IFRS 10 Consolidated Financial Statements

Overview

IFRS 10 replaces the part of IAS 27 Consolidated and Separate Financial Statements that addresses accounting for subsidiaries on consolidation. What remains in IAS 27 after the implementation of IFRS 10 is the accounting treatment for subsidiaries, jointly controlled entities and associates in their separate financial statements.

The aim of IFRS 10 is to establish a single control model that is applied to all entities including special purpose entities. The changes require those dealing with the implementation of IFRS 10 to exercise significant judgement to determine which entities are deemed to be controlled and, therefore require consolidation by the parent company.

Objective of the standard

The objective of IFRS 10 as set out in the standard is to establish principles for the presentation and preparation of consolidated financial statements when an entity controls one or more other entities.

To meet this objective, the standard:

- Requires an entity (the parent) that controls one or more other entities (subsidiaries) to present consolidated financial statements;
- Defines the principle of "control", and establishes control as the basis for consolidation;
- Sets out how to apply the principle of control to identify whether an investor controls an investee and therefore must consolidate the investee;
- Sets out the accounting requirements for the preparation of consolidated financial statements; and
- Defines an investment entity and sets out the exception to consolidating particular subsidiaries of an investment entity.

Scope of the standard

IFRS 10 applies to all entities, except as follows:

- If all the following conditions are met, a parent need not present consolidated financial statements:
  - It is a 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;
  - It did not file, nor is in the process of filing, financial statements for the purpose of issuing instruments in a public market; and
  - Its ultimate or any intermediate parent produces consolidated financial statements that comply with the IFRSs and are available for public use.
- Post or long-term employee benefit plans to which IAS 19 Employee Benefits applies.
- An investment entity need not present consolidated financial statements but rather measure all of its subsidiaries at fair value through profit or loss.

IFRS 10 - effective date

IFRS 10 shall be applied for annual periods beginning on or after 1 January 2013. An entity shall apply those amendments made to IFRS 10 with regards to Investment Entities for annual periods beginning on or after 1 January 2014. Early application is permitted.

Steps to consider when determining whether there is control

The following steps highlight the thought process that should be followed when determining whether the investor's rights' gives it control over the investee.

- Identifying the investee, consideration of its purpose and design
- Identifying the relevant activities of the investee
- Identifying how decisions about the relevant activities are made
- Assessing whether the investor controls the investee

The control model

CONTROL	=	Power over the investee	+	Exposure or rights to variable returns	+	Link between power and returns
(i.e. the investor controls the investee IF AND ONLY IF ALL the following three elements are met)		'Power' is defined as 'existing rights that give the current ability to direct the relevant activities'		An investor is exposed or has rights to variable returns from its involvement with the investee		The investor must have the ability to use its power to affect the amount of the investor's returns from its involvement with the investee

Identifying the investee and considering its purpose and design

The term "investee" is not defined in IFRS 10, therefore the purpose and design of an investee shall be considered by the investor when assessing whether it has control of an investee.

Investee controlled by means of equity instruments - An investor controls an investee when the investor holds majority of the voting rights and is able to exercise these rights to determine the investee's operating and financing policies and no additional arrangements that alter this decision making are present.

Where voting rights are not the dominant factor in determining control, the investor would need to consider

The design of the investee in terms of:

- The risks the investee will be exposed to;
- The risk it will pass on to the parties involved with it; and
- Whether the investor is exposed to some or all of that risk.

By implication if the investee's risk exposure is high, it passes part of it on to the investor and the investor is exposed to some of that risk, it is likely that the investee has been set up under the power of the investor.

Control over specified assets and liabilities of an investee

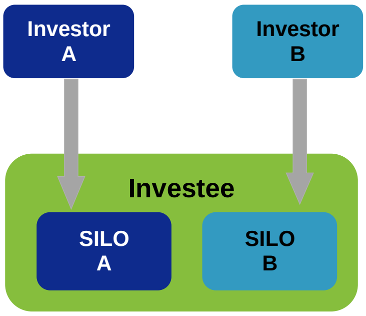
An investor shall consider whether it treats a portion of an investee as a deemed separate entity and, if so, whether it controls the deemed separate entity. [IFRS 10, B76]

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

- Specified assets of the investee are the only source of payment for specified liabilities of, or specified other interest in, the investee. Parties other than those with the specified liability do not have rights or obligations related to the specified assets or to residual cash flows from those assets. In substance, none of the returns from the specified assets can be used by the remaining investee and none of the liabilities of the deemed separate entity are payable from the assets of the remaining investee. [IFRS 10, B77]

In substance, all the assets, liabilities and equity of that deemed separate entity are ring-fenced from the overall investee. Such a deemed separate entity is often called a 'silo'. [IFRS 10, B77]

Diagramatic representation of a 'silo' (deemed separate entity)



The assets, liabilities and equity of each of the above 'silo's' are ring fenced from the overall investee and each other

Identifying the relevant activities of the investee

Relevant activities' is an important new concept, as it assists in determining whether an investor has power over an investee.

'Relevant activities' are defined as 'activities of the investee that SIGNIFICANTLY affect the investee's returns'.

Examples of relevant activities include, but are not limited to:

- Selling and purchasing of goods or services
- Managing financial assets during their life
- Selecting, acquiring and disposing of assets
- Researching and developing new products or processes
- Determining a funding structure or obtaining funding

How decisions about the relevant activities are made

The definition of "power" requires consideration whether the investor has the current ability to direct the relevant activities, therefore it's important that we consider how decisions about the relevant activities are made.

Examples of how decisions about relevant activities are made (not only limited to these);

- Establishing operating and capital decisions of the investee, including budgets; and
- Appointing and remunerating an investee's key management personnel or service providers and terminating their services or employment.

Power over the investee

Power arises either individually or in combination, from rights:

- In the form of voting rights or potential voting rights;
- To appoint, reassign, or remove members of an investee's key management personnel or any other entity that has the ability to direct the relevant activities;
- To direct the investee to enter into or veto any changes to transactions for the benefit of the investor; and

- That give the holder the current ability to direct the relevant activities even if its rights to direct have yet to be exercised.

Assessing power - consider the appropriate 'rights'

In order to assess power, only substantive rights that are NOT protective shall be considered.

Substantive rights

A right is substantive when the holder of that right has the practical ability to exercise that right.

This requires judgement and factors to consider when making this decision include (but are not limited to) whether

- There are barriers that prevent the holder from exercising its rights, for example laws and regulations
- There is a practical mechanism to facilitate multiple parties to collectively exercise their rights
- The party(s) holding the rights would benefit from the exercise of those rights
- The rights are exercisable when decisions about relevant activities need to be made
- For an example refer to IFRS 10, application examples, example 3

Protective rights

'Protective rights' is defined as '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.'

Therefore an investor that only holds protective rights does not have power over an investee, neither can they prevent another party from having power over an investee.

Franchise agreements are generally considered to be protective rights.

Example – Protective rights and control

The board of directors of Pacific Plc have decided to dispose of a major subsidiary that accounts for a significant portion of their revenues and assets as they have decided to restructure the entity.

For this decision to be passed, it will require the approval of 75% voting rights held by shareholders.

One of the shareholders, Atlantic Plc holds a 15% stake in the group and has a "golden vote" (deciding vote). Atlantic Plc is unhappy with the proposed transaction.

Atlantic Plc can veto/block the decision (it has protective rights), it cannot make an alternate suggestion, therefore this is representative of Atlantic Plc having significant influence over Pacific Plc but not control.

Power - voting rights

Power with a majority of the voting rights

- Relevant activities are directed by a vote
- Majority of the governing body members are appointed by a vote

Majority of voting rights but no power

- Voting rights are not substantive
- Relevant activities are not directed by vote

Potential voting rights

- Only considered if they are substantive
- Could arise from convertible instruments, options or forward contracts
- The investor must consider the purpose and the design of the instrument
- For an example refer to IFRS 10, application examples, example 9

Power without a majority of voting rights

Power without a majority of voting rights can be exercised by ANY of the following

Contractual arrangements with other vote holders

- An investor can gain the right to exercise voting rights sufficient to give it power
- Might ensure that the investor can direct other vote holders on how to vote to enable the investor to make decisions about relevant activities

Rights from other contractual arrangements

- Voting rights in combination with other decision making rights, can give an investor the current ability to direct the relevant activities of the investee
- Economic dependence of an investee on an investor does not automatically lead to the investor having power over the investee

The investor's voting rights

The investor has the practical ability to direct the relevant activities unilaterally after considering all facts and circumstances such as

- Relative size and dispersion of other vote holders
- Potential voting rights held by other vote holders, other parties or the investor
- Right from other contractual arrangements
- Any additional facts or circumstances

Power - more than a passive interest

Sometimes there will be indications that an investor has more than simply a passive interest.

This may indicate that the investor has other related rights sufficient to give it power or provide evidence of existing power over an investee.

Examples that suggest that the investor has a more than passive interest:

- The investee's key management personnel who direct relevant activities are current or previous employees of the investor.
- The investee's operations are dependent on the investor.
- A significant portion of the investee's activities either involve or are conducted on behalf of the investor.
- The investor's exposure or rights to returns is disproportionally greater than its voting or other similar rights.

Exposure or rights to variability in returns

This refers to returns that are not fixed but rather vary depending on the performance of the investee. The basis of the investor's assessment in determining this should focus on the substance of the arrangement and not on the legal form of returns.

Examples of variable returns

- Dividends
- Commissions
- Royalties
- Interest
- Management fees
- Other distributions of economic benefits
- Change in value of an investment

Link between power and returns

An investor with decision making rights therefore has to determine whether it is a principal or an agent. An 'agent' is defined as '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'.

Thus, sometimes a principal's power may be held and exercisable by an agent, but on behalf of the principal. An investor that is an agent does not control an investee when it exercises decision making rights delegated to it.

Principal versus Agent

To determine whether a decision maker is an agent, it shall consider the overall relationship between itself, the investee being managed and other parties involved with the investee. ALL the following factors also need to be considered unless a single party holds substantive rights to remove the decision maker without cause.

Scope of decision making authority

- The activities permitted by the decision making agreement and specified by law
- The discretion available to the decision maker when making decisions
- Purpose and the design of the investee
- The risks the investee will be exposed to
- The risk it will pass on to the parties involved with it and
- The level of involvement the decision maker had in the design of the investee

Rights held by other parties

Substantive rights may affect the decision maker's ability to direct relevant activities

- When a single party holds removal rights, this is sufficient to conclude that the decision maker is an agent
- Substantive right to restrict activities of the decision maker – apply same treatment as removal rights

Remuneration	**Decision maker’s returns from other interests in the investee**
The greater the magnitude of and variability associated with the decision maker’s remuneration in relation to the returns expected, the more likely that the decision maker is a principal A decision maker cannot be an agent unless the following conditions are present • The remuneration is commensurate with the services provided • The remuneration includes only terms, conditions or amounts that are customarily present for similar services and level of skills negotiated on an arm’s length basis	A decision maker shall consider its exposure to variability of returns from its other interests in the investee in assessing whether it is an agent, in doing this the following are considered • The greater the magnitude of, and variability associated with, its economic interests, considering its remuneration and other interests in aggregate, the more likely that the decision maker is a principal • Whether its exposure to variability of returns is different from that of the other investors and, if so, whether this might influence its actions

Example – Principal versus agent

Pluto owns 68% of Jupiter and the remaining 32% is owned by Mars.

Pluto appoints Mars which is a management company to run its investment entity Jupiter. Mars is paid fixed and performance fees in relation to the services provided. This, in combination with the return on investment creates exposure to variability in return.

Pluto has the right to remove Mars as the management company of Jupiter if it so wishes.

Pluto has power as Pluto has substantive rights to remove Mars if it so wishes therefore Mars is an agent and not a principal therefore Mars would not need to consolidate Jupiter.

For further principal versus agent examples, refer to IFRS 10, application examples, example 14.

Relationship with other parties (”de facto agents”)

When assessing control, an investor needs to consider the nature of its relationship with other parties. In doing so the investor must consider whether those other parties are acting on the investor’s behalf (i.e. they are ‘de facto agents’). Such a relationship need not have a contractual arrangement.

Examples of other parties that may act as “de facto agents” for the investor:

- The investor’s related parties.
- A party whose interest in the investee is through a loan from the investor.
- A party that has agreed not to sell,transfer or encumber its interests in the investee without prior approval of the investor.
- A party that cannot finance its operations without the investor’s subordinated financial support.
- An investee for which the majority of its governing body or key management personnel are the same as that of the investor.
- A party that has close business relationship with the investor.

Accounting requirements

Consolidation procedures	• Combine assets, liabilities, equity, income, expenses and cash flows of the parent and its subsidiary • Offset (eliminate) the parent’s investment in each subsidiary with its portion of equity of the subsidiary • Eliminate in full all intra-group transactions and balances
Uniform accounting policies	Parent and its subsidiaries must have and apply uniform accounting policies. If not, appropriate adjustments are made when preparing the consolidated financial statements to ensure conformity.
Measurement	Consolidation of a subsidiary begins from the date the investor gains control of an investee and ceases when the investor loses control of an investee

Potential voting rights	Consolidated financial statements are prepared solely on the basis of existing ownership interests. The consolidated financial statements do not reflect the possible exercise or conversion of potential voting rights and other derivatives unless, in substance, an interest is as a result of a transaction that currently gives the entity access to the returns associated with an ownership interest.
Reporting date	Parent and its subsidiaries must have the same reporting date. If not, the subsidiary, for consolidation purposes prepares additional financial information as of the same date as the financial statements of the parent unless it is impracticable to do so. The difference between the reporting dates shall be no more than 3 months.

Disclosure and accounting treatment of non-controlling interests

A parent must present non-controlling interests in the consolidated statement of financial position within equity, separately from the equity of the owners of the parent. Changes in a parent's ownership interest in a subsidiary that do not result in the parent losing control of the subsidiary are equity transactions.

Accounting treatment - loss of control

If the parent loses control of a subsidiary, the parent shall:

- Derecognise the assets and liabilities of the former subsidiary.
- Recognise any investment retained in the former subsidiary at its fair value when control is lost and subsequently accounts for it and for any amounts owed by or to the former subsidiary in accordance with relevant IFRSs. That fair value shall be regarded as the fair value on initial recognition of a financial asset in accordance with IFRS 9 or, when appropriate, the cost on initial recognition of an investment in associate or joint venture.
- Recognise the gain or loss associated with the loss of control in profit or loss.

Investment entities

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

Typical characteristics of an investment entity:
- It has more than one investment;
- It has more than one investor;
- The investors are not related parties of the entity; and
- It has ownership interests in the form of equity or similar interests.

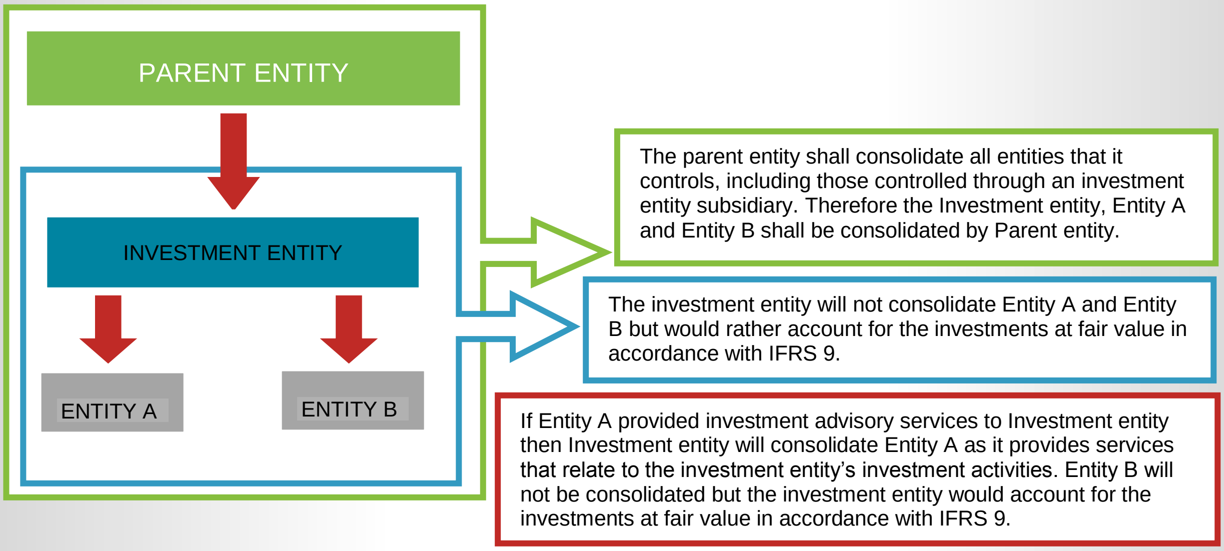
Consolidation specifics and exceptions

Investment entities shall not consolidate its subsidiaries but rather measure an investment in a subsidiary at fair value through profit or loss in accordance with IFRS 9 UNLESS:
- If an investment entity has a subsidiary that provides services that relate to the investment entity's investment activities, it shall consolidate that subsidiary.
- A parent of an investment entity shall consolidate all its subsidiaries, including the investment entity and any entities controlled through that investment entity, unless the parent itself is an investment entity.

Examples of investment related services

- Investment advisory services
- Investment management
- Investment support

Example – Investment entity consolidation



In conclusion

IFRS 10 does not change the consolidation procedures but does change whether an entity is consolidated, by redefining the definition of control. Refer to IFRS 10 and IFRS 12 e-Learning for more.