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IFRS Global office
May 2011

IFRS in Focus
IASB issues new standard on consolidation

Contents

Introduction

Overview of significant changes

Elements of control: Power

Relationships with other parties

Elements of control: Exposure, or rights, to variable returns

Elements of control: Ability to use power to affect returns

Other considerations

Effective date and transition

The Bottom Line

- The objective of IFRS 10 is to have a single basis for consolidation for all entities, regardless of the nature of the investee, and that basis is control.
- The definition of control includes three elements: power over an investee, exposure or rights to variable returns of the investee and the ability to use power over the investee to affect the investor's returns.
- IFRS 10 provides detailed guidance on how to apply the control principle in a number of situations, including agency relationships and holdings of potential voting rights.
- An investor would reassess whether it controls an investee if there is a change in facts and circumstances.
- IFRS 10 replaces those parts of IAS 27 that address when and how an investor should prepare consolidated financial statements and replaces SIC-12 in its entirety.
- The effective date of IFRS 10 is 1 January 2013, with earlier application permitted under certain circumstances.

Introduction

On 12 May 2011, the IASB issued IFRS 10 *Consolidated Financial Statements*, which is a replacement of IAS 27 Consolidated and Separate Financial Statements and SIC-12 *Consolidation – Special Purpose Entities*. Concurrent with the issuance of IFRS 10, the IASB also issued:

- IFRS 11 *Joint Ventures* (see our separate IFRS in Focus for further discussion);
- IFRS 12 *Disclosures of Involvement with Other Entities* (see our separate IFRS in Focus for further discussion);
- IAS 27 *Separate Financial Statements* (revised 2011), has been amended for the issuance of IFRS 10 but retains the current guidance for separate financial statements; and
- IAS 28 *Investments in Associates and Joint Ventures* (revised 2011), has been amended for conforming changes based on the issuance of IFRS 10 and IFRS 11.

Each of the standards in the 'package of five' has an effective date for annual periods beginning on or after 1 January 2013, with earlier application permitted so long as each of the other standards in the 'package of five' is also early applied. However, entities are permitted to incorporate any of the disclosure requirements in IFRS 12 into their financial statements without early adopting IFRS 12 (and thereby the other standards in the 'package of five').

For more information please see the following websites:

www.iasplus.com

www.deloitte.com

Overview of significant changes

IFRS 10 uses control as the single basis for consolidation, irrespective of the nature of the investee, eliminating the risks and rewards approach included in SIC-12.

IFRS 10 identifies the following three elements of control:

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

An investor must possess all three elements to conclude it controls an investee. The assessment of control is based on all facts and circumstances and the conclusion is reassessed if there is an indication that there are changes to at least one of the three elements of control.

> **Observation**
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> In developing IFRS 10, the IASB identified the following four areas of current divergence in determining whether an investee should be consolidated:
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> - where an investor controls an investee with less than a majority of the voting rights;
> - special purpose entities and application of SIC-12's 'economic substance' notion;
> - issues around principal vs. agent relationships; and
> - consideration of protective rights.
>
> The Board considered that a perceived difference in emphasis between IAS 27 and SIC-12 has led to an inconsistent application of the concept of control. As a result, the decision was taken to withdraw the separate guidance in SIC-12.

Elements of control: Power

'Power' exists when the investor has existing rights that give it the current ability to direct the activities that significantly affect the investee's returns ('the relevant activities'). Power most commonly arises through voting rights granted by equity instruments, but can also arise through other contractual arrangements. Rights to direct the relevant activities do not need to be exercised for them to provide an investor power. If two or more investors have rights to direct different relevant activities, the investors must decide which of the relevant activities most significantly affects the returns of the investee.

The following factors should be considered in determining whether an investor has power over an investee:

- the purpose and design of the investee;
- the relevant activities of the investee and how decisions are made about those activities;
- whether the investor's rights give it the current ability to direct the relevant activities;
- whether the investor is exposed, or has rights, to variable returns from its involvement with the investee;
- whether the investor has the ability to use its power over the investee to affect the amount of the investor's returns; and
- relationships with other parties.

The relevant activities for entities whose operations are directed through voting rights will generally be its operating and financing activities. Examples of activities that may be relevant activities include product development, purchases and sales of goods or services, managing financial assets, acquiring and disposing of assets or obtaining financing. Examples of decisions about relevant activities include establishing operating and capital decisions of the investee and appointing and remunerating an investee's key management personnel or service providers and terminating their employment.

Observation

IFRS 10 provides the following example of two or more investors that have rights to direct different relevant activities of an entity:

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 product. 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 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); and (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); and (f) which investor controls the medical product once the development phase is successful.

There may be situations where voting rights are less relevant because the rights relate to administrative tasks only. In these cases, a careful analysis of the investor's contractual and non-contractual rights as well as its related party relationships is necessary. For example, an investor may be able to appoint an investee's key management personnel, veto significant transactions, or elect the investee's governing body with or without a contractual right to do so. Additionally, an investee's key management personnel or its governing body may be related parties of the investor.

An investor may have a special relationship with an investee that indicates that it has power over the investee. IFRS 10 provides the following examples of special relationships between an investor and investee that may indicate power:

- the investee's key management personnel are current or previous employees of the investor;
- the investee's operations are dependent on the investor;
- a significant portion of the investee's activities either involves or is conducted on behalf of the investor; and
- the investor's exposure, or rights, to investee returns is disproportionately greater than its voting or similar rights.

IFRS 10 acknowledges that there is a correlation between an investor's exposure, or rights, to variability of investee returns and its ability to direct the investee's relevant activities. However, the extent of the investor's exposure is not determinative in the power analysis.

There may be situations where an investee is designed so that its relevant activities occur or arise only upon a change in circumstances or the occurrence of a future event. IFRS 10 indicates that the circumstances or events do not need to have occurred for the relevant activities to be considered.

Observation

This may be relevant for entities that manage receivables only upon the event of default (i.e., special servicers to a trust managing commercial mortgage backed securities). As the relevant activities for such entities are generally the management of the defaulted receivables, there may be no substantive decisions to be made prior to a default. Therefore, the party that has the ability to manage the defaulted receivables may have power over the investee even before there are any defaults.

IFRS 10 specifies that only substantive rights and rights that are not protective are considered in assessing power. For a right to be substantive, it must give its holder the *practical ability* to exercise the right when the decisions about the relevant activities of the investee need to be made. Rights do not need to be currently exercisable to be substantive. Also, substantive rights held by other parties may prevent the investor from controlling the investee. Factors to consider in assessing whether a right is substantive include whether there is a:

- barrier that would prevent the holder from exercising the right (e.g., incurring a substantial penalty or fee if the right were exercised);
- mechanism that provides parties with the practical ability to permit the investor to exercise its right; or
- benefit from the investor exercising that right (e.g., by exercising an "in the money" call option).

Protective rights

IFRS 10 distinguishes between substantive rights and protective rights. An investor who holds only protective rights would not have power over an investee and could not prevent another party from having power over an investee. Protective rights relate to "fundamental changes to the activities of an investee or apply in exceptional circumstances". Examples of protective rights may include the right to approve new debt financing, the right of a party holding a non-controlling interest in an investee to approve the investee's issuance of additional equity instruments or the right of a lender to seize assets in the event of default.

Control with less than a majority of voting rights

IFRS 10 clarifies that an investor can have power over an investee even though it does not hold a majority of the voting rights. For example, an investor may have power through a contractual arrangement, holding voting rights, holding potential voting rights or a combination of the above.

A contractual arrangement between an investor and other investors can give the investor the right to exercise voting rights sufficient to give the investor power, even if the investor itself does not have sufficient voting rights to give it power. For example, a contractual arrangement may provide the investor the ability to direct enough other vote holders on how to vote to enable the investor to make decisions about the relevant activities or provide the investor with the current ability to direct the operating and financial activities of an investee.

An investor that holds less than a majority of the voting rights should also consider the size of their holding of voting rights relative to the size and dispersion of holdings of the other vote holders and any additional facts and circumstances that may be relevant (such as voting patterns at previous shareholders meetings).

Observation

The assessment of these factors may prove quite challenging to apply in practice because it is likely to involve a significant degree of judgement. IFRS 10 does not include any 'bright lines' in this area. The Standard does, however, provide the following example of an investor that holds less than a majority of the voting rights:

An investor acquires 48 per cent of the voting rights of an investee. The remaining voting rights are held by thousands of shareholders, none individually holding more than 1 per cent of the voting rights. None of the shareholders has any arrangements to consult any of the others or make collective decisions. When assessing the proportion of voting rights to acquire, on the basis of the relative size of the other shareholdings, the investor determined that a 48 per cent interest would be sufficient to give it control. In this case, on the basis of the absolute size of its holding and the relative size of the other shareholdings, the investor concludes that it has a sufficiently dominant voting interest to meet the power criterion without the need to consider any other evidence of power.

An investor would also need to consider potential voting rights held either by itself or by other parties. Potential voting rights are considered only when they are substantive and can, alone or in combination with other rights, give the current ability to direct the relevant activities.

Observation
IFRS 10 provides the following two examples of an investor that holds potential voting rights:

Example A
Investor A holds 70 per cent of the voting rights of an investee. Investor B has 30 per cent of the voting rights of the investee as well as an option to acquire half of investor A's voting rights. The option is exercisable for the next two years at a fixed price and is deeply out of the money (and is expected to remain so for that two-year period). Investor A has been exercising its votes and is actively directing the relevant activities of the investee. In such a case, investor A is likely to meet the power criterion because it appears to have the current ability to direct the relevant activities. Although investor B has currently exercisable options to purchase additional voting rights (that, if exercised, would give it a majority of the voting rights in the investee), the terms and conditions associated with those options are such that the options are not considered substantive.

Example B
Investor A and two other investors each hold a third of the voting rights of an investee. The investee's business activity is closely related to investor A. In addition to its equity instruments, investor A also holds debt instruments that are convertible into ordinary shares of the investee at any time for a fixed price that is out of the money (but not deeply out of the money). If the debt were converted, investor A would hold 60 per cent of the voting rights of the investee. Investor A would benefit from realising synergies if the debt instruments were converted into ordinary shares. Investor A has power over the investee because it holds voting rights of the investee together with substantive potential voting rights that give it the current ability to direct the relevant activities.

Principal vs. agent relationship

IFRS 10 introduces guidance on assessing whether an entity with decision making rights is a principal or an agent. The Standard describes an 'agent' as a party who has been engaged to act on behalf, and for the benefit, of another party (the 'principal'). However, the Standard clarifies that an investor is not an agent simply because other parties can benefit from their decision making.

Observation
The guidance on principal versus agent relationships is particularly relevant for investment managers who make investment decisions on behalf of investors in exchange for a fee. An investment manager may be considered a principal if the manager is not making investment decisions solely on behalf of the investors.

In determining whether a decision maker is an agent, the following factors should be considered, along with any other relevant elements of the relationship between the decision maker, the investee and other parties involved with the investee:

- the scope of their decision making authority over the investee;
- rights held by other parties;
- the remuneration to which it is entitled (including whether it is commensurate with the services provided and whether any non-standard terms are included);
- their exposure to variability of returns from other interests held in the investee; and
- the rights of a single party to remove the decision maker.

The Standard does not provide guidance on how to weight each of the above criteria, except when a single party has the unilateral ability to remove the decision maker without cause (commonly referred to as "kick-out" or "removal" rights). In those cases, the decision maker would be deemed an agent and the party holding those removal rights would be deemed the principal. However, if removal rights were shared among multiple investors, then each of the factors above would need to be considered in making the principal/agent assessment.
IFRS 10 indicates that the greater number of parties required to act together to remove the decision maker, the less weighting that should be placed on that factor.

Observation

IFRS 10 provides the following example of an investment manager that may be considered a principal.

The consideration of other interests held by the decision maker may impact the principal/agent determination as well as the overall conclusion. For example, a different conclusion may be reached for an investment manager with a standard 2% management fee and a 20% incentive fee arrangement who does not hold an equity investment in the managed fund and for an investment manager with the same fee structure who also holds a 35% equity investment. Likewise, a decision maker whose interests are exposed to higher degrees of variability than other investors may also be determined to be a principal. A servicer to a trust of mortgage backed securities who also invests in the 'equity' tranche of securities may be considered to be a principal whereas a servicer who only earns a fee based only on the outstanding receivables may be considered an agent.

Relationships with other parties

IFRS 10 also provides guidance on when an investor may have a relationship with another party such that the investor may direct the other party in acting on the investor's behalf (referred to as a 'de facto agent'). Examples of de facto agents include:

- related parties (as defined in IAS 24 *Related Party Disclosures*);
- an investor who received their interest in the investee as a result of a loan or contribution from the investor;
- an investor who has agreed not to sell, transfer or encumber their interest in the investee without prior approval of another investor;
- a party that cannot finance its operations without subordinated financial support from the investor;
- an investee who shares a majority of their board or key management personnel with an investor; and
- a party with a close business relationship with the investor (such as a service provider and a significant client).

Observation

The guidance on considering an investor's relationship with other parties is necessary to reflect properly the relationship that a group may have with an investee. An investor and its 'de facto agents' may each have power and economic involvements that when considered in isolation may not result in either party being identified as having control, but which together result in the group having control.

Elements of control: Exposure, or rights, to variable returns

The second criterion in the consolidation assessment is that the investor has exposure, or rights, to variable returns of the investee. IFRS 10 uses the term 'returns' rather than 'benefits' to clarify that the economic exposure to an investee may be either positive, negative or both. Examples of returns from involvement with an investee could include changes in the value of the investment in the entity, residual interests in cash flows of structured entities, dividends, interest, management or service fee arrangements, guarantees, tax benefits, or any other returns that may not be available to other interest holders. While only one investor will control an entity, multiple investors may share in the returns of the investee.

IFRS 10 clarifies that although certain economic interests may be fixed (e.g., a fixed coupon debt instrument or a fixed asset management fee based on assets under management) they might still result in variable returns as they expose the investor to variability such as credit risk from the debt instrument and performance risk from the asset management arrangement.

Elements of control: Ability to use power to affect returns

The third pillar in the assessment of control considers the interaction between the first two control components. To have control over an investee, an investor must not only have power over an investee and exposure or rights to variable returns from its involvement with the investee, but also have the ability to use its power over the investee to affect its returns from its involvement with the investee.

Other considerations

Whether a portion of an investee can be deemed as a separate entity

In some situations, an investor may have interests in a particular set of assets and liabilities (a portion of an investee) by virtue of legal and contractual arrangements. In addition, in some jurisdictions, legal entities are divided into separate parts (often referred to as 'silos'). In such circumstances, a question arises as to whether it is possible to consider only an individual silo or a portion of an investee (rather than the entire legal entity) as a separate entity for the purposes of the consolidation assessment.

Under IFRS 10, the determination of whether a silo exists is based on whether the individual silo is in-substance separate or 'ring-fenced' from the overall investee. If the portion of the investee is economically separate from the overall investee and the investor controls that portion of the investee, that portion should be treated as a subsidiary of the investor.

Continuous assessment

IFRS 10 requires a continuous assessment of control of an investee. This continuous reassessment would consider both changes in an investor's power over the investee and changes in the investor's exposure or rights to variable returns. This assessment will be made based on changes in facts and circumstances but would be visited at least at each reporting period.

Effective date and transition

IFRS 10 and the other components of the 'package of five' are effective for annual periods beginning on or after 1 January 2013. Earlier application is permitted so long as all components of the "package of five" are early applied.

> **Observation**
>
> The IASB expressed concerns that requiring all component parts to be early applied may discourage entities from providing the disclosure requirements of IFRS 12 before the required effective date. Therefore, IFRS 12 clarifies that entities are encouraged to provide any or all of the required disclosures prior to the effective date and that this will not result in a requirement to apply the other components of the "package of five".

IFRS 10 requires retrospective application in accordance with IAS 8, *Accounting Policies, Changes in Accounting Estimates and Errors*, subject to certain transitional provisions.

When the initial application of IFRS 10 results in consolidation of an investee that was not previously consolidated, an investor should measure the assets, liabilities and non-controlling interests in that previously unconsolidated investee on the date of initial application as if that investee had been consolidated from the date when the investor obtained control of that investee on the basis of the requirements of IFRS 10 (if the investee is a business, this would mean applying IFRS 3 as of that date). However, if this is impracticable, the investor should apply the requirements of IFRS 3, with the deemed acquisition date being the beginning of the earliest period for which application is practicable (which may be the current period).

When the initial application of IFRS 10 results in no longer consolidating an investee that was previously consolidated, an investor should measure its interest in the investee at the amount in which it would have been measured if the requirements of IFRS 10 had always been effective. If measurement of the interest is impracticable, the investor should apply the requirements in IFRS 10 for accounting for a loss of control at the start of the reporting period in which IFRS is adopted.

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