 Overview

IFRS 12 ‘Disclosure of Interests in Other Entities’ (IFRS 12) was published in May 2011 in response to users’ requests to improve financial statement disclosures about entities’ interests in other entities. The need for improvement in this area became more evident following the global financial crisis that began in 2007. The crisis exposed a lack of transparency about the risks faced by reporting entities as a result of their involvement with other entities.

The IASB answered the requests for more transparency and took the opportunity to integrate and make consistent the disclosure requirements for an entity’s interest in a subsidiary, joint arrangement, associate or unconsolidated structured entity by issuing IFRS 12.

Practical insight – reputation risk

During the financial crisis, some financial institutions stepped in to provide financial support to failing entities which they had sponsored (or had other relationships with) without having a contractual obligation to do so in attempt to protect their own reputations. As it is not possible to build reputational risk into an accounting standard, the IASB attempted to strengthen the disclosure requirements via IFRS 12 to provide more transparency to financial statement users which would paint a more complete picture of these types of relationships and resulting risks. As a result, the disclosure requirements shed new light on instances whereby an entity has provided support in the past or intends to do so in the future, even when under no obligation to do so.

1.1 Objective

The objective of IFRS 12 is to require an entity to disclose information that enables users of its financial statements to evaluate an entity’s so-called interests in other entities. In slightly more detail:

Objective of IFRS 12 [IFRS 12.1]:

The objective of IFRS 12 is to require an entity to disclose information that enables users of its financial statements to evaluate:

- the nature of, and risks associated with, its interests in other entities; and
- the effects of those interests on its financial position, financial performance and cash flows [IFRS 12.1].

To meet the objective, an entity shall disclose:

- significant judgements and assumptions made in determining the nature of its interest in another entity or arrangement
- information about its interests in subsidiaries, joint arrangements and associates, and unconsolidated structured entities [IFRS 12.2].

1.2 Scope

IFRS 12 applies to any entity that has an interest in a subsidiary, joint arrangement, associate, or unconsolidated structured entity, subject to the exclusions noted below.

IFRS 12 defines ‘interest in another entity’ broadly:

Definition of interest in another entity [IFRS 12.Appendix A]

As defined in IFRS 12, an interest in another entity:

- may include contractual or non-contractual involvement
- exposes an entity to variability of returns from the performance of the other entity
- may include, but is not limited to, the holding of equity or debt instruments, provision of funding, liquidity support, credit enhancements, or guarantees
- includes the means by which an entity has control, joint control or significant influence over another entity.

The entity shall also consider the purpose and design of the other entity (eg the risks that the entity was designed to create and/or pass on to the reporting entity or third parties) when assessing if it has an interest [IFRS 12.B7].

Scope exclusions [IFRS 12.6]:

IFRS 12 does not apply to:

- post-employment or other long-term employee benefit plans within the scope of IAS 19 ‘Employee Benefits’
- an entity’s separate financial statements within the scope of IAS 27 ‘Separate Financial Statements’¹
- an interest held by an entity that participates in, but does not have joint control of, a joint arrangement unless that interest results in significant influence over the joint arrangement or is an interest in a structured entity
- an interest that is accounted for in accordance with IFRS 9 ‘Financial Instruments’, unless that interest is an associate or joint venture measured at fair value through profit or loss or an unconsolidated structured entity.

1.3 Level of aggregation

Financial statement preparers must strike the difficult balance between providing excessive detail and obscuring information as a result of over-aggregation [IFRS 12.B2]. IFRS 12 provides the following application guidance to achieve this balance:

- present interests in subsidiaries, joint ventures, joint operations, associates and unconsolidated structured entities separately
- consider quantitative and qualitative information about the risk and return characteristics of each entity considered for possible aggregation
- consider the significance of each entity to the reporting entity
- examples of aggregation levels that may be appropriate include those based on the nature of activities, industry classification or geography [IFRS 12.B4-B6].

¹ If an entity has interests in unconsolidated structured entities and prepares separate financial statements as its only financial statements, it shall apply the requirements in IFRS 12 applicable for interests in unconsolidated structured entities.

2 Specific disclosure requirements

2.1 Summary

IFRS 12's disclosure requirements cover four main areas, as summarised below:

Area	More information
Judgements and estimates	<ul style="list-style-type: none">• See 2.2 below
Interests in subsidiaries	<ul style="list-style-type: none">• See 2.3 below
Interests in joint arrangements and associates	<ul style="list-style-type: none">• An entity shall disclose information that enables users of its financial statements to evaluate:<ul style="list-style-type: none">– the nature, extent and financial effects of its interests in joint arrangements and associates, including the nature and effects of its contractual relationship with the other investors with joint control of, or significant influence over, joint arrangements and associates; and– the nature of, and changes in, the risks associated with its interests in joint ventures and associates• Detailed requirements are set out in IFRS 12.20-23 and B10-B20
Interests in unconsolidated structured entities	<ul style="list-style-type: none">• See 2.4 below

The remainder of this Appendix considers these requirements in more detail. The guidance focuses on the disclosures applicable to consolidated entities (and unconsolidated structured entities) rather than joint arrangements and associates.

2.2 Significant judgements and estimates

IFRS 12 goes further than existing guidance² in requiring disclosure about situations in which an entity applies significant judgement in assessing the nature of its interest in another entity. Specifically, the reporting entity shall disclose the judgements and assumptions made in determining that it has control, joint control, significant influence or an interest in another entity. Other required disclosures include the judgements and assumptions made when:

- changes in facts and circumstances result in a change in the control assessment during the reporting period [IFRS 12.8]
- a variance from the general control and non-control assumptions exists (eg control exists despite holding less than half of the voting rights of the other entity) [IFRS 12.9]
- concluding if an agent or principal relationship exists [IFRS 12.9].

The requirements are set out below:

² Currently IAS 1 'Presentation of Financial Statements' requires an entity to disclose the judgements made by management in applying the entity's accounting policies and that have the most significant effect on the amounts recognised in the financial statements [IAS 1.122] while IAS 27 and IAS 28 supplement the general requirements requiring more specific disclosure when the assessment differs from the presumptions of control or significant influence [IFRS 12.BC.15].

Disclosure area	Required disclosures
Details of significant judgements and assumptions made [IFRS 12.7 and 9]	<ul style="list-style-type: none"> • significant judgements and assumptions made in determining that the investor: <ul style="list-style-type: none"> – controls another entity – does not control another entity – has joint control or significant influence • examples may include, but shall not be limited to situations in which an investor: <ul style="list-style-type: none"> – does not control another entity even though it holds more than half of the voting rights of the other entity – controls another entity even though it holds less than half of the voting rights of the other entity – is an agent or a principal
Details when facts and circumstances change during the reporting period [IFRS 12.8]	<ul style="list-style-type: none"> • significant judgements and assumptions made when changes in facts and circumstances result in a change in the conclusion regarding control

2.3 Disclosures related to interests in subsidiaries

The table below summarises IFRS 12's disclosure requirements related to interests in subsidiaries:

Disclosure area	Required disclosures
Objectives [IFRS 12.10]	<ul style="list-style-type: none"> • disclose information that enables users to understand/evaluate: <ul style="list-style-type: none"> – the composition of the group – interests of non-controlling interests in the group's activities and cash flows – significant restrictions on ability of the reporting entity to access/use group assets and/or settle group liabilities – nature of and changes to risks associated with interest in consolidated structured entities – consequences of changes in ownership in a subsidiary that do not result in a loss of control – consequences of losing control of a subsidiary during the reporting period
Non-coterminous period ends [IFRS 12.11]	<ul style="list-style-type: none"> • if the period-end dates of the subsidiary's financial statements and the consolidated financial statements differ, disclose: <ul style="list-style-type: none"> – the reporting period end date of the subsidiary and – the reason for using a different date or period
Interest that non-controlling interests have in the group's activities and cash flows [IFRS 12.12]	<ul style="list-style-type: none"> • for material non-controlling interests, disclose: <ul style="list-style-type: none"> – the name of the subsidiary – the principal place of business and country of incorporation (if different) – the proportion of ownership interests held by non-controlling interests – the proportion of voting rights held by non-controlling interests (if different from the proportion of interests held) – the profit or loss allocated to non-controlling interests of the subsidiary during the reporting period – the accumulated non-controlling interests of the subsidiary at the end of the reporting period – summarised financial information about the subsidiary [IFRS 12.B10-B11]

Disclosure area	Required disclosures
Nature and extent of significant restrictions [IFRS 12.13]	<ul style="list-style-type: none"> • significant restriction on its ability to access or use assets and settle the liabilities, such as: <ul style="list-style-type: none"> – those that restrict its ability (or its subsidiary's ability) to transfer cash or other assets to or from other entities within the group – guarantees – restrictions on dividends and other capital distributions being paid, – restrictions on loans and advances made/repaid to/from other entities within the group • nature and extent to which protective rights of non-controlling interests can significantly restrict the entity's ability to access or use the assets and settle the liabilities of the group • carrying amounts of the assets and liabilities in the consolidated financial statements to which the restrictions apply
Nature of, and changes to, risks associated with interest in consolidated structured entities [IFRS 12.14-17]	<ul style="list-style-type: none"> • terms of any contractual arrangement(s) that could require the parent or its subsidiaries to provide financial support to a consolidated structured entity (including events or circumstances that could expose the reporting entity to a loss), such as: <ul style="list-style-type: none"> – liquidity arrangements or credit rating triggers (obligating it to purchase assets or provide financial support) • when the parent or any of its subsidiaries provided financial or other support to a consolidated structured entity (without having a contractual obligation to do so), disclose: <ul style="list-style-type: none"> – the type and amount of support provided – the reason for providing the support • relevant factors for consolidating (concluding control exists) a previously unconsolidated structured entity after providing financial or other support • current intentions to provide financial or other support to a consolidated structured entity, including intentions to assist the structured entity in obtaining financial support
Consequences of changes in a parent's ownership interest in a subsidiary, not resulting in a loss of control [IFRS 12.18]	<ul style="list-style-type: none"> • schedule showing effects on the equity attributable to owners of the parent of any changes in its ownership interest that do not result in a loss of control
Consequences of losing control of a subsidiary during the reporting period [IFRS 12.19]	<ul style="list-style-type: none"> • gain or loss, if any, calculated in accordance with IFRS 10 • the portion of that gain or loss attributable to measuring any investment retained in the former subsidiary at its fair value at the date when control is lost • the line item(s) in profit or loss in which the gain or loss is recognised, if not presented separately

2.4 Disclosures related to interests in unconsolidated structured entities

IFRS 12 introduces and defines the term 'structured entity' as:

Definition of structured entity [IFRS 12.Appendix A]

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.

The disclosure requirements include information about ‘interests’ (see 1.2 above) in structured entities that are not consolidated. These are as follows:

Disclosure area	Required disclosures
Objective [IFRS 12.24]	<ul style="list-style-type: none"> • to disclose information that enables users to understand/ evaluate <ul style="list-style-type: none"> – nature/extent of interests in unconsolidated structured entities – nature of and changes in risks associated with interests in unconsolidated structured entities (includes information about exposure to risk from involvement that it had with unconsolidated structured entities in previous periods (eg sponsoring the structured entity), even if reporting entity no longer has any contractual involvement at the reporting date)
Nature and extent of interests [IFRS 12.26 -28]	<ul style="list-style-type: none"> • qualitative and quantitative information about its interests including, but not limited to, the below information about the structured entity: <ul style="list-style-type: none"> – nature – purpose – size – activities – how the entity is financed • for sponsored unconsolidated structures whereby the parent does not have an interest at the reporting date: <ul style="list-style-type: none"> – how it determined which structured entities it sponsored – income from those structured entities in the period – description of the types of income presented (presented in tabular format and by relevant categories) – carrying amount (at the time of transfer) of all assets transferred to those structured entities during the reporting period (presented in tabular format and by relevant categories)
Nature of risks [IFRS 12.29 – 31]	<ul style="list-style-type: none"> • tabular presentation (unless another format is more appropriate) of: <ul style="list-style-type: none"> – carrying amounts of assets and liabilities recognised in its financial statement relating to interests in unconsolidated structured entities – line items in the statement of financial position in which those assets and liabilities are recognised – best estimate of maximum exposure to loss from interests in unconsolidated structured entities and how determined (if an amount cannot be determined, disclose that fact and the reason) – comparison of carrying amounts of assets and liabilities relating to interests in unconsolidated structured entities and maximum exposure to loss from those entities • the entity's exposure to risk due to its involvement with the structured entity in previous periods (regardless of whether the entity has contractual involvement with the structured entity at the reporting date) • when financial or other support was provided to an unconsolidated structured entity, in the absence of any contractual obligation to do so, disclose the: <ul style="list-style-type: none"> – type and amount of support provided (including assisting in obtaining financial support) – reason for providing the support (regardless if the entity has contractual involvement with the structured entity at the reporting date) • current intentions to provide financial or other support to an unconsolidated structured entity, including intentions to assist the structured entity in obtaining financial support.

Practical insight – link with IFRS 7

IFRS 12's requirements with respect to unconsolidated structured entities appear to overlap with some of the risk disclosures in IFRS 7 Financial Instruments: Disclosures (IFRS 7). IFRS 7 requires disclosure of qualitative and quantitative information about risks arising from financial instruments held by the reporting entity.

While the Board agreed that these requirements will often result in disclosure of the same underlying risks, the disclosure requirements of IFRS 12 and IFRS 7 differ in how they describe the reporting entity's risk exposure. IFRS 12 requires an entity to disclose its exposure to risk from its interest in the structured entity and therefore while they may overlap, both perspectives are necessary and complimentary [IFRS 12.BC72 – BC 74].

2.5 Effective date

Entities shall apply IFRS 12 for annual periods beginning on or after 1 January 2013 [IFRS 12.C]. The IASB encourages early adoption of some or all requirements of IFRS 12 when providing such information allows financial statement users to gain a better understanding of the entity's relationships with other entities [IFRS 12.BC119]. Entities may do so without having to adopt all disclosure requirements or applying IFRS 10, IFRS 11, IAS 27 (as amended in 2011) and IAS 28 (as amended in 2011) at the same time [IFRS 12.C2].

3 Selective illustrative disclosures

This Section provides an example of select disclosures required by IFRS 12, specifically those related to:

- significant judgements and assumptions
- interests in unconsolidated structured entities.

The sample disclosures are not intended to illustrate all of the required disclosures in all circumstances. The form and content of the disclosures will depend on the specific facts and circumstances of each entity's relationships with other entities. Accordingly, the illustrative disclosures should be amended, amplified or abbreviated to reflect such specific circumstances.

The illustrative disclosures presented below represent excerpts from the 31 December 2011 consolidated financial statements of a fictional company, ABC Corporation Group (the Group). The Group manufactures, sells and leases automobiles to end-use customers and dealerships.

A. Significant judgements and estimates

The Group made certain judgements and assumptions in determining the appropriate accounting policies to apply with respect to its interests in other entities as outlined below:

IFRS 12.7(a) **Consolidation of Wheel Limited**

IFRS 12.9(b) The Group holds 40% ownership interest and voting rights in Wheel Limited. The remaining 60% ownership interest and voting rights are held by thousands of shareholders. Wheel Limited's Board of Directors maintains the power to direct the major activities and operations of Wheel Limited while the Group has the ability to appoint and remove the majority of the Board of Directors.

When determining control, management considered whether the Group has the practical ability to direct the relevant activities of Wheel Limited on its own to generate returns for itself. Management concluded that it has the power based on its ability to appoint and remove the majority of the Board of Directors at any time, without restrictions. The Group therefore accounts for Wheel Limited as a subsidiary, consolidating its financial results for the reporting period.

B. Unconsolidated structured entities

IFRS 12.24(a) **Involvement in Dealer Limited**

IFRS 12.26 The Group facilitated the establishment of a structured entity (Dealer Limited) on behalf of third party automobile dealers during 2009. The purpose of the arrangement is to securitise third party receivables originated by dealers. The cash received from the collection of the receivables is used to service the finance provided by the investors.

The Group determined that it does not control Dealer Limited as it has limited involvement with the structured entity, comprised of facilitating the establishment of the entity, providing asset management services, credit guarantees and investments in the structured entity. The relationship with Dealer Limited subjects the Group to losses that are potentially significant; however, the Group has no means of exerting power over the activities of Dealer Limited and therefore, does not control it. Dealer Limited generally finances its activities through issuing debt securities.

IFRS 12.24(b) **Carrying amount of assets and liabilities in Dealer Limited recognised in the Group's Statement of Financial Position**

IFRS 12.29(a)-(b) Class of Financial Asset	Investments	Credit Guarantees	Total assets	Total liabilities
	CU'000	CU'000	CU'000	CU'000
Debt Securities	2,680	0	2,680	0
Financial Guarantee Contracts	0	(10)	0	(10)
Total	2,680	(10)	2,680	(10)

IFRS 12.29(c) **Maximum exposure to loss in Dealer Limited**

IFRS 12.B26(a)(i) The group provides certain financial guarantee contracts which require it to reimburse investors for certain losses incurred when a debtor defaults on payment, up to 1% of the receivable. The Group calculates the maximum exposure to loss from Dealer Limited as the notional amounts of the guarantees, less any related liabilities recognised. The Group recognised a liability of CU10,000 relating to financial guarantee contracts at 31 December 2011.

The maximum exposure to loss related to the Group's investments is the carrying amount of the investments.

The table below outlines the maximum exposure to loss in Dealer Limited.

IFRS 12.29(c)-(d) Type of Asset in Dealer Limited	Current Carrying Amount of Assets Held by Dealer Limited		Group's Maximum Exposure to Loss			Carrying Amount in the Statement of Financial Position	
	CU'000	CU'000	Total Investments	Credit Guarantees	Assets	Liabilities	
							CU'000
Finance Receivables	100,000	1,000	0	1,000	0	(10)	
Debt Securities	60,000	2,680	2,680	0	2,680	0	
Total	160,000	3,680	2,680	1,000	2,680	(10)	

IFRS 12.27(b) **Income received during the reporting period from Dealer Limited**

IFRS 12.B26(c) The Group's asset management duties include collecting payments on the securitised assets and preparing monthly investor reports on the performance of the securitised assets, including amounts of interest and/or principal payments to be made to investors. For the year-ended 31 December 2011, the Group recognised CU37,000 in asset management fees from Dealer Limited.

IFRS12.30(a)-(b) **USE Limited**

Other support provided in the reporting period

USE Limited is a structured entity that the Group sponsored in 2008. During the period, USE Limited communicated that it was having difficulties in obtaining funding from other sources. As a result, the Group provided short-term funding to USE Limited of CU35,000. USE Limited repaid the full amount in 15 days and no additional support has been provided. Although the Group was not required to provide funding by contract, it did so as it considered the related risk to be minimal.

USE Limited discontinued its operations on 15 December 2011. More information about USE Limited including fees earned and the carrying amount of all assets transferred to USE Limited during the reporting periods identified (up to the time of transfer) is provided below.

IFRS 12.27(b) Type of Asset in USE Limited	Fee Income for the Year Ended		
	CU'000	CU'000	CU'000
	2011	2010	2009
Finance Receivables	25	23	26
Asset-Backed Securities	252	215	220
Total	277	238	246

IFRS 12.27(a) The Group considers itself to have sponsored another entity when it provides any funding to establish it and participates in the design of the entity.

The Group's asset management duties include collecting payments on the securitised assets and preparing monthly investor reports on the performance of the securitised assets, including amounts of interest and/or principal payments to be made to investors. For the year-ended 31 December 2011, the Group recognised CU277,000 in asset management fees from USE Limited.

IFRS 12.27(c) Type of Asset in USE Limited	Assets Transferred to USE Limited		
	CU'000	CU'000	CU'000
	2011	2010	2009
Finance Receivables	300	276	312
Total	300	276	312

Practical insight – structured entities in which investor has no remaining interest

If an entity no longer has an interest in an unconsolidated structured entity at the end of the reporting period, it is not required to apply IFRS 12.29. However, to provide users with information about the scale of its operations derived from transactions with unconsolidated structured entities (including those no longer held at period-end), the IASB decided to require entities to disclose income derived from, and asset information about, structured entities that the entity has sponsored to provide a sense of the scale of the operations and extent of the entity's reliance on such unconsolidated structured entities [IFRS 12.BC.89 and 90].

Appendix B – Investment entities

1 Overview

Neither IFRS 10 nor IAS 27 provide any exemption from consolidation of controlled investees for investment entities or similar. As a result, investment entities are required to consolidate any controlled investee entities in the same way as any other parent entity.

However, many commentators have long held the view that consolidating the financial statements of an investment entity and its investees does not provide the most useful information, regardless of whether some of the investees are controlled. In particular, consolidation makes it difficult for investors to judge the value of these investments, and investors are more interested in the fair value of their investments.

The IASB has evidently become persuaded by these arguments and, in August 2011, published an exposure draft ‘Investment Entities’ (the ED). The ED proposed an exception to the consolidation principle such that a qualifying investment entity would:

- measure its investments in controlled entities at fair value through profit or loss
- provide additional disclosures to enable users of its financial statements to evaluate the nature and financial effects of its investment activities
- have to meet six detailed criteria, all of which would need to be met, to qualify as an investment entity:

Criteria to be an investment entity in August 2011 Exposure Draft

An entity is an investment entity in accordance with the IASB’s August 2011 proposal if it meets all the following criteria:

- the entity’s nature is such that its only substantive activities are investing in multiple entities to achieve capital appreciation, earn investment income, or both
- the entity’s business purpose is investing to earn capital appreciation, investment income, or both and it makes an explicit commitment to investors about this
- investors own units of investments (eg shares or partnership interests) in the entity
- the entity pools the funds it receives from its investors, so that the investors can benefit from professional investment management
- the entity manages and evaluates the performance of its investments on a fair value basis
- the entity provides financial information about its investment activities to its investors.

The ED also proposed that a parent of an investment entity would not retain the fair value accounting that is applied by its investment entity subsidiary to controlled entities in its own consolidated financial statements, unless the parent qualifies as an investment entity itself. As a consequence, a parent of an investment entity would consolidate all entities it controls, including those that are controlled by an investment entity subsidiary, unless the parent itself is an investment entity. When consolidating, a parent of an investment entity would, however, retain the fair value accounting applied by the investment entity to investments in associates and joint ventures and other non-controlled entities.

2 Current developments and status

The ED closed for comment in January 2012 and the IASB has been re-deliberating its proposals since then. Based on the most recent discussions, the Board appears to be moving towards a less prescriptive definition of investment entities. In June 2012 the IASB tentatively decided that the definition of an investment entity would be as follows:

June 2012 proposed definition of investment entity

Based on the IASB's latest re-deliberations (June 2012):

- An investment entity does all of the following:
 - obtains funds from an investor or investors and provides the investor(s) with professional investment management services;
 - commits to its investor(s) that its business purpose and only substantive activities are investing the funds for returns from capital appreciation or capital appreciation and investment income; and
 - manages and evaluates the performance of substantially all of its investments on a fair value basis.
- An investment entity and its affiliates do not obtain, or have the objective of obtaining, returns or benefits from their investments that are either of the following:
 - other than capital appreciation or capital appreciation and investment income; and
 - not available to other non-investors or are not normally attributable to ownership interests
- An entity that has more than an insignificant amount of investments that are not managed on a fair value basis or held for investment income only would not be an investment entity.

The IASB has also made a number of other (tentative) decisions regarding application guidance and other detailed aspects of how the proposed exemption will work.

The IASB's June 2012 work-plan indicates that the Board expects to finalise this project, and publish amendments to IFRSs 10 and 12, by the end of 2012.

3 Interaction with IFRS 10

If finalised along the lines proposed, these changes would clearly result in the assessment of control over investees becoming much less significant for qualifying investment entities. However, the control assessment would remain relevant because such entities would still need to:

- consolidate subsidiaries that provide services to the investment entity (ie are not 'investments')
- determine which investments it controls based on IFRS 10's definition and guidance, in order to meet the disclosure requirements of IFRS 12 (as amended or supplemented by the new IFRS).

Practical insight – interaction with IFRS 10's principal versus agent guidance

IFRS 10's guidance on principal-agent (delegated power) is currently relevant to many of the investment entities that might in future be exempted from consolidation. Examples include many venture capital organisations and fund managers.

While, as noted above, these entities would still need to assess control (and therefore whether they are principal or agent) for disclosure purposes, the outcome of this assessment will be much less sensitive if it no longer determines whether an investee needs to be consolidated.



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