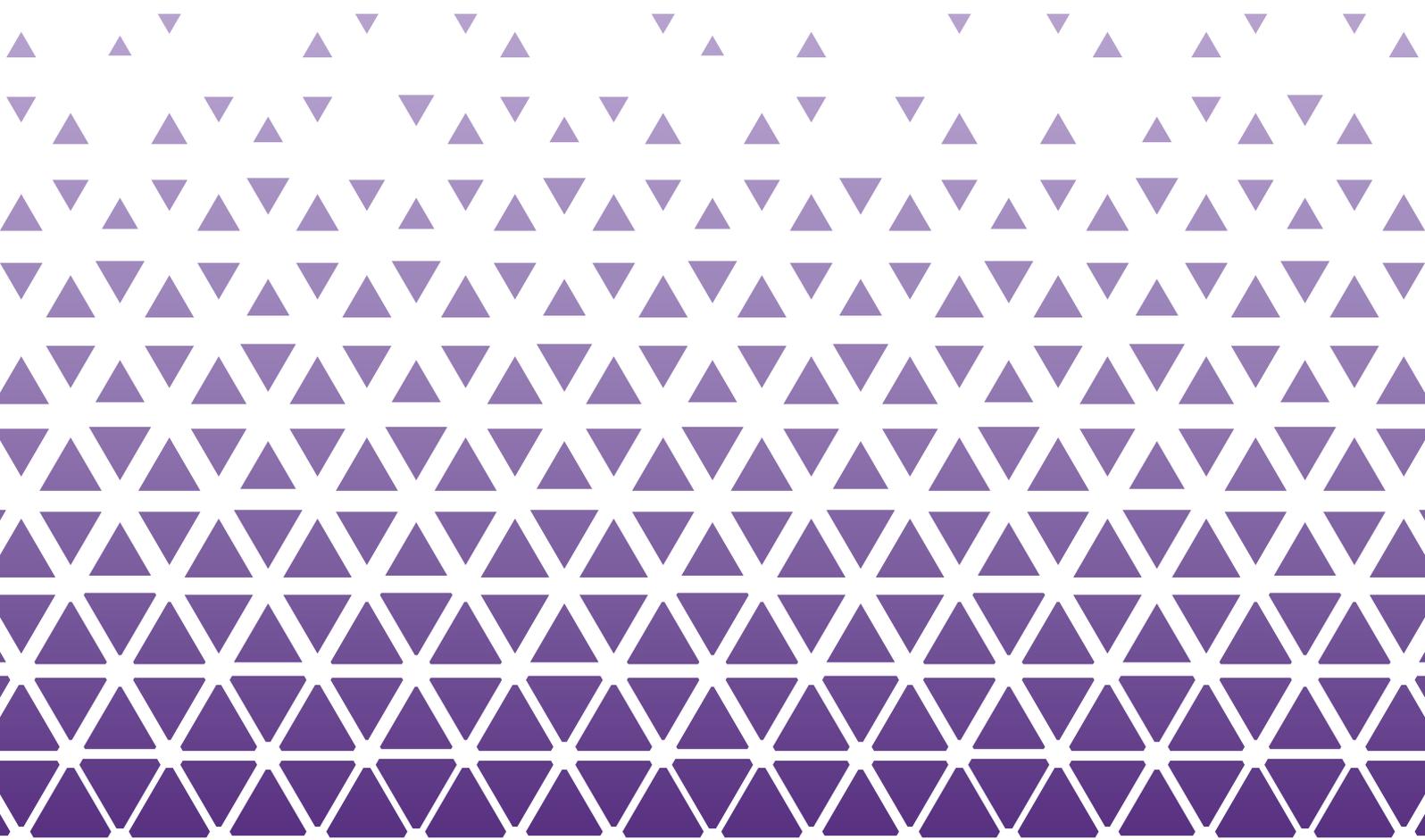


Under control?

A practical guide to applying IFRS 10 Consolidated Financial Statements

February 2017



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Introduction

Assessing when one entity controls another (in other words, when a parent-subsidary relationship exists) is essential to the preparation of financial statements in accordance with International Financial Reporting Standards (IFRS). The control assessment determines which entities are consolidated in a parent's financial statements and therefore affects a group's reported results, cash flows and financial position – and the activities that are 'on' and 'off' the group's balance sheet. Under IFRS, this control assessment is accounted for in accordance with IFRS 10 'Consolidated financial statements'.



IFRS 10 was issued in May 2011, and was part of a package of changes addressing different levels of involvement with other entities. IFRS 10 redefines 'control' and provides extensive guidance on applying the definition.

IFRS 10 applies both to traditional entities and to special purpose (or structured) entities and replaced the corresponding requirements of both IAS 27 'Consolidated and Separate Financial Statements' (IAS 27) (2008) and SIC-12 'Consolidation – Special Purpose Entities' (SIC-12).

It is unusual for IFRS 10 to affect the scope of consolidation in simple situations involving control through ownership of a majority of the voting power in an investee. However, more complex and borderline control assessments need to be reviewed carefully.

The member firms within Grant Thornton International Ltd ('GTIL') have gained extensive insights into the application of IFRS 10. GTIL, through its IFRS team, develops general guidance that supports its member firms' commitment to high quality, consistent application of IFRS. We are pleased to share these insights by publishing 'Under Control? A Practical Guide to Applying IFRS 10 Consolidated Financial Statements' (the Guide).

Using the Guide

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

- understanding IFRS 10's requirements
- identifying situations in which IFRS 10 can impact control assessments
- identifying and addressing the key practical application issues and judgements.

The Guide is organised as follows:

- **Section 1** provides an overview of IFRS 10 and areas where IFRS 10 can impact the scope of consolidation. It also explains how IFRS 10 fits into the overall package of Standards on involvement with other entities.
- **Section 2** explains the scope of IFRS 10 from an investor and investee perspective, and the situations in which a parent entity is exempt from presenting consolidated financial statements.
- **Section 3** sets out IFRS 10's control definition and its key elements, and identifies key practical issues in applying the guidance.
- **Section 4** discusses the specific situations and types of investee for which IFRS 10 can affect control conclusions and the scope of consolidation in practice.
- **Section 5** discusses consolidation procedures and the requirements on changes in ownership and loss of control.
- **Section 6** explains the consolidation exception for investment entities.
- **Appendix A** summarises the disclosure requirements in IFRS 12 'Disclosure of Interests in Other Entities' and provides selected application examples.

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When applying IFRS 10, complex and borderline control assessments need to be reviewed carefully.

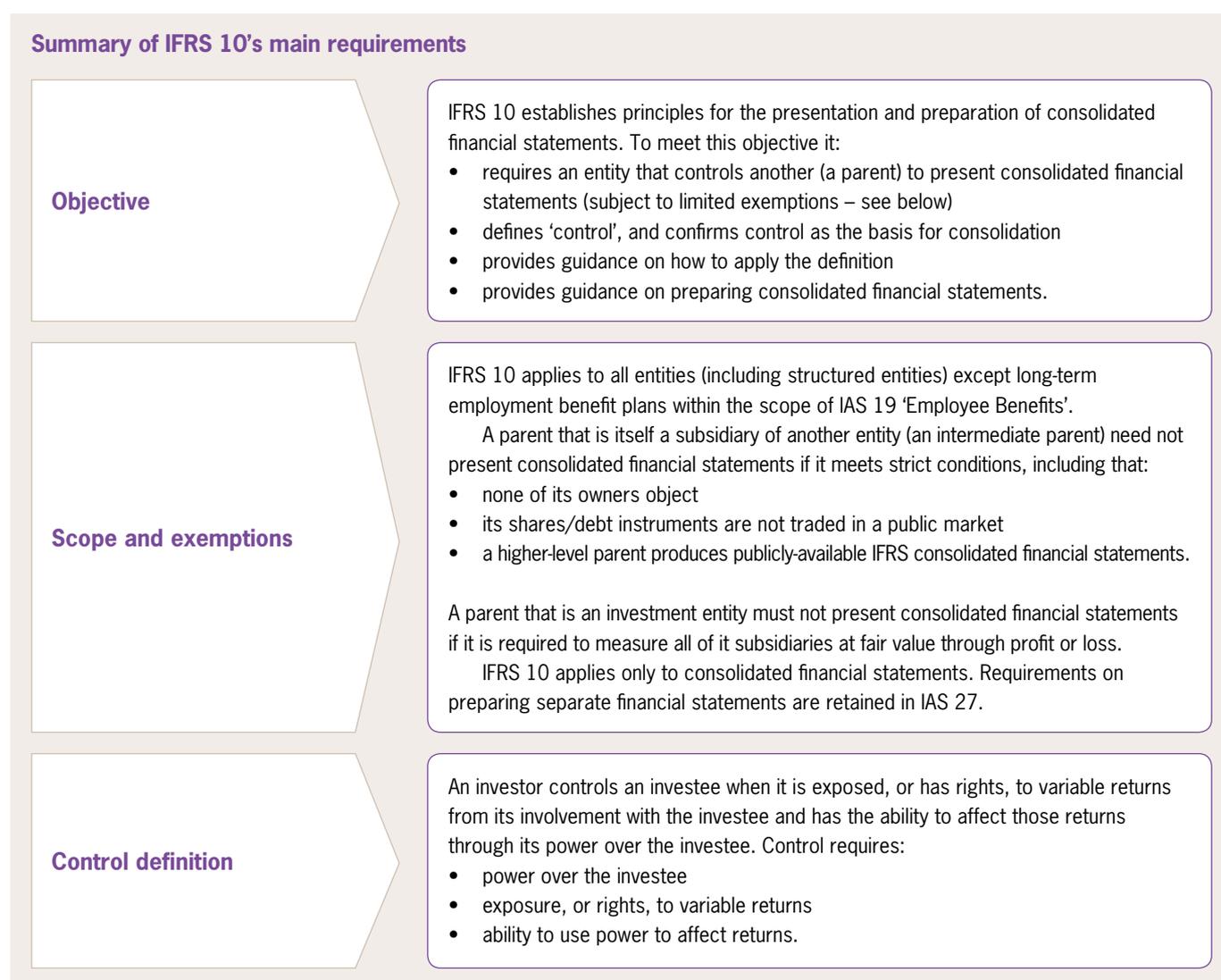
1 Overview

IFRS 10 establishes a single, control-based model for assessing control and determining the scope of consolidation. It applies to all entities, including 'structured entities', which were previously referred to as 'special purpose entities' under SIC-12.



This section summarises IFRS 10's main requirements, provides insights into areas where IFRS 10 most often impacts consolidation assessments and explains how IFRS 10 fits into the broader 'consolidation package'.

1.1 Summary of IFRS 10's main requirements



Summary of IFRS 10's main requirements

Applying the control definition

IFRS 10 includes additional guidance on the elements of the control definition and their interaction, including:

- purpose and design of the investee
- the 'relevant activities' of an investee
- whether the rights of the investor give it the current ability to direct the relevant activities
- whether the investor is exposed, or has rights, to variable returns.

IFRS 10 includes guidance on more difficult control assessments including:

- agency relationships
- control over structured entities
- potential voting rights
- control without a majority of voting rights.

Preparing consolidated financial statements

IFRS 10 retains established principles on consolidation procedures, including

- elimination of intra-group transactions and the parent's investment:
- uniform accounting policies
- the need for financial statements used in consolidation to have the same reporting date
- the allocation of comprehensive income and equity to non-controlling interests
- accounting for changes in ownership interests without loss of control
- accounting for losing control of a subsidiary.

Effective date and transition

IFRS 10 came into effect for accounting periods beginning on or after 1 January 2013.

Transition was mainly retrospective but was subject to reliefs for situations in which:

- the control assessment was the same as under IAS 27 (2008)
- a fully retrospective consolidation or de-consolidation would be impracticable.

Early adoption was permitted as long as the other standards in the consolidation package were adopted at the same time.

Disclosures

IFRS 10 does not include any disclosure requirements but an entity that applies IFRS 10 is also required to apply IFRS 12 – which sets out comprehensive disclosure principles.

Terminology – 'special purpose entities' (SPEs) and 'structured entities'

The Guide makes extensive references to 'special purpose entities' (SPEs). These references are used to broadly describe entities which used to be considered within the scope of SIC-12. SIC-12 described SPEs only in general terms, so deciding whether a particular entity is an SPE required judgement.

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

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

This is explained in more detail in section 4.4.1.

1.2 Areas where IFRS 10 can impact the scope of consolidation

It is unusual for IFRS 10 to affect the scope of consolidation in straightforward situations involving control through majority ownership of voting power. However, more complex and borderline control assessments need to be reviewed carefully.

The table below summarises the main situations and types of investee in which IFRS 10 can impact control assessments and scope:

Situations/type of investee	Impact of IFRS 10
Large minority holdings	<ul style="list-style-type: none"> control may exist where other shareholdings are widely dispersed and an investor holds significantly more voting rights than any other shareholder or group of shareholders.
Potential voting rights (PVRs)	<ul style="list-style-type: none"> under IFRS 10 PVRs may convey or contribute to control if 'substantive' IFRS has a broad range of indicators to assess whether PVRs are substantive.
Special purpose entities (SPEs) and structured entities	<ul style="list-style-type: none"> SPEs are not defined in IFRS 10 IFRS 10's general principles apply to entities previously covered by SIC-12 consolidation outcomes for entities that were previously within the scope of SIC-12 can change because: <ul style="list-style-type: none"> – exposure to risks and rewards is only an indicator of control under IFRS 10 and is not determinative of control on its own – IFRS 10 places less emphasis on the concept of 'autopilot' and instead requires a more specific identification of the future activities and decisions that can affect returns IFRS 10 does include guidance on situations in which voting or similar rights are not the dominant factor in deciding who controls the investee.
Delegated power (principal-agent situations)	<ul style="list-style-type: none"> the guidance in IFRS 10 on principal-agent situations can impact on consolidation decisions investment and asset managers in particular can be affected IFRS 10 includes extensive guidance on whether an investor is a principal or an agent. An investor engaged primarily to act on behalf of other parties (ie an agent) does not control the investee.
Investment entities	<ul style="list-style-type: none"> when the parent is an investment entity, IFRS 10 provides an exception to the consolidation requirement.

IFRS 10 establishes a single, control-based model for assessing control and determining the scope of consolidation.

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

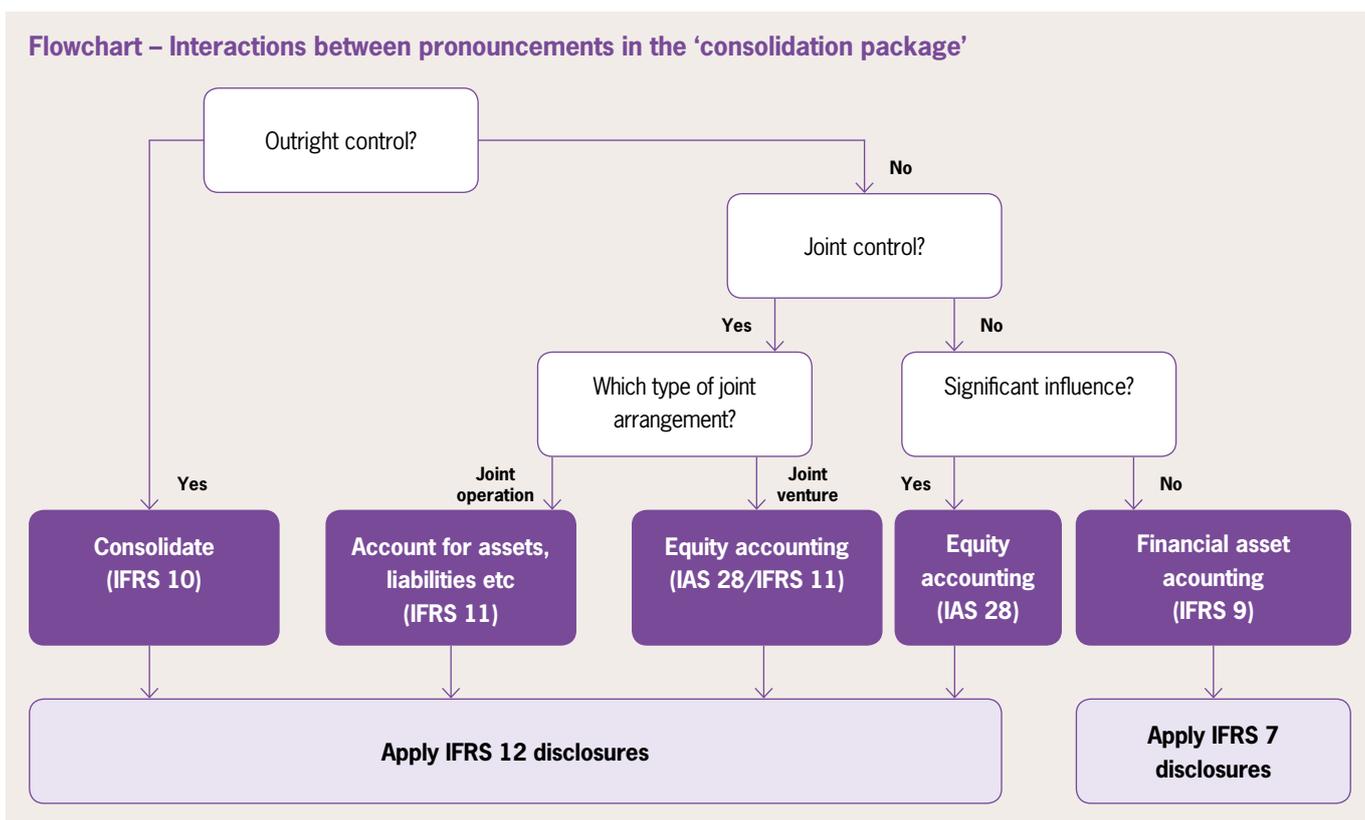
IFRS 10 was issued in May 2011 as part of a package of three new and two amended standards, sometimes referred to as the consolidation package. The other standards included in this package were:

- IFRS 11 ‘Joint Arrangements’, which replaced IAS 31 ‘Interests in Joint Ventures’ and SIC-13 ‘Jointly Controlled Entities – Non-Monetary Contributions by Venturers’
- IFRS 12 ‘Disclosure of Interests in Other Entities’
- an amended version of IAS 27, which was renamed IAS 27 ‘Separate Financial Statements’ and addresses only separate financial statements

- an amended version of IAS 28, which was renamed IAS 28 ‘Investments in Associates and Joint Ventures’, but is substantively the same as the previous version.

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

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

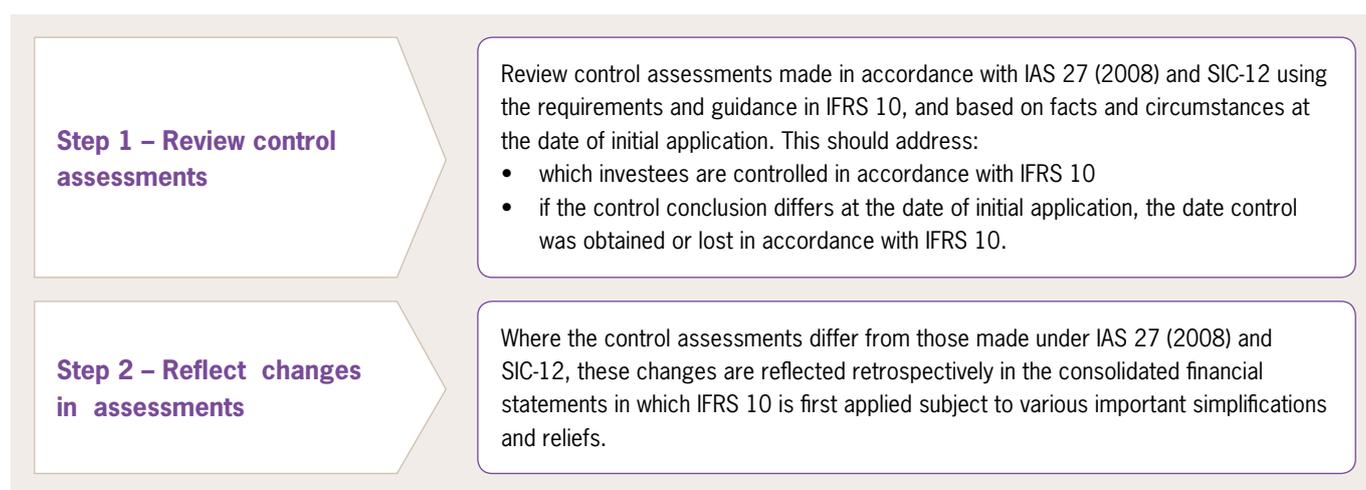


1.4 Effective date and transition of IFRS 10

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

Earlier application was permitted, as long as this was disclosed and the other standards and amendments in the consolidation package were applied at the same time – in particular IFRS 11 and IFRS 12 [IFRS 10.C1].

In practice the transition from IAS 27 (2008) to IFRS 10 involved two main steps, as follows:

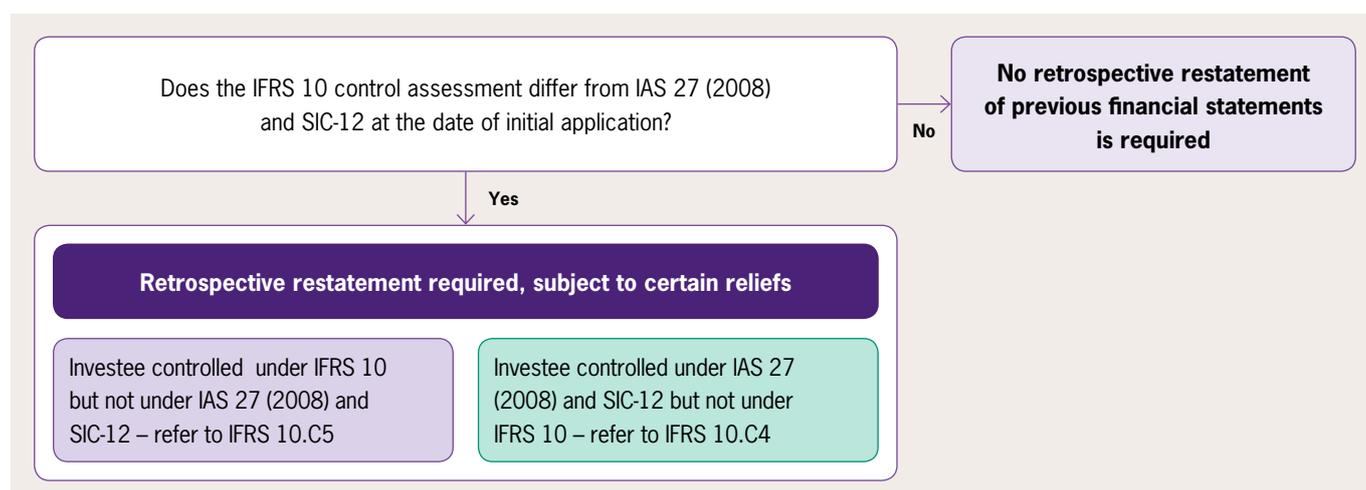


As noted in step 2 above, IFRS 10 requires retrospective application in accordance with IAS 8 'Accounting Policies, Changes in Accounting Estimates and Errors', however it contains important reliefs as follows:

- relief from full retrospective application when the control assessment at the date of initial application under IFRS 10 differs from that under IAS 27 (2008) and SIC-12 but full retrospective application is impractical
- relief from restatement when the control assessment at the date of initial application is the same under IFRS 10 as it was under IAS 27 (2008), even if the date on which control was obtained or lost differs.

When IFRS 10 requires retrospective application, an investor is required to measure the investee's assets, liabilities, and non-controlling interests on the date of initial application as though the investee were consolidated from the date when the investor obtained control on the basis of the requirements in IFRS 10.

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

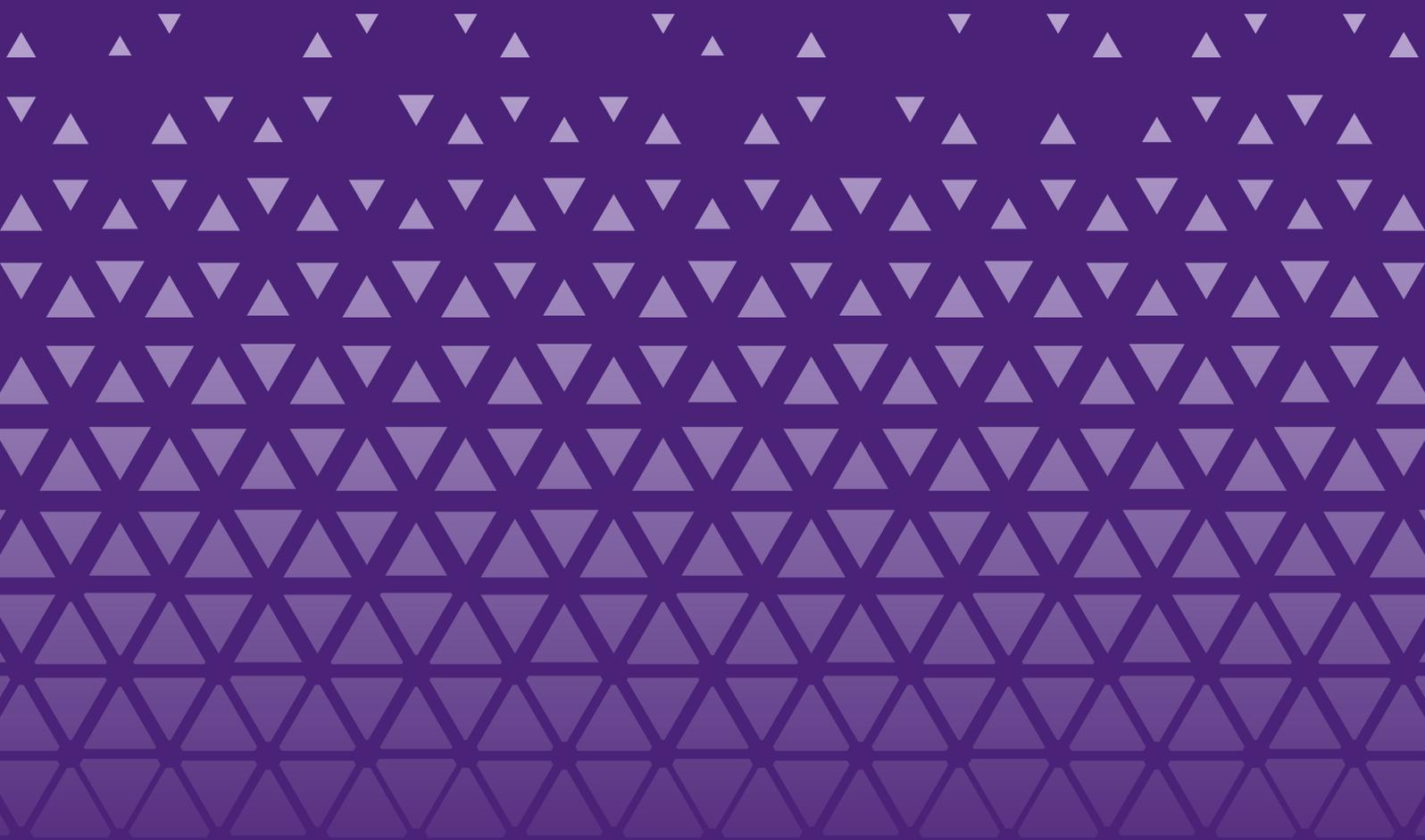


2 Scope and consolidation exemptions

IFRS 10 applies to all entities (including structured entities) except long-term employment benefit plans within the scope of IAS 19.

A parent that is itself a subsidiary of another entity (an intermediate parent) need not present consolidated financial statements if it meets strict conditions as detailed further in this section.

A parent that is an investment entity must not present consolidated financial statements if it is required to measure all of its subsidiaries at fair value through profit or loss.



This section discusses the scope of IFRS 10 and associated practical issues, and details IFRS 10's exceptions and exemptions from preparing consolidated financial statements.

2.1 Scope of IFRS 10

IFRS 10 addresses the scope of consolidated financial statements and the procedures for their preparation. The requirements on separate financial statements are retained in the revised version of IAS 27.

The scope of IFRS 10 covers:

- the reporting entities that are required to assess control of their investees – see section 2.1.1 below
- the investees that the control assessment is applied to – see section 2.1.2 below
- circumstances in which parent entities are exempt from presenting consolidated financial statements – see section 2.2 below.

Terminology – 'investor' and 'investee'

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

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

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

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

2.1.2 Which investees is the control assessment applied to?

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

Silos most often exist within special purpose vehicles in the financial services and real estate sectors (for example, 'multi-seller conduits' and captive insurance entities). However, the conditions for a silo to be deemed a separate entity for IFRS 10 purposes are strict. The example below illustrates the silo concept:

Example – Silos and deemed separate entities

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

Analysis:

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

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

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

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

Example – Co-ownership agreement

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

Analysis:

Based on these limited facts, judgement is required to decide whether the property, combined with the co-ownership agreement, is an 'entity'. One view, based on an Exposure Draft of a Conceptual Framework chapter on the 'Reporting entity' issued by the IASB in March 2010, is that an entity is any circumscribed area of economic activity for which discrete financial information exists. Under this definition the arrangement described would be an entity. However, this definition is not authoritative.

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

If the arrangement is not an entity:

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

2.2 Consolidation exceptions and exemptions

IFRS 10 requires all parent entities to present consolidated financial statements, other than:

- parent entities that are investment entities. These are an exception to consolidation if they are required (in accordance with IFRS 10.31) to measure all of their subsidiaries at fair value through profit or loss [IFRS 10.4B]. Refer to section 6 on investment entities
- intermediate parent entities that meet the strict conditions for exemption, which are set out below:

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

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

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

In practice, questions do arise on whether the consolidation exemption is available in particular circumstances. The following examples provide guidance on three common issues:

Example – Ultimate parent with different year-end

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

Analysis:

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

Example – Immaterial intermediate parent

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

Analysis:

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

Example – Ultimate parent's financial statements not yet available

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

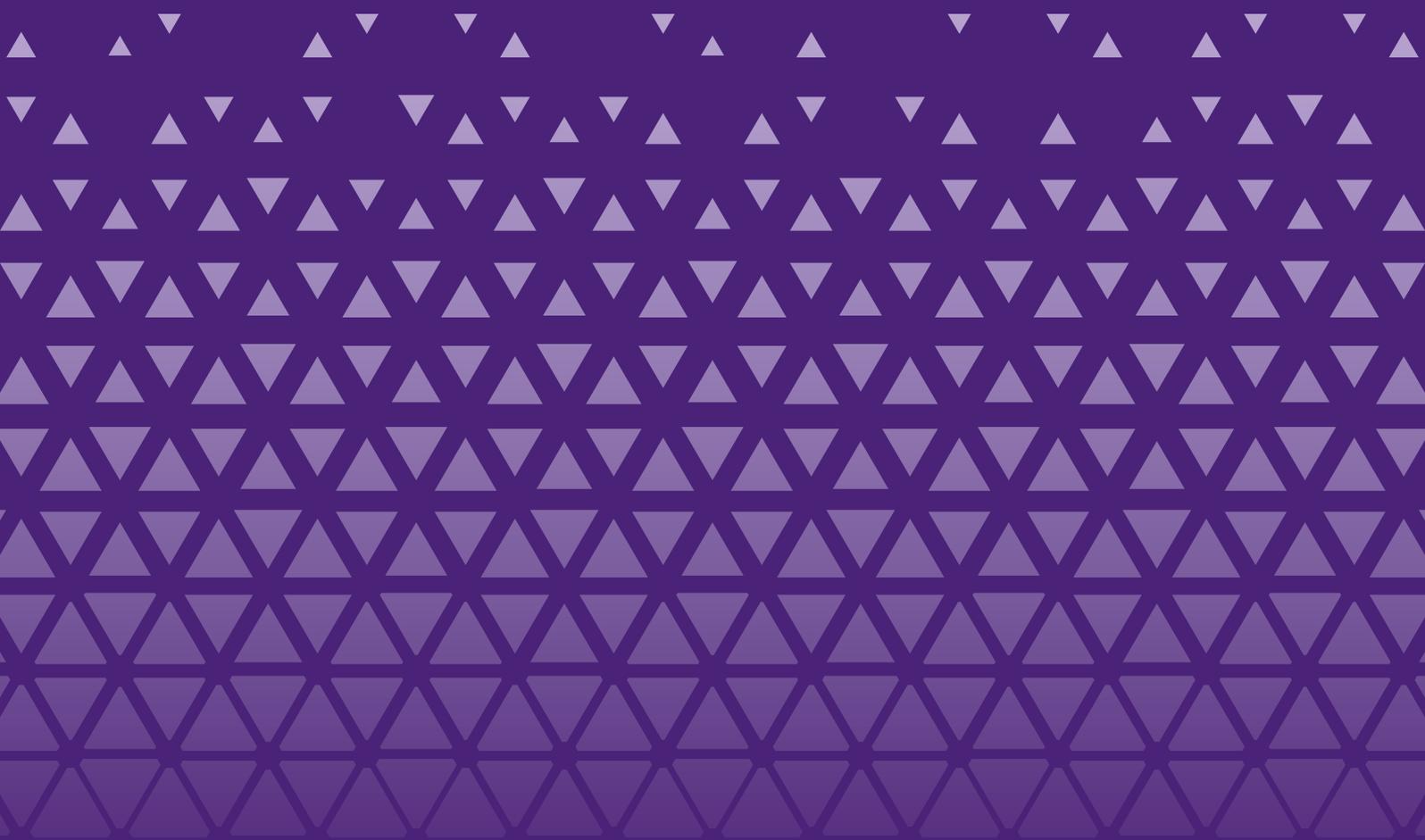
Analysis:

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

3 The control definition and guidance

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

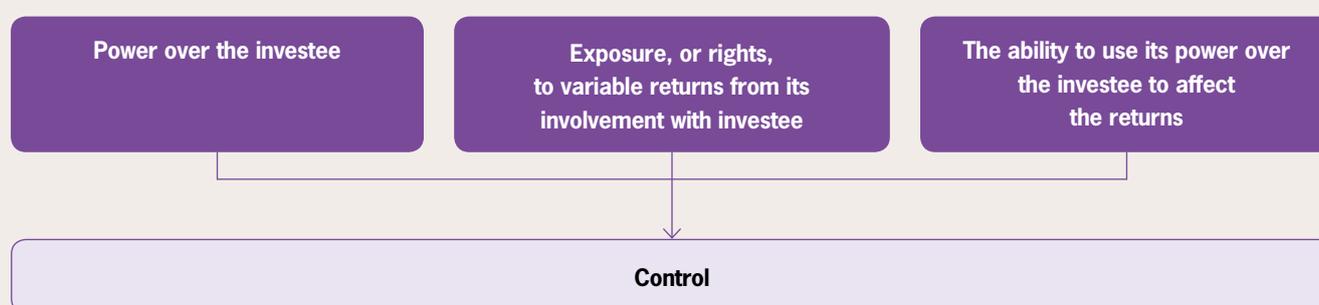
- power over the investee
- exposure, or rights, to variable returns
- ability to use power to affect returns.



IFRS 10 requires all reporting entities that prepare IFRS financial statements (subject to a narrow-scope exception discussed in section 2.1.1) to apply the definition of control noted below to determine which of their investees they control.

Definition of control [IFRS 10.6]

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

Three elements of control

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

For an investor to have control it must have the three defined elements of control.

3.1 The practical implications of the control definition

The control definition and accompanying guidance has little or no practical effect on control assessments when a single investor owns a majority of the voting rights of an investee with a conventional governance and ownership structure. Under the old definition in IAS 27 (2008), direct or indirect ownership of a majority of the voting rights presumptively resulted in control.

This type of relationship results in control under IFRS 10 in most cases, although IFRS 10 has more guidance on situations in which this is not the case – see section 4.1.

However, IFRS 10's definition does include changes that impact the control assessment in more complex and judgemental situations. The table below summarises some of the key practical implications:

Key elements of the control definition	Practical implications
'Rights' and 'ability'	<ul style="list-style-type: none"> • both the definition and guidance clarify that owning a majority of the voting or other rights is not always necessary to have control • control instead requires that the investor's power/rights are sufficient for it to unilaterally direct the activities that most affect the investee's returns • more analysis and judgement is required to determine whether an investor with a significant minority of voting or other rights has control.
'The ability to affect returns'	<ul style="list-style-type: none"> • the definition reflects the fact that IFRS 10 applies to special purpose or structured entities as well as more conventional entities • in more complex control assessments IFRS 10 requires identification of the activities that most affect the investee's returns (the 'relevant activities'), and how they are directed, at a more granular level • in simpler assessments involving conventional entities it is sufficient to consider activities at the financial and policy level.
'Exposure or rights to variable returns'	<ul style="list-style-type: none"> • IFRS 10 clarifies that: <ul style="list-style-type: none"> – returns should be interpreted broadly, for example, to include synergy benefits as well as financial returns – returns can be negative or positive – a right to returns that is fixed is not consistent with control (although returns that are contractually-fixed are often still variable in substance – see section 3.3.2).

3.2 The three key elements of control in more detail

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

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

3.2.1 Power

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

Practical insight – assessing power in straightforward situations

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

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

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

An investor also considers the purpose and design of the investee (see section 3.3 below).

Relevant activities [IFRS 10.B11-B13]

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

Definition of relevant activities [IFRS 10.Appendix A]

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

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

- selling and purchasing of goods or services
- managing financial assets during their life (including upon default)
- selecting, acquiring or disposing of assets
- researching and developing new products or processes
- determining a funding structure or obtaining funding [IFRS 10.B11].

Questions sometimes arise as to whether an investee whose activities are largely pre-determined (such as some special purpose and structured entities) really has any relevant activities. As discussed in section 4.4, in our view it is very rare (although not impossible) that an investee has no relevant activities at all.

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

Example – Rights to direct different relevant activities

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

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

Analysis:

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

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

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

Practical insight – relevant activities for conventional business entities

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

However, a more specific and detailed analysis of relevant activities is required in less straightforward situations. This will often be the case for special purpose or structured entities. The example illustrates one such situation:

Example – Specific relevant activity

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

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

Analysis:

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

In this case, Entity B's relevant activity is likely to be managing the loans. Bank A should therefore consider:

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

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

Example – Different relevant activities at different times

Scenario 1 – research and development

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

Analysis:

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

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

In this type of situation a change of control (from one investor to another) is possible, following reassessment of the investee's relevant activities. This is consistent with IFRS 10's continuous assessment requirement (see section 3.6).

Scenario 2 – construction of a facility

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

Analysis:

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

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

Directing relevant activities

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

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

Practical insight – decisions about relevant activities

Decisions about relevant activities include but are not limited to:

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

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

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

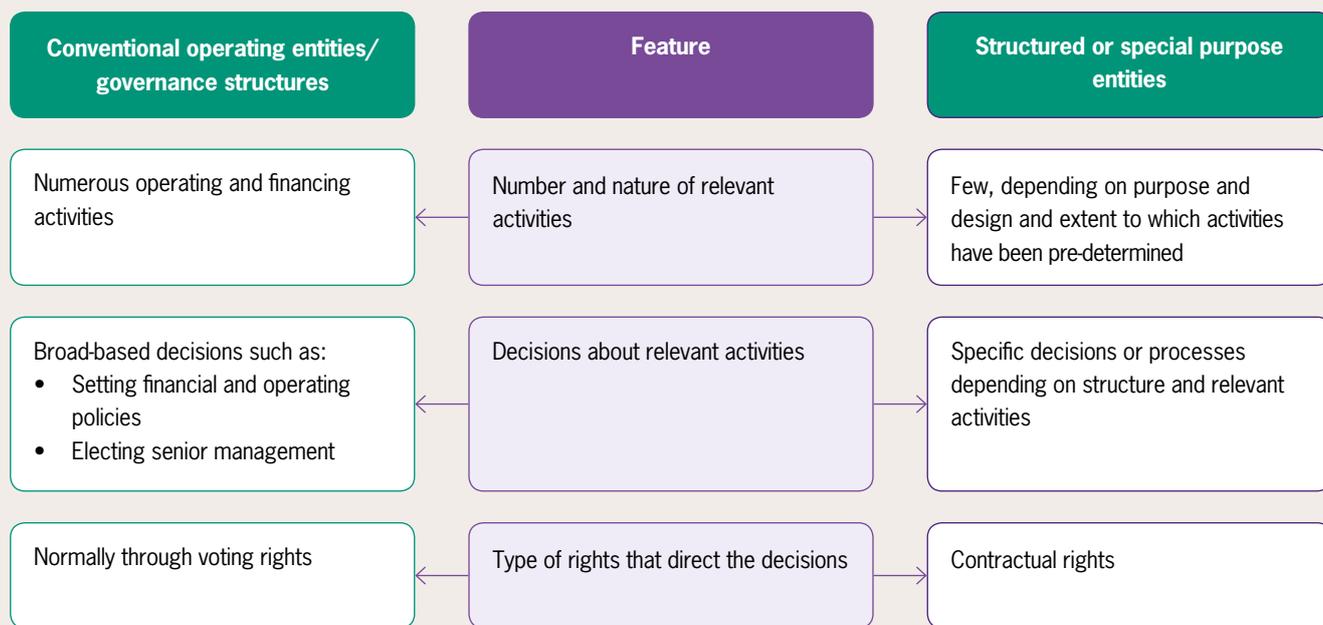
IFRS 10 envisages two types of rights that may confer ability to direct these decisions (ie power):

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

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

The flowchart below illustrates how the direction of relevant activities differs for conventional and structured or special purpose entities:

Flowchart – Direction of relevant activities for conventional and structured entities



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

Example – Voting versus contractual rights

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

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

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

Analysis:

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

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

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

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

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

Definition of substantive rights [IFRS 10.B22]

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

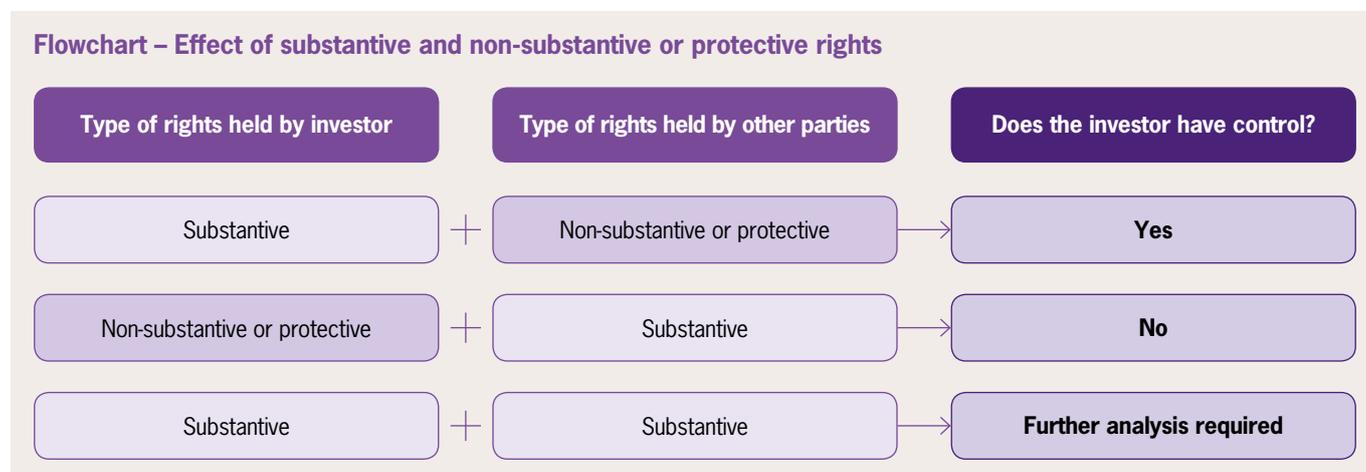
Definition of protective rights [IFRS 10.Appendix A and B26-B27]

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

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

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

For an investor to have control it must have power over the investee.



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

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

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

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

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

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

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

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

- assessing potential voting rights – see section 4.3
- assessing control over a franchise – see section 4.6
- determining the acquisition date in a business combination – demonstrated in the following example.

Example –

Acquisition date in a business combination

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

Acquirer A and Vendor V enter into an agreement that:

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

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

Analysis:

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

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

Other factors in assessing whether an investor has power

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

- current ability to direct the relevant activities confers power even if the rights to direct have yet to be exercised
- evidence that the investor has been directing relevant activities can help determine whether the investor has power, but such evidence is not, in itself, conclusive in determining whether the investor has power
- if two or more investors each have existing rights that give them the unilateral ability to direct different relevant activities, the investor that has the current ability to direct the activities that most significantly affect the returns of the investee has power over the investee
- an investor can have power over an investee even if other entities have existing rights that give them the current ability to participate in the direction of the relevant activities, for example, when another entity has significant influence [IFRS 10.12-14].

3.2.2 Exposure, or rights, to variable returns

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

Definition of variable returns [IFRS 10.15 and B56]

Variable returns are returns that are not fixed and have the potential to vary as a result of the performance of an investee. Variable returns can be only positive, only negative or both positive and negative.

IFRS 10 provides the following examples of variable returns:

- dividends
- other distributions of economic benefits (for example, interest from debt securities)
- changes in value of an investment
- remuneration for servicing an investee's assets or liabilities
- fees and exposure to loss from providing credit or liquidity support
- residual interests in the investee's assets and liabilities on liquidation
- tax benefits
- access to future liquidity
- returns that are not available to other interest holders such as:
 - use of own assets in combination with investee's assets
 - combining operating functions to achieve economies of scale
 - cost savings
 - gaining access to proprietary knowledge [IFRS 10.B57].

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

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

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

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

Example – Outsourcing arrangement

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

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

Analysis:

This fact pattern raises two main issues:

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

3.2.3 Ability to use power to affect returns

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

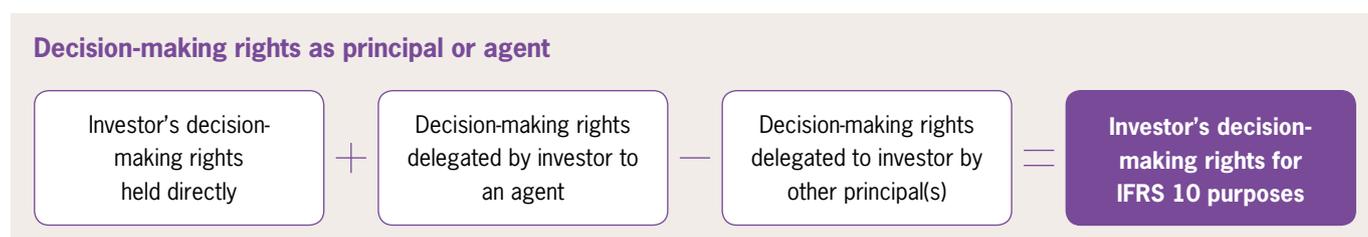
- on its own account (in other words, as a principal); or
- on behalf of other investors that have delegated their power to it (in other words, as an agent).

Definition of agent [IFRS 10.B58]

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

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

If an investor has some or all of its decision-making rights in the capacity of agent, those rights do not count towards the assessment of whether it controls the investee. Conversely, if the investor has delegated some or all of its decision-making rights to an agent, those rights are treated as the investor's rights for IFRS 10 purposes. This is illustrated as follows:



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

Definition of de facto agent [IFRS 10.B74]

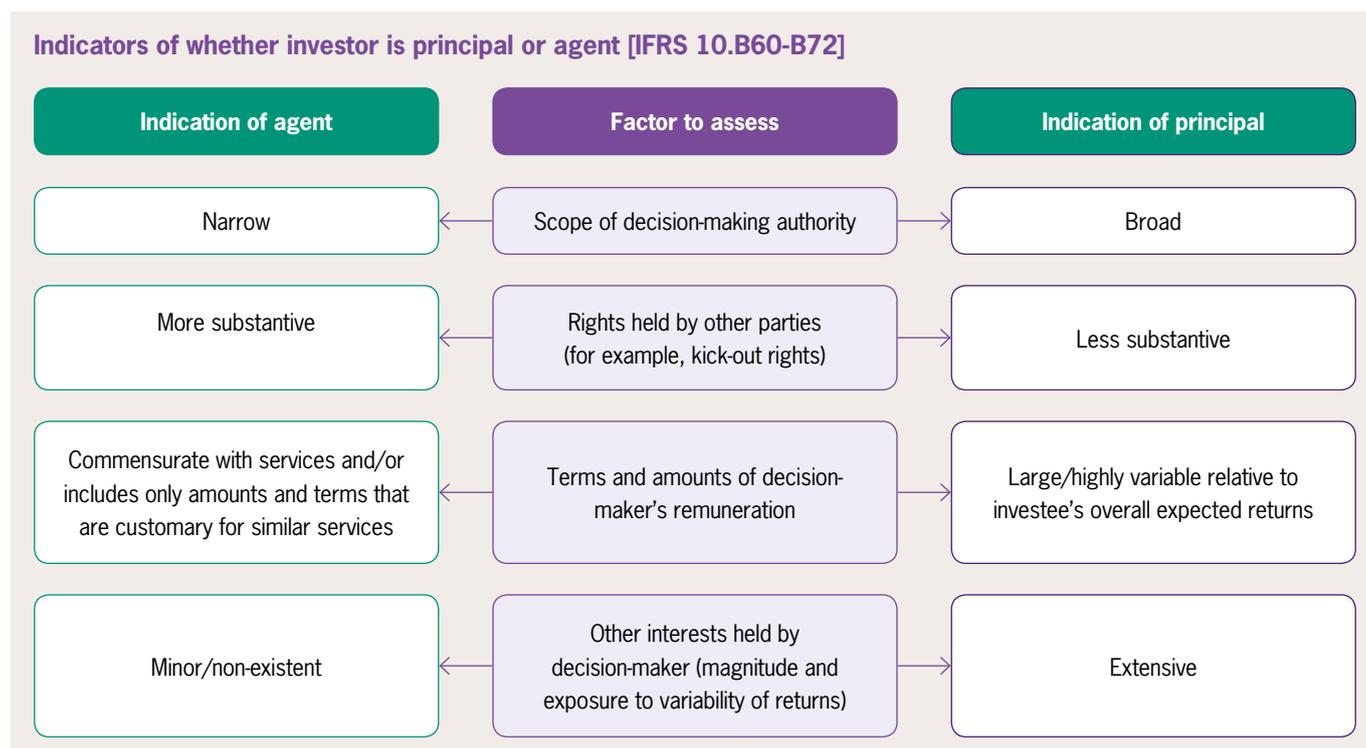
A party is a de facto agent when the investor has, or those that direct the activities of the investor have, the ability to direct that party to act on the investor's behalf.

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

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

- the investor's related parties
- a party that received its interest in the investee as a contribution or loan from the investor
- a party that has agreed not to sell, transfer or encumber its interests in the investee without the investor's prior approval
- a party that cannot finance its operations without subordinated financial support from the investor
- an investee for which the majority of the members of its governing body or for which its key management personnel are the same as the investor's
- a party that has a close business relationship with the investor such as the relationship between a professional service provider and one of its significant clients [IFRS 10.B75].

To determine whether a decision-maker is a principal or an agent, IFRS 10 requires an assessment of a range of indicators aimed at identifying the decision-maker's primary role. The indicators consider the nature of the decision-maker's rights and its incentives to act primarily on its own behalf or on behalf of others. The indicators are summarised below and discussed in more detail in section 4.5:



For an investor to have control it must have the ability to use power to affect returns.

3.3 Purpose and design of investee

IFRS 10 refers to assessing the 'purpose and design' of an investee in several different contexts. The IASB's intention appears to be that, in assessing control, an investor considers all facts and circumstances, including the substance and intended purpose of specific structures and arrangements. A summary of IFRS 10's references to assessing purpose and design is noted below.

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

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

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

In addition purpose and design is considered in assessing:

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

IFRS 10 refers to assessing the 'purpose and design' of an investee in several different contexts.

3.4 Situations where the control assessment is unclear

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

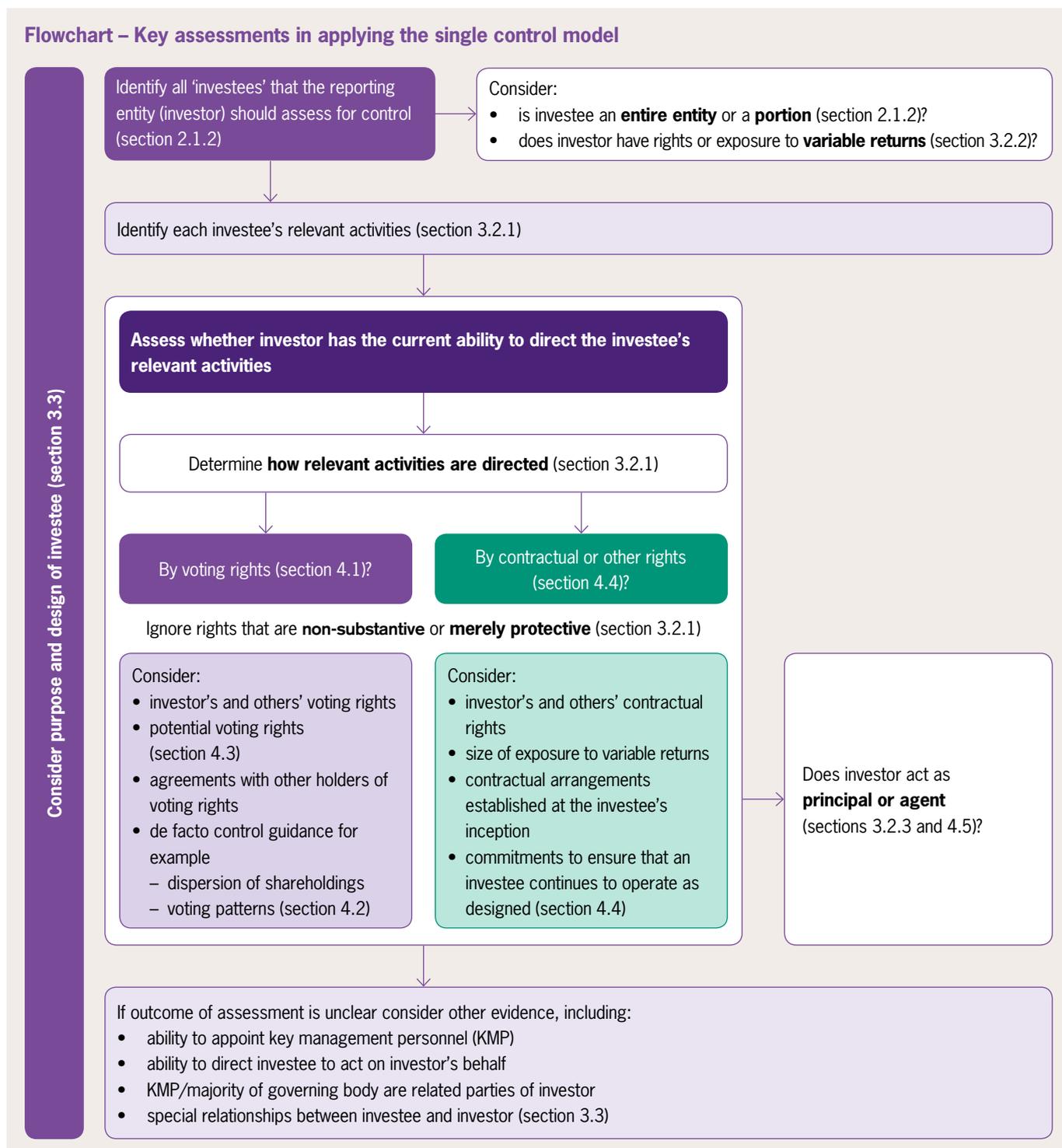
- evidence of possible power
- indicators of possible power
- incentives to obtain power.

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

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

3.5 Summary of the control assessment process

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



3.6 Continuous assessment

IFRS 10 clarifies that control over another entity is reassessed if facts and circumstances indicate that there are changes to one or more of the three elements control discussed above [IFRS 10.B80].

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

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

- changes to the investor's decision-making rights
- lapse of decision-making rights held by other parties
- investor becomes or ceases to be entitled to variable returns
- changes resulting in reassessment of whether an investor acts as agent or principal [IFRS 10.B80-B86].

In our view reassessment may also be required when different investors have rights over activities that take place at different times – see the example on page 21.

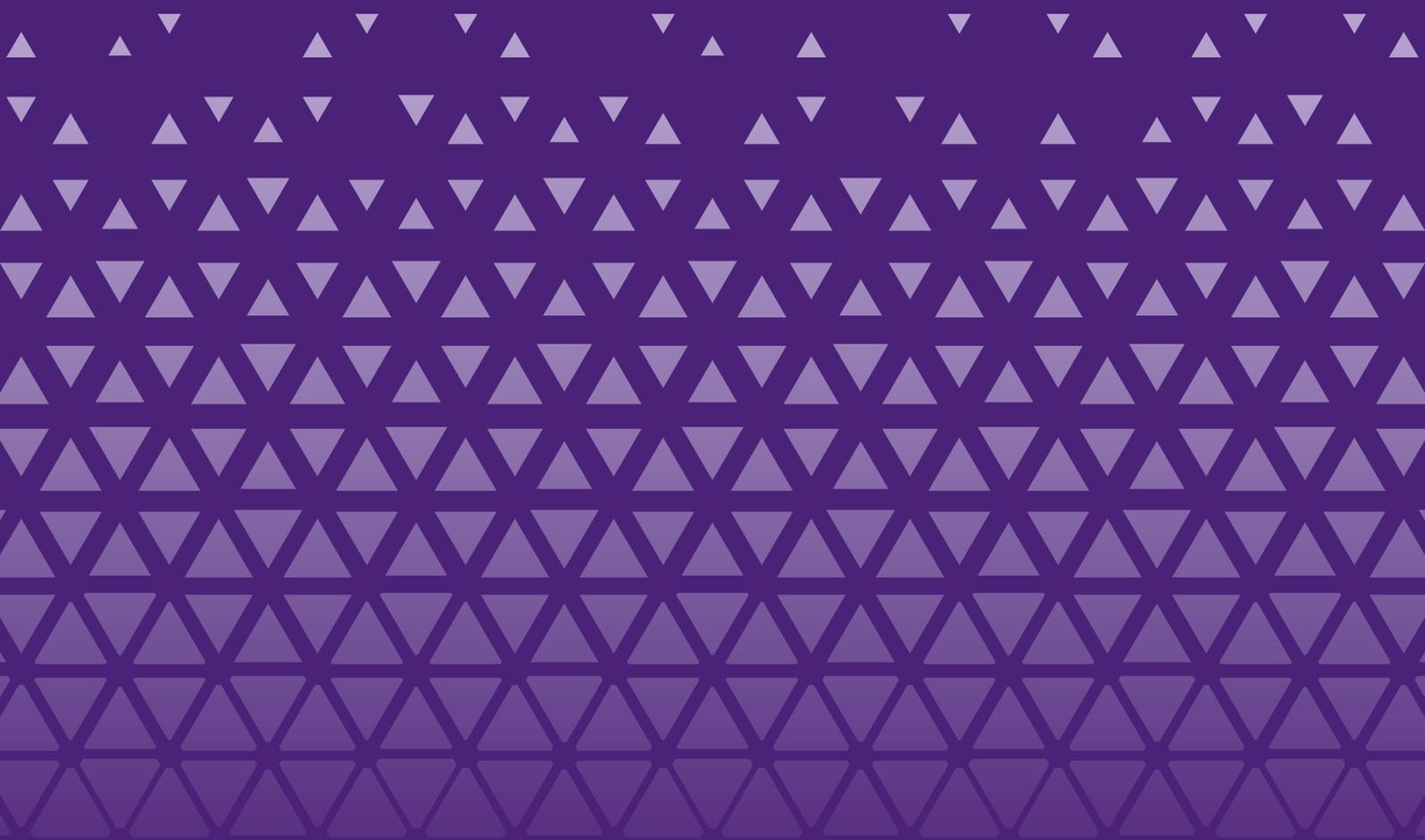
In our view reassessment may also be required when different investors have rights over activities that take place at different times.

4 Applying the control model in specific circumstances

IFRS 10 includes guidance on more difficult control assessments including:

- agency relationships
- control over structured entities
- potential voting rights
- control without a majority of voting rights.

These more difficult control assessments are discussed in this section.



IFRS 10 sets out requirements for how to apply the control principle in less straight forward circumstances, which are detailed over the following pages:

- when voting rights or similar rights give an investor power, including situations where the investor holds less than a majority of voting rights and in circumstances involving potential voting rights
- when an investee is 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
- involving agency relationships
- when the investor has control only over specified assets of an investee
- franchises.

4.1 Majority holdings in an investee

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

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

IFRS 10 has more specific guidance on when the majority owner does not have control in the following situations:

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

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

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

Example – Scheme of protection from creditors

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

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

Analysis:

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

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

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

4.2 Large minority holdings in an investee

4.2.1 IFRS 10’s approach

While control assessments involving majority ownership are relatively straightforward, IFRS 10 requires more focus on investees in which the investor holds a significant minority of voting rights. This is because, under IFRS 10, control exists when the investor has the practical ability to direct an investee’s relevant activities. This approach is often referred to an effective (or de facto) control model.

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

4.2.2 Practical application

To illustrate a de facto control approach, and how it differs from a legal control model, consider this example below:

Example – Large minority shareholding

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

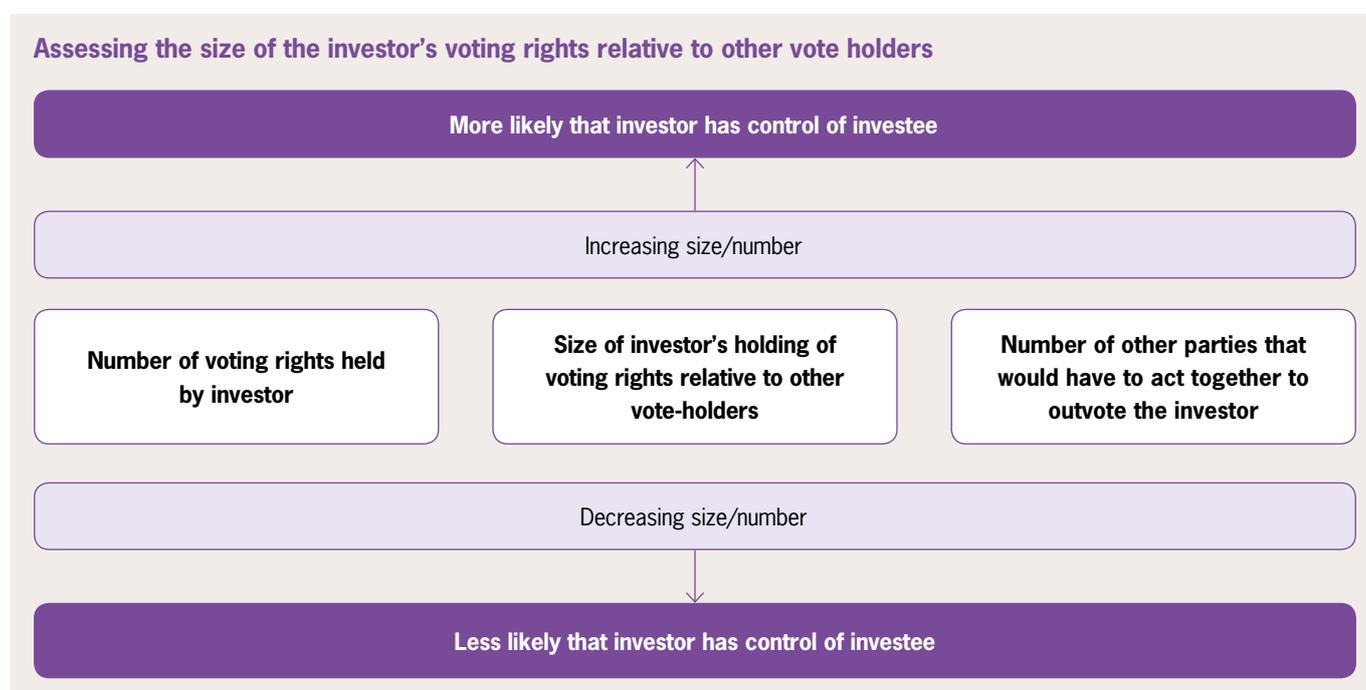
The remaining 53% of the shares are owned by hundreds of other unrelated investors, none of whom own more than 1% individually. There are no arrangements for the other shareholders to consult one another or act collectively and past experience indicates that few of the other owners actually exercise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

Analysis:

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

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

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



While control assessments involving majority ownership are relatively straightforward, IFRS 10 requires more focus on investees in which the investor holds a significant minority of voting rights.

Although IFRS 10 has no bright lines on when a particular distribution of voting power confers control, our example above and the following two examples below are based on similar examples in IFRS 10 and therefore serve to illustrate the IASB's thinking:

Example – Two other shareholders could outvote Investor

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

Analysis:

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

Example – Eleven other shareholders could outvote Investor

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

Analysis:

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

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

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

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

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

Example – Shareholder participation

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

Analysis:

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

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

- how far back an investor should look when assessing past voting behaviour
- whether it is appropriate to assume that past behaviour trends will continue (for example, it is possible that other shareholders' voting behaviour will be altered by another investor acquiring a major holding)

- situations in which past data is not available such as start-ups and some newly acquired holdings.

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

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

Example – Different levels of knowledge and expertise

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

Analysis:

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

IFRS 10 does however include various other 'indicators' and 'evidence' to assist in more difficult assessments. Some of this guidance may suggest that Investor A does have control in this example.

The following are non-conclusive indicators:

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

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

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

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

4.3 Potential voting rights

4.3.1 IFRS 10's approach

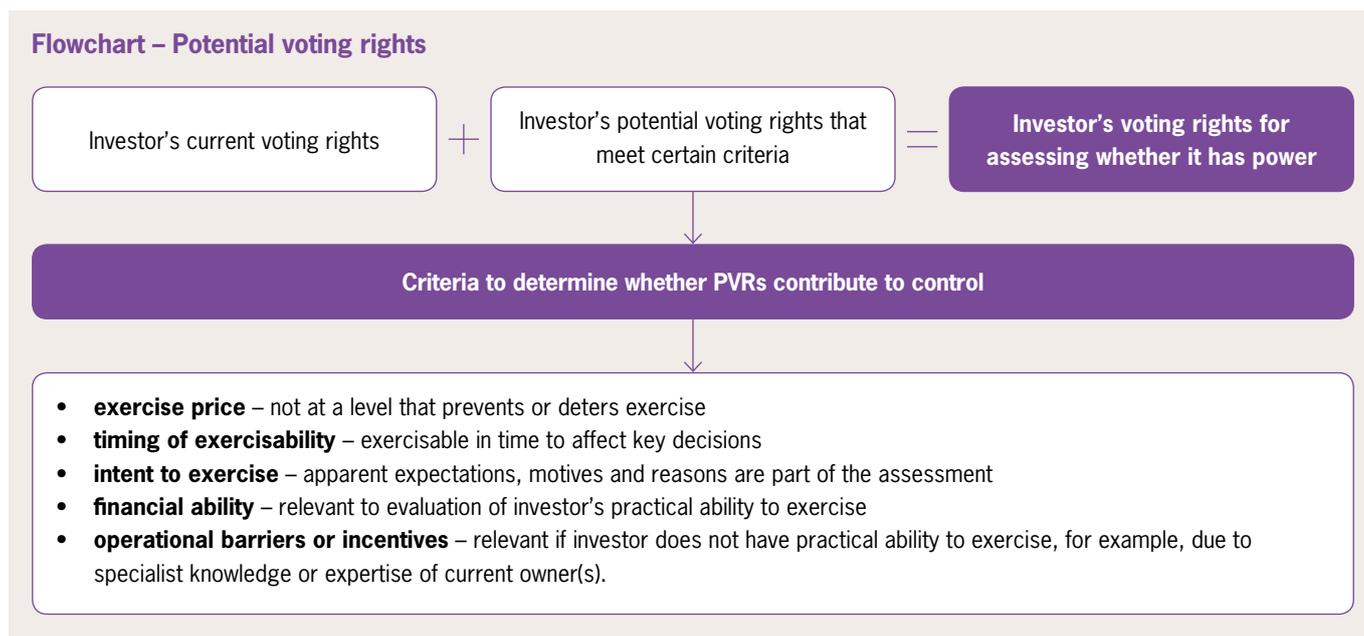
An investor may hold instruments that (if exercised or converted), give the investor power to direct the relevant activities. These are called 'potential voting rights' and may be held through ownership of the following types of instrument:

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

Potential voting rights can contribute to control of an investee in combination with current voting rights, or even confer control on their own. However, IFRS 10 requires an assessment to determine whether potential voting rights are substantive. IFRS 10 has no bright lines and so judgement will be required.

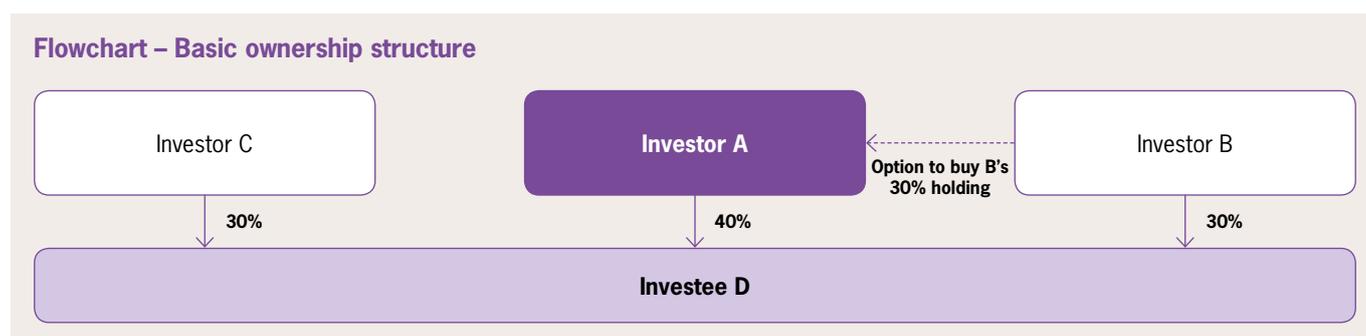
- IFRS 10's 'substantive' assessment takes into account both:
- the general guidance in IFRS 10.B22-B25 – summarised in section 3.2
 - the purpose and design of the instrument – including its terms and conditions, and the investor's apparent expectations, motives and reasons for agreeing to them [IFRS 10.B48].

In our experience some of the factors referred to in IFRS 10.B22-B25 are normally more relevant than others, although any could be relevant in some situations. The following flowchart summarises the factors that are most commonly of practical relevance:



4.3.2 Practical application

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



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

Example – Exercise price somewhat out-of-the-money

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

Analysis:

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

Investor A should consider additional factors such as:

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

Example – Option not yet exercisable

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

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

Analysis:

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

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

Variation 1 – longer exercise date:

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

In this case, for IFRS 10 purposes, the option would not be substantive on purchase. However, it may become so 15 days later.

Variation 2 – staggered exercise dates:

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

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

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

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

Example – Option held for defensive purposes

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

Analysis:

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

4.4 Special purpose and structured entities

4.4.1 IFRS 10's approach

As noted in section 1, IFRS 10 applies to both normal and structured or special purpose entities (SPEs). IFRS 10 has no specific guidance on SPEs. The reasons for referring to SPEs in this guide are that:

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

An SPE is not defined in IFRS nor was it defined in SIC-12. The latter simply noted that 'an entity may be created to accomplish a narrow and well-defined objective (for example, to effect a lease, research and development activities or securitisation of financial assets)'. This lack of a clear definition (and consequent lack of a clear dividing line as to which entities SIC-12 applied to) was a perceived shortcoming of IAS 27 (2008) and SIC-12.

Despite the lack of a definition, entities typically considered to be SPEs in practice normally have some of the characteristics noted in the box on the following page.

As noted in section 1, IFRS 10 applies to both normal and structured or special purpose entities (SPEs).

Practical insight – typical features of SPEs

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

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

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

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

The practical implications of IFRS's 10's control definition on SPE's are as follows:

- SPE control assessments are in the scope of IFRS 10's single model
- IFRS 10 includes guidance on investees for which voting rights cannot significantly affect the returns and contractual rights determine the direction of the relevant activities
- SIC-12 was applied in different ways by different entities and some approaches was longer sufficient, for example, assessments based only on:
 - quantitative analysis of risks and rewards
 - qualitative consideration of whether an SPE's activities are conducted on behalf of the investor and is on 'autopilot'.

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

Definition of structured entity [IFRS 12 Appendix A]

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

Although IFRS 10 has no separate guidance on SPEs, it does have guidance on assessing control over entities for which voting rights do not have a significant effect on returns.

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

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

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

Practical insight – link with financial asset derecognition rules

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

4.4.2 Practical application

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

Although SIC-12 was strictly an interpretation of IAS 27 (2008), its indicators were often treated as separate criteria that form the basis of control assessments of SPEs by the sponsoring entity. The following table provides a broad overview of how SIC-12's indicator approach maps onto IFRS 10's approach:

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

Consider purpose and design of investee

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

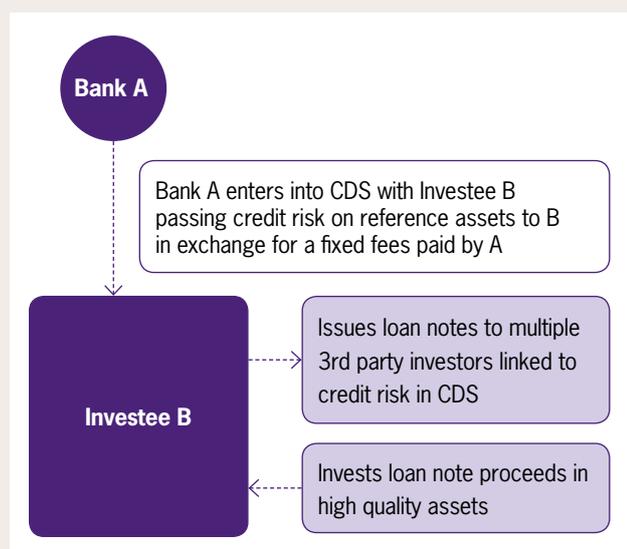
- identifying the investee's returns, which in turn involves identifying its assets and liabilities. This may appear straightforward but complications arise when the legal ownership of assets diverges from the accounting depiction (for example, in financial asset transfers that 'fail' de-recognition,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

The following examples illustrate these issues.

Example – Investment vehicle

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

The structure can be summarised as follows:



Analysis:

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

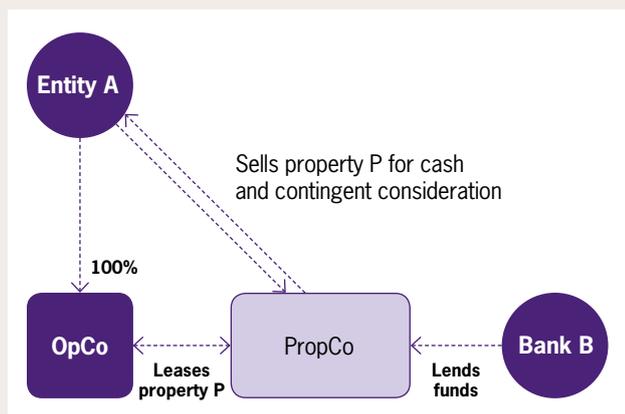
- whether Bank A has exposure to **variable returns**. If the assets held by Investee B are considered 'risk free' it is appropriate to conclude that Bank A does not have involvement that exposes it to variability of returns from the performance of Investee B. This is because the CDS transfers variability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

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

Example – ‘OpCo/PropCo’ structure

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

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



Analysis:

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

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

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

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

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

Example – ‘OpCo/PropCo’ structure – variation #1

The facts are similar to Example 11 except that:

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

Analysis:

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

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

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

Example – ‘OpCo/PropCo’ structure – variation #2

Facts are similar to Example 11 except that:

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

Analysis:

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

4.5 Principal-agent situations

4.5.1 IFRS 10's approach

As explained in section 3.2.3, IFRS 10 includes extensive guidance on situations in which an entity with decision-making rights over an investee is an agent or a principal. An agent is an entity primarily engaged to act in the best interests of the other parties (ie the principals) in exercising its rights. An investor that has rights to direct an investee's relevant activities as an agent does not meet the 'linkage' element of the control definition.

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

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

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

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

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

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

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

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

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

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

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

IFRS 10 requires an assessment of a range of indicators in order to determine whether the decision-maker's primary role is agent or principal.

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

Indicator [IFRS 10.B62-72]	Description
The scope of decision-making authority	<ul style="list-style-type: none"> • the investor considers: <ul style="list-style-type: none"> – the activities permitted by the agreement and by law – the extent of its discretion – purpose and design of the investee – risks to which the investee was designed to be exposed – the risks it was designed to pass on to the parties involved – level of its involvement with the investee's design • significant involvement in the investee's design may indicate that the decision-maker had the opportunity and incentive to obtain rights that result in the ability to direct the relevant activities.
Rights held by other parties (for example, removal or 'kick-out' rights)	<ul style="list-style-type: none"> • substantive rights held by other parties may affect the decision-maker's ability to direct relevant activities of an investee • substantive removal or other rights may indicate that the decision-maker is an agent • if a single party can remove the decision-maker without cause the related decision-making rights are held as agent, with no further analysis required.
Decision-maker's remuneration	<ul style="list-style-type: none"> • the greater the magnitude and variability of the decision-maker's remuneration relative to the investee's overall expected returns the more likely the decision-maker is a principal • a decision-maker cannot be an agent unless: <ul style="list-style-type: none"> – its remuneration is commensurate with the services provided – the remuneration agreement includes only terms, conditions or amounts that are customarily present in arrangements for similar services and level of skills negotiated on an arm's length basis.
Exposure to variability of returns from other interests in the investee	<ul style="list-style-type: none"> • holding other interests in an investee (ie in addition to its management contract) indicates that the decision-maker may be a principal • in evaluating its exposure to variability of returns the decision-maker: <ul style="list-style-type: none"> – considers all its exposures (for example, fees based on performance of a managed fund plus direct holdings in that fund) – considers both magnitude and variability associated with its total economic interests – assesses whether its exposure to variability of returns is different from that of the other investors and, if so, whether this might influence its actions. For example, this might be the case when a decision-maker holds subordinated interests in, or provides other forms of credit enhancement.

4.5.2 Practical application

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

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

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

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

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

Example – Different investment mandates

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

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

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

Analysis:

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

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

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

Substantive removal (or 'kick-out') rights held by other parties may affect the decision maker's ability to direct the investee's relevant activities. Indeed the only situation in which a single indicator is conclusive in isolation is that a decision-maker is an agent if a single party can remove the decision-maker without cause [IFRS 10.B65].

Example – Kick-out rights held by one party

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

Analysis:

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

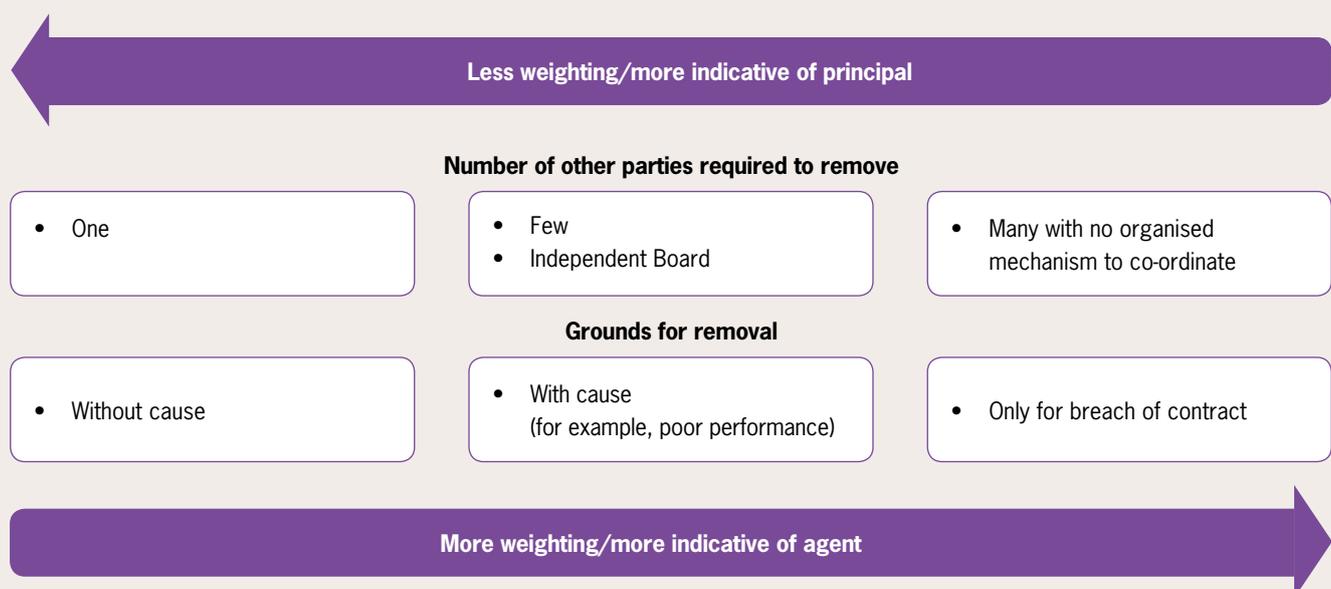
When kick-out rights exist that do not meet the 'single party, without cause' criteria (which rarely apply in practice), they need to be assessed to determine how much weight is given to them. The general guidance on substantive rights, discussed in section 3.2.1, is relevant to this. However, in our view kick-out rights are not necessarily wholly substantive or wholly non-substantive. Instead, the assessment determines how much weight is given to these rights within the overall analysis.

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

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

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

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

Assessing removal rights

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

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

The following two examples illustrate these points:

Example – No kick-out rights

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

Analysis:

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

Example – Kick-out rights held by a few parties

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

Analysis:

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

Kick-out rights that are exercisable by more than one party are not conclusive in isolation.

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

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

Practical insight – remuneration structures

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

Asset or fund management

In the funds management industry an asset manager:

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

Hotel management

Typically, a hotel operator's fee structure includes:

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

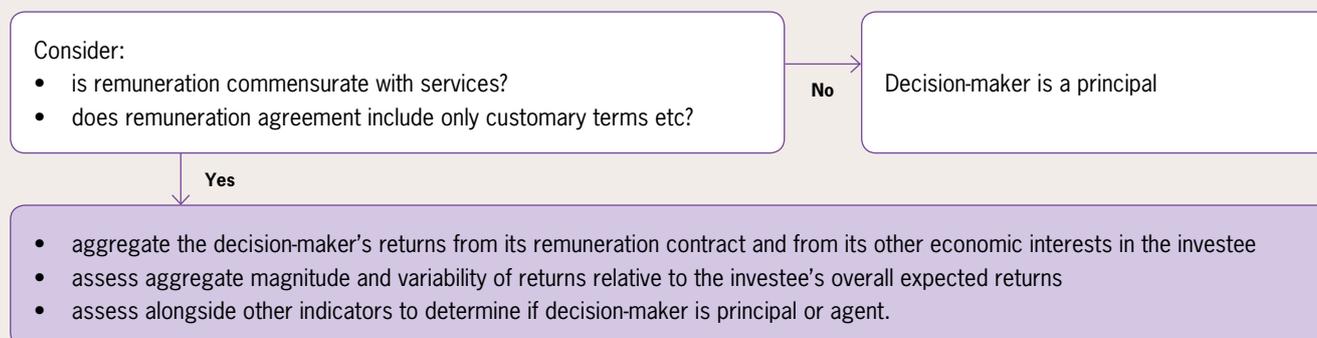
Assessing the decision-maker's remuneration and its basis is necessary for two main reasons:

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

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

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

Flowchart – Assessing fee structure



The assessment of the decision-maker’s remuneration is summarised in the flowchart above.

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

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

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

Practical insight – other interests in the investee

For the purpose of the principal agent analysis ‘other interests’ could be any type of involvement with the investee that creates rights or exposure to variable returns – see section 3.2.2. However, as a practical matter the most significant or commonplace types of interest are:

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

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

More specifically, these examples suggest that:

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

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

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

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

Applying the indicators together

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

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

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

4.6 Franchises

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

Practical insight – franchises

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

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

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

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

Key points are that:

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

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

In a franchise operation, both the franchisor and franchisee normally have some decision-making rights and some rights to variable returns from the franchise business.

Example – Franchise

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

Under the terms of the agreement:

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

Analysis:

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

5 Consolidation procedures

IFRS 10 retains established principles on consolidation procedures, including:

- elimination of intra-group transactions and the parent's investment
 - uniform accounting policies
 - the need for financial statements used in consolidation to have the same reporting date
 - the allocation of comprehensive income and equity to non-controlling interests
 - accounting for changes in ownership interests without loss of control
 - accounting for losing control of a subsidiary.
- 
- A decorative pattern of light purple triangles arranged in a grid-like fashion, filling the bottom half of the page. The triangles are oriented in alternating directions, creating a complex geometric design.

This section provides a high level overview of the key consolidation requirements and identifies some common practical issues for the consolidation process, changes in non-controlling interests and losing control of a subsidiary.

5.1 The consolidation process

5.1.1 Summary

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

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

The concept of a single economic entity is illustrated in the example below:

Example – Single economic entity concept

A subsidiary buys an asset from a third party for CU100. It subsequently sells the asset on to its parent for CU 130. The subsidiary records a profit of CU30 and the parent records an asset of CU130 in its separate financial statements.

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

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

The detailed 'mechanics' of the consolidation process vary from one group to another, depending on the group's structure, history and financial reporting systems.

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

The table above summarises the key steps in a typical consolidation process and identifies the more common practical issues.

These steps are discussed in more detail below.

5.1.2 Combine financial statements of each group entity

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

Uniform accounting policies

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

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

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

Example – Accounting policy alignment

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

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

Analysis:

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

There is no need to make adjustments to remove the effects of hedge accounting for S1, or to apply hedge accounting for S2. IFRS 9 permits but does not require hedge accounting, on a case by case basis, if the applicable conditions are met.

Non-coterminous reporting dates

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

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

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

Example – Non-coterminous year-end

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

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

Analysis:

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

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

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

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

Overseas subsidiaries

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

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

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

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

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

Immaterial subsidiaries

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

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

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

Changes in group composition

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

A transaction in which an entity obtains control over a business (including an entity that contains a business) is a business combination.



Accounting for business combinations is discussed in detail in our publication 'Navigating the Accounting for Business Combinations – Applying IFRS 3 in Practice'. To obtain your copy, please get in touch with the IFRS contact in your local Grant Thornton office.

Accounting for loss of control of a subsidiary is discussed in section 5.3.

5.1.3 Eliminate intragroup transactions and balances

As noted in section 5.1.1 above, the single entity concept requires that a parent eliminates in full intragroup assets and liabilities, equity, income, expenses and cash flows relating to transactions between group entities. Profits or losses resulting from intragroup transactions that are included in the carrying amount of assets, such as inventory and property, plant and equipment, are also eliminated.

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

Example – Elimination of intragroup loss

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

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

Analysis:

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

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

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

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

Example – Tax effecting an intragroup elimination

The basic facts are the same as the example above.

In addition:

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

Analysis:

In its individual financial statements S has a taxable temporary difference of CU11.7 (CU 91.7 – CU80). S should therefore have already recognised a deferred tax liability of CU 2.9 (CU11.7* 25%) in its individual financial statements.

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

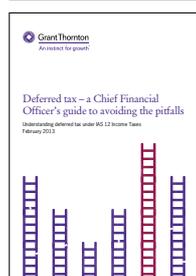
The following further adjustment is required to 'tax effect' this elimination:

	Debit CU	Credit CU
Tax expense	4.6*	
Deferred tax liability		4.6**

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

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

Another tax issue that often causes confusion in practice is the need to recognise deferred tax on some temporary differences associated with investments in subsidiaries (event though the investment is eliminated).



Our guide 'Deferred Tax – A Chief Financial Officer's Guide to Avoiding the Pitfalls' explains the relevant requirements. To obtain your copy, please get in touch with the IFRS contact in your local Grant Thornton office or go to www.grantthornton.global/en/insights/articles/deferred-tax--avoiding-the-pitfalls/.

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

Example – Intercompany loan between entities with different functional currencies

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

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

Analysis:

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

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

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

Impacts of intergroup arrangements

Investment property

If a group entity holds property that is leased to another group entity, this property might meet the definition of investment property in the individual financial statements of the holder but would be considered 'owner occupied' at group level (see IAS 40).

Debt-equity classification and parent company guarantees

When a subsidiary issues shares or other financial instruments and a parent or other group entity agrees additional terms directly with the holders (for example, a guarantee), this may require reclassification of the instruments from equity to liability on consolidation (see IAS 32 'Financial Instruments: Presentation' – IAS 32.AG29).

Group share-based payment schemes

A subsidiary that enters into a share-based payment scheme that requires it to settle the obligation by providing shares in the parent company would classify the scheme as cash-settled in its individual financial statements. On consolidation the scheme would be treated as equity-settled (see IFRS 2 'Share-based Payment' – IFRS 2.43A-43D).

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

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

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

The basic process is illustrated in the example below:

Example – Elimination of parent's investment

Some years ago Parent P acquired 80% of the issued share capital of Subsidiary S for CU 5,000. At that time S's balance sheet showed net assets of CU4,000. Fair value adjustments totalling CU800 were recognised in the business combination. P decides to recognise non-controlling interests using the proportionate share of net assets method rather than fair value (see IFRS 3.19).

S's summary balance sheet is therefore:

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

Analysis:

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

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

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

- the income statement effects of fair value adjustments
- any goodwill impairment (goodwill identified in the business combination must be tested annually for impairment, by applying the requirements of IAS 36 'Impairment of Assets')
- changes in ownership without loss of control (see section 5.2 below).

Example – Updating consolidation entries to reflect fair value adjustments

Continuing the example above assume that:

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

Analysis:

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

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

5.1.5 Allocate comprehensive income and equity to non-controlling interests

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

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

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

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

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

Example – Different voting rights and economic interests

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

Analysis:

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

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

Other practical issues in determining the allocation percentage include:

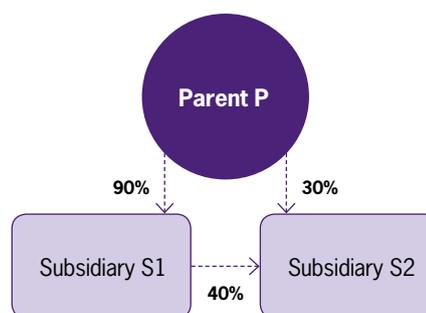
- indirect holdings
- potential voting rights and other derivatives.

Indirect holdings

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

Example – Indirect holdings

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



The summarised statements of financial position are as follows:

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

Analysis:

The effective controlling and non-controlling interest percentages are:

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

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

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

The consolidated statement of financial position is as follows:

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

Potential voting rights and other derivatives

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

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

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

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

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

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

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

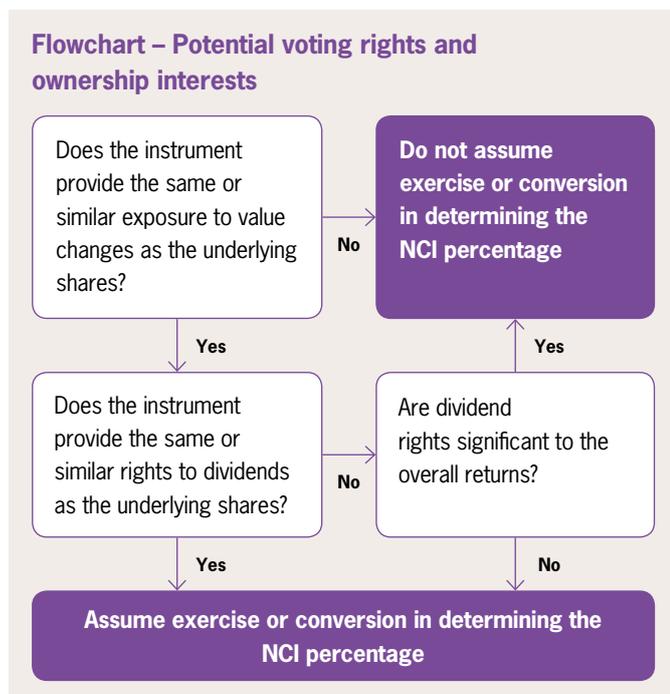
Instruments that might currently give an investor access to the returns associated with an ownership interest include:

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

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

- changes in the value of the shares
- dividends.

The broad approach to the assessment is summarised in the flowchart below:



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

Practical insight – are dividends significant to the overall returns?

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

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

The practical application of the analysis is illustrated by the following two examples:

Example – Purchased call option

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

Analysis:

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

P therefore continues to allocate 20% of the results and net assets of S to M in its consolidated financial statements. If the call option meets the definition of an equity instrument in accordance with IAS 32 its purchase price is debited to equity. If not, it is measured at fair value in accordance with IFRS 9.

In our view dividend rights must be considered in determining whether the parent or non-controlling interest has the rights to returns associated with the underlying shares.

Example – Combination of put and call options

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

Analysis:

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

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

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

5.2 Changes in non-controlling interests

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

Parent's accounting treatment [IFRS 10.23 and B96]

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

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

The accounting is illustrated in the following three examples:

Example – Parent sells shares in a subsidiary

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

Analysis:

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

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

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

Example – Parent acquires additional shares in a subsidiary

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

Analysis:

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

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

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

	Debit CU	Credit CU
Equity	10	
Accumulated other comprehensive income		10

Example – Subsidiary issues new shares

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

Analysis:

Accounting for the change in ownership interest:

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

- Any subsequent adjustment to NCI is based on NCI's proportionate share of the subsidiary. The CU200 proceeds from the issuance of shares increases the net assets of S3 and also increases NCI's ownership interest from 10% to 25%. The increase in NCI is determined to be CU170 based on NCI's proportional interest in the adjusted net assets of S3.
- The difference between the increase in NCI of CU170 and the fair value of the consideration for such shares of CU200, amounting to CU30, is recorded as an adjustment to equity. No gain or loss is recognised.

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

	Debit CU	Credit CU
Cash	200	
NCI		170
Equity attributable to the parent		30

5.3 Losing control of a subsidiary

5.3.1 Accounting for loss of control

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

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

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

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

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

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

Example – Disposal of a subsidiary while retaining an investment

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

Analysis:

Accounting for the sale of the subsidiary:

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

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

Entry to record the sale:

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

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

Entry to transfer the revaluation reserve to retained earnings:

	Debit CU	Credit CU
Revaluation reserve	60	
Retained earnings		60

Disclosure of the components of the gain on sale:

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

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

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

The total gain recorded by Parent P comprises:

	CU
Gain on disposal of subsidiary	270
Gain on retained investment	30
Total gain	300

5.3.2 Multiple transactions that result in loss of control

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

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

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

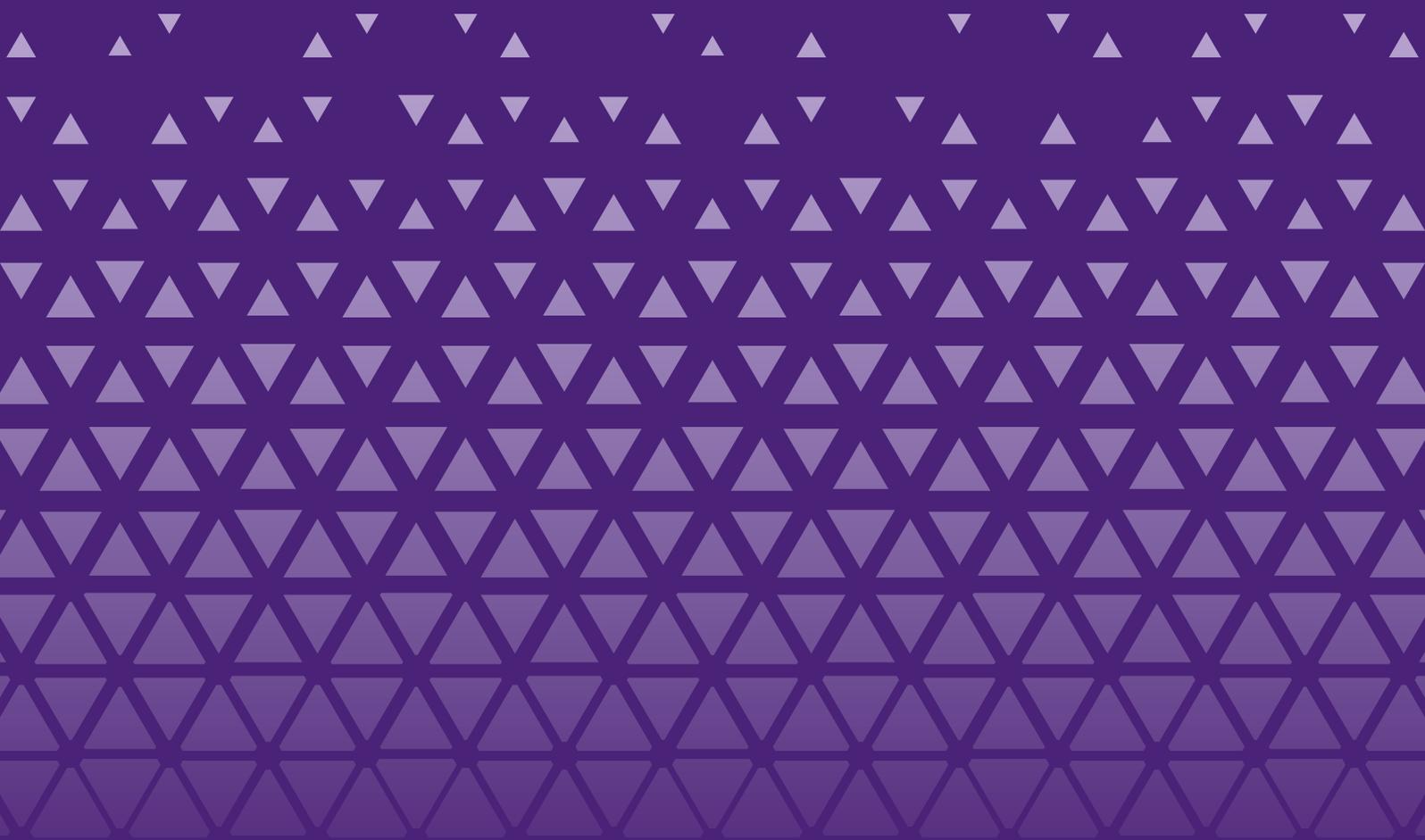
- they are entered into at the same time or in contemplation of each other
 - they form a single transaction designed to achieve an overall commercial effect
 - the occurrence of one arrangement is dependent on the occurrence of at least one other arrangement
 - one arrangement considered on its own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

Transactions resulting in loss of control affect profit or loss while other transactions with NCI do not.

6 Investment entities

IFRS 10 provides an exception to consolidating particular subsidiaries for investment entities. The exception requires an investment entity to measure those subsidiaries at fair value through profit or loss in accordance with IFRS 9 in its consolidated and separate financial statements.

This section defines an investment entity and how to apply the consolidation exception and the accounting treatment of an investment entity.



For many years, preparers and investors in the investment entity industry felt that consolidating the financial statements of an investment entity and its investees does not provide the most useful information. Consolidation made it more difficult for investors to understand what they are most interested in – the value of the entity’s investments.

The IASB were influenced by these arguments. In October 2012, the IASB amended IFRS 10 to provide a limited scope exception from the consolidation guidance for a parent entity that meets the definition of an investment entity. The changes provided a definition of an investment entity together with detailed application guidance. Entities that meet the definition of an investment entity in accordance with IFRS 10, do not consolidate certain subsidiaries and instead measure those investments that are controlling interests in another entity (ie their subsidiaries) at fair value through profit and loss. This exception does not apply to subsidiaries which provide investment related services to the parent entity (‘service subsidiaries’) which will continue to be consolidated. This is a mandatory exception, not an optional one.

There were a number of implementation issues identified in applying this exception and therefore in December 2014 the IASB published amendments to the investment entity exception entitled ‘Investment Entities: Applying the Consolidated Exception (Amendments to IFRS 10, IFRS 12 and IAS 28)’ addressing these issues. These amendments are incorporated in the detail of this section.

Practical insight – number of entities affected

Many entities that fit the investment entity definition are nonetheless not impacted by the exception to consolidation because their investments are not subsidiaries. Investment entities that commonly hold controlling interests include venture capital and private equity groups, along with some ‘master-feeder’ and ‘fund-of-funds’ structures. Some pension funds and sovereign wealth funds may be impacted. Unit trust and mutual fund-type entities rarely hold controlling interests and therefore are normally less likely to be affected.

6.1 Definition of an investment entity

The definition of an investment entity is fundamental when determining if the exception should be applied. It has three components, accompanied by four ‘typical characteristics’. Establishing whether an entity meets the definition of an investment entity is the central element to this exception, and could require significant judgement.

The definition, typical characteristics and their interaction are set out below:

Definition of an ‘investment entity’ [IFRS 10.27]

An investment entity is an entity that:

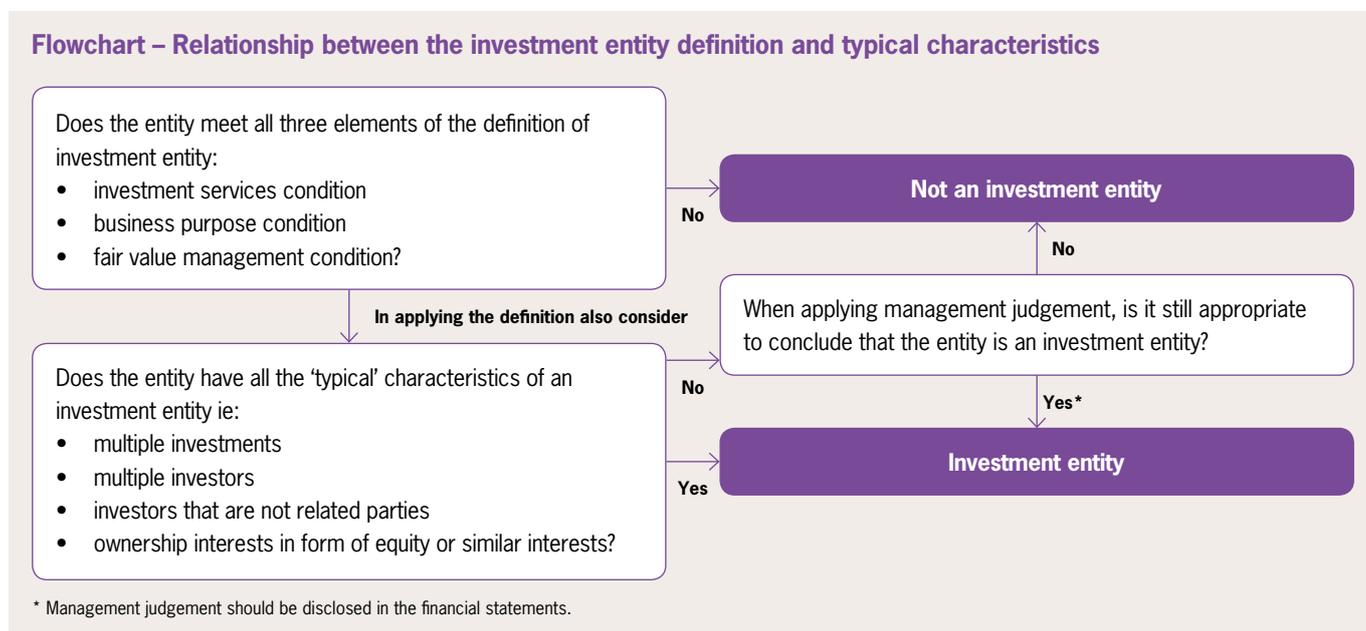
- a) obtains funds from one or more investors for the purpose of providing those investor(s) with investment management services (investment services condition)
- b) commits to its investor(s) that its business purpose is to invest funds solely for returns from capital appreciation, investment income,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

Typical characteristics [IFRS 10.28]

In assessing whether it meets the definition, an entity shall consider whether it has the following typical characteristics of an investment entity:

- a) it has more than one investment
- b) it has more than one investor
- c) it has investors that are not related parties of the entity
- d) it has ownership interests in the form of equity or similar interests.

In October 2012, the IASB amended IFRS 10 to provide a limited scope exception from the consolidation guidance for a parent entity that meets the definition of an investment entity.



Although the investment entity definition is paramount, most entities that meet that definition are also in general expected to have all four of these typical characteristics. If an entity lacks one or more of the characteristics additional judgement is required to assess whether it meets the definition. In our view it is very unlikely that an entity with none of the typical characteristics would meet the definition of an investment entity.¹

IFRS 10 provides examples of situations in which the absence of a typical characteristic would not necessarily preclude the entity from being an investment entity. More detail on each of the characteristics together with these examples is provided below:

6.1.1 More than one investment

An investment entity typically holds several investments to diversify its risk and maximise its returns. An entity may hold a portfolio of investments directly or indirectly, for example, by holding a single investment in another investment entity that itself holds several investments [IFRS 10.B85O].

Even though having more than one investment is typical of an investment entity, there may, however, be times when the entity has only one investment. This does not necessarily prevent an entity from meeting the definition of an investment entity; all facts and circumstances need to be taken into account. For example, an investment entity may hold only a single investment when the entity:

- is in its start-up period and has not yet identified suitable investments and, therefore, has not yet executed its investment plan to acquire several investments
- has not yet made other investments to replace those it has disposed of
- is established to pool investors' funds to invest in a single investment when that investment is unobtainable by individual investors (for example, when the required minimum investment is too high for an individual investor)
- is in the process of liquidation [IFRS 10.B85P].

The intention of IFRS 10 is that generally an investment entity will have more than one investment and so therefore it is unusual for it to have only one investment for its entire period as an investment entity. Having one investment is typically only temporary.

If the investment entity only has one investment then it can still qualify as an investment entity, however this is not typical of an investment entity. Therefore management will need to apply and disclose their significant judgement made in reaching this conclusion.

¹ The IFRIC were asked to clarify whether an entity still qualifies as an investment entity if it possesses all three elements of the definition (IFRS 10.27) but none of the typical characteristics listed in IFRS 10.28. At the time of writing, they have tentatively concluded that an entity that possess all three elements of the definition of an investment entity in IFRS 10.27 is an investment entity. This is the case even if that entity does not have one or more of the typical characteristics of an investment entity listed in IFRS 10.28. If an entity does not have one or more of the typical characteristics, it applies additional judgement in determining whether it possesses the three elements of the definition.

6.1.2 More than one investor

Usually, an investment entity would have several investors who pool their funds to gain access to investment management services and investment opportunities that they might not have had access to individually. Having several investors would make it less likely that the entity, or other members of the group containing the entity, would obtain benefits other than capital appreciation or investment income [IFRS 10.B85Q].

However, an investment entity may be formed by, or for, a single investor that represents or supports the interests of a wider group of investors (for example, a pension fund, government investment fund or family trust).

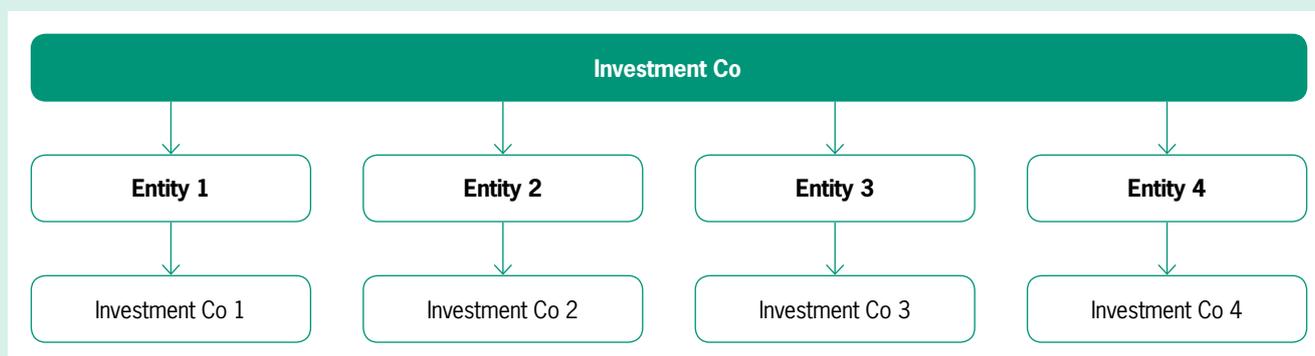
There may also be times when the entity temporarily has a single investor. For example, an investment entity may have one investor when the entity:

- is within its initial offering period
- has not yet identified suitable investors to replace those that have redeemed their interests
- is in the process of liquidation.

If the entity only has one investor or that investor represents the interests of a wider group of investors then it can still qualify as an investment entity, however this is not typical of an investment entity. Therefore management will need to apply and disclose their significant judgement they make in reaching this conclusion.

Practical insight – Intermediate Holding Companies

Some group structures are set up for regulatory, tax or similar purposes and are wholly owned subsidiaries that own only one investment. In these cases it may be appropriate to consider the group structure as a whole. For example, this would apply to the following:



Investment Co is owned by a number of unrelated investors. Entities 1-4 have been set up purely for regulatory purposes and are wholly owned subsidiaries of Investment Co. They control only one investment. Entities 1-4 do not carry out any other activities.

Whilst individually Investment Co and entities 1-4 would be unlikely to qualify as investment entities because they do not display enough of the typical characteristics (only equity ownership interests), as a group however, they have all the typical characteristics of an investment entity. This is because the group has:

- more than one investment
- more than one investor
- unrelated investors
- equity ownership interests.

If therefore the group has the three conditions documented in the definition in IFRS 10.27 (investment services, business purpose and fair value) then all of entities 1-4 and Investment Co would be considered investment entities. This is because the purpose and design of the entities is purely to meet the regulatory requirements in the various jurisdictions.

6.1.3 Investors that are not related parties

Typically, an investment entity has several investors that are not related parties of either the entity or other members of its group. Having unrelated investors would make it less likely that the entity, or other members of its group, would obtain benefits other than capital appreciation or investment income [IFRS 10.B85T].

However, an entity may still qualify as an investment entity even though its investors are related to the entity. For example, an investment entity may set up a separate 'parallel' fund for a group of its employees or other related party investors, which mirrors the investments of the entity's main investment fund. This 'parallel' fund may qualify as an investment entity even though all of its investors are related parties [IFRS 10.B85U].

6.1.4 Ownership interests in the form of equity or similar interests

An entity is normally a separate legal entity; however this is not an explicit requirement. Ownership interests in an investment entity typically take the form of equity or similar interests (for example, partnership interests), to which proportionate shares of the net assets of the investment entity are attributed. However, having different classes of investors, some of which have rights only to a specific investment or groups of investments or which have different proportionate shares of the net assets, does not preclude an entity from being an investment entity [IFRS 10.B85V].

In addition, an entity that has significant ownership interests in the form of debt that, in accordance with other applicable IFRSs, does not meet the definition of equity, may still qualify as an investment entity, provided that the debt holders are exposed to variable returns from changes in the fair value of the entity's net assets [IFRS 10.B85W].

Practical insight – regulated investment entities

In many countries investment services are subject to specific laws and regulations. Accordingly, certain entities are considered to be 'investment companies' or similar for the purpose of local law and regulation. This leads to a question as to whether these regulated entities should automatically be presumed to meet the definition of an investment entity.

The answer is no – the definition does not refer to any local regulatory requirements. The IASB concluded that referring to local legal definitions would not be appropriate in an international standard. Accordingly, an entity is not necessarily an investment entity under IFRS 10 simply because it is regulated. Conversely, an entity can be an investment entity under IFRS 10 even if not considered as such under local requirements. This differs to US GAAP, which specifies that an entity regulated under the SEC's Investment Company Act of 1940 would be an investment company for accounting purposes.

Typically, an investment entity has several investors that are not related parties of either the entity or other members of its group.

6.2 Applying the definition

In assessing whether an entity meets the definition, all facts and circumstances should be considered, including the entity's purpose and design [IFRS 10.B85A]. It will often be straightforward to determine whether an entity is an investment entity. However, in view of the fundamental importance this assessment has on affected entities' financial statements, IFRS 10 provides extensive application guidance.

More detail on each element of the definition is provided below:

6.2.1 Investment services condition

One of the essential activities of an investment entity is that it obtains funds from investors in order to provide those investors with investment management services. This is a feature that distinguishes investment entities and other entities, although not in isolation; other features need to be present for an entity to meet the definition of an investment entity.

6.2.2 Business purpose condition

The second part of the definition of an investment entity is that the entity has committed to its investor(s) that its business purpose is to invest funds solely for returns from capital appreciation, investment income, or both [IFRS 10.27(b)].

Typically an entity's investment objectives (ie its business purpose) will be evidenced by documents such as:

- a) the offering memorandum
- b) publications distributed
- c) other corporate or partnership documents.

Further evidence may include how the entity presents itself to third parties. An entity that presents itself as an investor whose objective is to jointly develop, produce or market products with its investees is not an investment entity [IFRS 10.B85B].

As well as its own investing activities, an investment entity may provide (directly or through a subsidiary):

- a) investment-related services (for example, investment advisory services, investment management, investment support and administrative services) to third parties as well as to its own investors, even if those activities are substantial to the entity – on the condition the entity continues to meet the definition of an investment entity
- b) management services and strategic advice to investees
- c) financial support to investees (such as a loan, capital commitment or guarantee) [IFRS 10.B85C and D].

Activities b) and c) are only permitted if these activities are undertaken to maximise the investment return (capital appreciation or investment income) from its investees and do not represent a separate substantial business activity or a separate substantial source of income to the investment entity.

If an investment entity has a subsidiary (that isn't an investment entity) that provides investment related services or activities such as those mentioned above to the investment entity, the subsidiary should be consolidated.

Practical insight – mandatory requirement

It is not uncommon for entities meeting the definition to nonetheless have a preference for consolidation of an investment entity subsidiary. Arguments are sometimes made as to why subsidiary investments should not be consolidated. For example, people may question whether showing the investments as a single line in the consolidated financial statements provides useful information to investors. In particular they argue that such a treatment:

- results in intercompany items between the investment entity parent and the investment entity subsidiary not being eliminated. This means that
 - the consolidated financial statements may show a large intercompany debtor
 - the fair value of the investments will be affected not just by its investments but also by its creditor to the parent and any other financing
- means the values of the individual investments held by the subsidiary will not be shown
- means any external liabilities held by the subsidiary such as bank loans will not be shown (being merged into the overall fair value of the investment entity subsidiary).

However these reasons do not override the mandatory requirement not to consolidate the investment entity subsidiary.

What can preparers do?

Preparers of investment entity parent financial statements can assist users in understanding the information on investment entity subsidiaries and investments by providing additional information and disclosures. This can be in the form of pro-forma information on their investments. This would need to be described as additional disclosure not required by IFRS.

Exit strategy

The definition of an investment entity does not refer directly to exit strategies. However, the application guidance makes it clear that an investment entity does not plan to hold its investments indefinitely but instead holds them for a limited period [IFRS 10.B85F]. Accordingly, to meet the definition, an investment entity is required to have an exit strategy documenting how it plans to realise capital appreciation. The requirements allow some flexibility as to the scope and detail of that strategy, as noted in the following paragraphs.

Exit strategies should cover substantially all of an investment entity's equity investments, non-financial investments and debt investments that have the potential to be held indefinitely. Those debt investments that have a maturity date are already seen as having an exit strategy as there is no possibility of holding them indefinitely. As well as those investments that have an exit strategy by default through limited life, exit strategies also do not need to include investments in other investment entities that are formed in connection with the entity for legal, regulatory, tax or similar business reasons if those entities have an exit strategy for their investments.

An exit strategy need not address each individual investment but should identify potential strategies for different types or portfolios of investments. It should however include a substantive timeframe for exiting the investment. Exit mechanisms that are only put in place for default events, such as a breach of contract or non-performance, are not considered exit strategies for the purpose of this assessment.

Exit strategies can vary by type of investment. The application guidance in IFRS 10 provides some examples of how investment entities can exit:

- private equity securities – via IPO, trade sale of a business, placement, distributions to investors of ownership interests in investees and sales of assets, liquidation or sale in an active market
- publicly traded equities – selling the investment in a private placement or in a public market
- real estate investments – sale of the real estate through specialised property dealers or the open market.

Practical insight – what should an exit strategy contain?

Exit strategies should be documented and include the following:

- the type of investment (or portfolio of investments the strategy relates to)
- how exit of the investment will be achieved
- expected outcomes and results to be achieved before the strategy is exercised
- the timeframe involved
- value of the investment to be achieved on exit
- confirmation the board has approved the strategy.

Benefits from investees

An investment entity's business purpose is to invest funds solely for returns from capital appreciation, investment income, or both. By contrast, a non-investment holding company normally seeks to obtain a wider range of benefits from its subsidiaries and typically operates more as an integrated business in order to obtain these benefits. Accordingly, a non-investment parent typically has more involvement in its subsidiaries' operations and the subsidiaries typically have more involvement with each other.

IFRS 10 aims to capture this distinction by stating that an entity does not meet the business purpose component of the investment entity definition if it obtains (or has the objective of obtaining) benefits from its investees that are 'unavailable to parties unrelated to the investee'.

IFRS 10 provides guidance on particular types of benefits from and involvement with investee entities and whether they are compatible with an investing business model. Put broadly, the more involvement the entity has with its investees (and the investees have with each other), the less likely it is that the entity will qualify as an investment entity. Conversely, it will be easier to demonstrate an entity meets the business purpose part of the definition when investees are substantially autonomous and operate independently of the investment entity and one another. The following table provides a summary of permitted and prohibited types of involvement with investees:

Permitted [IFRS 10.B85I and B85J]	Prohibited [IFRS 10.B85I and B85J]
<p>The following benefits gained from investees are permitted for an investment entity:</p> <ul style="list-style-type: none"> • using an investment in an investee as collateral for borrowings • intercompany trading between investees in the same industry, market or geographic area • other intercompany transactions that: <ul style="list-style-type: none"> – are on terms that would be available to parties unrelated to the entity, another group member or the investee – are at fair value – do not represent a substantial portion of the investee's or the entity's business activity, including business activities of other group entities. 	<p>The following benefits gained from investees are prohibited for an investment entity:</p> <ul style="list-style-type: none"> • the acquisition, use, exchange or exploitation of the processes, assets or technology of an investee • disproportionate, or exclusive rights to acquire assets, technology, products or services of any investee (for example, holding an option to purchase an asset from an investee if development is deemed successful) • joint or other arrangements between the investee and another group member to develop, produce, market or provide products or services • provision by investee of financial guarantees or assets to serve as collateral for another group member's borrowings • an option held by a related party of the entity to purchase an ownership interest in an investee • intercompany transactions other than those in the 'permitted' column.
<p>The following other involvement with investees is permitted for an investment entity:</p> <ul style="list-style-type: none"> • providing investees (directly or through a subsidiary) with: <ul style="list-style-type: none"> – management and strategic services – financial support such as a loan, capital commitment or guarantee <p>if such activities are undertaken to maximise returns from investments rather than being a separate business activity or income stream.</p>	<p>The following other involvement with investees is prohibited for an investment entity:</p> <ul style="list-style-type: none"> • provision of services to investees that represent a separate business activity or income stream.

In some cases meeting the business purpose element of the definition will be straight forward; ie. if the entity does not provide any additional services or gain any additional benefits other than those of capital appreciation and investment income. Others will be less so, for example, when the entity provides both investing activities, investment related services and has an involvement in the management or the financial support of the entity. The extent to which each of these activities are provided will vary entity by entity and therefore careful consideration of individual facts and circumstances will be needed. This is discussed further in the practical insight box below.

Practical insight – extent of involvement in the investees’ activities

As noted above, management services, strategic advice to investees and financial support to investees are only permitted by an investment entity if they do not represent a separate substantial business activity or separate substantial source of income to the investment entity. What represents “substantial” and the extent of services provided will vary and judgement will be required to determine whether the entity is an investment entity or not. When the required judgement is considered significant, it should be disclosed in the financial statements as a critical accounting judgement.

It is important to consider the reason for the entity providing services other than investing activities as well as the quantum. Management should be questioning whether:

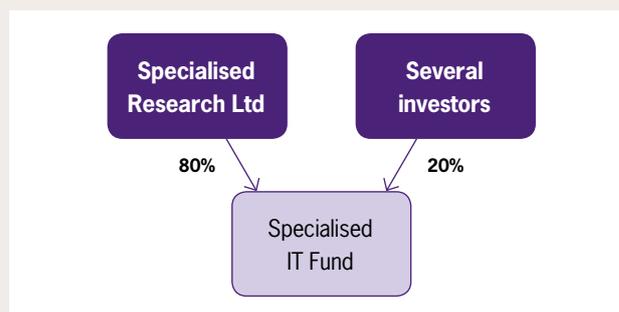
- the entity is likely to gain any other benefits other than capital appreciation and investment income
- how it presents itself to third parties. If the entity is a genuine investment entity, they will more likely discuss levels of investment returns rather than how the investment is performing in the other activities the entity is involved in.

In our view the level of involvement can be high as long as it is done with the aim to maximise the investees overall value in order to maximise capital appreciation. If there are other reasons for the involvement then this could result in the entity not being an investment entity.

As well as the above, entities must also remember to consider other prohibited activities, for example, having investments without exit strategies, and gaining significant benefits other than capital appreciation and investment income, as noted above.

Example – Specialised IT Fund (based on illustrative example 2 accompanying IFRS 10)

Specialised Research Ltd formed Specialised IT Fund, with the aim being to invest in IT start-up companies for capital appreciation. The group structure is as follows:



Specialised Research Ltd holds options to acquire investments held by Specialised IT Fund, at their fair value, which would be exercised if the IT systems produced by the investees would benefit the operations of Specialised Research Ltd.

Specialised IT Fund has not identified any exit plans with regards to its investments. An investment adviser manages Specialised IT fund, acting as an agent on behalf of the investors of the fund.

Is the fund an investment entity?

Conclusion

Specialised IT Fund is not an investment entity, despite its business purpose being investing for capital appreciation and the potential for investment income, because:

- Specialised Research Ltd could obtain additional benefits (as well as the capital appreciation and investment income), if the IT assets developed by the investees benefit the operations of Specialised Research Ltd (through the options exercisable by Specialised Research Ltd)
- Specialised IT Fund hold equity investments, which do not include exit strategies. Specialised IT Fund do not control the options held by Specialised Research Ltd and these are therefore not considered to be an exit strategy.

Practical insight – real estate investment entities

Real estate entities that own or lease investment property directly (ie that have no subsidiaries) are not affected by this exception. However, many real estate investment entities hold properties in separate legal entities (sometimes referred to as ‘corporate wrappers’). These separate entities may include borrowings used to finance the property purchase. In such cases consolidation versus fair value measurement has a significant impact on the parent entity’s reported financial position, even if the IAS 40 fair value model is used. Fair valuing the various separate legal entities will result in a net rather than gross balance sheet position and will also change reported net assets (due to the entities’ debt being fair valued among other factors).

Determining whether a real estate entity meets the investment entity definition is therefore critical and has to be done on a case-by-case basis. In many cases it is readily apparent that a real estate entity fails the definition – for example, because it undertakes property development activities that are distinct from its investment activities. IFRS 10’s illustrative examples include a case in which an entity is not considered an investment entity for various reasons including that it ‘has a separate substantial business activity that involves the active management of its property portfolio, including lease negotiations, refurbishments and development activities, and marketing of properties to provide benefits other than capital appreciation, investment income, or both’.

Other factors to consider include:

- whether or not the real estate entity has an exit strategy for its properties or portfolios of properties, including a substantive timeframe for exit
- the extent to which the real estate entity uses fair value as its primary performance measure. Even if an entity applies the IAS 40 fair value model, it may use other measures to assess performance and to make investment decisions, such as information about expected cash flows, rental revenues and expenses.

6.2.3 Fair value condition

The last element of the definition is that an investment entity measures and evaluates the performance of substantially all of its investments on a fair value basis. This is because using fair value results in more relevant information than, for example, consolidating its subsidiaries or using the equity method for its interests in associates or joint ventures. In order to demonstrate that it meets this element of the definition, an investment entity:

- provides investors with fair value information
- measures substantially all of its investments at fair value in its financial statements whenever fair value is required or permitted in accordance with IFRSs (for example, uses fair value alternatives in IAS 28, IAS 40, IFRS 9)
- uses fair value as the primary basis for reporting internally to key management personnel [IFRS 10.B85K].

Practical insight – ‘substantially all’

IFRS 10 does not define ‘substantially all’. Therefore assessing whether an entity meets this element will require judgement. The IASB does not provide any bright lines (for example, a level or a percentage). In our view if an entity genuinely considers itself to be an investment entity then it would have selected the fair value option for their investments, as the fair value option provides more meaningful information to investors. If the entity has a significant investment measured at cost then it is unlikely to meet the fair value element of the definition.

An investment entity may have some non-investment assets, such as a head office property and related equipment, and may also have financial liabilities. The fair value measurement element of the definition of an investment entity in IFRS 10.27(c) applies to an investment entity’s investments. Therefore, an investment entity need not measure its non-investment assets or liabilities at fair value.

6.3 Accounting treatment for an investment entity

6.3.1 Accounting by an investment entity

The accounting requirements in IFRS 10 for investment entities are limited to an exception from consolidation of investments in certain subsidiaries. The exception also impacts the separate financial statements of an investment entity (if these are prepared). The table summarises the key requirements:

Requirement	Details
Accounting for subsidiaries held as investments	<ul style="list-style-type: none"> • subsidiaries held as investments are measured at fair value through profit or loss in accordance with IFRS 9 instead of being consolidated [IFRS 10.31]. This accounting is mandatory not optional. Voluntary consolidated financial statements that state compliance with IFRS are not permitted • IFRS 3 does not apply to the obtaining of control over an exempt subsidiary • the consolidation exception also applies to controlling interests in another investment entity.
Accounting for service subsidiaries	<ul style="list-style-type: none"> • an investment entity is still required to consolidate subsidiaries that are not themselves investment entities and whose main purpose and activities are providing services that relate to its investment activities [IFRS 10.32] • IFRS 3 applies on obtaining control over a service subsidiary.
Accounting in separate financial statements	<ul style="list-style-type: none"> • an investment entity's fair value accounting for its controlled investees also applies in its separate financial statements [IAS 27.11A] • if the consolidation exception applies to all an investment entity's subsidiaries throughout the current and all comparative periods (ie it has no services subsidiaries) its separate financial statements are its only financial statements [IAS 27.8A].

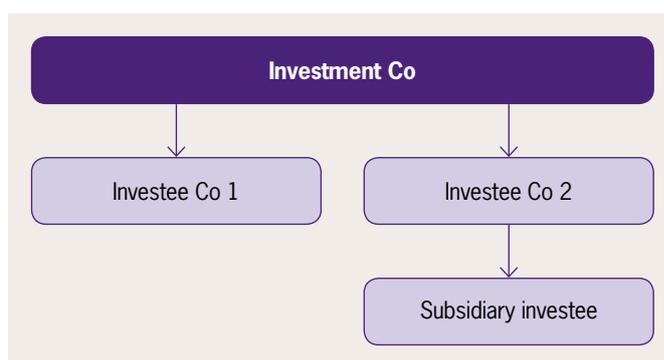
Accounting for subsidiaries held as investments

Except for subsidiaries required to be consolidated under IFRS 10.32 (see section on accounting for service subsidiaries across the page), an investment entity shall not consolidate its subsidiaries or apply IFRS 3 when it obtains control of another entity. Instead subsidiaries held as investments are measured at fair value through profit and loss in accordance with IFRS 9.

An investment entity is not required to produce consolidated financial statements if all of its subsidiaries are required to be measured at fair value through profit or loss (see section overleaf on discussion of separate financial statements).

Indirect subsidiaries

When accounting for subsidiaries that have subsidiaries of their own, the investment entity accounts only for the fair value of its direct subsidiary. This fair value would include the fair value of those entities the direct subsidiary controls (ie the indirect subsidiaries). This is demonstrated in the following group structure:



In the above example, Investment Co would account for the fair value of both Investee Co 1 and Investee Co 2; the fair value of the subsidiary investee would be taken into account in the fair value of Investee Co 2.

Accounting for service subsidiaries

Practical insight – what are service subsidiaries?

Service subsidiaries are:

- not investment entities themselves
- entities whose main purpose and activity is providing services relating to investment activities.

IFRS 10 does not provide a definition of these ‘services’, however refers to the guidance in IFRS 10.B85C-E for examples. These are services or activities such as:

- investment advisory services
- investment management
- investment support
- administrative services
- management services and strategic advice to investees
- financial support to investees (such as a loan, capital commitment or guarantee).

This list is not considered exhaustive and the services can be provided to the entity or to other parties.

As stated in section 6.2.2, investment entities are allowed to perform these services and still meet the definition of an investment entity under the conditions noted. However service subsidiaries are not themselves investment entities and so the consolidation exception will not apply. This is an important consideration and one which was clarified when the IASB published the amendments to the investment entity exception in December 2014.

In our view, only subsidiaries that have a clear purpose of providing services relating to investing activities which are a substantial part of their business should be consolidated.

If an investment entity has subsidiaries that are not themselves investment entities and whose main purpose and activities are providing services that relate to its investment activities, the investment entity must consolidate these in accordance with the requirements of IFRS 10. In addition, IFRS 3 needs to be applied to acquisitions of these subsidiaries [IFRS 10.32]. This requirement is demonstrated in the following group structure:



Services Co provides investment support and administrative services to the group. Investment Co would therefore consolidate Services Co and account for Investee Co 1 at fair value through profit or loss.

In the above example, the accounting is clear, however, there can be some judgement required in determining whether or not a subsidiary is a service subsidiary.

Practical insight box: Tax optimisation – is this an investment-related service?

The IFRS Interpretations Committee (IFRIC) were asked to clarify whether the activities carried out by wholly-owned intermediate subsidiaries that have been established to minimise the tax paid by investors in the investment entity parent should be considered to be investment-related services or activities. In the fact pattern presented to the IFRIC, the intermediate subsidiaries themselves had no other activity other than tax optimisation.

The following extract from the IFRIC Update in March 2014 records the agenda decision taken:

‘The Interpretations Committee noted that, according to paragraph BC272 of IFRS 10, the IASB thinks that fair value measurement of all of an investment entity’s subsidiaries would provide the most useful information, except for subsidiaries providing investment-related services or activities. In addition, the Interpretations Committee noted that the IASB had considered requiring an investment entity to consolidate investment entity subsidiaries that are formed for tax purposes, but had decided against this.

The Interpretations Committee noted that one of the characteristics of ‘tax optimisation’ subsidiaries described in the submission is “that there is no activity within the subsidiary”. Accordingly, the Interpretations Committee considers that the parent should not consolidate such subsidiaries, because they do not provide investment-related services or activities, and do not meet the requirements to be consolidated in accordance with paragraph 32 of IFRS 10. The parent should therefore account for such an intermediate subsidiary at fair value.

On the basis of the analysis above, the Interpretations Committee considered that in the light of the existing IFRS requirements, neither an interpretation nor an amendment to a Standard was necessary and consequently decided not to add the issue to its agenda.’

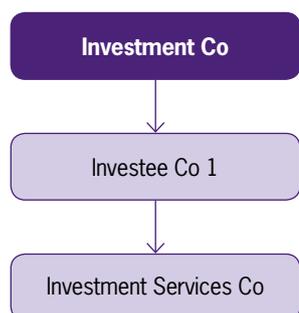
Accounting in separate financial statements

An investment entity's separate financial statements are its only financial statements if all of its subsidiaries are required to be measured at fair value through profit or loss for the current period and all the comparative periods presented. A parent that is an investment entity does not present consolidated financial statements if it is required by IFRS 10.31 to measure all of its subsidiaries at fair value through profit or loss (IFRS 10.4B).

As discussed earlier in the guide (refer to section 2.2), there is also an exemption for an intermediate parent from preparing consolidated financial statements if its parent produces financial statements, in which subsidiaries are consolidated or measured at fair value through profit or loss in accordance with IFRS 10. The following two examples demonstrate how this exemption can apply to investment entity intermediate parent companies.

Example – intermediate parent is an investment entity

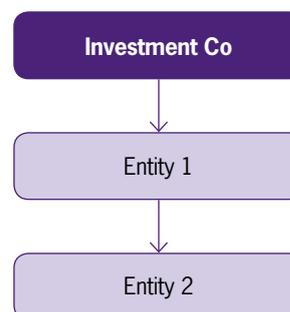
In the following example, Investee Co 1 is an investment entity and Investment Services Co provides investment related services or activities to the group:



In this example, you would expect Investee Co 1 to consolidate Investment Services Co and Investment Co to apply the consolidation exception and include Investee Co 1 at fair value through profit or loss. However, the intermediate parent is allowed to take the exemption from preparing consolidated financial statements in IFRS 10.4(a)(iv), as long as it meets the conditions described in section 2.2. When preparing its separate financial statements, Investee Co 1 could account for its investment in Investment Services Co at either cost or fair value as an accounting policy choice.

Example – intermediate parent is not an investment entity

In the below structure, Investment Co is an investment entity that has a controlling interest in Entity 1 (which itself controls Entity 2). Entity 1 and Entity 2 are not investment entities or entities that provide investment related services.



As mentioned above, under IFRS 10.1(a)(iv), a parent entity is exempted from preparing consolidated financial statements if it meets certain criteria. One of those criteria is that: "its ultimate or any intermediate parent produces consolidated financial statements that are available for public use and comply with IFRSs". The IASB have clarified (through the amendments to the investment entity exemption issued in December 2014) that this exemption is also available to parent entities that are subsidiaries of investment entities where the investment entity measures its investments at fair value in accordance with IFRS 10.31.

Accounting for other investments of an investment entity

Investment entities may hold, in addition to controlling interests in other entities, investments in associates, other equity investments, debt assets and investment property. The investment entity exception does not directly affect the accounting for these other investments. However, in order to qualify as an investment entity these other investments will have to be fair-valued wherever required or permitted by IFRSs. Accordingly, the entity would apply:

- for associates the option in IAS 28.18 that permits a 'venture capital organisation, or a mutual fund, unit trust and similar entities including investment-linked insurance funds' to measure associates and joint ventures at fair value through profit or loss in accordance with IFRS 9
- for investment property, the fair value model in IAS 40.

Other equity and debt investments are covered by IFRS 9. When IFRS 9 is applied, the entity would measure debt investments that are managed on a fair value basis at fair value through profit or loss. It is expected that investment entities would manage their investments on such a fair value basis, although they might also have some financial assets that are not 'investments'. Other equity investments would also be measured at fair value, although the entity could elect for fair value through other comprehensive income (which would not preclude investment entity status).

For entities that still apply IAS 39 'Financial Instruments: recognition and measurement', IAS 39's 'fair value' option would need to be elected to achieve this outcome for many debt investments. The IAS 39 fair value option is available in particular circumstances, including for assets that are managed on a fair value basis. This designation must be made on initial recognition and is then irrevocable in most circumstances. Other equity investments would be treated as available-for-sale and measured at fair value through other comprehensive income, unless the fair value option is used.

6.3.2 Accounting by a non-investment entity parent or investor of an investment entity

Accounting by non-investment entity parents of investment entity subsidiaries, associates and joint ventures will continue to be consolidated in the usual way. However, there can be complexities with how to account for subsidiaries, associates and joint ventures of direct investment entity subsidiaries and these are explained in this section.

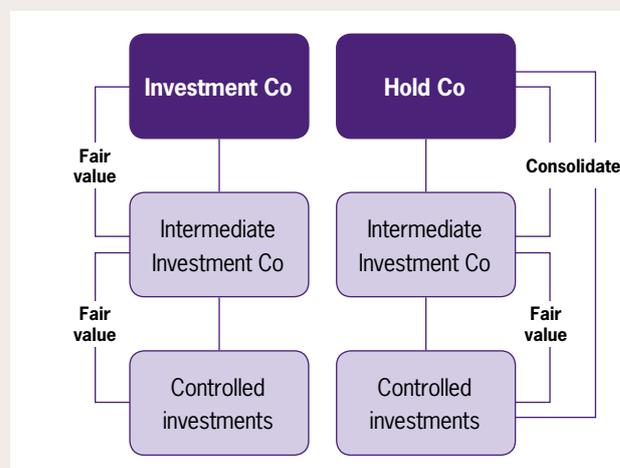
Accounting by the parent of an investment entity

A (non-investment) parent entity of an investment entity will continue to consolidate its subsidiaries in the normal way, including any subsidiaries of the investment entity sub-parent. Put another way, the consolidation exception for an investment entity parent does not carry forward into the consolidated financial statements of its higher level parent unless that higher parent is also an investment entity.

Accordingly, investment entity sub-parents will need to perform fair value measurements for the purpose of their own financial statements and also provide consolidation information (for example, a consolidation package) for their higher-level parent's group financial statements. This is illustrated in the following example:

Example – non-investment parent entity accounting

Consider the two group structures illustrated below. Both structures include investment entity sub-parents, which have controlling interest investments in other companies. The first group is headed by Investment Co, which is an investment entity and the second by Hold Co which is not an investment entity.



Application of requirements

For the Investment Co (left-hand) group:

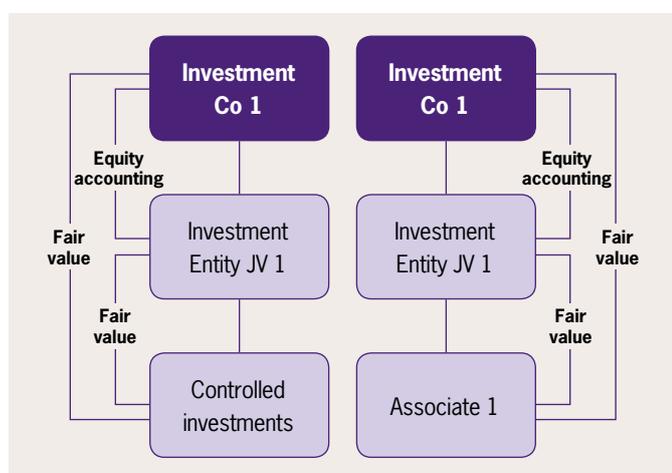
- Intermediate Investment Co will account for its controlled investments at fair value
- Investment Co will also account for its investment in Intermediate Investment Co at fair value.

For the Hold Co (right-hand) group:

- Intermediate Investment Co will account for its controlled investments at fair value
- Hold Co must consolidate Intermediate Investment Co and its controlled investments.

Accounting by investors of investment entity associates or joint ventures

A (non-investment) entity will continue to account for its share in joint ventures and joint operations that are investment entities using the equity method in the usual way. Questions then arise as to how to account for indirect shares of either subsidiaries or joint ventures or associates of the investment entity joint ventures. This is illustrated in the following group structures:



In scenario one (the left hand group), Investment Co 1 would account for its investment in Investment Entity JV 1 using the equity method. Investment Entity JV 1 would account for its controlled investments using fair value through profit and loss as required by the investment entity exception. The question arises as to how Investment Co 1 should be accounting for its indirect investment in the controlled investments. As a result of the amendments published in December 2014, Investment Co 1 is allowed to retain the Investment Entity JV accounting and also account for the controlled investments at fair value through profit or loss.

In scenario two (the right hand group), Investment Co 1 would account for its investment in investment entity JV1 using the equity method. Investment Entity JV 1 would account for its associate by applying the requirement in IFRS 10.B85L(b) and electing the exemption from applying the equity method in IAS 28, and hence recognise its investment in the associate at fair value through profit or loss. Investment Co 1 can then apply IAS 28.18 and elect to apply the exemption from the equity method in IAS 28 for its indirect share in the associate. Therefore maintaining the fair value accounting made by Investment Entity JV 1.

6.3.3 Continuous assessment and change of status

A parent entity should reassess whether it has become, or has ceased to be, an investment entity if relevant facts and circumstances change. A change in status is accounted for prospectively, from the date at which the change in status occurs.

Investment entity becoming a non-investment entity [IFRS 10.B100]

For subsidiaries that were measured at fair value in accordance with IFRS 10:

- IFRS 3 is applied using the fair value of the investment on the date of the change of status as the deemed consideration transferred
- subsidiaries are consolidated prospectively from that date (comparatives are not restated).

Non-investment entity becoming an investment entity [IFRS 10.B101]

For investments that are controlling interests in another entity:

- consolidation ceases prospectively from the date of change of status (comparatives are not restated)
- at that date the entity applies IFRS 10's requirements on loss of control of a subsidiary:
 - recognises the fair value of the investment
 - records a gain or loss for the difference between this fair value and the carrying value of the previously recognised assets and liabilities (less non-controlling interests)
 - reclassifies amounts recognised in other comprehensive income where required.

Ceasing to be an investment entity

When an investment entity ceases to meet the definition of an investment entity in accordance with IFRS 10, the date this change occurs is treated similarly to a business combination (and becomes the deemed acquisition date). IFRS 3 is applied to any subsidiary that was previously measured at fair value through profit or loss. Therefore the assets and liabilities of the subsidiary are measured at fair value and the difference between the fair value currently recorded and the fair value of the assets and liabilities is recorded as goodwill. The fair value of the subsidiary at the deemed acquisition date represents the transferred deemed consideration when measuring any goodwill (or gain from a bargain purchase) that arises from the deemed acquisition. All subsidiaries are consolidated from the deemed acquisition date and comparatives are not restated.

In the separate financial statements, the parent entity either:

- accounts for the subsidiary at cost (using the fair value at the date of change in status as the deemed cost); or
- continues to account for the subsidiary at fair value through profit or loss in accordance with IFRS 9.

Becoming an investment entity

When an entity becomes an investment entity, it ceases consolidation of its subsidiaries at the date of the change in status, (except for any service subsidiaries that are still consolidated). This change is prospective from the date of change in status and comparatives are not restated. The entity applies the loss of control requirements in IFRS 10 to the investment entity. This means the entity:

- de-recognises the assets and liabilities in the consolidated financial statements
- recognises the investment at its fair value through profit in accordance with IFRS 9
- records a gain or loss for the difference between this fair value and the carrying value of the previously recognised assets and liabilities (less non-controlling interests)
- reclassifies amounts recognised in other comprehensive income where required.

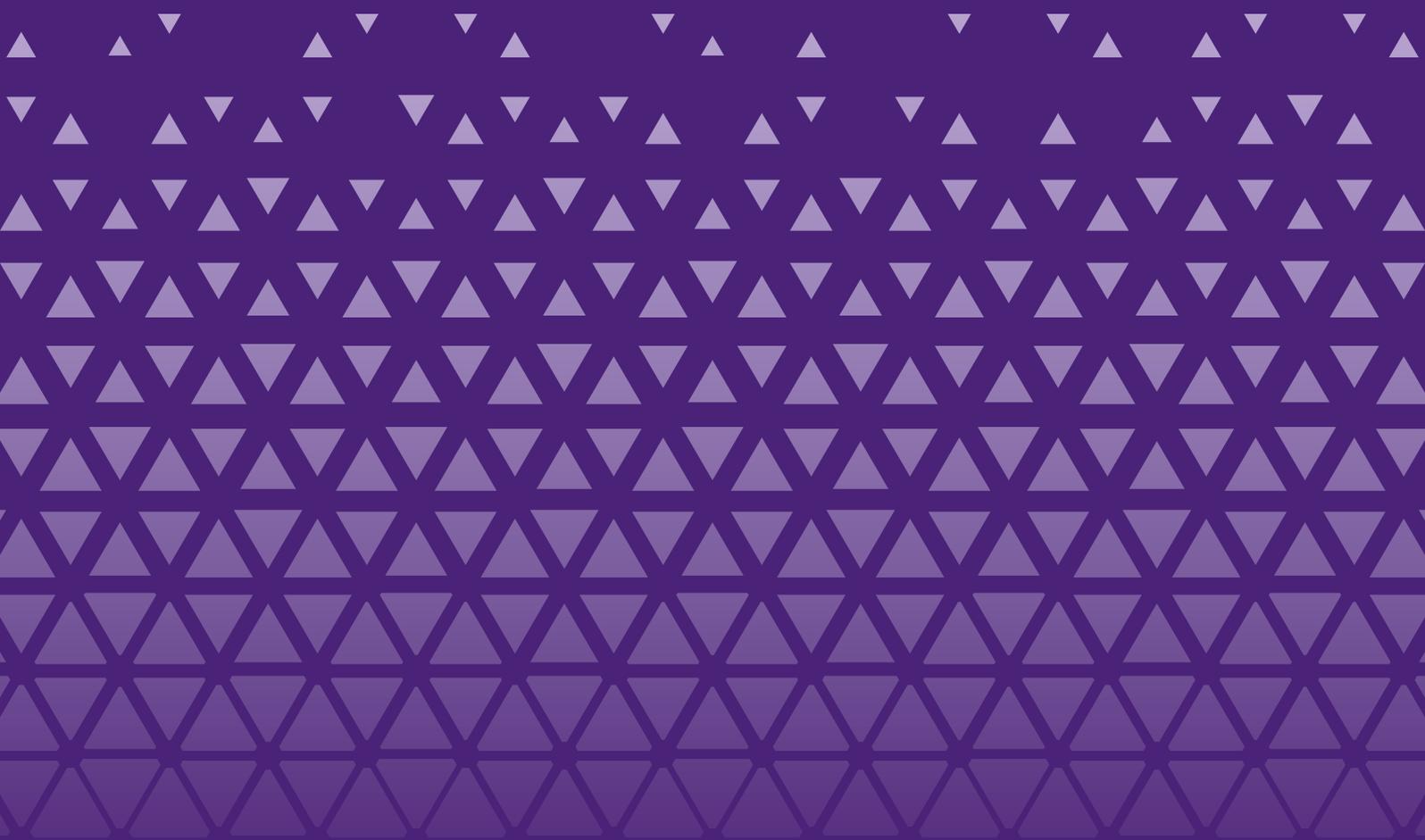
In the separate financial statements, the investment entity recognises the investment at its fair value through profit in accordance with IFRS 9. The difference between the fair value and the previous carrying value is recognised as a gain or loss in profit or loss. Finally, any amounts included in other comprehensive income are recycled to profit or loss.

A parent entity should reassess whether it has become, or ceased to be, an investment entity if relevant facts and circumstances change.

Appendix – Disclosures under IFRS 12: Understanding the requirements

IFRS 10 does not include any disclosure requirements but an entity that applies IFRS 10 is also required to apply IFRS 12 ‘Disclosure of Interests in Other Entities’ – which sets out comprehensive disclosure principles.

Our appendix provides an overview of IFRS 12 and discusses some specific disclosure requirements.



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

1 Overview

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

Practical insight – reputation risk

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

1.1 Objective

The objective of IFRS 12 is to require an entity to disclose information that enables users of its financial statements to evaluate an entity's interests in other entities.

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

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

To meet the objective, an entity shall disclose:

- significant judgements and assumptions made in determining
 - the nature of its interest in another entity or arrangement
 - that it meets the definition of an investment entity (if applicable)
- information about its interests in subsidiaries, joint arrangements and associates, and unconsolidated structured entities [IFRS 12.2].

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

1.2 Scope

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

IFRS 12 defines 'interest in another entity' as an entity that:

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

[IFRS 12.Appendix A]

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

Scope exclusions [IFRS 12.6]:

IFRS 12 does not apply to:

- post-employment or other long-term employee benefit plans within the scope of IAS 19
 - an entity's separate financial statements within the scope of IAS 27²
 - an interest held by an entity that participates in, but does not have joint control of, a joint arrangement unless that interest results in significant influence over the joint arrangement or is an interest in a structured entity
 - an interest that is accounted for in accordance with IFRS 9, unless that interest is an associate or joint venture measured at fair value through profit or loss or an unconsolidated structured entity.
-

1.3 Level of aggregation

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

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

² If an entity has interests in unconsolidated structured entities and prepares separate financial statements as its only financial statements, it shall apply the requirements in IFRS 12 applicable for interests in unconsolidated structured entities.

2 Specific disclosure requirements

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

Area	More information
Judgements and estimates	See 2.1 below.
Interests in subsidiaries	See 2.2 below.
Interests in unconsolidated subsidiaries (investment entities)	See 2.3 below.
Interests in joint arrangements and associates	<ul style="list-style-type: none"> • An entity shall disclose information that enables users of its financial statements to evaluate: <ul style="list-style-type: none"> – the nature, extent and financial effects of its interests in joint arrangements and associates, including the nature and effects of its contractual relationship with the other investors with joint control of, or significant influence over, joint arrangements and associates; and – the nature of, and changes in, the risks associated with its interests in joint ventures and associates • Detailed requirements are set out in IFRS 12.20-23 and B10-B20
Interests in unconsolidated structured entities	See 2.4 below.

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

2.1 Significant judgements and estimates

IFRS 12 goes further than existing guidance³ in requiring disclosure about situations in which an entity applies significant judgement in assessing the nature of its interest in another entity. Specifically, the reporting entity shall disclose the judgements and assumptions made in determining that it has control, joint control, significant influence or an interest in another entity.

Other required disclosures include the judgements and assumptions made when:

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

³ IAS 1 'Presentation of Financial Statements' requires an entity to disclose the judgements made by management in applying the entity's accounting policies and that have the most significant effect on the amounts recognised in the financial statements [IAS 1.122] while IAS 27 and IAS 28 supplement the general requirements requiring more specific disclosure when the assessment differs from the presumptions of control or significant influence [IFRS 12.BC.15].

The requirements are set out below:

Disclosure area	Required disclosures
Details of significant judgements and assumptions made [IFRS 12.7 and 9]	<ul style="list-style-type: none"> • significant judgements and assumptions made in determining that the investor: <ul style="list-style-type: none"> – controls another entity – does not control another entity – has joint control or significant influence • examples may include, but shall not be limited to situations in which an investor: <ul style="list-style-type: none"> – does not control another entity even though it holds more than half of the voting rights of the other entity – controls another entity even though it holds less than half of the voting rights of the other entity – is an agent or a principal.
Details when facts and circumstances change during the reporting period [IFRS 12.8 and 9B]	<ul style="list-style-type: none"> • significant judgements and assumptions made when changes in facts and circumstances result in a change in the conclusion regarding control • when an entity becomes or ceases to be an investment entity and the reasons for the change • an entity that becomes an investment entity discloses the effect (in the period of the change), including: <ul style="list-style-type: none"> – the fair value of the subsidiaries no longer being consolidated (at the date of the change) – the gain or loss recognised in accordance with the loss of control requirements – where in the profit or loss the gain or loss is included (if not shown separately).

2.2 Disclosures related to interests in subsidiaries

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

Disclosure area	Required disclosures
Objectives [IFRS 12.10]	<ul style="list-style-type: none"> • disclose information that enables users to understand/evaluate: <ul style="list-style-type: none"> – the composition of the group – interests of non-controlling interests in the group's activities and cash flows – significant restrictions on ability of the reporting entity to access/use group assets and/or settle group liabilities – nature of and changes to risks associated with interest in consolidated structured entities – consequences of changes in ownership in a subsidiary that do not result in a loss of control – consequences of losing control of a subsidiary during the reporting period.
Non-coterminous period ends [IFRS 12.11]	<ul style="list-style-type: none"> • if the period-end dates of the subsidiary's financial statements and the consolidated financial statements differ, disclose: <ul style="list-style-type: none"> – the reporting period end date of the subsidiary and – the reason for using a different date or period

Disclosure area	Required disclosures
Interest that non-controlling interests have in the group's activities and cash flows [IFRS 12.12]	<ul style="list-style-type: none"> • for material non-controlling interests, disclose: <ul style="list-style-type: none"> – the name of the subsidiary – the principal place of business and country of incorporation (if different) – the proportion of ownership interests held by non-controlling interests – the proportion of voting rights held by non-controlling interests (if different from the proportion of interests held) – the profit or loss allocated to non-controlling interests of the subsidiary during the reporting period – the accumulated non-controlling interests of the subsidiary at the end of the reporting period – summarised financial information about the subsidiary [IFRS 12.B10-B11].
Nature and extent of significant restrictions [IFRS 12.13]	<ul style="list-style-type: none"> • significant restriction on its ability to access or use assets and settle the liabilities, such as: <ul style="list-style-type: none"> – those that restrict its ability (or its subsidiary's ability) to transfer cash or other assets to or from other entities within the group – guarantees – restrictions on dividends and other capital distributions being paid, – restrictions on loans and advances made/repaid to/from other entities within the group • nature and extent to which protective rights of non-controlling interests can significantly restrict the entity's ability to access or use the assets and settle the liabilities of the group • carrying amounts of the assets and liabilities in the consolidated financial statements to which the restrictions apply.
Nature of, and changes to, risks associated with interest in consolidated structured entities [IFRS 12.14-17]	<ul style="list-style-type: none"> • terms of any contractual arrangement(s) that could require the parent or its subsidiaries to provide financial support to a consolidated structured entity (including events or circumstances that could expose the reporting entity to a loss), such as: <ul style="list-style-type: none"> – liquidity arrangements or credit rating triggers (obligating it to purchase assets or provide financial support) • when the parent or any of its subsidiaries provided financial or other support to a consolidated structured entity (without having a contractual obligation to do so), disclose: <ul style="list-style-type: none"> – the type and amount of support provided – the reason for providing the support • relevant factors for consolidating (concluding control exists) a previously unconsolidated structured entity after providing financial or other support • current intentions to provide financial or other support to a consolidated structured entity, including intentions to assist the structured entity in obtaining financial support.
Consequences of changes in a parent's ownership interest in a subsidiary, not resulting in a loss of control [IFRS 12.18]	<ul style="list-style-type: none"> • schedule showing effects on the equity attributable to owners of the parent of any changes in its ownership interest that do not result in a loss of control.
Consequences of losing control of a subsidiary during the reporting period [IFRS 12.19]	<ul style="list-style-type: none"> • gain or loss, if any, calculated in accordance with IFRS 10 • the portion of that gain or loss attributable to measuring any investment retained in the former subsidiary at its fair value at the date when control is lost • the line item(s) in profit or loss in which the gain or loss is recognised, if not presented separately.

2.3 Disclosures relating to interests in unconsolidated subsidiaries (investment entities)

The table below summarises IFRS 12's disclosure requirements related to interests in unconsolidated subsidiaries (investment entities):

Disclosure area	Required disclosures
Overall [IFRS 12.19A]	<ul style="list-style-type: none"> an investment entity must state the fact it meets the definition investment entity and is required to apply the exception to consolidation.
Details of each unconsolidated subsidiary [IFRS 12.19B]	<ul style="list-style-type: none"> the subsidiary's name the principal place of business of the subsidiary percentage of ownership held by the investment entity and if different the proportion of voting rights held <p>These details are also required for unconsolidated entities controlled by investment entity subsidiaries.</p>
Nature and extent of significant restrictions [IFRS 12.19D(a)]	<ul style="list-style-type: none"> significant restriction on the ability of the unconsolidated subsidiary to transfer funds to the investment entity for cash dividends or to repay loans, such as from: <ul style="list-style-type: none"> borrowing arrangements regulatory requirements contractual arrangements.
Financial support to unconsolidated subsidiaries [IFRS 12.19D(b)-19G]	<ul style="list-style-type: none"> in relation to providing financial support to an unconsolidated subsidiary, an investment entity should disclose: <ul style="list-style-type: none"> any commitments or intentions to provide financial or other support to an unconsolidated subsidiary – including those to assist the subsidiary in obtaining financial support any financial support provided to each unconsolidated subsidiary during the period and the reasons for providing it the terms of any contractual arrangements that could require the investment entity (or its unconsolidated subsidiaries) to provide support to an unconsolidated subsidiary explanation of any decisions to provide support to entities that investment entity did not control (without a contractual obligation to do so), but that the provision of the support resulted in the investment entity controlling the structured entity.

The portion of that gain or loss attributable to measuring any investment retained in the former subsidiary is its fair value at the date when control is lost.

2.4 Disclosures related to interests in unconsolidated structured entities

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

Definition of structured entity [IFRS 12.Appendix A]

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

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

Disclosure area	Required disclosures
Objective [IFRS 12.24]	<ul style="list-style-type: none"> • to disclose information that enables users to understand/evaluate <ul style="list-style-type: none"> – nature/extent of interests in unconsolidated structured entities – nature of and changes in risks associated with interests in unconsolidated structured entities (includes information about exposure to risk from involvement that it had with unconsolidated structured entities in previous periods (for example, sponsoring the structured entity), even if reporting entity no longer has any contractual involvement at the reporting date).
Nature and extent of interests [IFRS 12.26-28]	<ul style="list-style-type: none"> • qualitative and quantitative information about its interests including, but not limited to, the below information about the structured entity: <ul style="list-style-type: none"> – nature – purpose – size – activities – how the entity is financed • for sponsored unconsolidated structures whereby the parent does not have an interest at the reporting date: <ul style="list-style-type: none"> – how it determined which structured entities it sponsored – income from those structured entities in the period – description of the types of income presented (presented in tabular format and by relevant categories) – carrying amount (at the time of transfer) of all assets transferred to those structured entities during the reporting period (presented in tabular format and by relevant categories).

Disclosure area	Required disclosures
<p>Nature of risks [IFRS 12.29-31]</p>	<ul style="list-style-type: none"> • tabular presentation (unless another format is more appropriate) of: <ul style="list-style-type: none"> – carrying amounts of assets and liabilities recognised in its financial statement relating to interests in unconsolidated structured entities – line items in the statement of financial position in which those assets and liabilities are recognised – best estimate of maximum exposure to loss from interests in unconsolidated structured entities and how determined (if an amount cannot be determined, disclose that fact and the reason) – comparison of carrying amounts of assets and liabilities relating to interests in unconsolidated structured entities and maximum exposure to loss from those entities • the entity's exposure to risk due to its involvement with the structured entity in previous periods (regardless of whether the entity has contractual involvement with the structured entity at the reporting date) • when financial or other support was provided to an unconsolidated structured entity, in the absence of any contractual obligation to do so, disclose the: <ul style="list-style-type: none"> – type and amount of support provided (including assisting in obtaining financial support) – reason for providing the support (regardless if the entity has contractual involvement with the structured entity at the reporting date) • current intentions to provide financial or other support to an unconsolidated structured entity, including intentions to assist the structured entity in obtaining financial support.

Practical insight – link with IFRS 7

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

While the Board agreed that these requirements will often result in disclosure of the same underlying risks, the disclosure requirements of IFRS 12 and IFRS 7 differ in how they describe the reporting entity's risk exposure. IFRS 12 requires an entity to disclose its exposure to risk from its interest in the structured entity and therefore while they may overlap, both perspectives are necessary and complimentary [IFRS 12.BC72–BC74].

3 Selective illustrative disclosures

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

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

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

The illustrative disclosures presented below represent excerpts from the 31 December 2016 consolidated financial statements of a fictional company, ABC Corporation Group (the Group). The Group manufactures, sells and leases automobiles to end-use customers and dealerships.

A. Significant judgements and estimates

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

IFRS 12.7(a)
IFRS 12.9(b)

Consolidation of Wheel Limited

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

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

B. Unconsolidated structured entities

IFRS 12.24(a)
IFRS 12.26

Involvement in Dealer Limited

The Group facilitated the establishment of a structured entity (Dealer Limited) on behalf of third party automobile dealers during 2014. The purpose of the arrangement is to securitise third party receivables originated by dealers. The cash received from the collection of the receivables is used to service the finance provided by the investors.

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

IFRS 12.24(b)

Carrying amount of assets and liabilities in Dealer Limited recognised in the Group's Statement of Financial Position

IFRS 12.29(a)-(b)

Class of Financial Asset	Investments	Credit Guarantees	Total Assets	Total Liabilities
	CU000	CU000	CU000	CU000
Debt Securities	2,680	0	2,680	0
Financial Guarantee Contracts	0	(10)	0	(10)
Total	2,680	(10)	2,680	(10)

IFRS 12.29(c)

Maximum exposure to loss in Dealer Limited

IFRS 12.B26(a)(i)

The group provides certain financial guarantee contracts which require it to reimburse investors for certain losses incurred when a debtor defaults on payment, up to 1% of the receivable. The Group calculates the maximum exposure to loss from Dealer Limited as the notional amounts of the guarantees, less any related liabilities recognised. The Group recognised a liability of CU10,000 relating to financial guarantee contracts at 31 December 2016.

IFRS 12.B26(e)

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

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

IFRS 12.29(c)-(d)

Type of Asset in Dealer Limited	Current Carrying Amount of Assets Held by Dealer Limited		Group's Maximum Exposure to Loss		Carrying Amount in the Statement of Financial Position	
		Total	Investments	Credit Guarantees	Assets	Liabilities
	CU000	CU000	CU000	CU000	CU000	CU000
Finance Receivables	100,000	1,000	0	1,000	0	(10)
Debt Securities	60,000	2,680	2,680	0	2,680	0
Total	160,000	3,680	2,680	1,000	2,680	(10)

IFRS 12.27(b)

Income received during the reporting period from Dealer Limited

IFRS 12.B26(c)

The Group's asset management duties include collecting payments on the securitised assets and preparing monthly investor reports on the performance of the securitised assets, including amounts of interest and/or principal payments to be made to investors. For the year-ended 31 December 2016, the Group recognised CU37,000 in asset management fees from Dealer Limited.

IFRS12.30(a)-(b)

USE Limited

Other support provided in the reporting period

USE Limited is a structured entity that the Group sponsored in 2013. During the period, USE Limited communicated that it was having difficulties in obtaining funding from other sources. As a result, the Group provided short-term funding to USE Limited of CU35,000. USE Limited repaid the full amount in 15 days and no additional support has been provided. Although the Group was not required to provide funding by contract, it did so as it considered the related risk to be minimal.

USE Limited discontinued its operations on 15 December 2016. More information about USE Limited including fees earned and the carrying amount of all assets transferred to USE Limited during the reporting periods identified (up to the time of transfer) is provided below.

IFRS 12.29(a)-(b)

Type of Asset in USE Limited	Fee Income for the Year Ended		
	CU000	CU000	CU000
	2016	2015	2014
Finance Receivables	25	23	26
Asset-Backed Securities	252	215	220
Total	277	238	246

IFRS 12.27(a)

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

IFRS 12.27(b)

The Group's asset management duties include collecting payments on the securitised assets and preparing monthly investor reports on the performance of the securitised assets, including amounts of interest and/or principal payments to be made to investors. For the year-ended 31 December 2016, the Group recognised CU 277,000 in asset management fees from USE Limited.

IFRS 12.29(a)-(b)

Type of Asset in USE Limited	Assets Transferred to USE Limited		
	CU000	CU000	CU000
	2016	2015	2014
Finance Receivables	300	276	312
Total	300	276	312

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

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



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