

# Applying IFRS

IFRS 10 Consolidated Financial Statements

## Challenges in adopting and applying IFRS 10

December 2013



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# Introduction

IFRS 10 *Consolidated Financial Statements* was issued by the IASB in May 2011 together with an amended version of IAS 27 *Separate Financial Statements* and IFRS 12 *Disclosure of Interests in Other Entities*. These standards are effective for annual periods beginning on or after 1 January 2013 and must be applied retrospectively, subject to certain transition rules.

In June 2012, IFRS 10 and IFRS 12 were amended by *Consolidated Financial Statements, Joint Arrangements and Disclosure of Interests: Transition Guidance (Amendments to IFRS 10, IFRS 11 and IFRS 12)*. These amendments clarified the transition guidance in these standards and are applicable for annual periods beginning on or after 1 January 2013.

In October 2012, IFRS 10 and IFRS 12 were amended by *Investment Entities (Amendments to IFRS 10, IFRS 12 and IAS 27)*, which is applicable for annual periods beginning on or after 1 January 2014.

IFRS 10 replaces the portion of IAS 27 that addresses the accounting for consolidated financial statements. It also addresses the issues raised in SIC-12 *Consolidation*

- *Special Purpose Entities* and, therefore, SIC-12 has been withdrawn. What remains in IAS 27 is limited to accounting for investments in subsidiaries, joint ventures and associates in separate financial statements.

IFRS 12 contains all the disclosure requirements related to an entity's interests in subsidiaries, joint arrangements, associates and structured entities, including a number of new disclosures.

This publication describes the requirements of IFRS 10, focusing on those areas that differ most from IAS 27. It also explores application issues related to IFRS 10 and describes the related disclosure requirements for subsidiaries and structured entities required by IFRS 12. This publication also addresses some of the key issues about implementing IFRS 10, although further issues and questions continue to arise as entities apply the standards.

December 2013



# Contents

## Introduction

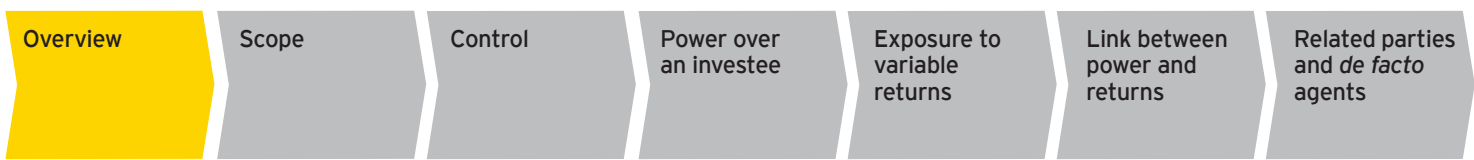
<b>Chapter 1</b>	<b>Overview</b>	<b>4</b>
<b>Chapter 2</b>	<b>Scope</b>	<b>6</b>
2.1	Exemption from preparing consolidated financial statements by an intermediate parent	6
2.2	Employee benefit plans and employee share trusts	6
2.3	Investment entities	7
2.3.1	Elements of the definition of an investment entity	7
2.3.2	Typical characteristics of an investment entity	8
2.3.3	Subsidiary with investment-related services	8
2.3.4	Parent entities that are not investment entities	8
<b>Chapter 3</b>	<b>Control</b>	<b>9</b>
<b>Chapter 4</b>	<b>Power over an investee</b>	<b>11</b>
4.1	Relevant activities	11
4.1.1	More than one relevant activity	11
4.1.2	No relevant activities	13
4.2	Existing rights	13
4.2.1	Evaluating whether rights are substantive	13
4.2.2	Evaluating whether rights are protective	14
4.2.3	Incentives to obtain power	16
4.3	Voting rights	17
4.3.1	Power with a majority of the voting rights	17
4.3.2	A majority of voting rights without power	17
4.3.3	Power without a majority of voting rights ( <i>de facto</i> control)	18
4.3.4	Potential voting rights	20
4.3.5	Contracts related to voting rights	23
4.4	Contractual arrangements	23
4.4.1	Structured entities	23
4.5	Other evidence of power	24
4.6	Determining whether sponsoring (designing) a structured entity gives power	25
<b>Chapter 5</b>	<b>Exposure to variable returns</b>	<b>26</b>
5.1	Exposure to variable returns is an indicator of control	26
5.2	Returns that appear fixed can be variable	26
5.3	Evaluating whether derivatives provide an exposure to variable returns	26
5.4	Exposure to variable returns from involvement with an investee	28
5.5	Exposure to variable returns in bankruptcy filings	28



<b>Chapter 6</b>	<b>Link between power and returns: principal-agency situations</b>	<b>29</b>
6.1	Delegated power: principals and agents	29
6.2	Scope of decision-making	30
6.2.1	Involvement in design and autopilot situations	30
6.2.2	Assessing whether scope of powers is narrow or broad	31
6.3	Rights held by other parties	31
6.3.1	Evaluating whether a removal right is substantive	32
6.3.2	Liquidation rights and redemption rights	33
6.4	Remuneration	33
6.4.1	Evaluating remuneration in the asset management industry	34
6.4.2	Evaluating remuneration in other industries	34
6.5	Exposure to variability of returns from other interests	34
<hr/>		
<b>Chapter 7</b>	<b>Related parties and <i>de facto</i> agents</b>	<b>36</b>
7.1	Customer-supplier relationships	36
<hr/>		
<b>Chapter 8</b>	<b>Control of specified assets</b>	<b>37</b>
8.1	Identifying a silo	39
8.1.1	Identifying silos in the real estate industry	39
8.1.2	Identifying silos in a structured entity	40
8.1.3	Identifying silos in the insurance industry	41
8.2	Evaluating control of a silo	41
8.3	Consolidating a silo	41
<hr/>		
<b>Chapter 9</b>	<b>Continuous assessment</b>	<b>42</b>
9.1	Changes in market conditions	42
9.2	Bankruptcy filings and troubled debt restructurings	44
9.3	Control re-assessment as a result of action by others	45
<hr/>		
<b>Chapter 10</b>	<b>Consolidation procedures</b>	<b>46</b>
10.1	Non-controlling interests when there is a <i>de facto</i> agent	46
<hr/>		
<b>Chapter 11</b>	<b>Disclosures</b>	<b>47</b>
11.1	Principles of IFRS 12	47
11.2	Disclosing judgements	47
11.3	Interests in subsidiaries	48
11.3.1	Non-controlling interests in subsidiaries	48
11.3.2	Summarised financial information for subsidiaries	48
11.3.3	Significant restrictions on subsidiaries	49
11.3.4	Changes in ownership of a subsidiary	49



11.4	Structured entities	49
11.4.1	Consolidated structured entities	49
11.4.2	Unconsolidated structured entities	50
11.4.3	Related party disclosures	52
<hr/>		
<b>Chapter 12</b>	<b>Transition</b>	<b>53</b>
12.1	Date of initial application	53
12.2	Newly consolidating an investee	53
12.2.1	Investee is a business	53
12.2.2	Investee is not a business	53
12.3	Practical issues with consolidating an investee retrospectively	53
12.3.1	Purchase price allocations	53
12.3.2	Goodwill impairment	54
12.3.3	Borrowing costs	54
12.3.4	Hedging	54
12.4	De-consolidating a former subsidiary	54
<hr/>		
<b>Conclusion</b>		<b>55</b>
<hr/>		
<b>Appendix – Defined terms</b>		<b>56</b>
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## Chapter 1 Overview

IFRS 10 establishes a single control model that applies to all entities including 'structured entities' ('special purpose entities' as they were previously referred to). The changes introduced by IFRS 10 require management to exercise significant judgement to determine which entities are controlled, compared with the requirements that were in IAS 27.

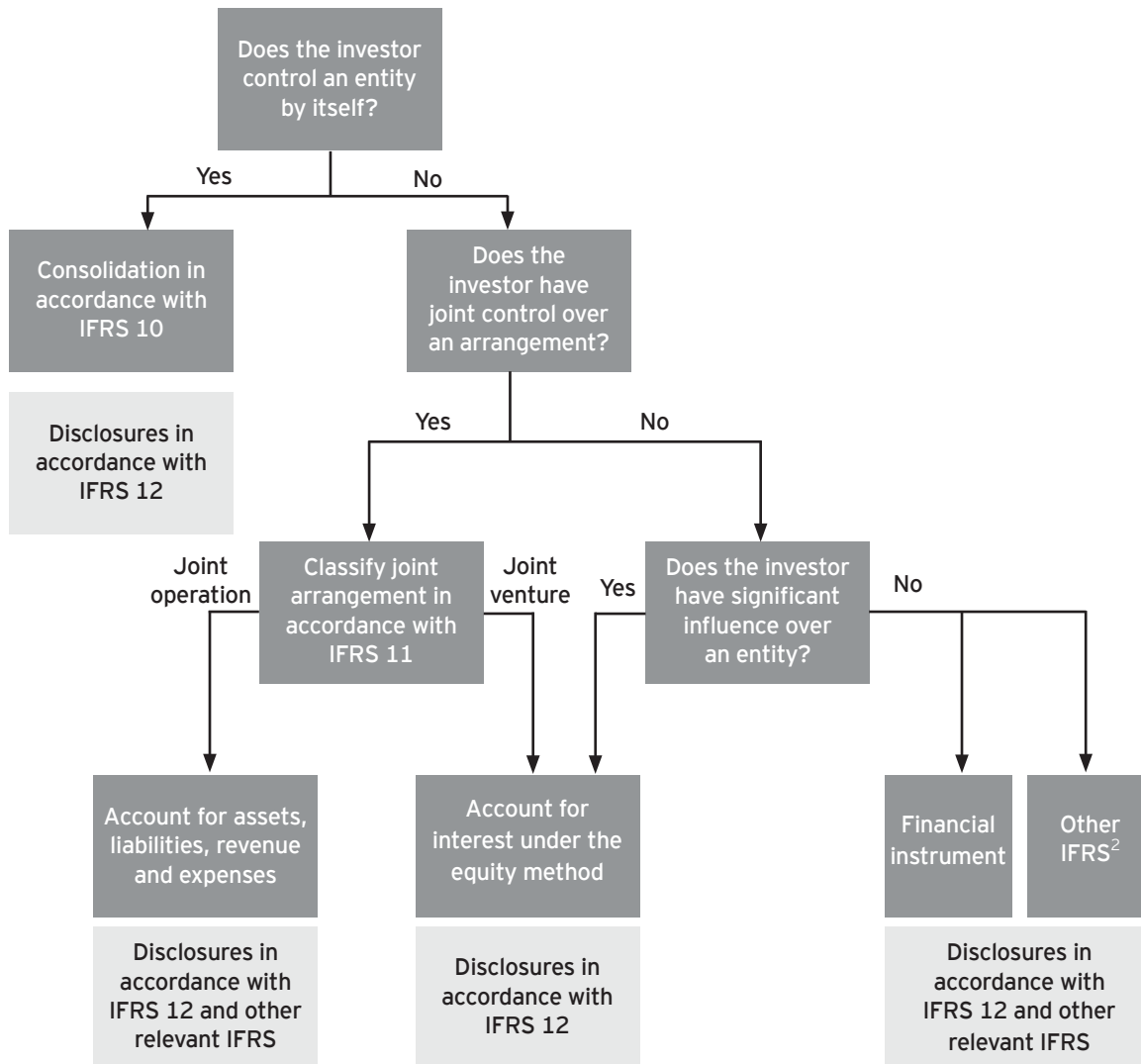
IFRS 10 does not change consolidation procedures (i.e., how to consolidate an entity) from the requirements that previously existed in IAS 27. Those requirements have simply been moved to IFRS 10. Rather, IFRS 10 changes whether an entity is consolidated, by revising the definition of control and adding requirements to consider when making control decisions.

There are no disclosure requirements in IFRS 10. IFRS 12 contains all disclosure requirements related to an entity's interests in subsidiaries, joint arrangements, associates and structured entities, including a number of new disclosures. One of the most significant changes introduced by IFRS 12 is that an entity is required to disclose judgements that were made in determining whether it

controls another entity. Even if management concludes that it does not control an entity, the information used to make that judgement will be transparent to users of the financial statements. The new disclosures will also assist users of the financial statements to make their own assessment of the financial impact were management to reach a different conclusion regarding consolidation - by providing more information about certain unconsolidated entities. IFRS 12 also includes all of the disclosures that were previously included in IAS 31 *Interests in Joint Ventures* and IAS 28 *Investments in Associates*.

When management concludes that an entity does not have control of an investee, the requirements of IFRS 11 *Joint Arrangements* and the revised IAS 28 *Investments in Associates and Joint Ventures* must be considered to determine whether it has joint control or significant influence, respectively, over the investee. The diagram below summarises the identification and accounting for each type of investment, as well as the interaction between IFRS 10, IFRS 11, IFRS 12 and IAS 28.

**Diagram 1 – Interaction between IFRS 10, IFRS 11, IFRS 12 and IAS 28**



<sup>2</sup> This would be the case, for example, if an entity has control over (or simply rights to) assets and obligations for liabilities, but not control of an entity. In this case, the entity would account for these assets and obligations in accordance with the relevant IFRS.

## Chapter 2 Scope

Consistent with the requirements previously included in IAS 27, IFRS 10 requires that a parent (unless exempt) present consolidated financial statements. That is, IFRS 10 requires financial statements of the group, in which the assets, liabilities, equity, income, expenses and cash flows of the parent and its subsidiaries, are presented as those of a single economic entity. A group consists of a parent and its subsidiaries (i.e., entities that the parent controls).

When an entity is a parent it needs to assess whether it (the investor) controls the other entity (the investee). IFRS 10 applies to all types of entities, including corporations, partnerships, limited liability corporations, trusts, and other types of entities.

IFRS 10 includes three scope exemptions, which are considered in the remainder of Chapter 2.

### 2.1 Exemption from preparing consolidated financial statements by an intermediate parent

A parent entity that prepares financial statements in accordance with IFRS is exempt from preparing consolidated financial statements if all of the following conditions are met:

- a) It is a wholly owned subsidiary, or a partially owned subsidiary and all owners consent to it not preparing consolidated financial statements
- b) Its debt and equity instruments are not traded in a public market
- c) It does not file, nor is in the process of filing, financial statements with a securities commission for the purpose of issuing instruments in a public market

- d) Its ultimate or any intermediate parent produces consolidated financial statements that are available for public use and comply with IFRS

### 2.2 Employee benefit plans and employee share trusts

IFRS 10 repeats the scope exception that was previously included in SIC-12 for post-employment benefit plans and other long-term employee benefit plans to which IAS 19 *Employee Benefits* applies. However, it is not clear whether this means that an employee benefit plan that controls an investee is not required to consolidate that investee in its financial statements, or whether an investor that controls an employee benefit plan need not consolidate the plan itself.

It seems that the latter was intended: a sponsor of an employee benefit plan need not evaluate whether it controls that employee benefit plan, and, therefore, need not consolidate it. However, the employee benefit plan would need to apply IFRS 10 if it is preparing financial statements under IAS 26 *Accounting and Reporting by Retirement Benefit Plans*.

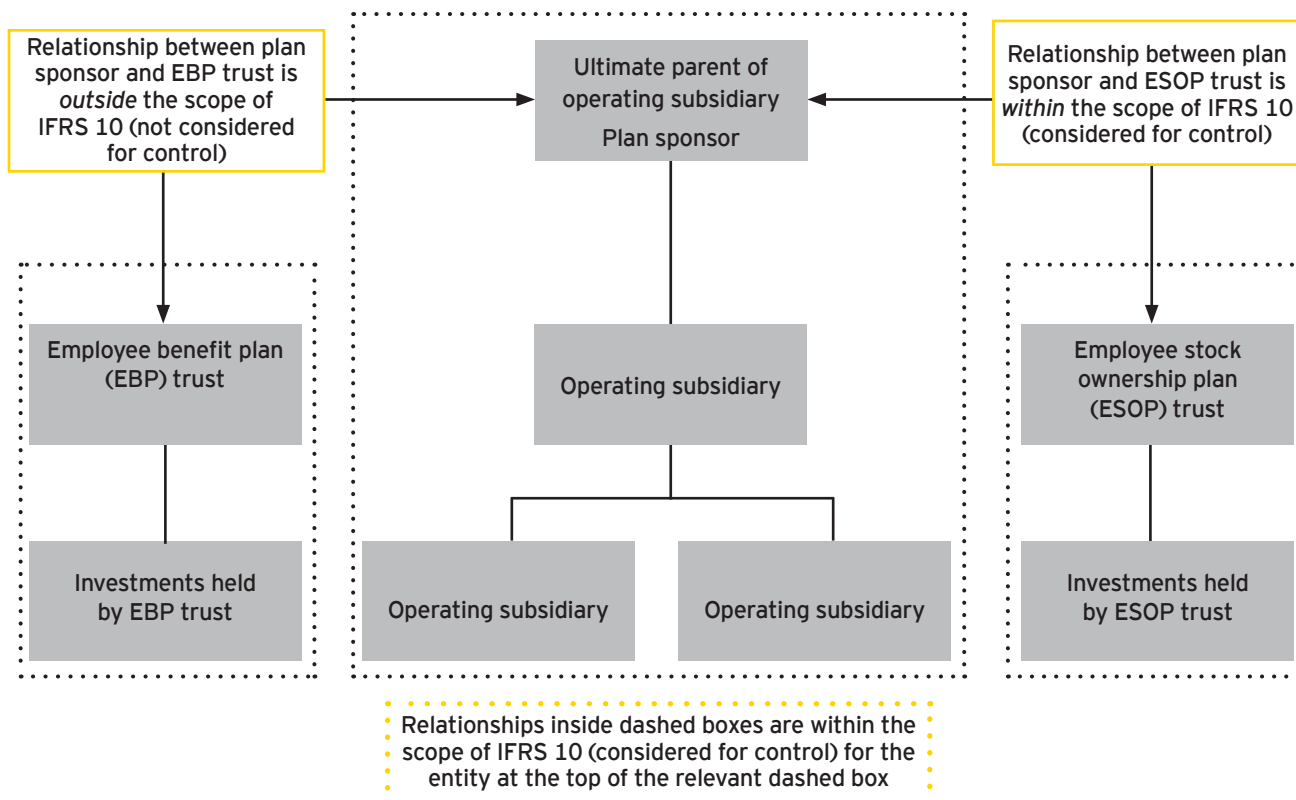
In contrast, employee benefit trusts (or similar entities) established for employee share option plans, employee share purchase plans and other share-based payment programmes are not excluded from the scope of IFRS 10. This is because these are outside the scope of IAS 19. The sponsoring entity of these trusts needs to evaluate whether it controls (and therefore consolidates) the trusts.

Diagram 2 illustrates what is in scope and out of scope of IFRS 10.





**Diagram 2 – Understanding scope of IFRS 10 for employee benefit plans and employee share option plans**



## 2.3 Investment entities

In October 2012, the IASB amended IFRS 10 to include an exemption from consolidation for investment entities that are required to measure subsidiaries at fair value through profit or loss.

### Excerpts from IFRS 10

Appendix A

An investment entity is an entity that:

- a) Obtains funds from one or more investors for the purpose of providing those investor(s) with investment management services
- b) Commits to its investor(s) that its business purpose is to invest funds solely for returns from capital appreciation, investment income or both; and
- c) Measures and evaluates the performance of substantially all of its investments on a fair value basis.

When an entity meets the definition of an investment entity, it must not consolidate its subsidiaries or apply IFRS 3 when it obtains control or an entity. Instead investments are measured at fair value through profit or loss in accordance with IAS 39 *Financial Instruments: Recognition and Measurement* or IFRS 9 *Financial Instruments* (as applicable). The application guidance to IFRS 10 clarifies that an entity must consider all facts and circumstances when assessing whether it is an investment entity, including its purpose and design.

### 2.3.1 Elements of the definition of an investment entity

The application guidance to IFRS 10 describes the elements of the definition in more detail to help entities identify investment entities. The key guidance is:

#### *Business purpose*

The purpose of an investment entity is to invest solely for capital appreciation, investment income or both. An investment entity may also provide investment-related services to third parties as well as investors, even if those activities are substantial to the entity. An investment entity may also provide management services, strategic advice and financial support to an investee, provided it is to maximise investment returns and does not represent a separate substantial activity or source of income.

**Exit strategies**

As investment entities do not hold investments indefinitely, there must be an exit strategy documenting how the entity intends to realise its equity investments and non-financial asset investments.

**Earnings from investments**

An entity is not an investment entity if it has the objective of obtaining benefits from its investments other than capital appreciation and investment income. For example, if an entity is investing to obtain benefits from the acquisition of intangible assets or technology of an investee, it would not be an investment entity.

**Fair value measurement**

An investment entity reports fair value information internally to key management personnel and provides investors with fair value information. To meet this requirement, an investment entity would:

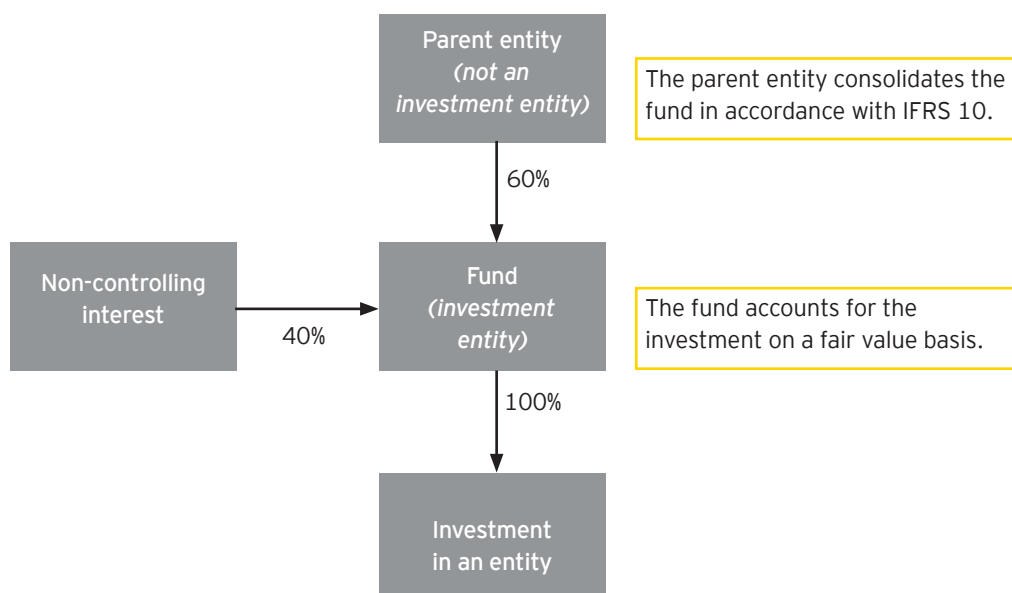
- ▶ Elect to account for investment property using the fair value model in IAS 40 *Investment Property*
- ▶ Elect the exemption from applying the equity method in IAS 28 for investments in associates and joint ventures available to venture capital organisations
- ▶ Measure financial assets at fair value in accordance with IFRS 9

**2.3.2 Typical characteristics of an investment entity**

In addition to applying the definition above, an entity should also consider whether it has the typical characteristics of an investment entity. These are described as:

- ▶ It has more than one investment, to diversify its risk and maximise returns
- ▶ It has multiple investors, who pool their funds to maximise investment opportunities
- ▶ It has investors that are not related parties of the entity
- ▶ It has ownership interests in the form of equity or similar interests

**Diagram 3 – Parent entities that are not investment entities**



The absence of one or more of these characteristics does not disqualify an entity from being an investment entity but it requires careful consideration. When management concludes that the entity is an investment entity despite not having all of the typical characteristics, additional disclosure is required by IFRS 12.

**2.3.3 Subsidiary with investment-related services**

Whilst investment entities generally do not consolidate subsidiaries, there is one exception to this. If an investment entity has a subsidiary that provides investment-related services, such as investment management services, to either the entity or to other parties, the investment entity must consolidate that subsidiary. Although investment-related services is not a defined term, IFRS 10 gives examples of investment advisory services, investment management and investment administration services.

**2.3.4 Parent entities that are not investment entities**

A parent entity that is not an investment entity itself, is not permitted to apply the investment entity accounting in its consolidated financial statements. Instead it must consolidate all entities that it controls, including those controlled through an investment entity. This is shown in Diagram 3 below.

**How we see it**

The Board discussed allowing parent entities to 'roll-up' the investment entity accounting when the proposals were discussed at the exposure draft stage. However, the Board decided not to permit this treatment, largely due to the structuring opportunities it could present. This decision creates a difference compared to US GAAP, which allows a non-investment entity parent to retain the fair value accounting used by an investment entity subsidiary.

## Chapter 3 Control

IFRS 10 includes a new definition of control and adds requirements to consider when assessing whether an entity has control of an investee.

### Excerpt from 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.
- 7 Thus, an investor controls an investee if and only if the investor has all of the following:
- ▶ 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.

Each of the three control criteria are explored in more detail in Chapters 4, 5 and 6, respectively. Although not a defined term, IFRS 10 uses the term 'investor' to refer to a reporting entity that potentially controls one or more other entities, and 'investee' to refer to an entity that is, or may potentially be, the subsidiary of a reporting entity. Ownership of a debt or equity interest may be a key factor in determining whether an investor has control. However, it is also possible for a party to be an investor and potentially control an investee, without having an equity or debt interest in that investee.

In many cases, when decision-making is controlled by voting rights that also give the holder exposure to variable returns, it is clear that whichever investor holds a majority of those voting rights controls the investee. However, in other cases (such as when there are potential voting rights, or an investor holds less than a majority of the voting rights), it may not be so clear. In those instances, further analysis is needed based on the facts and circumstances (considering the Application Guidance in IFRS 10), to determine which investor, if any, controls an investee. Diagram 4 illustrates this assessment.

### Excerpt from Appendix A to IFRS 12

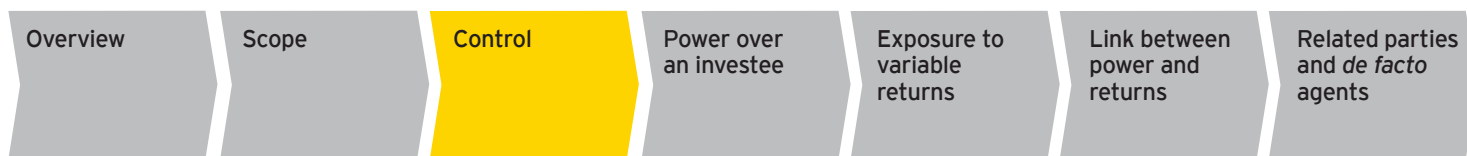
[A] structured entity [is] an entity that has been designed so that voting or similar rights are not the dominant factor in deciding who controls the entity, such as when any voting rights relate to administrative tasks only and the relevant activities are directed by means of contractual arrangements.

The control principle applies to all investees, including structured entities. There are no bright lines to determine whether an investor has an exposure, or has rights, to variable returns from its involvement with a structured entity, or whether it has the ability to affect the returns of the structured entity through its power over the structured entity. Rather, all facts and circumstances are considered when assessing whether the investor has control over an investee that is a structured entity. That is, the process outlined in Diagram 4 is used for structured entities, although the relevant facts and circumstances may differ from when voting rights are a more important factor in determining control.

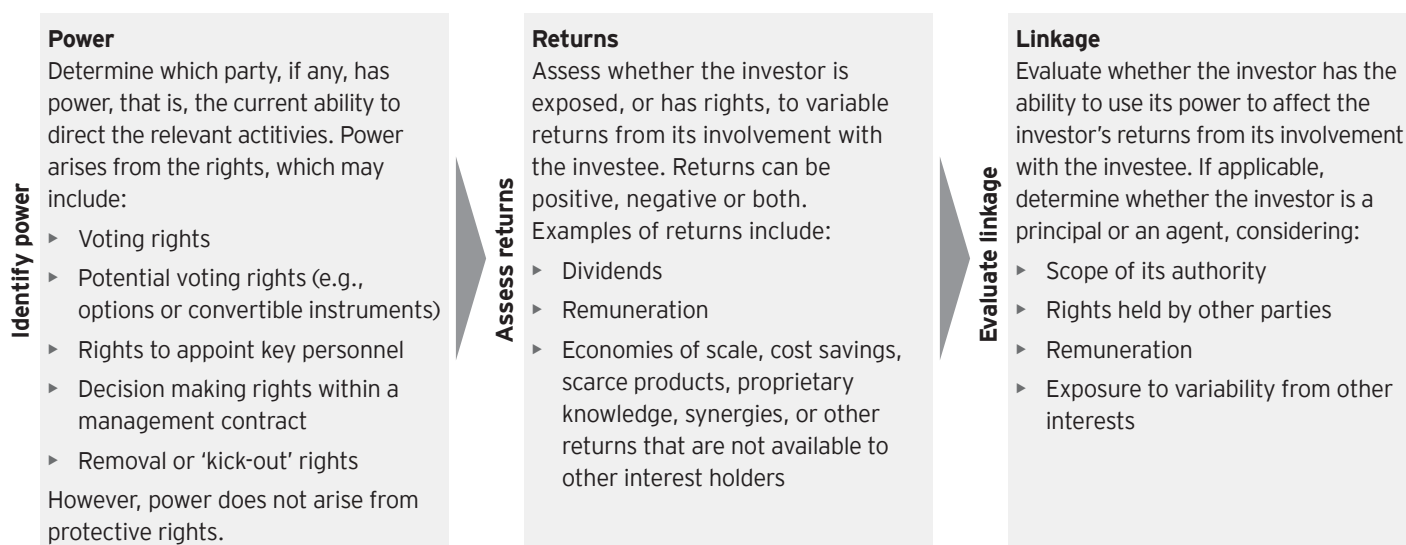
Understanding the purpose and design of an investee is critical when identifying who has control.

### Excerpt from IFRS 10

- B8 An investee may be designed so that voting rights are not the dominant factor in deciding who controls the investee, such as when any voting rights relate to administrative tasks only and the relevant activities are directed by means of contractual arrangements. In such cases, an investor's consideration of the purpose and design of the investee shall also include 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. Consideration of the risks includes not only the downside risk, but also the potential for upside.



**Diagram 4 – Assessing control**



**Understand purpose and design of investee**

Understanding the purpose and design of the investee helps to determine:

- ▶ What risks the investee was designed to be exposed to, and what risks it was designed to pass on to the parties with which it is involved
- ▶ What the relevant activities are
- ▶ How decisions about the relevant activities are made
- ▶ Who has the ability to direct the relevant activities
- ▶ Which parties have exposure to variable returns from the investee
- ▶ How the relevant activities affect returns
- ▶ Whether the parties that have power, and have exposure to variable returns have the ability to use that power to affect returns

In short, understanding the purpose and design of the investee helps to understand the goal of each investor; that is, why it is involved with the investee, and what that involvement is.

This publication focuses primarily on helping to identify which entities will be included in consolidated financial statements, that is, which entities are controlled. For more information on how to consolidate another entity, see *International GAAP*<sup>1</sup> (see also Chapter 10 of this publication) .

<sup>1</sup> International GAAP®, Ernst & Young, Wiley

## Chapter 4 Power over an investee

The first criterion to have control relates to power. An investor has power when it has existing rights that give it the current ability to direct the relevant activities. Therefore, when assessing whether an investor has power, there are two critical concepts:

- ▶ Relevant activities
- ▶ Existing rights

Each of these concepts is discussed in the remainder of Chapter 4 (e.g., voting rights, rights arising from contractual arrangements). We also discuss other evidence of power and determining whether sponsoring (designing) a structured entity gives power.

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, but do not give them control.

### 4.1 Relevant activities

In many cases, it is clear that control of an investee is held through voting rights. However, when it is not clear that control of an investee is held through voting rights, a crucial step in assessing control is identifying the relevant activities of the investee. Relevant activities are the activities of the investee that significantly affect the investee's returns.

Examples of relevant activities include:

- ▶ Determining or changing operating and financing policies (which might include the items below)
- ▶ Selling and purchasing goods and services
- ▶ Managing financial assets during their life (and/or upon default)
- ▶ Selecting, acquiring or disposing of assets
- ▶ Researching and developing new products or processes
- ▶ Making capital or funding decisions
- ▶ Appointing, remunerating or terminating the employment of an investee's service providers or key management personnel
- ▶ Establishing operating and capital decisions of the investee, including budgets.

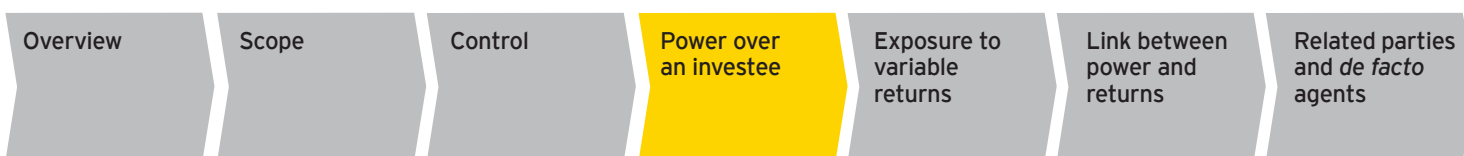
#### 4.1.1 More than one relevant activity

In many cases, more than one activity will significantly affect an investee's returns.

##### Excerpts from IFRS 10

- 13 If two or more unrelated 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.
- B13 In some situations, activities both before and after a particular set of circumstances arises or event occurs may be relevant activities. When two or more investors have the current ability to direct relevant activities and those activities occur at different times, the investors shall determine which investor is able to direct the activities that most significantly affect those returns consistently with the treatment of concurrent decision-making rights. The investors shall reconsider this assessment over time if relevant facts or circumstances change.

When there is more than one activity that significantly affects an investee's returns, and these activities are directed by different investors, it is important to determine which of the activities most significantly affect the investee's returns. For example, one activity might be directed by voting rights, which are held by one investor, whereas the other activity may be directed through a contract by different investors. This is illustrated in Example 1, which is from IFRS 10.



### **Example 1 – Identifying relevant activities in life sciences arrangements**

Two investors form an investee to develop and market a medical product. One investor is responsible for developing and obtaining regulatory approval of the medical product – that responsibility includes having the unilateral ability to make all decisions relating to the development of the product and to obtaining regulatory approval. Once the regulator has approved the product, the other investor will manufacture and market it – this investor has the unilateral ability to make all decisions about the manufacture and marketing of the project. If all the activities – developing and obtaining regulatory approval as well as manufacturing and marketing of the medical product – are relevant activities, each investor needs to determine whether it is able to direct the activities that most significantly affect the investee’s returns. Accordingly, each investor needs to consider whether developing and obtaining regulatory approval or the manufacturing and marketing of the medical product is the activity that most significantly affects the investee’s returns and whether it is able to direct that activity. In determining which investor has power, the investors would consider:

- (a) The purpose and design of the investee
- (b) The factors that determine the profit margin, revenue and value of the investee as well as the value of the medical product
- (c) The effect on the investee’s returns resulting from each investor’s decision-making authority with respect to the factors in (b)
- (d) The investors’ exposure to variability of returns

In this particular example, the investors would also consider:

- (e) The uncertainty of, and effort required in, obtaining regulatory approval (considering the investor’s record of successfully developing and obtaining regulatory approval of medical products)
- (f) Which investor controls the medical product once the development phase is successful

In this example, IFRS 10 does not conclude which of these activities would be deemed the most relevant activity (i.e., the activity that most significantly affects the investee’s returns). If it were concluded that the most relevant activity is:

- ▶ Developing and obtaining regulatory approval of the medical product – then the investor that has the power to direct that activity would have power from the date of entering into the arrangement
- ▶ Manufacturing and marketing the medical product – then the investor that has the power to direct that activity would have power from the date of entering into the arrangement

To determine whether either investor controls the arrangement, the investors would also need to assess whether they have exposure to variable returns from their involvement with the investee and the ability to use their power over the investee to affect the amount of the investor’s returns. These concepts are discussed in Chapters 5 and 6, respectively.

Example 1 illustrates a situation when different activities that significantly affect an investee’s returns are directed by different investors. Thus, it is important to identify the activities that most significantly affect returns, as part of assessing which investor, if any, has power. This differs from joint control, defined as the contractually agreed sharing of control of an arrangement, which

exists only when decisions about the relevant activities require the unanimous consent of the parties sharing control. Joint control is discussed in more detail in our publication *Applying IFRS: Challenges in adopting and applying IFRS 11*.

Example 2 illustrates a structured entity in which there is more than one activity that affects the investee’s returns.

### **Example 2 – Identifying relevant activities in a structured entity**

A structured entity buys dollar-denominated assets, issues euro-denominated notes, and hedges the cash flow differences through currency and interest rate swaps. The activities that affect the structured entity’s returns include:

- ▶ Sourcing the assets from the market
- ▶ Determining the types of assets that are purchased
- ▶ Deciding how the structure is hedged
- ▶ Managing the assets in the event of default

If each of these activities is managed by different investors (e.g., one investor manages the assets in the event of default, but a different investor determines the types of assets that are purchased), it is necessary to determine which activity most significantly affects the structured entity’s returns.

When there are multiple activities that significantly affect an investee's returns, but those activities are all directed by the same investor(s) (which is frequently the case when those activities are directed by voting rights), it does not matter which activities most significantly affect the investee's returns because the power assessment would be the same in each case.

#### 4.1.2 No relevant activities

We believe structured entities for which there is no substantive decision-making are rare. That is, we believe virtually all structured entities have some level of decision-making and few, if any, are on 'autopilot'. However, if a structured entity truly has no decision-making and is actually run on autopilot, then no investor controls that structured entity. This is because no investor has power over the structured entity, that is, no investor has the current ability to direct the activities that significantly affect the structured entity's returns if there are no relevant activities affecting those returns.

## 4.2 Existing rights

Once the relevant activities are identified, the next step is to determine which investor, if any, has the current ability to direct those activities (i.e., who has the power). Sometimes, assessing power is straightforward, such as when power over an investee is obtained directly and solely from the voting rights that stem from holding voting interests (e.g., shares) and can be assessed by considering the voting rights from those shareholdings. In other cases, the assessment is more complex and requires many factors to be considered (e.g., instances when power is embedded in one or more contractual arrangements).

### Excerpts from IFRS 10

**B14** Power arises from rights. To have power over an investee, an investor must have existing rights that give the investor the current ability to direct the relevant activities. The rights that may give an investor power can differ between investees.

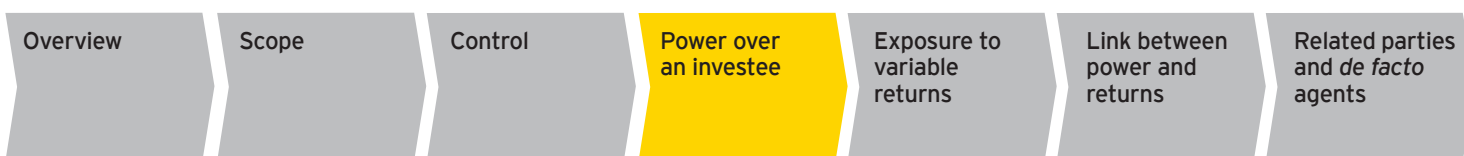
**B15** Examples of rights that, either individually or in combination, can give an investor power include but are not limited to:

- (a) Rights in the form of voting rights (or potential voting rights) of an investee;
- (b) rights to appoint, reassign or remove members of an investee's key management personnel who have the ability to direct the relevant activities;
- (c) rights to appoint or remove another entity that directs the relevant activities;
- (d) rights to direct the investee to enter into, or veto any changes to, transactions for the benefit of the investor; and
- (e) other rights (such as decision-making rights specified in a management contract) that give the holder the ability to direct the relevant activities.

Although not listed in IFRS 10, appointing or removing the majority of the board of directors (or equivalent governing body) could also give the investor holding that right power, if the directors have the ability to significantly affect the investee's returns. For example, this would be the case if the directors have the right to direct one or more of the activities listed in Section 4.1.

#### 4.2.1 Evaluating whether rights are substantive

For a right to give power, it must give the current ability to direct the relevant activities. Rights are only considered if they are substantive (i.e., the holder must have the practical ability to exercise the right). Whether rights are substantive depends on facts and circumstances. Diagram 5 describes some of the factors that should be considered.



**Diagram 5 – Factors to consider in assessing whether a right is substantive**

Factors	Examples
<ul style="list-style-type: none"> <li>Are there barriers (economic, operational or otherwise) that would prevent (or deter) the holder(s) from exercising their right(s)?</li> </ul>	<ul style="list-style-type: none"> <li>Financial penalties</li> <li>High exercise or conversion price</li> <li>Narrow exercise periods</li> <li>Absence of a mechanism to exercise</li> <li>Lack of information to exercise</li> <li>Lack of other parties willing or able to take over</li> <li>Legal or regulatory barriers</li> </ul>
<ul style="list-style-type: none"> <li>Do the holders have the practical ability to exercise their rights, when exercise requires agreement by more than one investor?</li> </ul>	<ul style="list-style-type: none"> <li>The more parties necessary to come together to exercise the right, the less likely that the right is substantive</li> <li>A mechanism is in place that provides those parties with the practical ability to exercise their rights collectively if they choose to do so</li> <li>An independent board of directors may serve as a mechanism for numerous investors to act collectively in exercising their rights</li> </ul>
<ul style="list-style-type: none"> <li>Would the investor that holds the rights benefit from their exercise or conversion?</li> </ul>	<ul style="list-style-type: none"> <li>A potential voting right is 'in-the-money'</li> <li>An investor would obtain benefits from synergies between the investor and the investee</li> </ul>
<ul style="list-style-type: none"> <li>Are the rights exercisable when the decisions about the relevant activities need to be made?</li> </ul>	<ul style="list-style-type: none"> <li>An investor has rights that are currently exercisable, but has not yet exercised them</li> <li>An investor can direct certain activities of an investee when a particular circumstance or event occurs</li> </ul>

It is important to remember that the purpose and design of an investee is critical when assessing whether a right is substantive. For example, the following should be considered when evaluating whether an investor's rights are substantive:

- Why were the rights granted?
- What compensation was given (or received) for the right? Does that compensation reflect fair value?
- Did other investors also receive this right? If not, why?

These questions should be considered both when a right is first granted, and also if an existing right is modified.

To be substantive and give power, a right must give the investor the 'current ability' to direct the investee's relevant activities. However, 'current ability' does not always mean 'able to be exercised this instant.' The concept of 'current ability' is discussed more in the context of potential voting rights, in Section 4.3.4.

#### 4.2.2 Evaluating whether rights are protective

In evaluating whether rights give power over an investee, the investor has to assess whether its rights and rights held by others, are protective rights. Protective rights are a newly defined concept under IFRS 10, although many may have considered this concept when evaluating control under IAS 27, even though not defined.

##### Excerpt from Appendix A IFRS 10

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.

Since power is an essential element of control, protective rights do not give the investor control over the investee. Holding protective rights cannot prevent another investor from having power over an investee.



Protective rights are typically held to prohibit fundamental changes in the activities of an investee that the holder does not agree with and usually apply only in exceptional circumstances (i.e., upon a contingent event). However, the fact that the right to make decisions is contingent upon an event occurring does not mean that the right is always a protective right. Examples of protective rights include the right to:

- ▶ Restrict an investee from undertaking activities that could significantly change the credit risk of the investee to the detriment of the investor
- ▶ Approve an investee's capital expenditures (greater than the amount spent in the ordinary course of business)
- ▶ Approve an investee's issuance of equity or debt instruments
- ▶ Seize assets if an investee fails to meet specified loan repayment conditions
- ▶ Veto transactions between the investee and a related party

When evaluating whether a right is protective, consideration is also given to whether the right is substantive (see Section 3.2.1). However, assuming that the right is substantive, the likelihood that the holder will exercise a right is not a factor in determining whether it is a protective right, or is potentially a right that gives power.

In some cases, a right might be deemed protective, such as the ability to sell assets of the investee if an investee defaults on a loan, when default is considered an exceptional circumstance. However, if the investee defaults on a loan, the investor holding that right would need to re-assess whether that right has become a substantive right (rather than a protective right), based on the change in facts and circumstances. The IFRS Interpretations Committee discussed this issue and published an agenda decision in September 2013. The Interpretations Committee concluded that reassessment is required when facts and circumstances change in such a way that rights, previously determined to be protective, change. For example, when breach of a covenant in a borrowing arrangement causes the borrower to be in default.

### ***Veto rights over operating budgets***

Whether veto rights are protective or not, will depend on the nature of the rights. If the veto rights relate to changes to operating and financing policies that significantly affect the investors returns, the veto rights may not be merely protective. This is illustrated in Example 3.

#### ***Example 3 – Veto right over annual budget – protective or not?***

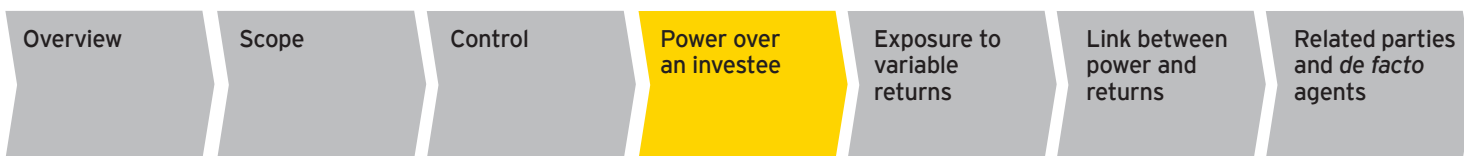
An investor determined that approving the annual operating budget of an investee is the relevant activity. For example, this might be the case if the operating budget is detailed and management has little latitude to deviate from the budget. An investor has the right to veto this annual operating budget. If that investor does veto the budget, management of the investee must re-draft and re-propose the budget, and re-submit the budget to the investor holding the veto right.

In this fact pattern, because approving the annual operating budget is the activity that most significantly affects the investee's returns, then a veto right over the annual operating budget would be substantive, and is not a protective right. Evaluating whether approving an annual operating budget is the most relevant activity will depend on facts and circumstances, and requires judgement.

### ***Other veto rights***

Other veto rights that are common, and are typically protective (because they rarely significantly affect the investee's returns), include veto rights over changes to:

- ▶ Amendments to articles of incorporation
- ▶ Location of investee headquarters
- ▶ Name of investee
- ▶ Auditors
- ▶ Accounting principles for separate reporting of investee operations



### Franchises

Many have questioned how to consider franchise rights, and whether they give power to the franchisor, or whether they are merely protective rights.

#### Excerpts from IFRS 10

B30 Generally, franchisors' rights do not restrict the ability of parties other than the franchisor to make decisions that have a significant effect on the franchisee's returns. Nor do the rights of the franchisor in franchise agreements necessarily give the franchisor the current ability to direct the activities that significantly affect the franchisee's returns.

B33 Control over such fundamental decisions as the legal form of the franchisee and its funding structure may be determined by parties other than the franchisor and may significantly affect the returns of the franchisee. 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.

When analysing whether a franchisor has power over a franchisee, it is necessary to consider the purpose and design of the franchisee. The assessment of whether a franchisor has power hinges on the determination of the relevant activities, and which investor (the franchisor or owner of the franchisee) has the current ability to direct that activity through its rights. The rights held by the franchisor must be evaluated to determine if they are substantive, or whether they are protective rights. A determination will need to be made in each case, based on the specific facts and circumstances.

A franchisor may have certain rights that are designed to protect its brand when it is being licensed by a franchisee. Activities that significantly affect the franchisee's returns may include:

- ▶ Determining or changing its operating policies
- ▶ Setting its prices for selling goods
- ▶ Selecting suppliers
- ▶ Purchasing goods and services
- ▶ Selecting, acquiring or disposing of equipment
- ▶ Appointing, remunerating or terminating the employment of key management personnel
- ▶ Financing the franchise

If certain of the activities above are directed by one investor (e.g., the owners of the franchisee), and other activities are directed by another investor (e.g., the franchisor), then the investors will need to determine which activities most significantly affect the franchisee's returns, as discussed in Section 4.1.

#### 4.2.3 Incentives to obtain power

There are many incentives to obtain rights that give power; generally, the more exposure to variable returns (whether positive or negative), the greater that incentive. IFRS 10 notes this in two contexts:

#### Excerpts from IFRS 10

B20 The greater an investor's exposure, or rights, to variability of returns from its involvement with an investee, the greater is the incentive for the investor to obtain rights sufficient to give it power. Therefore, having a large exposure to variability of returns is 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 over the investee.

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

Thus, even though there may be an incentive to obtain rights that give power when there is an exposure to variable returns, that incentive, by itself, does not give power. Rather, the investor must analyse whether it actually does have power through existing rights, which might be in the form of voting rights, or rights through a contractual agreement, as discussed in Sections 4.3 and 4.4, respectively.

## 4.3 Voting rights

Power stems from existing rights. In many cases, assessing power can be straightforward. This is often the case when, after understanding the purpose and design of the investee, it is determined that power over an investee is obtained directly and solely from the voting rights that stem from holding shares.

### 4.3.1 Power with a majority of the voting rights

In many cases, the legal environment or corporate structure dictate that the relevant activities are directed by the agreement of shareholders who hold more than half of the voting rights of the investee. Alternatively, a governing board, e.g., a Board of Directors, might make decisions regarding the investee and that Board might be appointed by whoever has the majority of the voting rights to direct an investee's relevant activities. In both cases, when one investor has more than half the voting rights, it has power, assuming that no other facts and circumstances are relevant.

However, there may be other facts and circumstances that are relevant to assessing control (e.g., potential voting rights), which are discussed in the remainder of Chapter 4.

### 4.3.2 A majority of voting rights without power

In some cases, voting rights do not give the holder the power to direct the relevant activities. This might be the case, when:

- ▶ Relevant activities are directed by contract (see Section 4.4)
- ▶ Relevant activities are directed by government, judiciary, administrator, receiver, liquidator, or regulator
- ▶ Voting rights are not substantive (see Section 4.2.2)
- ▶ Voting rights have been delegated to a decision-maker, which holds the voting rights as an agent (see Chapter 6)
- ▶ Voting rights are held as a *de facto* agent of another investor (see Chapter 7)

### Evaluating voting rights during bankruptcy

Many jurisdictions have laws that offer protection from creditors when an entity is in financial difficulty. For example, an investee in such a position might be placed in the hands of liquidators, receivers or court-appointed managers under a reorganisation plan. Evaluating whether an investor holding the majority of voting rights still has power over an investee in such situations requires the exercise of judgement based on the facts and circumstances. It also requires assessing whether the holder of the voting rights continues to have the current ability to direct the activities that most significantly affect the investee's returns.

In this evaluation, it should be determined whether the shareholders (who hold voting rights) can still direct the operating and financial policies of the investee (assuming that this is the relevant activity), once the investee enters into bankruptcy proceedings. Alternatively, the bankruptcy court (or trustee, or administrator) may direct operating and financial policies. Consideration should be given to the following:

- ▶ Who appoints management during the bankruptcy period?
- ▶ Who directs management (e.g., the shareholders, or a trustee for the creditors)?
- ▶ Does management have to seek approval from parties besides the shareholders (e.g., for significant and/or unusual transactions)?
- ▶ Who negotiates the plan of reorganisation?

Even if it appears that the shareholders retain power once the investee enters bankruptcy (i.e., they retain the current ability to direct the relevant activities), this does not mean that a majority shareholder automatically controls the investee. This is because the shareholder may not have any exposure to variable returns (see Section 5.5), or the ability to affect its returns through its power (see Chapter 6), which are the other two criteria for having control. Depending on the facts and circumstances, a shareholder might lose power (or control) when the investee files for bankruptcy protection, or when the investee exits from bankruptcy. Determining the appropriate method of accounting for the interest in the investee upon loss of power (or control) requires careful consideration of the nature of the rights and interests, such as whether the shareholder has significant influence over the investee, in which case it would apply the equity method. Alternatively, if the investor does not have significant influence, it would likely account for its investment in the investee as a financial instrument.

When an investee files for bankruptcy, parties holding other rights with respect to that investee should also consider whether the control assessment has changed. For example, a right that was previously deemed protective (such as the right to appoint an administrator in the event of a bankruptcy – a right that is frequently held by creditors), may become a right that gives power. Alternatively, the trustee itself might have power, through its ability to direct the activities of the investee in bankruptcy. This is discussed in more detail in Section 9.2.

**4.3.3 Power without a majority of voting rights (*de facto* control)**

An investor might have control over an investee even when it has less than a majority of the voting rights of that investee (a concept known as '*de facto* control').

**Excerpt from IFRS 10**

B42 When assessing whether an investor's voting rights are sufficient to give it power, an investor considers all facts and circumstances, including:

- (a) The size of the investor's holding of voting rights relative to the size and dispersion of holdings of the other vote holders, noting that:
  - (i) the more voting rights an investor holds, the more likely the investor is to have existing rights that give it the current ability to direct the relevant activities;
  - (ii) the more voting rights an investor holds relative to other vote holders, the more likely the investor is to have existing rights that give it the current ability to direct the relevant activities;
  - (iii) the more parties that would need to act together to outvote the investor, the more likely the investor is to have existing rights that give it the current ability to direct the relevant activities;
- (b) Potential voting rights held by the investor, other vote holders or other parties;
- (c) Rights arising from other contractual arrangements; and
- (d) 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.

It may be clear, after considering the factors in (a) – (c) alone, that an investor has power over an investee. In other situations, it may be clear, after considering the factors in (a) – (c) alone, that an investor does not have power. In addition, IFRS 10 states that if it is not clear that the investor has power, having considered the factors in IFRS 10.B42, then the investor does not control the investee.

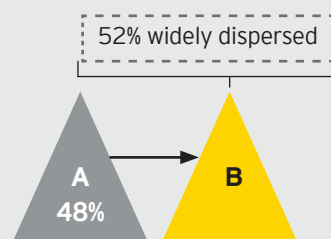
Potential voting rights and rights arising from other contractual arrangements are discussed in Sections 4.3.4 and 4.3.5, respectively. *De facto* control is discussed in more detail in the remainder of this section.

IFRS 10 includes several examples illustrating how to assess whether an investor has power when it has less than a majority of voting rights. Some of these are summarised in Examples 4–7. Our variation is introduced in Example 8. In each of the examples, it is assumed that, after understanding the purpose and design of the investee:

- ▶ Voting rights give an investor the ability to direct activities that significantly affect the investee's returns (i.e., voting rights give power)
- ▶ None of the shareholders has arrangements to consult any of the other shareholders or make collective decisions
- ▶ Decisions require the approval of a majority of votes cast at the shareholders' meeting
- ▶ No other facts or circumstances are relevant

**Example 4 – Less than a majority of voting rights No. 1**

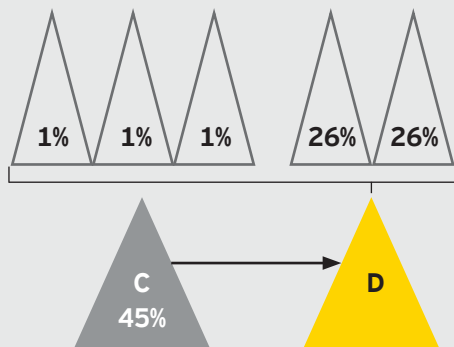
A holds 48% of the voting rights of B; the remaining 52% of B is widely held by thousands of shareholders (none of whom holds more than 1% of the voting rights).



A has power over B, because A has a dominant voting interest (based on the absolute size of its holding, and relative to other shareholders), and a large number of shareholders would have to agree to outvote A.

**Example 5 – Less than a majority of voting rights No. 2**

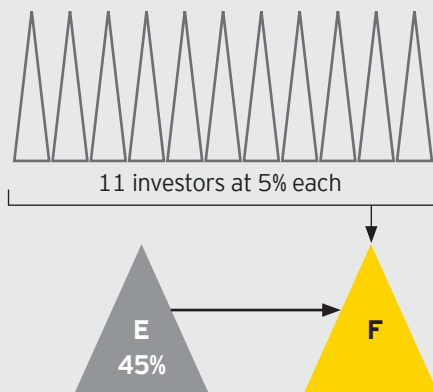
C holds 45% of the voting rights of D. The other 55% of D is held by two shareholders (each holds 26%), with the remaining 3% held by three other shareholders, each holding 1%.



C does not have power over D, because the two other significant shareholders (i.e., a relatively small number) could easily cooperate to outvote C. The size of C's holding, and size of that holding relative to other shareholders, would not give it power.

**Example 6 – Less than a majority of voting rights No. 3**

E holds 45% of the voting rights of F. The other 55% of F is dispersed among 11 shareholders, who each hold 5%.



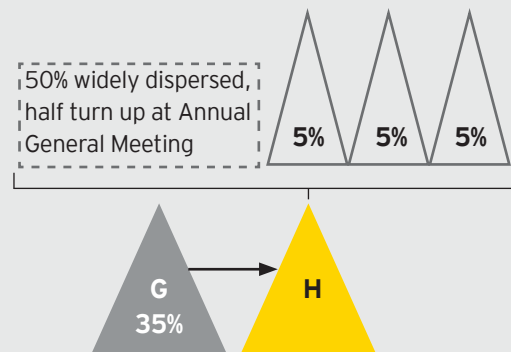
The size of E's holding and the dispersion of the other shareholders are not conclusive in determining whether E has power over F. Other evidence (such as that discussed in Section 4.5 below) would be considered to determine whether E has power over F.

Comparing Examples 5 and 6 illustrates the judgement that needs to be applied with respect to *de facto* control. The IASB views that it would be easy for two other shareholders to act together to outvote an investor (as in Example 5), but would be difficult for 11 other shareholders to act together to outvote an investor (in Example 6). Where is the line between these two situations?

Example 7 illustrates a situation where additional facts and circumstances need to be considered. For example, this may include whether other shareholders are passive in nature, as demonstrated at previous shareholder meetings.

**Example 7 – Less than a majority of voting rights No. 4**

G holds 35% of the voting rights of H. Three other shareholders each hold 5% of the voting rights of H. The remaining 50% of the voting rights are held by numerous other shareholders, none individually holding more than 1% of the voting rights. At recent shareholders' meetings, 75% of the voting rights have been represented (including G).

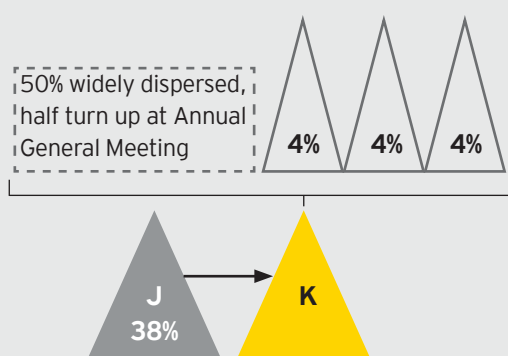


G does not have power over H. This is because the size of G's holding relative to other shareholders, when considering their active participation at recent shareholders' meetings, does not give G the current ability to direct the activities of H. This would be the case regardless of whether there is evidence that G directed H in the past, or whether other shareholders voted in the same way as G.

In Example 7, G cannot have power because it does not have, at a minimum, more than half the votes of shareholders that have turned up at recent meetings. That is, since 75% have turned up at recent meetings, G would need a minimum of 37.5% to have power, although this may not be sufficient on its own, as explained in Example 8.

**Example 8 – Less than a majority of voting rights No. 5**

J holds 38% of the voting rights of K. Three other shareholders each hold 4% of the voting rights of K. Numerous other shareholders hold the remaining 50% of the voting rights, although none individually holds more than 1%. At recent shareholders' meetings, 75% of the voting rights have been represented, including J.



There are diverse views regarding the conclusion on this fact pattern, and judgement will need to be applied in practice. Some believe that J has power, because it has more than half the voting rights of those who have turned up at recent shareholder meetings.<sup>3</sup> However, others believe that it is inconclusive whether J has power, because, while J has more than half the voting rights of those who have turned up at recent shareholder meetings, this is just barely the case. Contrast this fact pattern to Example 4, where IFRS 10 is conclusive that an entity (A) holding 48% in combination with remaining ownership that is widely dispersed results in A having power.

Some believe it would be rare for an investor to have power with less than a majority of voting rights without having other rights that give power over an investee, or other evidence of power (which is discussed in Section 4.5), and significant judgement will need to be applied in practice.

**How we see it**

Applying the concept of *de facto* control in the absence of bright lines will require significant judgement of the facts and circumstances. For example:

- ▶ How large does an investor's interest need to be relative to others? Would 40% of the voting rights be enough to have power?
- ▶ How widely dispersed are the other investors? Could three shareholders easily act together?
- ▶ Are past voting patterns expected to be indicative of future voting patterns? How much history would be needed to make an assessment?
- ▶ Are there other relevant agreements between shareholders?

Generally, the lower the percentage held by one investor (the dominant shareholders, in Examples 4–8), the less likely that investor has *de facto* control.

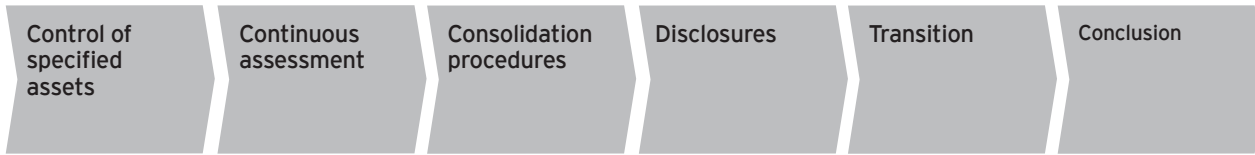
Although perhaps rare, an investor could find itself in control of an investee simply because of circumstances that exist at a point in time, rather than because of deliberate action (see Section 9.3). In addition, while it may be easy to use hindsight to determine whether an investor had (or has) control, it might be difficult to apply this principle on a real-time basis. Information will need to be gathered and analysed (e.g., how widely dispersed are the other shareholders), so that management can reach a timely conclusion (see Section 13.2).

**4.3.4 Potential voting rights**

When assessing whether it has power over an investee, an investor also considers the potential voting rights that it holds, as well as potential voting rights held by others. As mentioned in Chapter 3, potential voting rights are evaluated in the context of the investee's purpose and design. Common examples of potential voting rights include options, forward contracts, and conversion features of a convertible instrument. In the remainder of this section, reference is made to 'options', but the concepts apply to all potential voting rights.

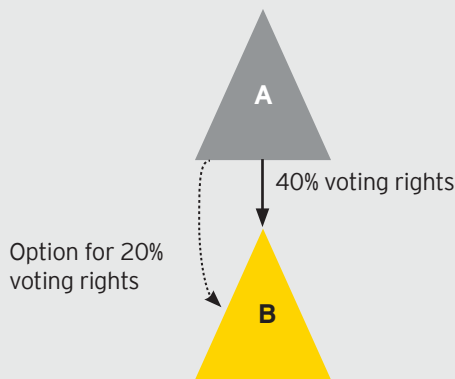
If an investor has less than a majority of voting rights, but holds a substantive option that, if exercised, would give the investor a majority of voting rights, that investor would likely have power. Example 9 illustrates when holding an option would likely give an investor power.

<sup>3</sup> J has more than half the voting rights, because J holds 38%, which is more than 37.5%, or half of 75% who have turned up at recent shareholders' meetings.



**Example 9 – Potential voting rights No. 1**

A holds 40% of the voting rights of B, and holds a currently exercisable in-the-money option to acquire a further 20% of the voting rights of B.



Assuming that voting rights give power over B, the option is substantive and no other facts and circumstances are relevant to this assessment, A would have power over B, because A can currently exercise its right to obtain a majority of B's voting shares at any time.

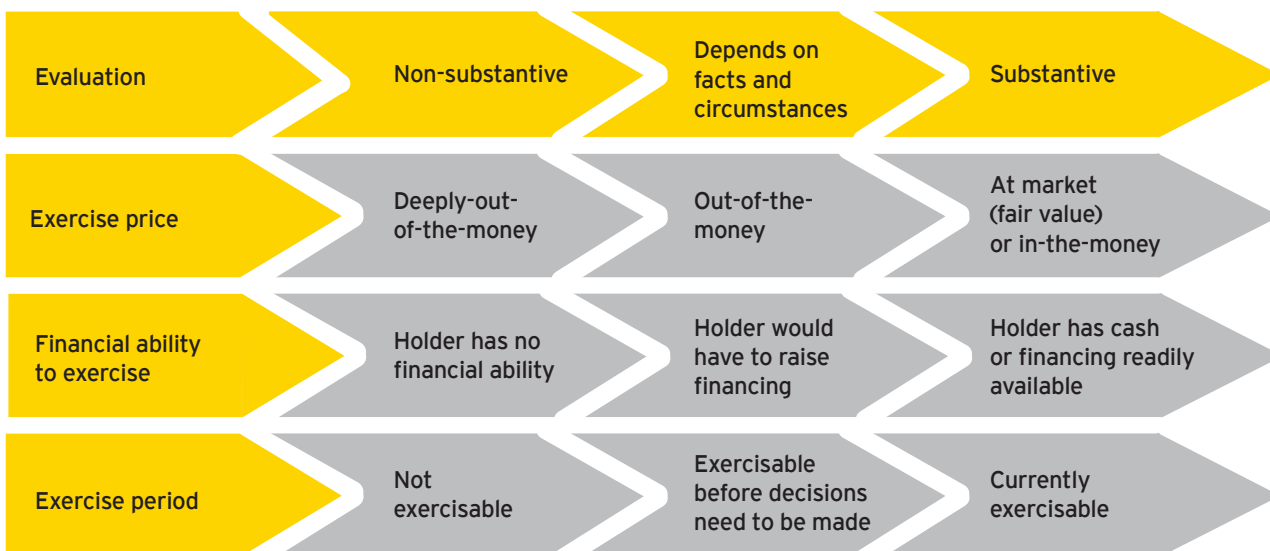
The opposite is also true. If an investor holds a majority of the voting rights, but those voting rights are subject to a substantive option held by another investor, the majority shareholder would likely not have power.

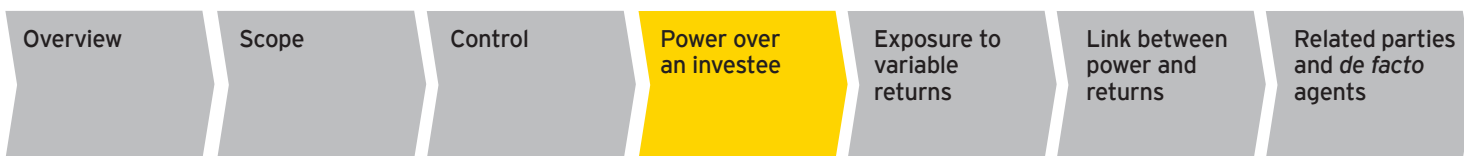
IFRS 10 is silent on whether the intention of the holder (i.e., whether it intends to exercise the option or not) is considered under IFRS 10. In contrast, IAS 27 was explicit that management's intention was not considered. However, IFRS 10 is clear that an option is only considered in the assessment of power if it is substantive (i.e., the holder has the practical ability to exercise the option). As discussed in Section 4.2.1, whether an option is substantive depends on facts and circumstances. Common factors to consider when evaluating whether an option is substantive include:

- ▶ Exercise price or conversion price, relative to market terms
- ▶ Ability to obtain financing
- ▶ Timing and length of exercise period

These factors are each discussed in more detail in the remainder of this section, and are shown in Diagram 6. The evaluation of whether an option is substantive should consider all the factors discussed in Section 4.2.1.

**Diagram 6 – Evaluating whether potential voting rights are substantive**





### **Exercise price or conversion price**

One of the most significant changes between IFRS 10 and IAS 27 in evaluating whether an option can give power is that the exercise price (or conversion price) can and should be considered, because it might represent a barrier to exercise:

- ▶ **Deeply-out-of-the-money** – Generally, these would be considered non-substantive
- ▶ **Out-of-the-money (but not deeply)** – Judgement will be needed to assess whether the cost of paying more than fair value is worth the potential benefits of exercise, including the exposures to variable returns that are associated with exercising that option (see Chapter 5 for examples of exposures to variable returns)
- ▶ **In-the-money (and at market options)** – Generally, these would be considered substantive; for an at market option, consideration is given as to whether the option conveys rights that differ from those that would be available to third parties in an open market

When evaluating the exercise price, consideration is given as to whether the nature of the exercise price (e.g., deeply out, out, or in-the-money) is expected to remain so for the entire exercise period, or whether the nature of the exercise price may change in the future. That is, the evaluation is not solely based on the option's nature at inception or as of the end of the reporting period. This is because to give power, an option must give an investor the current ability to direct the relevant activities when the decisions need to be made. Thus, for example, if an option was deeply-out-of-the-money at the reporting date, but expected to become in-the-money before the relevant activities of the investee need to be directed, then the option may be substantive. This evaluation will require the exercise of judgement based on all relevant facts and circumstances.

### **Financial ability**

The financial ability of an investor to pay the exercise price should be considered when evaluating whether an option is substantive, because this could be an 'economic barrier,' as contemplated by IFRS 10. This was previously prohibited from being considered under IAS 27. While financial ability is generally considered to be linked to the exercise price, because an investor should be able to obtain financing for an in-the-money option, this may not always be the case. For example, if there is evidence that an investor cannot obtain financing to exercise an in-the-money option, this might indicate that the option is not substantive; however, this is expected to be rare.

In contrast, it is probably more common that the holder has the financial ability to exercise an option that is out-of-the-money (but not deeply so) and would consider exercising that option to benefit from synergies. This might be the case when the investee has strategic importance to the option holder.

### **Exercise period**

To have power over an investee, an investor must have existing rights that give the investor the current ability to direct an investee's relevant activities. This would imply that an option needs to be currently exercisable to give power. However, under IFRS 10, an option can give an investor the current ability to direct an investee's relevant activities even when it is not currently exercisable, unlike in IAS 27. This is because the term 'current' is used more broadly in IFRS 10 than in IAS 27. Although 'current' often means 'as of today' or 'this instant' in practice, the IASB's use of the term in IFRS 10 broadly refers to the ability to make decisions about an investee's relevant activities when they need to be made. This is illustrated in Example 10.

#### **Example 10 – Potential voting rights No. 2**

An investee holds annual shareholder meetings, at which decisions to direct the relevant activities are made. An investor holds an option to acquire the majority of shares in the investee, which is not currently exercisable. However, the option is exercisable before the next scheduled shareholder meeting, and before a special shareholder meeting could be convened (based on the investee's governance policies).

When considering solely the exercise period, the investor's option would be a substantive right that gives the investor power (since it would give the holder a majority of shares). This is because the investor has the current ability to direct the investee's relevant activities when decisions need to be made, i.e., at the next scheduled shareholder meeting or a special shareholder meeting.

However, when concluding whether an investor has power over the investee in real fact patterns, all relevant facts and circumstances would be considered (not solely the exercise period) to evaluate whether the option is substantive.

In contrast, if the next shareholders' meeting occurs (or could be held) before the option is exercisable, the option would not be a right that would give the holder the current ability to direct the investee's activities (and therefore would not give the holder power).

IFRS 10 does not contain separate requirements for different types of potential voting rights; that is, employee options are subject to the same requirements as those that are held by a third party. However, it would be unlikely that an option held by an employee would give that employee power (or control) over an investee in practice, usually because the employee options represent such a small percentage of the outstanding shares, even if exercised. However, in a very small, privately owned, tightly held investee, it is possible for an employee (such as a member of management) to have power, if an option gives the employee the current ability to direct the relevant activities, or if the employee has other interests in the investee.

It should be noted that the IASB considered, but did not change, similar requirements in IAS 28 related to how options are considered when evaluating whether an investor has significant influence. That is, IAS 28 does not incorporate the IFRS 10 concept of evaluating whether an option is substantive. Accordingly, an option might give power under IFRS 10, but the same option might not result in significant influence under IAS 28.

#### How we see it

Simply holding a currently exercisable option that, if exercised, would give the investor more than half of the voting rights in an investee will no longer be sufficient to demonstrate control of the investee. All facts and circumstances must be considered to assess whether an investor has power over an investee, including whether an option is substantive (including, but not limited to consideration of the exercise period). This will require considerably more judgement than under IAS 27.

#### 4.3.5 Contracts related to voting rights

A contractual arrangement might give an investor the ability to direct the relevant activities by giving the investor the ability to direct other investors on how to vote, if voting rights give power over an investee.

### 4.4 Contractual arrangements

As noted in Section 4.3, power stems from existing rights. Sometimes, the relevant activities are not directed through voting rights, but rather, are directed by other means, such as through a contract. For example, an investor might have the contractual ability to direct manufacturing processes, operating activities, or determine financing of an investee through a contract or other arrangement.

#### Excerpt from IFRS 10

B52 When these contractual arrangements involve activities that are closely related to the investee, then these activities are, in substance, an integral part of the investee's overall activities, even though they may occur outside the legal boundaries of the investee. Therefore, explicit or implicit decision-making rights embedded in contractual arrangements that are closely related to the investee need to be considered as relevant activities when determining power over the investee.

When identifying which investor, if any, has power over an investee, it is important to review the contractual arrangements that the investor and the investee entered into. This analysis should include the original formation and governance documents of the investee, as well as the marketing materials provided to investors and other contractual arrangements entered into by the investee.

It is common that the relevant activities of a structured entity are directed by contractual arrangement. This is discussed further in Section 4.4.1.

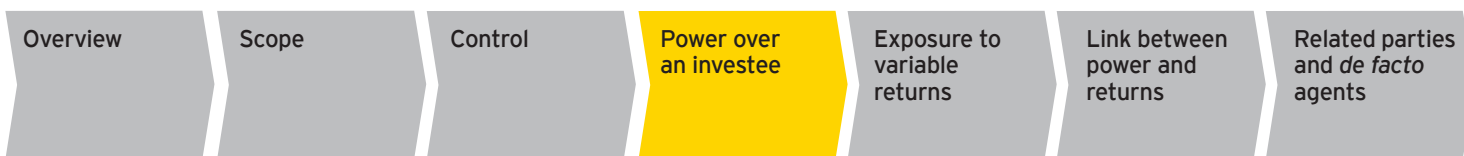
#### 4.4.1 Structured entities

IFRS 10 and IFRS 12 carry forward the concept of a 'special-purpose entity' from SIC-12, which is now called a 'structured entity'. However, the risks and rewards model under SIC-12 has been eliminated.

As defined in IFRS 12, a structured entity is 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. Therefore, an entity that is controlled by voting rights is not a structured entity. Accordingly, although it might be thought that an entity that receives funding from third parties following a restructuring is a structured entity, this would not be the case if that entity continues to be controlled by voting rights after the restructuring.

A structured entity often has some or all of the following features:

- ▶ Restricted activities
- ▶ A narrow and well-defined objective, such as
  - ▶ Holding a tax-efficient lease
  - ▶ Carrying out research and development activities
  - ▶ Funding an entity
  - ▶ Providing investment opportunities for investors by passing on risks and rewards associated with assets to investors
- ▶ Insufficient equity to finance its activities without subordinated financial support



- ▶ Financing in the form of multiple contractually-linked instruments to investors that create concentrations of credit or other risks (tranches)

Examples of structured entities include:

- ▶ Securitisation vehicles
- ▶ Asset-backed financings
- ▶ Some investment funds

Management needs to evaluate whether it controls a structured entity using the same approach as for traditional entities (those that are controlled through voting rights). That is, management evaluates whether an investor has power over the relevant activities, exposure to variable returns and the ability to affect those returns through its power over the structured entity, as shown in Diagram 4. Frequently, as discussed above, the relevant activities of a structured entity are directed by contractual arrangement. Example 11, which is summarised from an example included in IFRS 10, illustrates this.

#### **Example 11 – Power through contractual arrangements**

An investee's only business activity, as specified in its founding documents, is to purchase receivables and service them on a day-to-day basis for its investor. The servicing includes collecting the principal and interest payments as they fall due and passing them on to the investor. For any receivable in default, the investee is required to automatically put the receivable in default to the investor, as contractually agreed in the put agreement between the investor and the investee.

The relevant activity is managing the receivables in default, because it is the activity that significantly affects the investee's returns. The purpose and design of the investee gives the investor decision-making authority over the relevant activity. The terms of the put agreement are integral to the overall transaction and the establishment of the investee. Therefore, the put agreement, together with the founding documents of the investee, gives the investor power over the investee. This is the case, even though:

- ▶ The investor takes ownership of the receivables only in the event of a default
- ▶ The investor's exposures to variable returns are not technically derived from the investee (because the default receivables are no longer owned by the investee)

To conclude whether the investor has control, it would also need to assess whether the other two criteria are met, i.e., it has exposure to variable returns from its involvement with the investee, and the ability to use its power over the investee to affect the amount of its returns.

Notwithstanding the fact that the same approach is used to evaluate control for structured entities and traditional entities, it is still important to identify which entities are structured entities. This is because certain disclosure requirements apply only to structured entities, as discussed in Section 11.4.

### **4.5 Other evidence of power**

In some circumstances, it may be difficult to determine whether an investor's rights give it power over an investee. In such cases, the investor considers other evidence that it has the current ability to direct an investee's relevant activities. For example, the investor may have evidence that it has the practical ability to:

- ▶ Appoint, approve or nominate the investee's key management personnel (or Board of Directors)
- ▶ Direct the investee to enter into, or veto any changes to, significant transactions that affect the investor's exposure to variable returns
- ▶ Dominate either the nominations process for electing members of the investee's governing body, or obtaining proxies from other holders of voting rights

If the investor is a related party of the majority of the members of the investee's governing body or of its key management personnel, that may also provide evidence that the investor has power over the investee. This is because the IASB believes that this relationship may provide evidence that an investor has a special relationship with the investee, which suggests that the investor has more than a passive interest in the investee. Having such a passive interest in an investee may indicate that the investor has other rights that give it power over the investee.

Other factors might also indicate that an investor has power over an investee. For example, IFRS 10 states that this might be the case when the investee:

- ▶ Is directed by key management personnel who are current or previous employees of the investor
- ▶ Has significant:
  - ▶ Obligations that are guaranteed by the investor
  - ▶ Activities that either involve or are conducted on behalf of the investor
- ▶ Depends on the investor for:
  - ▶ Funding a significant portion of its operations
  - ▶ Licenses, trademarks, services, technology, supplies or raw materials that are critical to the licensee's operations
  - ▶ Key management personnel, such as when the investor's personnel have specialised knowledge of the investee's operations



## 4.6 Determining whether sponsoring (designing) a structured entity gives power

IFRS 10 discusses whether sponsoring (i.e., designing) a structured entity gives an investor power over the structured entity.

### Excerpt from IFRS 10

B51 In assessing the purpose and design of an investee, an investor shall consider the involvement and decisions made at the investee's inception as part of its design and evaluate whether the transaction terms and features of the involvement provide the investor with rights that are sufficient to give it power. Being involved in the design of an investee alone is not sufficient to give an investor control. However, involvement in the design may indicate that the investor had the opportunity to obtain rights that are sufficient to give it power over the investee.

An investor's involvement in the design of an investee does not, in and of itself, mean that investor necessarily has control, even if that involvement was significant. Rather, an investor has control of an investee when all three criteria of control are met (see Chapter 3), considering the purpose and design of the investee. Thus, an investor's involvement in the design of an investee is part of the context when concluding if it controls the investee, but is not determinative.

There are few structured entities for which there is no substantive decision-making. However, if a structured entity truly has no decision-making and is actually on autopilot, then no investor would control that structured entity, even if the investor sponsored the structured entity. This is because no investor has power over the structured entity, that is, no investor has the current ability to direct the activities that significantly affect the structured entity's returns.

### How we see it

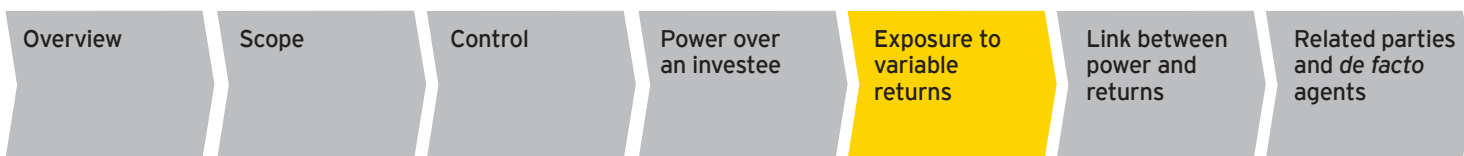
There are few structured entities that have no substantive decision-making. That is, virtually all structured entities have some level of decision-making and few, if any, are on autopilot. If the decision-making can significantly affect the returns of the structured entity, the investor with the rights to make those decisions would have power. This is because IFRS 10 clarifies that an investor has power when it has existing rights that give it the current ability to direct the relevant activities, even if those relevant activities only occur when particular circumstances arise or specific events occur.

However, a structured entity with limited decision-making requires additional scrutiny to determine which investor, if any, has power (or control) over the structured entity, particularly for the investors that have a potentially significant explicit or implicit exposure to variable returns. Careful consideration is required regarding the purpose and design of the structured entity.

In addition, the evaluation of power may require an analysis of the decisions made at inception of the structured entity, including a review of the structured entity's governing documents, because the decisions made at formation may affect which investor, if any, has power.

For a structured entity with a limited range of activities, such as certain securitisation entities, power is assessed based on which activities, if any, significantly affect the structured entity's returns, and if so, which investor, if any, has existing rights that give it the current ability to direct those activities. The following considerations may also be relevant when determining which investor, if any, has power (or control):

- ▶ An investor's ability to direct the activities of a structured entity only when specific circumstances arise or events occur may constitute power if that ability relates to the activities that most significantly affect the structured entity's returns (see Section 4.1.1)
- ▶ An investor does not have to actively exercise its power to have power over a structured entity (see Diagram 5 in Section 4.2.1)
- ▶ An investor is more incentivised to obtain power over a structured entity the greater its obligation to absorb losses or its right to receive benefits from the structured entity (see Section 4.2.3)



## Chapter 5 Exposure to variable returns

The second criterion for assessing whether an investor has control of an investee is determining whether the investor has an exposure, or has rights, to variable returns from its involvement with the investee. Returns can be positive, negative or both.

Examples of exposures to variable returns include:

- ▶ Dividends, fixed interest on debt securities that expose the investor to the credit risk of the issuer (see Section 5.2), variable interest on debt securities, other distributions of economic benefits and changes in the value of an investment in an investee
- ▶ Remuneration for servicing an investee's assets or liabilities, fees and exposure to loss from providing credit or liquidity support, residual interests in the investee's assets and liabilities on liquidation of that investee, tax benefits and access to liquidity that an investor has from its involvement with the investee
- ▶ Economies of scale, cost savings, scarce products, proprietary knowledge, synergies, or other exposures to variable returns that are not available to other investors

Simply having an exposure to variable returns from its involvement with an investee does not mean that the investor has control. To control the investee, the investor would also need to have power over the investee, and the ability to use its power over the investee to affect the amount of the investor's returns. For example, it is common for a lender to have an exposure to variable returns from a borrower through variable interest payments that it receives from the borrower. However, the lender would not control the borrower if it does not have the ability to affect those variable interest payments (which is frequently the case).

It should be emphasised that with respect to this criteria, the focus is on the existence of an exposure to variable returns, not the amount of the exposure to variable returns.

### 5.1 Exposure to variable returns is an indicator of control

Exposure to variable returns is an indicator of control. This is because the greater an investor's exposure to the variability of returns from its involvement with an investee, the greater the incentive for the investor to obtain rights that give the investor power. However, the magnitude of the exposure to variable returns does not determine whether the investor holds power.

When an investor's exposure, or rights, to variable returns from its involvement with the investee are disproportionately greater than its voting or other similar rights, this might be an indicator of control. However, an assessment must still be completed to determine if an investor actually has control (i.e., all three criteria shown in Diagram 4 must be met).

### 5.2 Returns that appear fixed can be variable

An investor assesses whether exposures to returns from an investee are variable, based on the substance of the arrangement (regardless of the legal form of the returns). Even a return that appears fixed may actually be variable.

IFRS 10 gives the example of an investor that holds a bond with fixed interest payments. The fixed interest payments are considered an exposure to variable returns, because they expose the investor to the credit risk of the issuer. How variable those returns are depends on the credit risk of the bond.

Similarly, IFRS 10 also explains that fixed performance fees earned for managing an investee's assets are considered an exposure to variable returns, because they expose the investor to the performance risk of the investee. That is, the amount of variability depends on the investee's ability to generate sufficient income to pay the fee.

In contrast, a non-refundable fee received up-front (wherein the investor does not have exposure to credit risk or performance risk) would likely be considered a fixed return.

### 5.3 Evaluating whether derivatives provide an exposure to variable returns

Under IFRS 10, investors need to evaluate whether being party to a derivative gives them an exposure to a variable return.

#### Excerpt from IFRS 10

B8 An investee may be designed so that voting rights are not the dominant factor in deciding who controls the investee, such as when any voting rights relate to administrative tasks only and the relevant activities are directed by means of contractual arrangements. In such cases, an investor's consideration of the purpose and design of the investee shall also include consideration of the risks to which the investee was designed to be exposed, the risks that it was designed to pass on to the parties involved with the investee and whether the investor is exposed to some or all of these risks. Consideration of the risks includes not only the downside risk, but also the potential for upside.



When evaluating whether being party to a derivative is an exposure to a variable return, it is helpful to consider the following steps:

- ▶ Analyse the nature of the risks in the investee – for example, assess whether the purpose and the design of the investee exposes the investor to the following risks:
  - ▶ Credit risk
  - ▶ Interest rate risk (including prepayment risk)
  - ▶ Foreign currency exchange risk
  - ▶ Commodity price risk
  - ▶ Equity price risk
  - ▶ Operations risk
- ▶ Determine the purpose(s) for which the investee was created – for example, obtain an understanding of the following:
  - ▶ Activities of the investee
  - ▶ Terms of the contracts the investee has entered into
  - ▶ Nature of the investee's equity interests issued
  - ▶ Manner in which the investee's interests were negotiated or marketed to potential investors
  - ▶ Investors who participated significantly in the design or redesign of the investee
- ▶ Determine the variability that the investee is designed to create and pass along to its interest holders – considering the nature of the risks of the investee and the purposes for which the investee was created

Some argue that any derivative creates an exposure to variable returns, even if that exposure is only a positive exposure. However, others do not believe that this was the IASB's intention, given the comments in the Basis for Conclusions to IFRS 10 (which are also repeated in IFRS 12).

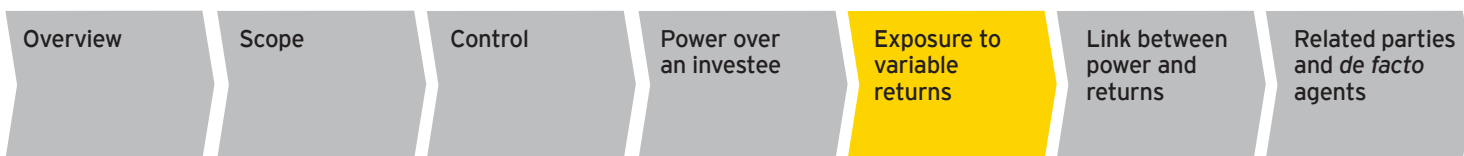
#### Excerpt from Basis for Conclusions to IFRS 10

BC66 Some instruments are designed to transfer risk from a reporting entity to another entity. During its deliberations, the Board concluded that such instruments create variability of returns for the other entity but do not typically expose the reporting entity to variability of returns from the performance of the other entity. For example, assume an entity (entity A) is established to provide investment opportunities for investors who wish to have exposure to entity Z's credit risk (entity Z is unrelated to any other party involved in the arrangement). Entity A obtains funding by issuing to those investors notes that are linked to entity Z's credit risk (credit-linked notes) and uses the proceeds to invest in a portfolio of risk-free financial assets. Entity A obtains exposure to entity Z's credit risk by entering into a credit default swap (CDS) with a swap counterparty. The CDS passes entity Z's credit risk to entity A, in return for a fee paid by the swap counterparty. The investors in entity A receive a higher return that reflects both entity A's return from its asset portfolio and the CDS fee. The swap counterparty does not have involvement with entity A that exposes it to variability of returns from the performance of entity A because the CDS transfers variability to entity A, rather than absorbing variability of returns of entity A.

#### How we see it

Generally, a derivative that introduces risk to an investee (e.g., a structured entity) would not be considered an exposure to variable returns under IFRS 10. Only a derivative that exposes a counterparty to risks that the investee was designed to create and pass on would be considered an exposure to variable returns under IFRS 10.

This view is consistent with the IASB's intentions. In addition, this view would result in convergence with US GAAP in most cases. The IASB and FASB have stated that they believe that they have achieved convergence with respect to evaluating control of a structured entity, and it would be difficult to reach converged solutions on many fact patterns involving derivatives and structured entities if the alternative view (that all derivatives create an exposure to variable returns) were taken.



An exposure to variable returns generally absorbs or receives the variability created by the investee's assets, liabilities or other contracts, and the risks the investee was designed to pass along to its investors. In contrast, interests that introduce risk to the investee are generally not exposures to variable returns in the investee.

It follows that if a derivative is entered into to reduce the variability of a structured entity's cash flows, it is not a risk that the structured entity was designed to be exposed to, nor is it a risk that the structured entity was designed to pass on to the counterparty. Instead, the derivative is entered into to align the cash flows of the assets of the structured entity with those of the investors and so reduce the risks to which the investors in the structured entity are exposed. Accordingly, the counterparty would not have an exposure to a variable return.

For example, consider a situation in which a structured entity acquired a portfolio of equity instruments, issued fixed or floating rate notes, and hedged the mismatch in cash flows between the equity instruments and the notes through writing a total return swap to a counterparty. In this case, the structured entity was not designed to provide an interest rate exposure to the note holders; it is clearly designed to give equity risk to the counterparty. Accordingly, the counterparty would have an exposure to a variable return.

#### 5.4 Exposure to variable returns from involvement with an investee

When identifying an exposure to variable returns, in addition to returns generated directly by the investee, other returns that are received by the investor from that involvement are also considered. IFRS 10 refers to both sets of returns in specifying the criteria to be met when determining if an investor has control over an investee.

##### Excerpt from IFRS 10

- 7 Thus, an investor controls an investee if and only if the investor has all the following:
- (a) Power over the investee;
  - (b) Exposure, or rights, to **variable returns from its involvement with the investee**; and
  - (c) The ability to use its power over the investee to affect the **amount of the investor's returns**.
- (Emphasis added)

Generally, the focus is on the returns that are generated by the investee. However, depending on the purpose and design of the arrangements and the investee, when the investor receives returns that are not generated by the investee, but stem from involvement with the investee, these returns are also considered.

For example, if an investor would achieve economies of scale or synergies by combining the operations or assets of the investee with its own operations or assets, this would give the investor an exposure to a variable return.

#### 5.5 Exposure to variable returns in bankruptcy filings

As discussed in Section 4.3.2, evaluating whether an investor has control when its investee files for bankruptcy requires the exercise of judgement based on the facts and circumstances. Part of the assessment includes an evaluation of whether the investor has an exposure to variable returns from the investee once the investee files for bankruptcy. For example, based on the requirements for the particular type of bankruptcy in the relevant jurisdiction:

- ▶ Is the investee restricted from paying dividends to the investors upon filing for bankruptcy?
- ▶ Are the investors exposed to a variable return through their interests in the investee, notwithstanding the bankruptcy (e.g., do shares in the investee retain any value)?
- ▶ Do the investors have a loan receivable, or other financial interest in the investee, that is expected to provide a return (or is the loan worthless)?
- ▶ Do the investors have access to other synergies from the investee?

For an investor to have control, it must also have power (as discussed in Section 4.3.2) and the ability to use its power over the investee to affect the amount of the investor's returns (see Chapter 6).

## Chapter 6 Link between power and returns: principal-agency situations

The third criterion for having control is that the investor must have the ability to use its power over the investee to affect the amount of the investor's returns. The link between power over an investee and exposure to variable returns from involvement with the investee is essential to having control. An investor that has power over an investee, but cannot benefit from that power, does not control that investee. An investor that has an exposure to a variable return from an investee, but cannot use its power to direct the activities that most significantly affect the investee's returns, does not control that investee. This is illustrated in Example 12.

### **Example 12 – Link between power and returns is essential for control**

A structured entity is created and financed by debt instruments held by a senior lender and a subordinated lender and a minimal equity investment from the sponsor. The subordinated lender transferred receivables to the structured entity. Managing the receivables in default is the only activity of the structured entity that causes its returns to vary, and this power has been given to the subordinated lender by contract. The subordinated loan is designed to absorb the first losses and to receive any residual return from the structured entity. The senior lender has exposure to variable returns due to the credit risk of the structured entity.

When analysing which investor, if any, has control, the first step is to identify the relevant activities. In this example, managing the receivables in default is the only activity of the structured entity that causes its returns to vary. Therefore, it would be the relevant activity. The next step is to determine which investor, if any, has the current ability to direct that relevant activity. In this example, the subordinated lender has the power that it was granted by contract. The subordinated lender is exposed to variable returns from its involvement with the structured entity through its subordinated debt. The subordinated lender has the ability to affect those returns through its power to manage the receivables in default. Since all three elements of control are present, the subordinated lender has control over the structured entity. This evaluation is made in the context of understanding the structured entity's purpose and design.

While the senior lender's exposure to variable returns is affected by the structured entity's activities, the senior lender has no power to direct those activities. Thus, the senior lender does not control the structured entity, because it is missing two of the elements of control.

### **6.1 Delegated power: principals and agents**

When decision-making rights have been delegated or are being held for the benefit of others, it is necessary to assess whether the decision-maker is a principal or an agent to determine whether it has control. This is because if the decision-maker has been delegated rights that give it power, the decision-maker must assess whether those rights give it power for its own benefit, or merely power for the benefit of others. As an agent cannot have control over the investee, it does not consolidate the investee. A principal may have control over the investee, and if so, would consolidate the investee.

While principal-agency situations often occur in the asset management and banking industries, they are not limited to those industries. Entities in the construction, real estate and extractive industries also frequently delegate powers when carrying out their business. This is especially common when an investee is set up and one of the investors (often the lead investor) is delegated powers by the other investors to carry out activities for the investee. Assessing whether the lead investor is making decisions as a principal, or simply carrying out the decisions made by all the investors (i.e., acting as an agent) will be critical to assessing control (or joint control).

#### **Excerpts from IFRS 10**

- 17 An investor controls an investee if the investor not only has power over the investee and exposure or rights to variable returns from its involvement with the investee, but also has the ability to use its power to affect the investor's returns from its involvement with the investee.
- 18 Thus, an investor with decision-making rights shall determine whether it is a principal or an agent. An investor that is an agent in accordance with paragraphs B58-B72 does not control an investee when it exercises decision-making rights delegated to it.

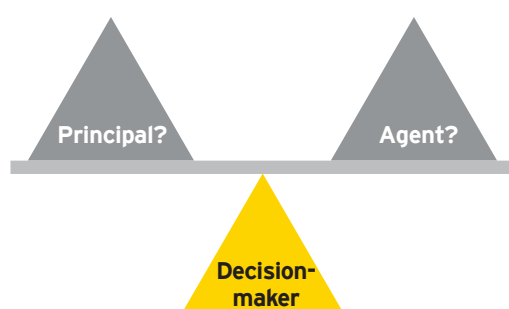
An agent is a party engaged to act on behalf of another party or parties (the principal(s)), but does not have control over the investee. An investor may delegate decision-making authority to an agent on some specific issues or on all relevant activities, but, ultimately, the investor as principal retains the power. Accordingly, a decision-maker that is not an agent is a principal. However, it should be noted that:

- ▶ A decision-maker is not an agent simply because others benefit from the decisions that it makes
- ▶ An obligation to act in the best interest of those who have delegated the power does not prevent the decision-maker from being a principal

The terms and conditions of the arrangement are considered to assess whether an entity is an agent or a principal. The determination of whether a decision-maker is an agent or a principal is made based on the following:

- ▶ Scope of decision-making authority
- ▶ Rights held by other parties (e.g., existence of removal rights)
- ▶ Remuneration of the decision-maker
- ▶ Exposure to variability of returns through other interests

Each of these factors is discussed in more detail in the remainder of Chapter 6. When reaching a conclusion, each of the factors is weighted according to the facts and circumstances of each case, which will require judgement. The only situation that is conclusive by itself is when removal rights are held by a single investor and the decision-maker can be removed without cause. This is discussed in more detail in Section 6.3. Accordingly, although each of the factors is discussed in isolation, a conclusion should be based on all of the factors considered together.



## 6.2 Scope of decision-making

To assess whether a decision-maker is a principal or an agent, the scope of its authority is evaluated by considering both:

- ▶ The activities that the decision-maker is permitted to direct (e.g., by agreement or by law)
- ▶ The discretion that the decision-maker has when making decisions about those activities

It is implicit in the definition of control that, for a decision-maker to control the entity over which it has been delegated decision-making authority, the decision-maker must have power. This means that it must have been delegated the rights that give the current ability to direct the relevant activities (the activities that significantly affect that investee's returns). If a decision-maker has been delegated rights that do not relate to the relevant activities, it would not control the investee.

For this reason, it is imperative to understand the purpose and design of the investee, the risks to which it was designed to be exposed and the risk that was designed to pass on to the other parties involved. Understanding the purpose and design of the investee often helps to determine which rights were delegated, why they were delegated, and which rights have been retained by other parties, and why those rights were retained.

### 6.2.1 Involvement in design and autopilot situations

A decision-maker's involvement in the design of an investee does not, in itself, mean that decision-maker necessarily is a principal, even if that involvement was significant.

#### Excerpt from IFRS 10

B63 A decision maker shall consider the purpose and design of the investee, the risks to which the investee was designed to be exposed, the risks it was designed to pass on to the parties involved and the level of involvement the decision maker had in the design of an investee. For example, if a decision maker is significantly involved in the design of the investee (including in determining the scope of decision-making authority), that involvement may indicate that the decision maker had the opportunity and incentive to obtain rights that result in the decision maker having the ability to direct the relevant activities.

A decision-maker is a principal if it is determined that it is using its power for its own benefit. This determination is made in the context of considering the purpose and design of the investee, and the other factors listed in this chapter. Thus, a decision-maker's involvement in the design of an investee is part of the context when concluding if it is a principal or agent, but is not determinative.

#### How we see it

Similar to the considerations for structured entities discussed in Section 4.6, when a decision-maker sponsors an investee, and establishes certain decisions in the governing documents of the investee, there should be increased scrutiny as to whether that decision-maker is a principal or an agent of the investee, particularly if the other factors are indicative of the decision-maker being a principal. However, when there are many parties involved in the design of an investee, the decisions established in the governing documents might be less relevant.



### 6.2.2 Assessing whether scope of powers is narrow or broad

When evaluating whether a decision-maker is a principal or an agent, in considering the scope of its decision-making authority, it appears that a relevant factor is whether the scope of powers that have been delegated (and the discretion allotted) is narrow or broad. In IFRS 10 Example 13, where a decision-maker (fund manager) establishes, markets and manages a publicly traded, regulated fund according to narrowly defined parameters set out in the investment mandate, the example concludes that this is a factor that indicates that the fund manager is an agent. In IFRS 10 Example 14, where the decision-maker (fund manager) has wide decision-making authority, the example implies that the extensive decision-making authority of the fund manager would be an indicator that it is a principal. This suggests that when the scope of powers is broad, this would be an indicator that the decision-maker is a principal. However, to conclude whether a decision-maker is an agent or a principal, the scope of power needs to be evaluated with the other three factors (discussed in Section 6.1) in totality.

### 6.3 Rights held by other parties

The decision-maker may be subject to rights held by other parties that may affect the decision-maker's ability to direct the relevant activities of the investee, such as rights held by those parties to remove the decision-maker. Rights to remove a decision-maker are often referred to as kick-out rights. Substantive removal rights may indicate that the decision-maker is an agent. Liquidation rights and redemption rights held by other parties, which may in substance be similar to removal rights, are discussed in Section 6.3.2.

Other substantive rights held by other investors that restrict a decision-maker's discretion are considered similarly to removal rights when evaluating whether the decision-maker is an agent. For example, a decision-maker that is required to obtain approval from a small number of other investors for its actions is generally an agent.

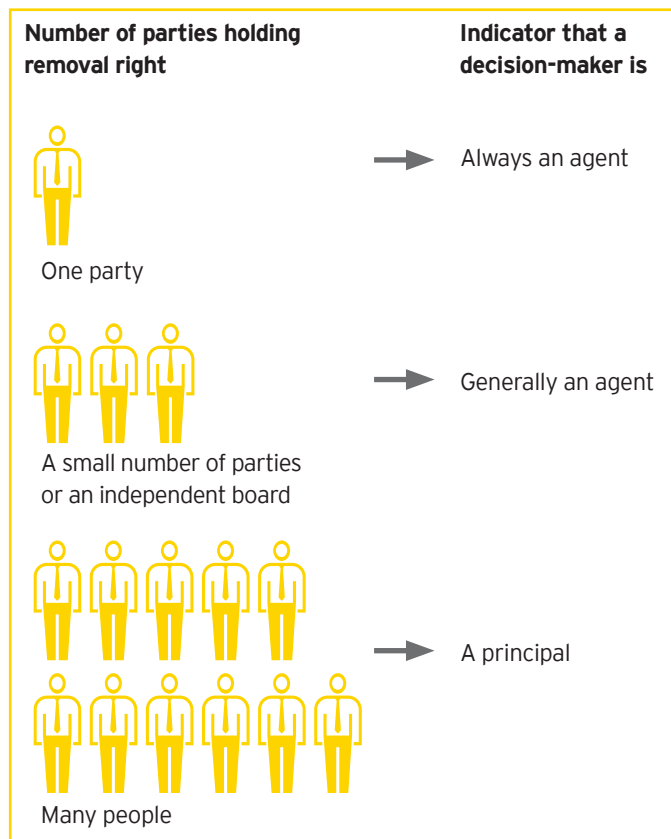
As shown in Diagram 7, when a single investor holds substantive rights to remove the decision-maker without cause, that fact in isolation is sufficient to conclude that the decision-maker is an agent. That is, the decision-maker does not control the entity with respect to which the rights have been delegated.

However, if multiple investors hold such rights (i.e., no individual investor can remove the decision-maker without cause without the others), these rights would not, in isolation, determine whether a decision-maker is an agent or a principal. That is, all other facts and circumstances would need to be considered. The more parties that must act together to remove a decision-maker and the greater the magnitude of, and variability associated

with, the decision-maker's other economic interests, the less weighting that is placed on the removal right. This is reflected in an example provided in IFRS 10, where there is a large number of widely dispersed unrelated third party investors. Although the decision-maker can be removed, without cause, by a simple majority decision of the other investors, this is given little weighting in evaluating whether the decision-maker is a principal or an agent.

If an independent Board of Directors (or governing body), which is appointed by the other investors, holds a right to remove without cause, that would be an indicator that the decision-maker is an agent. This is the position taken in an example in IFRS 10 where a fund has a Board of Directors, all of whose members are independent of the fund manager and are appointed by the other investors. The Board of Directors appoints the fund manager annually. The example explains that the Board of Directors provides a mechanism to ensure that the investors can remove the fund manager if they decide to do so. By placing greater emphasis on the substantive removal rights, the conclusion in the example is that the fund manager is an agent, and therefore does not control the fund.

**Diagram 7 – Evaluating rights to remove without cause**

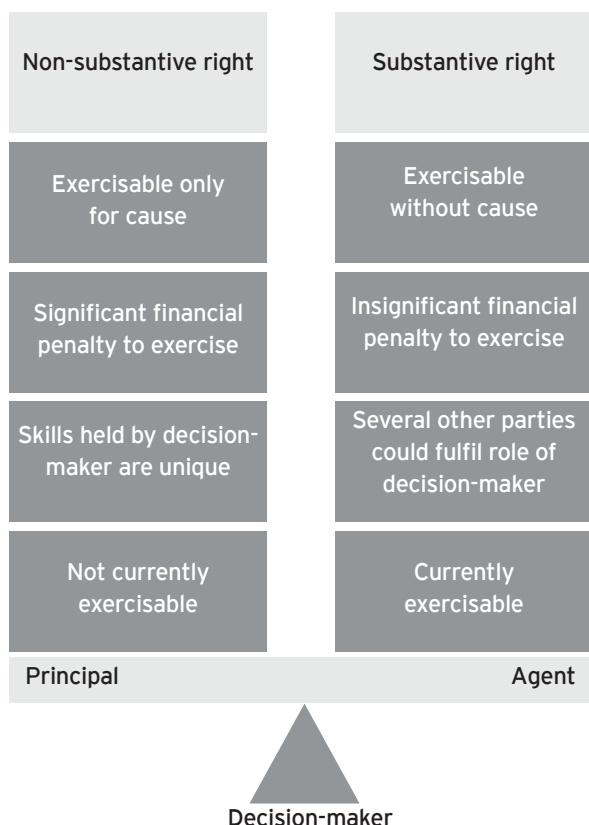


### 6.3.1 Evaluating whether a removal right is substantive

When evaluating removal rights, it is important to determine whether they are substantive, as discussed in Section 4.2.1. If the removal right is not substantive, that is an indicator that the decision-maker is a principal (although the determination needs to be based on the three other factors, i.e., scope of decision-making authority, remuneration and exposure to variability of returns through other interests). In contrast, if the removal right is substantive, that is an indicator that the decision-maker is an agent.

Some of the criteria that might be more relevant when evaluating whether a removal right is substantive are shown in Diagram 8. However, all of the factors noted in Diagram 5 in Section 4.2.1 and IFRS 10 must be considered in this evaluation.

**Diagram 8 – Evaluating whether removal rights are substantive**



Evaluating whether a removal right is substantive will depend on facts and circumstances.

### Available replacements

When evaluating whether a removal right is substantive, consideration is given to whether suitable replacements exist. This is because if there are no (or few) suitable replacements for the decision-maker, this would be an operational barrier that would likely prevent the parties holding the removal right from exercising that removal right.

In the asset management industry, suitable replacements are generally available. However, in other industries (e.g., construction, real estate, extractive), it is more common for the decision-maker to possess unique traits. For example, the decision-maker may have experience with a particular geographic location, local government, or proprietary intellectual property or tools. That might make it more difficult to assess whether there are other parties that could replace the decision-maker if the parties wanted to remove the decision-maker. However, regardless of the industry, an assessment of whether there are available replacements depends upon the specific facts and circumstances, and will require judgement.

### Exercise period

A removal right may not be exercisable until a date in the future. In such cases, judgement must be exercised to determine whether (or when) that right becomes substantive. Similarly, when a removal right can only be exercised during a narrow period (e.g., for one day on the last day of the reporting period), judgement will also need to be applied to conclude whether the right is substantive or not.

When a removal right is exercised, there is typically a period (e.g., six months) until the decision-maker transitions decision-making back to the principal (or to another decision-maker) in an orderly manner. In such cases, judgement will need to be applied to assess whether the principal has the current ability to direct the relevant activities when decisions need to be made, and therefore whether the removal right is substantive.

### How we see it

Even if there is a transition period between when the decision-maker is removed and when the principal (or another decision-maker) becomes responsible for making decisions, the removal right may still be substantive.



### 6.3.2 Liquidation rights and redemption rights

In some cases, rights held by other parties (such as some liquidation rights and some redemption rights) may have the same effect on the decision-maker's authority as removal rights. When a liquidation right or a redemption right is in substance the same as a removal right, its consideration in the evaluation of whether a decision-maker is a principal or an agent is the same.

For example, if a limited partnership were required to be liquidated upon the withdrawal of one limited partner, that right would be considered a removal right if it were substantive (as discussed in Sections 4.2.1 and 6.3.1). However, such rights must be analysed carefully, based on the facts and circumstances.

## 6.4 Remuneration

The third factor to evaluate when assessing whether a decision-maker is a principal or an agent is remuneration.

### Excerpts from IFRS 10

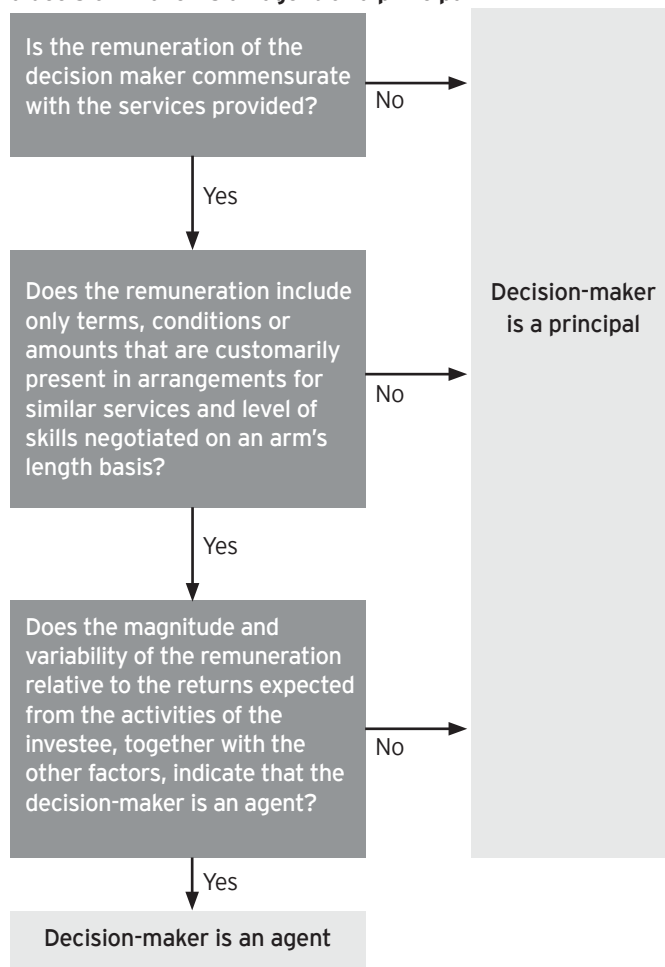
B68 The greater the magnitude of, and variability associated with, the decision maker's remuneration relative to the returns expected from the activities of the investee, the more likely the decision maker is a principal.

B69 In determining whether it is a principal or an agent the decision maker shall also consider whether the following conditions exist:

- (a) The remuneration of the decision maker is commensurate with the services provided.
- (b) 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.

B70 A decision maker cannot be an agent unless the conditions set out in paragraph B69(a) and (b) are present. However, meeting those conditions in isolation is not sufficient to conclude that a decision maker is an agent.

**Diagram 9 – Evaluating remuneration in determining whether a decision-maker is an agent or a principal**



### 6.4.1 Evaluating remuneration in the asset management industry

When evaluating whether a decision-maker is a principal or an agent, an entity is required to evaluate the magnitude and the variability of the remuneration relative to the expected returns from the investee. In examples related to the asset management industry, IFRS 10 describes three common remuneration structures:

- ▶ 1% of net assets under management
- ▶ 1% of assets under management and performance-related fees of 10% of profits if the investee's profits exceed a specified level
- ▶ 1% of assets under management and 20% of all the fund's profits if a specified profit level is achieved

In each case, IFRS 10 concludes that the remuneration is commensurate with the services provided. In addition, the remuneration aligns the interests of the decision-maker with those of other investors. However, IFRS 10 concludes for each of these cases that remuneration does not create an exposure to variable returns that is of such significance that it, in isolation, indicates that the fund manager is a principal. Although IFRS 10 does not address whether the remuneration only includes market terms in each of the fact patterns, this would also need to be assessed. IFRS 10 does not include any examples of remuneration arrangements where it is clear the remuneration is of such significance that it, in isolation, indicates that the fund manager is a principal.

#### How we see it

In most asset management scenarios involving retail investors, management will be able to conclude that the remuneration is commensurate with services provided and only includes market terms. This is because otherwise, retail investors would take their business elsewhere. As shown in Diagram 9, when both of those criteria are met, the decision-maker must evaluate whether the magnitude and exposure to variable returns received through the remuneration, together with the other factors, indicates that the decision-maker is an agent or a principal.

Further examples and discussion of the impact on the asset management industry can be found in our publication, *Applying IFRS: IFRS 10 – Consolidation for fund managers*, which can be found at [www.ey.com/ifrs](http://www.ey.com/ifrs).

### 6.4.2 Evaluating remuneration in other industries

IFRS 10 does not include any examples of principal-agency evaluations in construction, real estate and extractive industries.

#### How we see it

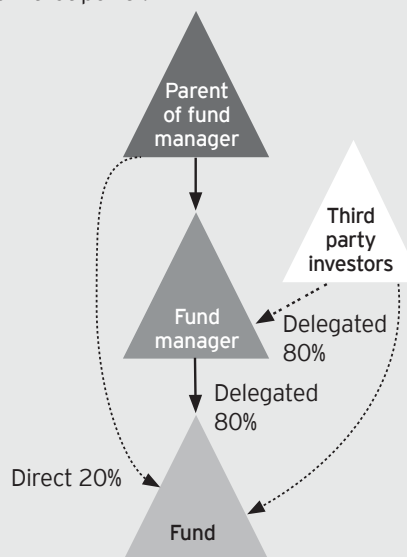
In the construction, real estate and extractive industries, it is more common for the decision-maker to possess unique traits. That might make it more difficult to assess whether the remuneration is commensurate with the skills provided, and includes only market terms.

### 6.5 Exposure to variability of returns from other interests

When an investor has exposure to variable returns from its involvement with an investee (e.g., a direct financial investment in that investee, or provides a guarantee), and has been delegated decision-making authority by other parties, the investor considers that exposure to variable returns when assessing whether it has control over that investee. This is illustrated in Example 13.

#### Example 13 – Illustration of exposure to variability of returns through other interests

A parent of a fund manager has a 20% direct interest in a fund. The other 80% of the fund is held by third party investors, who have delegated their rights with respect to the fund to the fund manager. When evaluating whether the parent controls the fund, it assesses whether the fund manager (which the parent controls) would use the power that has been delegated to it by the third parties holding the 80% interest, to benefit the parent, since the parent has a 20% direct interest in the fund and could benefit from that power.



Remember that being an 'investor' and having an 'interest' in an investee is not limited to holding equity or debt instruments. As discussed in Chapter 5, a variety of exposures to variable returns can represent an interest and any potential controlling party is referred to as an investor.

#### Excerpt from IFRS 10

B72 In evaluating its exposure to variability of returns from other interests in the investee a decision maker shall consider the following:

- (a) The greater the magnitude of, and variability associated with, its economic interests, considering its remuneration and other interests in aggregate, the more likely the decision maker is a principal.
- (b) 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 to, an investee.

The decision maker shall evaluate its exposure relative to the total variability of returns of the investee. This evaluation is made primarily on the basis of returns expected from the activities of the investee but shall not ignore the decision maker's maximum exposure to variability of returns of the investee through other interests that the decision maker holds.

IFRS 10 states that if a decision-maker has interests in an investee, just by virtue of holding those other interests, the decision-maker may be a principal. In the Basis for Conclusions to IFRS 10, the IASB notes that a decision-maker might use its decision-making authority primarily to affect the returns it receives. That is, the decision-maker would have power for its own benefit. The IASB also notes in its Basis for Conclusions that it would be inappropriate to conclude that every decision-maker that is obliged, by law or contract (i.e., having any fiduciary responsibility) to act in the best interests of other parties is always an agent. This is because it would assume that a decision-maker that is legally or contractually obliged to act in the best interests of other parties will always do so, even if that decision-maker receives the vast majority of the returns that are influenced by its decision-making. Accordingly, IFRS 10 requires an entity to evaluate the magnitude and variability of its other interests when determining if it is a principal or an agent, notwithstanding its fiduciary responsibility.

#### How we see it

Since the magnitude and variability of exposure to returns are considered together with the other factors, there is no bright line as to what level of other direct interests, on their own, would cause a decision-maker to be a principal or an agent. That is, scope of authority, removal rights, and remuneration also need to be considered. The examples in IFRS 10 also do not specify the magnitude and variability of the remuneration.

In certain industries, such as private equity, asset management and insurance, large direct interests are common and careful evaluation of this criterion will be needed. The conclusions reached under IFRS 10 may differ from those reached under IAS 27 and SIC-12. This is particularly likely when management previously considered an investee (such as a fund) to be a structured entity and concluded that because it did not have a majority of risks and rewards (even though it had a significant interest, such as 40%), it was not required to consolidate under SIC-12.

## Chapter 7 Related parties and *de facto* agents

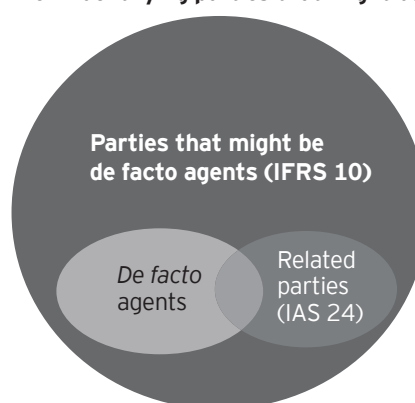
IFRS 10 also requires an investor to consider whether there are other parties who are acting on behalf of the investor by virtue of their relationship with it. That is, IFRS 10 requires consideration of whether the other parties are acting as *de facto* agents for the investor. Such relationships need not be contractual. IFRS 10 lists several examples of parties that might be *de facto* agents.

### Excerpt from IFRS 10

- B75 The following are examples of such other parties that, by the nature of their relationship, might act as *de facto* agents for the investor:
- 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 (except for situations in which the investor and the other party have the right of prior approval and the rights are based on mutually agreed terms by willing independent parties).
  - 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 those of the investor.
  - 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.

However, just because a party falls within the examples above, that does not mean that it is necessarily a *de facto* agent for the investor, as shown in Diagram 10. It simply means that management must carefully evaluate whether that party is a *de facto* agent for the investor. Parties that are actually *de facto* agents are only a sub-set of this list. Therefore, management must determine whether the other party is acting on behalf of the investor because of its relationship to the investor. IFRS 10 does not provide much explanation on how this evaluation is to be made; IFRS 10 only states that the evaluation considers the nature of the relationship and how the parties interact with each other.

Diagram 10 – Identifying parties that might be *de facto* agents



### How we see it

Given the breadth of the parties that might be a *de facto* agent in IFRS 10, there are likely to be numerous parties that need to be evaluated to determine if they are actually *de facto* agents, which requires careful evaluation of the facts and circumstances, including the purpose and design of the investee.

If a party is determined to be a *de facto* agent, then its rights and exposures to variable returns are considered together with those of the investor when evaluating whether an investor has control of an investee. Just because one party is a *de facto* agent of the other party, that does not mean that the *de facto* agent is controlled by the investor. Consolidation procedures in situations when a *de facto* agent exists are discussed in Section 10.1.

### 7.1 Customer-supplier relationships

Normally, a typical supplier-customer relationship is not expected to result in one party being a *de facto* agent of the other. This is because in a typical supplier-customer relationship, one party cannot direct the other party to act on its behalf, because the activities of each are directed by their respective shareholders, Board of Directors and management.

However, a party with a close business relationship is an example of a *de facto* agent. Accordingly, where a close business relationship exists between a customer and a supplier, consideration needs to be given to whether the supplier is a *de facto* agent of the customer. A close business relationship is not defined but, for example, this might be the case if:

- ▶ An entity has only one significant customer
- ▶ The customer and supplier have common management or common shareholders
- ▶ The customer has the ability to direct product design, sales, etc.
- ▶ The supplier is a service provider (e.g., investment banker, attorney) that assists in structuring a transaction

## Chapter 8 Control of specified assets

IFRS 10 requires that an investor consider whether it treats a portion of an investee as a deemed separate entity (a silo) and, if so, whether it controls the deemed separate entity. Therefore, IFRS 10 clarifies, as shown in the excerpt below, that an investor can have control over specified assets of an investee (i.e., whether a silo exists within a host entity). This concept was not explicitly included in IAS 27 or SIC-12, but was frequently considered in practice.

IFRS 10 gives a very strict rule as to when a portion of an entity is deemed to be a silo, and therefore, evaluated separately for consolidation from the remainder of the host entity.

### Excerpt from IFRS 10

**B77** An investor shall treat a portion of an investee as a deemed separate entity if and only if the following condition is satisfied:

Specified assets of the investee (and related credit enhancements, if any) are the only source of payment for specified liabilities of, or specified other interests in, the investee. 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. Thus, in substance, all the assets, liabilities and equity of that deemed separate entity are ring-fenced from the overall investee. Such a deemed separate entity is often called a 'silo'.

### How we see it

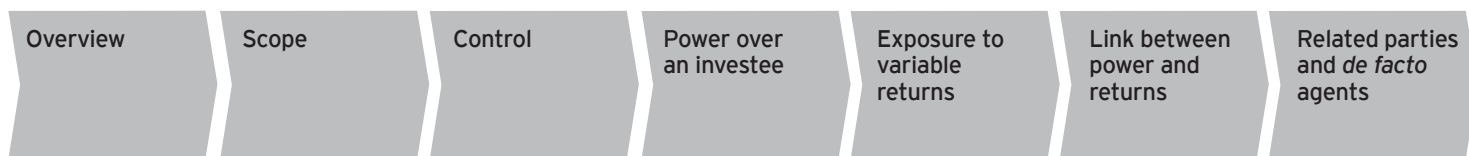
In many cases, where a silo exists, it will be because a trust or similar legal structure exists to ring-fence the assets and liabilities from the host.

From the host's perspective, adopting IFRS 10 may not change the conclusions reached under IAS 27 and SIC-12. Under IFRS 10, silos will often not be consolidated. Under IAS 27 and SIC-12, it is common for the assets and liabilities held by silos to not be consolidated or not be recognised.

From an investor's perspective, adopting IFRS 10 may change the conclusions reached under IAS 27 and SIC-12. This is because, in some cases, an investor may not have considered the concept of whether a silo existed, and if so, whether the investor controlled that silo, since this was not an explicit requirement in IAS 27 and SIC-12. Under IFRS 10, it is clear that an investor needs to identify and consolidate any silos that it controls. Accordingly, it is crucial to identify silos early in the process (as discussed in Section 7.2).

Identifying whether a silo exists, and whether an investor controls a silo, can be complex. However, the same process outlined in Diagram 4 can be used for silos, with one additional step, as shown in Diagram 11. Understanding the purpose and design of an investee is critical when identifying whether a silo exists, and if so which investor, if any, has control of that silo.





**Diagram 11 – Assessing control over a silo**

**Silos**

Determine whether a deemed separate entity (a silo) exists. Consider:

- ▶ Are the specified assets of the investee (and related credit enhancements, if any) the only source of payment for specified liabilities of, or specified other interests in, the investee?
- ▶ Do parties other than those with the specified liability have rights or obligations related to the specified assets or to residual cash flows from those assets?
- ▶ In substance, can any of the the returns from the specified assets be used by the remaining investee and are any of the the liabilities of the deemed separate entity payable from the assets of the remaining investee?



**Understand purpose and design of investee**

## 8.1 Identifying a silo

When identifying a silo, it is important to meet the condition specified in IFRS 10.B77. Silos are often considered in the following industries: real estate, banking and insurance. They are discussed further in the remainder of this section.

### 8.1.1 Identifying silos in the real estate industry

Investors should evaluate whether real estate properties that are collateralised by debt would be considered silos under IFRS 10. The answer will depend on the facts and circumstances of the particular case, and may vary depending on how they are funded or collateralised, and what other guarantees are given.

Examples 14-16 illustrate the evaluation of whether silos exist. In each example, A, B and C each lease separate buildings (buildings A, B and C, respectively) that are owned by an investee (the host/lessor). A, B and C, are considered investors in the sense that they potentially control the investee, notwithstanding their lack of equity investment. In addition, there are other investors who have equity interests in the investee. In each of these examples, if silos are identified, the investors would need to evaluate if they control the silos, which is discussed in Section 8.2.

#### *Example 14 – Identifying silos in the real estate industry No. 1*

Each lessee provides a residual value guarantee on the building it leases, and the investee has debt that is cross-collateralised by the three buildings (i.e., all three of the buildings support repayment of the debt).

No silos exist. None of the assets is individually the only source of payment for the debt (all three buildings are). In addition, other investors have exposures to variable returns from increases in the value of the buildings.

#### *Example 15 – Identifying silos in the real estate industry No. 2*

A has a fixed price purchase option that allows it to purchase Building A for CU 120. No such option exists for Building B or C.

The investee's balance sheet is as follows (recorded on a fair value basis, in CU):

Assets		Liabilities and equity	
Cash	20	Debt (recourse only to Building A)	120
Building A (leased to A)	120	Debt (recourse only to Building B)	50
Building B (leased to B)	100	Debt (recourse only to Building C)	50
Building C (leased to C)	100	Equity	120
<b>Total assets</b>	<b>340</b>	<b>Total liabilities and equity</b>	<b>340</b>

A silo exists for Building A. The lender is the only investor with an exposure to variable returns created by a decrease in the value of Building A, because it has been wholly financed with nonrecourse debt (i.e., none of the liabilities of the silo are payable from the other assets of the investee). Furthermore, A is the only investor with an exposure to variable returns created by an increase in the value of Building A, because of the fixed price purchase option (i.e., if Building A appreciates in value, only A will receive this benefit).

No silo exists for Building B or C. Although there is debt that is recourse only to the building, the debt is only 50% of the fair value of Buildings B and C. The remaining fair value is supported by equity that also supports the investee's other assets. In addition, other investors have exposures to variable returns resulting from an increase in the value of Building B and C, because there are no fixed price purchase options related to these buildings.

**Example 16 – Identifying silos in the real estate industry No. 3**

Each lease contains a CU 100 fixed price purchase option and provides a residual value guarantee of CU 85 to the investee. The investee's balance sheet is as follows (recorded on a fair value basis, in CU):

Assets		Liabilities and equity	
Building A (leased to Company A)	100	Debt (recourse only to the entity)	290
Building B (leased to Company B)	100		
Building C (leased to Company C)	100	Equity	10
<b>Total assets</b>	<b>300</b>	<b>Total liabilities and equity</b>	<b>300</b>

No silos exist. Although the lease agreements each contain a residual value guarantee and fixed price purchase option that result in each lessee having an exposure to variable returns, none of the assets is individually the only source of payment for the debt (the debt is cross-collateralised by all three buildings).

**8.1.2 Identifying silos in a structured entity**

Assets that are held by a structured entity, and securitised, may be considered silos under IFRS 10. This determination will depend on the facts and circumstances in each case. An illustration is shown in Example 17.

**Example 17 – Impact of silos in a structured entity**

A structured entity is created and financed by debt instruments held by a senior lender, two subordinated lenders and a minimal equity investment by the sponsor. The subordinated lenders transferred receivables to the structured entity. Managing the receivables in default is the only activity of the structured entity that causes its returns to vary. This power has been given to the subordinated lenders by contract for their respective receivables transferred to the structured entity. The subordinated loan is designed to absorb the first losses and to receive any residual return from the structured entity. The senior lender has exposure to variable returns due to the credit risk of the structured entity.

The terms and conditions of the contractual agreement between the lenders and the structured entity (and the relevant jurisdictional law) specify that the cash flows from the receivables can only be transferred back to the lender that transferred the receivables into the structured entity, and cannot be used for any other purpose, even if other receivables are in default.

There is a silo with respect to each group of receivables transferred by each subordinated lender. This is because each group of transferred receivables, and the cash flows from those receivables, can only be transferred back to the subordinated lender from which they originated. Other parties (such as the senior lender and equity investors) do not have rights or obligations related to the transferred receivables or to cash flows from those transferred receivables. In substance, none of the returns from the transferred receivables can be used by the structured entity and none of the liabilities to the structured entity are payable from the other assets of the structured entity. Thus, in substance, all the assets, liabilities and equity of the silo (for each group of transferred receivables) are ring-fenced from the structured entity.

Each lender would then need to evaluate whether it controls the relevant silo (as described in Section 8.2).



### 8.1.3 Identifying silos in the insurance industry

For insurers, silos may arise in a structure such as a multi-cell reinsurance vehicle, which is an entity comprised of a number of cells where the assets and liabilities are ring-fenced. Insurers need to evaluate whether investments made on behalf of policyholders would be considered silos under IFRS 10. The evaluation will depend on the facts and circumstances of the particular case, and may vary by jurisdiction and by policy, given the differences in regulatory environments and types of policies offered by insurance entities. Some of the factors to consider are shown in Diagram 12.

All of the relevant facts and circumstances would need to be considered when determining if a silo exists. As discussed in Section 8.2, if a silo exists, control is evaluated for each silo. However, if a silo does not exist, this simply means that the control evaluation is made for each entity.

**Diagram 12 – Identifying a silo in the insurance industry**

	Indicator that silo exists	Indicator that no silo exists
Who selects the investments?	Contract holder	Insurer
Would other funds beyond the specified assets be necessary to fulfil the obligation to the policyholder in certain situations – for example, payment of a death benefit or annuity payments?	No	Yes
Is there an exact matching of the policy to the assets held (the insurer has no latitude)?	Yes	No

### 8.2 Evaluating control of a silo

If a silo exists, the next step is to identify the relevant activities (the activities that most significantly affect the silo’s returns). Only the relevant activity of the silo would be considered, even if other activities affect the returns from other portions of the host.

The next step is to identify which rights give an investor the ability to direct the relevant activity, and which investor, if any, holds those rights (i.e., who has the power over the silo). Only rights that affect the relevant activity of the silo would be considered. Rights that affect relevant activities of other portions of the host entity would not be considered.

To conclude whether an investor has control over the silo, the investor also evaluates whether the investor has exposure to variable returns from the silo, and whether the investor can use its power over the silo to affect the amount of the investor’s returns. Only exposure to variable returns from the silo would be considered; exposures to variable returns from other portions of the host would be excluded.

### 8.3 Consolidating a silo

If an investor concludes that it controls a silo, it consolidates only the silo. That investor does not consolidate the remaining portions of the host entity.

Similarly, if an investor concludes that it controls a host entity, but not a silo within that entity, it would only consolidate the host entity, but exclude the silo.

## Chapter 9 Continuous assessment

IFRS 10 clarifies that an investor is required to reassess whether it controls an investee if the facts and circumstances indicate that there are changes to one of the three elements of control, which are repeated below. For example, the following would likely be triggers:

- ▶ Power over the investee
  - ▶ An investor increases or decreases its holdings in the investee – see Example 18
  - ▶ A potential voting right is granted, expires, or changes from being substantive to non-substantive (or vice versa) – see Example 19
  - ▶ An investee's governance or structure, such that its activities are no longer governed through voting rights, but instead, are directed by contract (or vice versa)
  - ▶ Bankruptcy filings – see Example 22
  - ▶ Troubled debt restructurings – see Example 23
  - ▶ Interests held by other investors are acquired from each other – see Example 24
  - ▶ Voting patterns
  - ▶ Exercise of rights held by other investors
- ▶ Exposures, or rights, to variable returns from involvement with the investee – in many cases, these changes occur concurrent with a change in power, such as when acquiring an interest or selling an interest in an investee
- ▶ Ability of the investor to use its power over the investee to affect the amount of its returns
  - ▶ When power has been delegated to a decision-maker, a change in market conditions could change whether the magnitude and variability of exposures to variable returns from remuneration and/or other interests are such that they indicate that the decision-maker is a principal (as discussed in Sections 6.4 and 6.5)

Therefore, it is possible that a previously unconsolidated investee would need to be consolidated (or vice versa), as facts and circumstances change. However, absent a change in facts and circumstances, control assessments are not expected to change.

### *Example 18 – Providing seed money for a fund*

A fund manager provides all of the seed money for a new fund upon inception. Until such times as other investors invest in the fund, the fund manager would likely control the fund. This is because the fund manager has the power to direct the relevant activities of the fund, exposure to variable returns from its involvement with the fund, and the ability to use its power over the fund to affect the amount of its returns.

As third parties invest in the fund and dilute (or acquire) the fund manager's interest, this would likely result in a re-assessment of whether the fund manager has control. As the third parties invest, they are likely to obtain rights to direct the relevant activities (that is, the third parties will gain power). In many cases, analysing the facts and circumstances may indicate that the fund manager is acting as an agent of those third parties (as discussed in Chapter 5). Accordingly, the fund manager would no longer have control and would de-consolidate the fund.

### 9.1 Changes in market conditions

IFRS 10 discusses when a change in market conditions triggers a re-assessment of control.

#### Excerpt from IFRS 10

B85 An investor's initial assessment of control or its status as a principal or an agent would not change simply because of a change in market conditions (eg a change in the investee's returns driven by market conditions), unless the change in market conditions changes one or more of the three elements of control listed in paragraph 7 or changes the overall relationship between a principal and an agent.

Only a market condition that causes a change in one of the three criteria would trigger a re-assessment (see Examples 19-20). Evaluating whether a change in a market condition triggers a re-assessment of control is considered in the context of the investee's purpose and design.



As discussed in Chapter 5, with respect to the second criteria, the focus is on the existence of an exposure to variable returns, not the amount of the variable returns. While a change in market conditions often affects the amount of the exposure to variable returns, it typically does not affect whether the exposure exists.

However, when power has been delegated to a decision-maker, a change in market conditions could change whether the magnitude and variability of exposures to variable returns from remuneration and/or other interests are such that they indicate that the decision-maker is a principal (as discussed in Sections 6.4 and 6.5). That is, a change in market conditions could change the evaluation of whether a decision-maker has the ability to use its power over the investee to affect the amount of the decision-maker's returns (the linkage between power and returns). Accordingly, a change in market conditions may trigger a re-assessment of control in principal-agency evaluations.

**Example 19 – Value of option changes from 'in-the-money' to 'out-of-the-money'**

A holds 40% of the voting rights of B, and holds a currently exercisable in-the-money option to acquire a further 20% of the voting rights of B. Assuming that voting rights give power over B, the option is substantive and no other facts and circumstances are relevant, A would have power over B, because A could currently exercise its right to obtain a majority of B's voting shares.

Consider a situation in which the in-the-money option changed to being slightly (but not deeply) out-of-the-money, due to a change in market conditions (and this change was not previously expected to occur, as discussed in Section 4.3.4). This would not trigger re-assessment, because the option is likely to remain substantive, and therefore there is no change in how power over B is evaluated.

Consider another situation in which the option changed to being deeply-out-of-the-money due to a change in market conditions (and this change was not previously expected to occur, as discussed in Section 4.3.4). This would trigger re-assessment, since the option would no longer be substantive, and the fact that the option was previously a substantive right was a critical factor in assessing whether A had power over B.

**Example 20 – Structured entity re-assessments**

There are two investors in a structured entity; one holds the debt, and the other holds the equity. In the initial assessment, the investors concluded that the equity holder had control because it had the power to direct the relevant activities, exposure to variable returns through its equity interests, and the ability to use its power over the structured entity to affect the equity holder's returns. Due to a change in market conditions, the value of the equity diminishes. This fact, by itself, would not trigger re-assessment, because the equity holder continues to have exposure to variable returns (i.e., it continues to be exposed to further decreases in equity, and have potential upside if the market conditions improve). Accordingly, the conclusion that the equity holder had control of the structured entity would not change.

However, if, concurrently with the deterioration of the equity, there are other changes in facts and circumstances (e.g., the equity holder loses its ability to direct the relevant activities), this would trigger a re-assessment. In this case, the trigger is actually the other change in facts and circumstances, not the decrease in equity itself. In this case, whether the debt holder has control depends on whether it has rights that give it the current ability to direct the relevant activities, and the ability to affect its exposure to variable returns.

**Example 21 – Investee loses money due to change in market conditions**

C holds 100% of the voting rights of D, which is a profitable entity. In its initial assessment, C concludes that it controls D.

Due to a change in the market conditions, D begins to lose money and is no longer profitable (e.g., due to a decrease in demand for its products). This would not trigger re-assessment, because the change in market conditions would likely not change the identification of the relevant activities, how those activities are directed, the investors' exposure to variable returns, or the linkage between power and returns.

However, at some point, D might become so unprofitable as to consider restructuring its debt, or filing for bankruptcy. This situation is discussed in Section 9.2.

## 9.2 Bankruptcy filings and troubled debt restructurings

Filing for bankruptcy or restructuring a debt will usually trigger re-assessment of which investor, if any, controls the investee. While control should be re-assessed at such triggering points, it does not necessarily mean the conclusion of which entity consolidates will change. Examples 22 and 23 illustrate situations when the control conclusion might change, and result in a bank consolidating an entity that it had previously concluded it did not control.

### *Example 22 – Bankruptcy filing*

A made a loan to B. Because of A's position as a senior creditor, if B defaults on the loan, A has the right to direct B to sell certain assets to repay the loan to A. In its initial assessment of control, A concluded that this right was a protective right, because it concluded that defaulting on the loan would be an exceptional circumstance. Consequently, this right did not give A power over B, and therefore, A did not control B. A concluded that the voting rights, which are held by the equity investors, give the equity investors power over B.

B later defaults on the loan and files for bankruptcy, giving A the right to direct B to sell certain assets to repay the loan to A. Upon B filing for bankruptcy, A would need to evaluate whether having this right, which was previously protective, gives A power. This would be the case if A's right to direct B to sell its assets is the activity that most significantly affects A's returns. A may delegate this right to another party, such as a trustee or an administrator, who might be acting as A's agent.

Before concluding which investors, if any, control B once it files for bankruptcy, consideration would also be given to what rights the equity investors have, if any, to direct the relevant activities of B, and also to whether A and the equity investors have exposure to variable returns from B.

### *Example 23 – Troubled debt restructuring*

Consider the same facts as Example 23, except that A and B agree to restructure the loan, rather than B filing for bankruptcy. During the restructuring, A determines which assets will be sold to repay the loan, with management and the equity investors agreeing to this plan. In addition, management agreed to an incentive scheme under which payments are based on asset sale and loan repayment targets.

Upon restructuring the loan, A would need to evaluate whether determining which assets should be sold to repay the loan gives A power. This might be the case if voting rights do not give power over B, because management is required to comply with the asset sale plan mandated by A.

Before concluding which investors, if any, control B, consideration would also be given to what rights the equity investors have, if any, to direct the relevant activities of B, and also to whether A and the equity investors have exposure to variable returns from B.

In some jurisdictions, it is possible that a trustee or court administrator may have power (and possibly control) over an investee that files for bankruptcy. In such situations, consideration needs to be given not only to whether the trustee has power, but also whether it has an exposure to variable returns from the investee, and if so, whether it has the ability to use that power to affect its exposure to variable returns. In many cases, a trustee or court administrator might have power, but this power is held as an agent (see Chapter 6), and thus it would not control the investee. However, a determination will need to be made whether the trustee or court administrator is an agent for a specific lender, or for the creditors as a group. This will depend on individual facts and circumstances for the jurisdiction.

In the situations in Examples 22 and 23, it might be determined that the lender obtained control over the investee. In this case, judgement will also be needed to determine the date at which the lender obtained control over the investee. Is it the date that the investee filed for bankruptcy or restructured the debt? Or, did the lender obtain control over the investee before the filing, or restructuring, when it became evident that the investee would likely have to file for bankruptcy or restructure the debt?



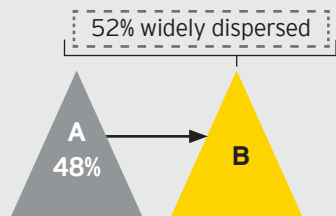
### 9.3 Control re-assessment as a result of action by others

An investor may gain or lose power over an investee as a result of action by others (i.e., without direct involvement in the change in circumstances). IFRS 10 gives the example of a substantive decision-making right held by an investor that lapses. In such cases, it might be more difficult to determine whether an event has happened that would cause an investor to re-assesses control, because the information might not be publicly available. Consider the situation in Example 24.

While the situation in Example 24 might be uncommon, management should consider what systems and processes are needed to monitor external events for changes that could trigger re-assessment. Without knowledge of such events, and a process for gathering this information, it may be difficult to determine the date when the other voters became sufficiently dispersed or disorganised to conclude that the investor had control. Depending on the facts and circumstances (particularly in the case of *de facto* control), there could be a lag in the period between when the facts and circumstances actually change, and when management is able to conclude that the investor has control.

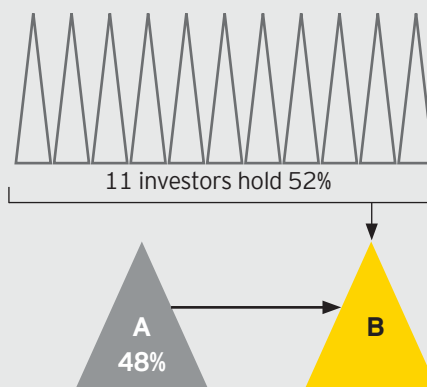
**Example 24 – Control re-assessment as a result of action by others**

Before



A holds 48% of the voting rights of B, with the remaining 52% being widely dispersed. In its initial assessment, A concludes that the absolute size of its holding, relative to the other shareholdings, gives it power over B.

After



Over time, some of the shareholders begin to consolidate their interests, such that eventually, the 52% is held by a much smaller group of shareholders. Depending on the regulatory environment, and rights held by A regarding the right to receive information when shareholders acquire other interests in B, it is possible, although perhaps unlikely, that A would not be aware of this occurrence. Nonetheless, it would seem that IFRS 10 would require A to re-evaluate whether it has control over B, because the other shareholders are no longer widely dispersed, and thus A may not have the current ability to direct the relevant activities of B.

## Chapter 10 Consolidation procedures

When an investor determines that it controls an investee, the investor (the parent) consolidates the investee (the subsidiary). IFRS 10 does not change the requirements of how to prepare consolidated financial statements; it simply carries forward the existing requirements of IAS 27 into IFRS 10.

A parent consolidates a subsidiary from the date on which the parent first obtains control, and continues consolidating that subsidiary until the date on which control is lost. IFRS 3 *Business Combinations* defines the date of acquisition, that is, the date on which control is first obtained. The term 'date of acquisition' is used even if a parent gains control without acquiring an interest, or taking any action, as discussed in Section 9.3.

The income and expenses of a subsidiary are included from the date of acquisition until the date on which the parent ceases to control the subsidiary. Income and expenses of a subsidiary are based on the values of the assets and liabilities recognised in the parent's consolidated financial statements at the acquisition date. For example, depreciation expense recognised in the consolidated statements is based on the fair values of the related depreciable assets recognised in the consolidated financial statements at the acquisition date. The requirement to continue consolidating also applies to a subsidiary held for sale accounted for under IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*.

When a parent gains control of a group of assets or an entity that is not a business, such transactions are excluded from the scope of IFRS 3. This is often the case when a parent gains control of a structured entity. Business combinations under common control are also excluded from the scope of IFRS 3, which means that if a parent gains control of a subsidiary (as defined in IFRS 10) that was previously controlled by an entity under common control, IFRS 3 also does not apply in that situation.

A parent consolidates all subsidiaries and recognises non-controlling interests for any interests held by investors outside of the group. As a result of applying IFRS 10, there might be changes to the subsidiaries consolidated, and accordingly changes to the non-controlling interests recognised, depending on the facts and circumstances.

Refer to *International GAAP*<sup>®</sup> for more information on these and related topics.

### 10.1 Non-controlling interests when there is a *de facto* agent

When consolidating a subsidiary, a parent only reflects its exposures to variable returns (including those held by its subsidiaries), in its consolidated financial statements. Any rights or exposures to variable returns held by a *de facto* agent that is not in the group would generally be shown as non-controlling interests. This is illustrated in Example 25.

#### **Example 25 – Control evaluation and consolidation with a *de facto* agent**

A has a 40% interest in Z, whose relevant activities are directed by voting shares that entitle the holder to a pro rata share of returns of Z. Based on the facts and circumstances, A concludes that, by itself, its 40% interest does not give A control over Z.

B holds a 15% interest in Z.

A evaluates the facts and circumstances and concludes that B is a *de facto* agent of A. This might be concluded if, for example, A and B are members of the same group – that is, when A and B have the same ultimate parent, but B is not part of A's group in its sub-level consolidated financial statements. Based on the combined interest, A concludes that it controls Z, because it can direct B how to vote by virtue of being a *de facto* agent. Accordingly, A consolidates Z in its consolidated financial statements and reflects a non-controlling interest in B of 60% (i.e., all interests not held by A).

Careful evaluation of arrangements between the parties is needed to ensure that there are no other rights and exposures that are required to be accounted for in the consolidated financial statements.

# Chapter 11 Disclosures

IFRS 12 combines the disclosure requirements for an entity's interests in subsidiaries, joint arrangements, associates and structured entities into one comprehensive disclosure standard. Many of the disclosure requirements were previously included in IAS 27, IAS 31 and IAS 28, while others are new.

In the remainder of this chapter, we describe the disclosure requirements of IFRS 12 with respect to subsidiaries (controlled investees), including structured entities that are consolidated, and unconsolidated structured entities. Disclosure requirements in IFRS 12 related to joint arrangements and associates are discussed in our publication *Applying IFRS: Challenges in adopting and applying IFRS 11*.

The disclosure requirements of IFRS 12 are applied retrospectively. However, IFRS 12 does not need to be applied for any period presented before the annual period immediately preceding the first annual period for which IFRS 12 is applied. The disclosure requirements relating to interests in unconsolidated structured entities only need be applied in the first annual period when IFRS 12 is applied.

## 11.1 Principles of IFRS 12

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

- ▶ The nature of, and risks associated with, its interests in other entities
- ▶ The effects of those interests on its financial position, financial performance, and cash flows

### Excerpts from IFRS 12

- 3 If the disclosures required by this IFRS, together with disclosures required by other IFRSs, do not meet the objective in paragraph 1, an entity shall disclose whatever additional information is necessary to meet that objective.
- 4 An entity shall consider the level of detail necessary to satisfy the disclosure objective and how much emphasis to place on each of the requirements in this IFRS. It shall aggregate or disaggregate disclosures so that useful information is not obscured by either the inclusion of a large amount of insignificant detail or the aggregation of items that have different characteristics.

When complying with the disclosure requirements of IFRS 12, an entity may aggregate the disclosures for interests in similar entities if that would be consistent with meeting the objective of the disclosures and would not obscure the information provided. IFRS 12 states that when determining whether to aggregate information, quantitative and qualitative information about the different risk and return characteristics and the significance of each investee to the investor are both considered.

At a minimum, IFRS 12 notes that an investor must separately present information for interests in:

- ▶ Subsidiaries
- ▶ Joint ventures
- ▶ Joint operations
- ▶ Associates
- ▶ Unconsolidated structured entities

An investor is also required to disclose how it aggregated its interests in similar entities.

## 11.2 Disclosing judgements

One of the new requirements of IFRS 12 is that an entity discloses the significant judgements and assumptions it has made (and changes thereto) in determining whether or not it has control over an investee.

The requirement in IFRS 12 is more expansive than the requirement in IAS 27, which only required entities to disclose circumstances when: (1) a subsidiary was consolidated and the parent owned less than a majority of voting rights; and (2) an investee was not consolidated, and the investor owned more than a majority of voting rights. This change in the disclosure requirements reflects the degree of judgement that is required to determine whether an entity is controlled, and therefore, consolidated. For example, an entity is required to disclose how it evaluated potential voting rights (e.g., options) and whether it is a principal or an agent.

### 11.3 Interests in subsidiaries

The disclosures related to subsidiaries (controlled investees) are greatly expanded from IAS 27.

#### Excerpt from IFRS 12

- 10 An entity shall disclose information that enables users of its consolidated financial statements
- (a) To understand:
- (i) the composition of the group; and
  - (ii) the interest that non-controlling interests have in the group's activities and cash flows; and
- (b) To evaluate:
- (i) the nature and extent of significant restrictions on its ability to access or use assets, and settle liabilities, of the group;
  - (ii) the nature of, and changes in, the risks associated with its interests in consolidated structured entities;
  - (iii) the consequences of changes in its ownership interest in a subsidiary that do not result in a loss of control; and
  - (iv) the consequences of losing control of a subsidiary during the reporting period.

Each of these is discussed in more detail in the remainder of Section 11.3. For subsidiaries that are wholly owned and not structured entities, the disclosure requirements are very similar to those contained in IAS 27.

#### 11.3.1 Non-controlling interests in subsidiaries

For each subsidiary that has non-controlling interests that are material to the group, an entity is required to disclose the following:

- ▶ Name
- ▶ Principal place of business (and country of incorporation if different)
- ▶ Proportion of ownership interests held by non-controlling interests (and proportion of voting rights held, if different)
- ▶ Profit or loss allocated to non-controlling interests during the reporting period

- ▶ Accumulated non-controlling interests at the end of the reporting period
- ▶ Dividends paid to non-controlling interests
- ▶ Summarised financial information (see Section 11.3.2)

#### 11.3.2 Summarised financial information for subsidiaries

IFRS 12 requires disclosure of summarised financial information for subsidiaries with respect to which there are non-controlling interests that are individually material to the group. The summarised financial information should provide information about the assets, liabilities, profit or loss and cash flows of the subsidiary that enables users to understand the interest that non-controlling interests have in the group's activities and cash flows. IFRS 12 does not require specific captions to be disclosed, but states that certain information might include but is not limited to:

- ▶ Current assets
- ▶ Non-current assets
- ▶ Current liabilities
- ▶ Non-current liabilities
- ▶ Revenue
- ▶ Profit or loss
- ▶ Total comprehensive income

When a subsidiary is classified as held for sale in accordance with IFRS 5, summarised financial information is not required (presumably because the relevant information is already required by IFRS 5).

It is not entirely clear whether the summarised financial information for subsidiaries should reflect fair value adjustments that resulted from their acquisition (i.e., the purchase price allocation adjustments). This differs from the requirements for providing summarised financial information for joint ventures and associates, which are explicitly required to reflect such purchase price allocations (as discussed in *Applying IFRS - Challenges in adopting and applying IFRS 11*). In any case, the summarised financial information for subsidiaries is presented in accordance with IFRS, using the same accounting policies as the parent.



### 11.3.3 Significant restrictions on subsidiaries

When the IASB was deliberating IFRS 12, it noted that users of financial statements commented that, in addition to legal requirements, the existence of non-controlling interests in a subsidiary might restrict the subsidiary's ability to transfer funds to the parent or any of its other subsidiaries. However, the disclosure requirement in IAS 27 regarding significant restrictions did not refer explicitly to non-controlling interests. Accordingly, the IASB amended the requirements as shown in the following excerpt from IFRS 12.

#### Excerpt from IFRS 12

An entity shall disclose:

- 13(a) Significant restrictions (e.g., statutory, contractual and regulatory restrictions) on its ability to access or use the assets and settle the liabilities of the group, such as:
- (i) Those that restrict the ability of a parent or its subsidiaries to transfer cash or other assets to (or from) other entities within the group.
  - (ii) Guarantees or other requirements that may restrict dividends and other capital distributions being paid, or loans and advances being made or repaid, to (or from) other entities within the group.
- (b) The 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 (such as when a parent is obliged to settle liabilities of a subsidiary before settling its own liabilities, or approval of non-controlling interests is required either to access the assets or to settle the liabilities of a subsidiary).
- (c) The carrying amounts in the consolidated financial statements of the assets and liabilities to which those restrictions apply.

### 11.3.4 Changes in ownership of a subsidiary

IFRS 12 carries forward the disclosure requirements that previously existed in IAS 27 related to transactions with non-controlling interests that do not result in a loss of control. In addition, IFRS 12 requires that, if control is lost, the consequences (any gain or loss) must be disclosed, separately from any gain or loss that resulted from remeasuring any retained investment.

## 11.4 Structured entities

IFRS 12 introduces the term structured entity, which replaces and expands upon the concept of a special-purpose entity that was previously used in SIC-12. These entities are discussed in Section 4.4.1. The required disclosures for the interests in structured entities have been significantly expanded, and are discussed in the remainder of Section 11.4.

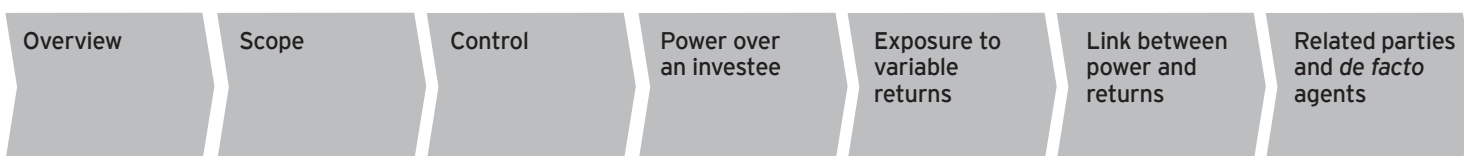
When specifying the required disclosures, the IASB distinguished between those required for consolidated structured entities (i.e., subsidiaries), and those that are not consolidated.

### 11.4.1 Consolidated structured entities

An entity is required to disclose the nature and extent of, and changes in, the risks associated with its interests in consolidated structured entities. For example, an entity is required to disclose the terms of any arrangement that could require the entity to provide financial support, including events or circumstances that could expose the group to a loss (e.g., liquidity arrangements or credit rating triggers associated with obligations to purchase assets of the structured entity or provide financial support).

If an entity provides financial or other support to a consolidated structured entity without being obliged to do so, it is required to disclose the type and amount of support, the situation, reasons for providing the support, any change in control that resulted, and whether there is any current intention to provide further support.

Since a consolidated structured entity is also considered a subsidiary, the information discussed in Section 11.3 would be required if the non-controlling interest is material to the group.



### 11.4.2 Unconsolidated structured entities

Given the increased risk associated with structured entities that an entity is involved with, but does not consolidate, the IASB requires several additional disclosures.

#### Excerpt from IFRS 12

- 24 An entity shall disclose information that enables users of its financial statements:
- To understand the nature and extent of its interests in unconsolidated structured entities; and
  - To evaluate the nature of, and changes in, the risks associated with its interests in unconsolidated structured entities.
- 25 The information required by paragraph 24(b) includes information about an entity's exposure to risk from involvement that it had with unconsolidated structured entities in previous periods (eg sponsoring the structured entity), even if the entity no longer has any contractual involvement with the structured entity at the reporting date.
- 26 An entity shall disclose qualitative and quantitative information about its interests in unconsolidated structured entities, including, but not limited to, the nature, purpose, size and activities of the structured entity and how the structured entity is financed.
- 27 If an entity has sponsored an unconsolidated structured entity for which it does not provide information required by paragraph 29 (eg because it does not have an interest in the entity at the reporting date), the entity shall disclose:
- How it has determined which structured entities it has sponsored;
  - Income from those structured entities during the reporting period, including a description of the types of income presented; and
  - The carrying amount (at the time of transfer) of all assets transferred to those structured entities during the reporting period.
- 28 An entity shall present the information in paragraph 27(b) and (c) in tabular format, unless another format is more appropriate, and classify its sponsoring activities into relevant categories.

An example of the disclosures required by paragraphs 27(b) and (c) of IFRS 12 is shown in Example 26.

#### Example 26 – Disclosures for unconsolidated structured entities for which the entity does not have an interest at the reporting date

Type of asset in unconsolidated entity	Total income for the year ended		
	20X3 CU million	20X2 CU million	20X1 CU million
Collateralised debt obligations	1,025	820	697
Residential mortgage-backed securities	6,055	4,844	4,117
Commercial mortgage-backed securities	878	703	597
Assets under lease	332	265	226
Credit card receivables	189	151	128
<b>Total</b>	<b>8,479</b>	<b>6,783</b>	<b>5,765</b>

Type of asset in unconsolidated entity	Carrying amount of assets transferred during the year ended		
	20X3 CU million	20X2 CU million	20X1 CU million
Collateralised debt obligations	14,650	11,720	9,962
Residential mortgage-backed securities	86,500	69,200	58,820
Commercial mortgage-backed securities	12,546	10,037	8,532
Assets under lease	4,739	3,791	3,223
Credit card receivables	2,695	2,156	1,833
<b>Total</b>	<b>121,130</b>	<b>96,904</b>	<b>82,370</b>



Income from a structured entity includes, but is not limited to, recurring and non-recurring:

- ▶ Fees
- ▶ Interest
- ▶ Dividends
- ▶ Gains or losses on the remeasurement or derecognition of an interest in a structured entity
- ▶ Gains or losses from the transfer of assets and liabilities to a structured entity

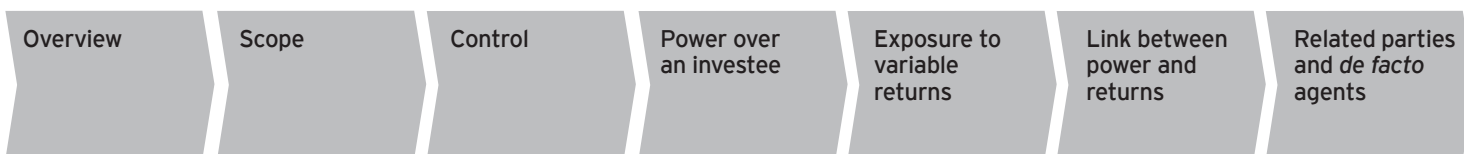
When evaluating whether an entity has an interest in a structured entity (to determine if the information required by paragraph 27 of IFRS 12 is required or not), an 'interest' refers to any contractual or non-contractual involvement that exposes it to variability of returns from the performance of the structured entity (see Chapter 5). For example, it includes:

- ▶ Equity or debt instruments
- ▶ Provision of funding, liquidity support, credit enhancement and guarantees
- ▶ Any means by which an entity has control, joint control, or significant influence over another entity

However, a typical customer/supplier relationship would generally not be considered an 'interest in another entity'.

#### Excerpt from IFRS 12

- 29 An entity shall disclose in tabular format, unless another format is more appropriate, a summary of:
- (a) The carrying amounts of the assets and liabilities recognised in its financial statements relating to its interests in unconsolidated structured entities.
  - (b) The line items in the statement of financial position in which those assets and liabilities are recognised.
  - (c) The amount that best represents the entity's maximum exposure to loss from its interests in unconsolidated structured entities, including how the maximum exposure to loss is determined. If an entity cannot quantify its maximum exposure to loss from its interests in unconsolidated structured entities it shall disclose that fact and the reasons.
  - (d) A comparison of the carrying amounts of the assets and liabilities of the entity that relate to its interests in unconsolidated structured entities and the entity's maximum exposure to loss from those entities.
- 30 If during the reporting period an entity has, without having a contractual obligation to do so, provided financial or other support to an unconsolidated structured entity in which it previously had or currently has an interest (for example, purchasing assets of or instruments issued by the structured entity), the entity shall disclose:
- (a) The type and amount of support provided, including situations in which the entity assisted the structured entity in obtaining financial support; and
  - (b) The reasons for providing the support.
- 31 An entity shall disclose any current intentions to provide financial or other support to an unconsolidated structured entity, including intentions to assist the structured entity in obtaining financial support.



Example 27 illustrates how an entity might provide the quantitative information required by paragraphs 29(a) and (c). However, an entity also needs to disclose the qualitative information required by IFRS 12, as well as comparative information.

**Example 27 – Quantitative disclosures for structured entities in which there is still an interest at the end of the reporting period**

At 31 December 20X3

Maximum exposure to loss in unconsolidated structured entities

CU million	Maximum exposure to loss				Carrying amount in statement of financial position	
	Total	Investments	Credit guarantees	Liquidity commitments	Assets	Liabilities
<b>Type of asset in unconsolidated entity</b>						
<b>Originated by XYZ Bank</b>					<b>Assets</b>	<b>Liabilities</b>
Collateralised debt obligations	196	196			196	
Subtotal	196	196			196	
<b>Originated by other entities</b>					<b>Assets</b>	<b>Liabilities</b>
Collateralised debt obligations	6,031	1,856		4,175	1,856	(167)
Real estate, credit-related and other investing	6,944		248	6,696		(285)
Assets under lease	512	43		469	43	(2)
Credit card receivables	1,260	1,260			1,260	
Subtotal	14,747	3,159	248	11,340	3,159	(454)
<b>Total</b>	<b>14,943</b>	<b>3,355</b>	<b>248</b>	<b>11,340</b>	<b>3,355</b>	<b>(454)</b>

Further examples of the disclosures for unconsolidated structured entities can be found in *Applying IFRS: IFRS 12 – Example disclosures for interests in unconsolidated structured entities*, which can be found at [www.ey.com/ifrs](http://www.ey.com/ifrs).

### 11.4.3 Related party disclosures

In addition to the disclosures required by IFRS 12, an entity must comply with the disclosure requirements of IAS 24 *Related Party Disclosures*. More information can be found in *International GAAP*<sup>®</sup>.



## Chapter 12 Transition

IFRS 10, IFRS 11, IFRS 12 and the consequential amendments to IAS 27 and IAS 28 are effective for annual periods beginning on or after 1 January 2013. The standards may be applied early but must be applied as a package. That is, the standards must all be applied as at the same date, except that an entity may apply the disclosure provisions of IFRS 12 early without applying the other standards. The standards are applied on a retrospective basis, although certain specific transition requirements apply, which are discussed below.

The amendments to IFRS 10 relating to the definition of investment entities and the requirements for those entities are applicable for accounting periods beginning on or after 1 January 2014, although earlier application is permitted.

### 12.1 Date of initial application

When an entity first applies IFRS 10 it does so from 'the date of initial application', which is the beginning of the annual period for which IFRS 10 is applied for the first time. An entity is not required to make adjustments to the previous accounting for its involvement with entities if the consolidation conclusion reached at the date of initial application is the same under both IFRS 10 and IAS 27 or SIC 12. Therefore, the adjustments that need to be made are limited to circumstances in which application of IFRS 10 leads to a different consolidation conclusion than under previous standards. This is considered further in the remainder of this chapter.

### 12.2 Newly consolidating an investee

At the date of initial application, if an entity determines that it controls an investee that was not previously consolidated, it must apply acquisition accounting from the date that control was obtained.

#### 12.2.1 Investee is a business

If the investee is a business, the entity applies IFRS 3 as if the investee had been consolidated from the date the investor obtained control under IFRS 10. The investor retrospectively adjusts the annual period immediately preceding the date of initial application. When the date control was obtained is prior to the beginning of the immediately preceding period, any difference between the previous carrying amounts and the amounts recognised on the retrospective application of IFRS 10 must be recognised as an adjustment to equity at the beginning of the immediately preceding period.

IFRS 10 permits entities to use either IFRS 3 (2008) or IFRS 3 (2004) in applying the transition requirements, when control was obtained before the effective date of IFRS 3 (2008).

#### 12.2.2 Investee is not a business

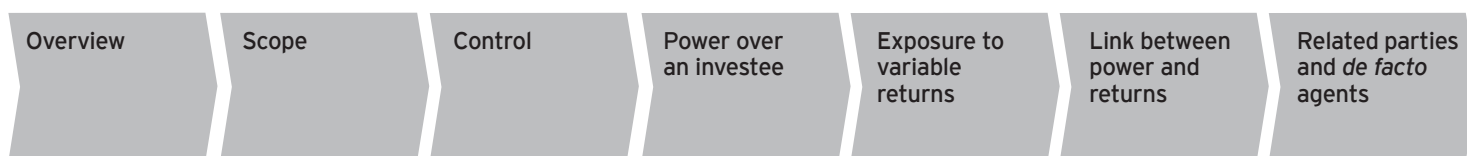
If the investee is not a business, the investor measures the assets, liabilities and non-controlling interests, applying the acquisition method described in IFRS 3 (without recognising any goodwill for the investee), as if the investee had been consolidated from the date the investor obtained control under IFRS 10. Entities are only required to retrospectively adjust the annual period immediately preceding the date of initial application. When the date control was obtained is prior to the beginning of the immediately preceding period, any difference between the previous carrying amounts and the amounts recognised on retrospective application of IFRS 10 must be recognised as an adjustment to equity at the beginning of the immediately preceding period.

### 12.3 Practical issues with consolidating an investee retrospectively

IFRS 10 states that when applying the requirements in Section 12.2 is impracticable (as defined in IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*), the requirements are applied at the beginning of the earliest period for which it is practicable. IFRS 10 does not give any further guidance about what circumstances would make it impracticable to apply IFRS 10 retrospectively. However, there may be several practical issues to consider in retrospectively consolidating an investee. It is a matter of judgement as to whether these issues make full retrospective application of IFRS 10 impracticable.

#### 12.3.1 Purchase price allocations

In order to consolidate an investee, a purchase price allocation at the date control was obtained will be required. In some instances, such as if the investee was previously equity accounted, this information may be available. However, in practice, the nature of the purchase price allocations may have varied depending on the materiality of the investment to the group. Therefore, in some circumstances it may be necessary to perform a new purchase price allocation. The practical difficulties in doing this are likely to be greater if less information was obtained at the acquisition date.



### 12.3.2 Goodwill impairment

#### Diagram 13 – Effect of changes from equity method to consolidation on goodwill

When changing the accounting for an investee from the equity method to consolidation, the following goodwill impairment issues may arise:

	Equity method	Consolidation	Impact
<b>When to test for impairment</b>	IAS 28 requires the equity-accounted investment to be tested for impairment when there are indicators that the investment is impaired (as listed in IAS 39), measured in accordance with IAS 36. <sup>4</sup>	Goodwill and the acquired assets are recognised as separate assets under IFRS 3. Goodwill is tested for impairment at least annually, and other assets are tested when indicators exist, in accordance with IAS 36.	If goodwill is recognised, an investor will have to test goodwill for impairment when consolidating for the first time, even if no indicators existed.
<b>What is tested</b>	The entire equity-accounted investment is tested for impairment.	Only the assets for which there are indicators, or cash-generating units (CGUs) containing goodwill, are tested for impairment.	Each CGU's impairment analysis and the allocation of impairment losses may be affected.
<b>Reversal of impairment</b>	Because the embedded goodwill is considered an element of the equity method investee, an impairment can be reversed (if certain criteria are met).	Goodwill impairment cannot be reversed. Impairments of other acquired assets can be reversed, if certain criteria are met.	Any impairment that was reversed might not be permitted when consolidated.

<sup>4</sup> IAS 36 *Impairment of Assets*.

### 12.3.3 Borrowing costs

IAS 23 *Borrowing Costs* requires that borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset form part of the cost of that asset.

When an investee is consolidated, if the investee did not incur any borrowing costs on its qualifying assets, then the investor would capitalise its own borrowing costs that are directly attributable to a qualifying asset in accordance with IAS 23. However, borrowing costs cannot be capitalised on equity method investments or financial instruments, because they are not qualifying assets under IAS 23.

Accordingly, when an investee is controlled, the parent will have to capitalise borrowing costs on the qualifying assets of that investee, as well as any depreciation, foreign exchange, and potential impairment on the higher carrying amount of those qualifying assets that resulted from the capitalisation of additional borrowing costs.

### 12.3.4 Hedging

An investor may be able to apply hedge accounting to assets, liabilities, firm commitments and highly probable forecast transactions of a subsidiary. In contrast, if the investee was previously accounted for as an equity method investment or as a financial instrument, the investor would have been restricted as to what it could have designated as a hedged item.

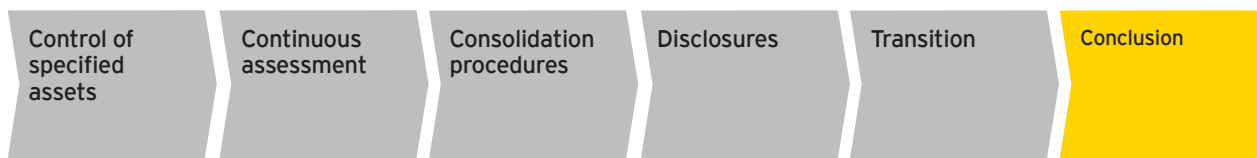
Meanwhile, it is not permitted to designate an investment in an equity method investment as the hedged item in a fair value hedge. This means that some hedges may need to be de-designated and the change in fair value of the hedging instrument recognised in retained earnings as a transition adjustment.

### 12.4 De-consolidating a former subsidiary

If an investor concludes that it does not control an investee, and it was previously consolidated, it must de-consolidate the former subsidiary. When deconsolidating an investment, an investor is required to measure its retained interest in the investee on the date of initial application at an amount as if the investor had always accounted for that interest in accordance with IFRS 10.

The investor must de-recognise the assets, liabilities and non-controlling interests of the previously consolidated entity, and recognise the interest in the investee at fair value at the beginning of the reporting period when first applying IFRS 10.

Any difference between the previously recognised amount of the assets, liabilities and non-controlling interest, and the newly recognised interest in the investee is recorded as an adjustment to equity.



## Conclusion

Some investors will consolidate investees that they did not consolidate under IAS 27 and SIC-12. Other investors will not consolidate investees that were consolidated under IAS 27 and SIC-12. Whether an investor will consolidate more or fewer investees under IFRS 10, as compared to IAS 27 and SIC-12, will depend on the nature of its interests in its investees. The method of assessing whether an investee is consolidated under IFRS 10 will be the same, regardless of whether the relevant activities of that investee are directed by voting rights, or not, that is, regardless of whether the investee is a structured entity.

Investors that enter into complex arrangements that give rights to direct the activities of investees need to consider whether they have control, and consolidate accordingly. Significant judgement will be needed in many cases to apply the definition of control, and the Application Guidance in IFRS 10.

## Appendix – Defined terms

<b>Agent<sup>5</sup></b>	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.
<b>Consolidated financial statements</b>	The financial statements of a group in which the assets, liabilities, equity, income, expenses and cash flows of the parent and its subsidiaries are presented as those of a single economic entity.
<b>Control of an investee</b>	An investor controls an investee when the investor 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.
<b>Decision-maker</b>	An entity with decision-making rights that is either a principal or an agent for other parties.
<b>Group</b>	A parent and its subsidiaries.
<b>Income from a structured entity</b>	Includes, but is not limited to, recurring and non-recurring fees, interest, dividends, gains or losses on the remeasurement or derecognition of interests in structured entities and gains or losses from the transfer of assets and liabilities to the structured entity.
<b>Interest in another entity</b>	Refers to contractual and non-contractual involvement that exposes an entity to variability of returns from the performance of the other entity. An interest in another entity can be evidenced by, but is not limited to, the holding of equity or debt instruments as well as other forms of involvement such as the provision of funding, liquidity support, credit enhancement and guarantees. It includes the means by which an entity has control or joint control of, or significant influence over, another entity. An entity does not necessarily have an interest in another entity solely because of a typical customer supplier relationship.
<b>Investor<sup>5</sup></b>	A party that potentially controls another party (the investee).
<b>Investee</b>	A party that is potentially controlled by another party (the investor).
<b>Joint control</b>	The contractually agreed sharing of control of an arrangement, which exists only when decisions about the relevant activities require the unanimous consent of the parties sharing control.
<b>Non-controlling interest</b>	Equity in a subsidiary not attributable, directly or indirectly, to a parent.
<b>Parent</b>	An entity that controls one or more entities.
<b>Power</b>	Existing rights that give the current ability to direct the relevant activities.
<b>Principal<sup>5</sup></b>	A party that engages another party (the agent) to act on its behalf and for its benefit. A principal may, but does not necessarily, control an investee.
<b>Protective rights</b>	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.
<b>Relevant activities</b>	For the purpose of IFRS 10, relevant activities are activities of the investee that significantly affect the investee's returns.
<b>Removal rights</b>	Rights to deprive the decision maker of its decision-making authority.
<b>Silo<sup>5</sup></b>	A deemed separate entity (i.e., a portion of a host entity) for which the specified assets (and related credit enhancements, if any) are the only source of payment for specified liabilities of, or specified other interests in, the investee. 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. Thus, in substance, all the assets, liabilities and equity of that deemed separate entity are ring-fenced from the overall investee.
<b>Structured entity</b>	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.
<b>Subsidiary</b>	An entity that is controlled by another entity.

<sup>5</sup> Not a defined term in IFRS 10, IFRS 11 or IFRS 12, but inferred from the standards.



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