

IFRS industry insights

The new consolidation standard – insights for the real estate industry



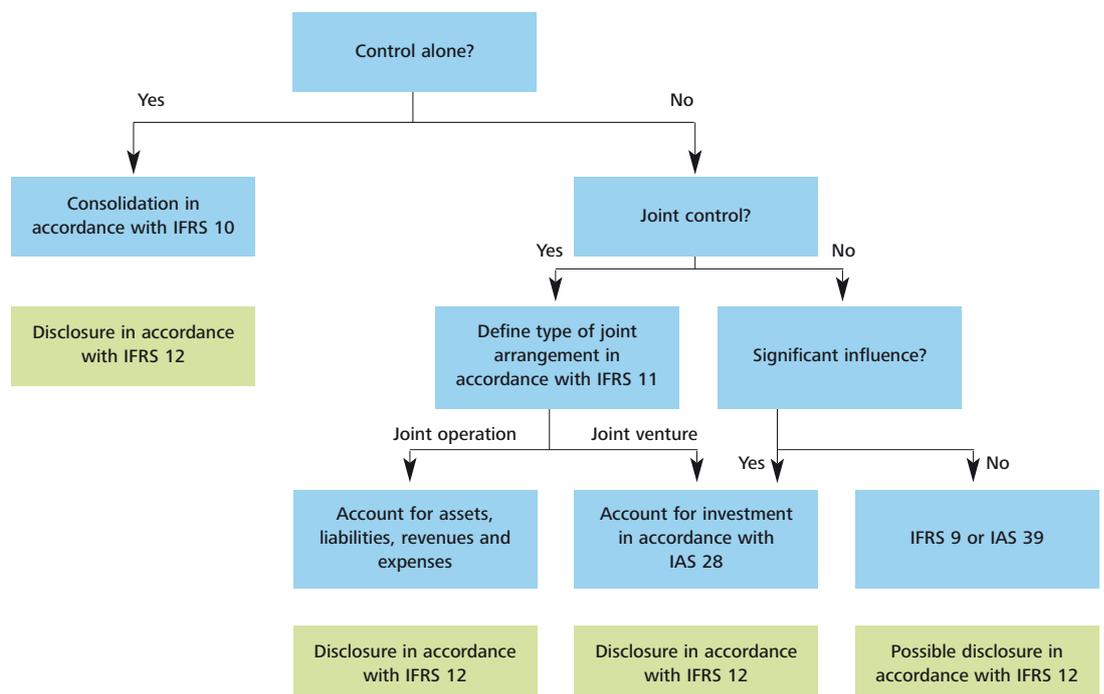
The IASB's recently issued consolidation standard may have an effect on the real estate industry.

The International Accounting Standards Board's (IASB) recently issued consolidation standard may have an effect on the real estate industry. IFRS 10 *Consolidated Financial Statements*, replaces the consolidation guidance previously contained in IAS 27 *Consolidated and Separate Financial Statements* and SIC-12 *Consolidation – Special Purpose Entities*. Concurrent with the issuance of IFRS 10, the IASB also issued:

- IFRS 11 *Joint Arrangements*;
- IFRS 12 *Disclosure of Interests in Other Entities*;
- IAS 27 *Separate Financial Statements* (2011) which has been amended for the issuance of IFRS 10 but retains the current guidance for separate financial statements; and
- IAS 28 *Investments in Associates and Joint Ventures* (2011) which has been amended for conforming changes based on the issuance of IFRS 10 and IFRS 11.

These standards are effective for annual periods beginning on or after 1 January 2013.

The interaction amongst the new standards is summarised below:



IFRS 10 uses control as the single basis for consolidation, replacing the risks and rewards focused approach included in SIC-12.

This Industry Insight publication highlights some of the issues the real estate industry is likely to encounter as it adopts IFRS 10 and IFRS 12 and provides insight and examples to assist in the implementation of these new standards.

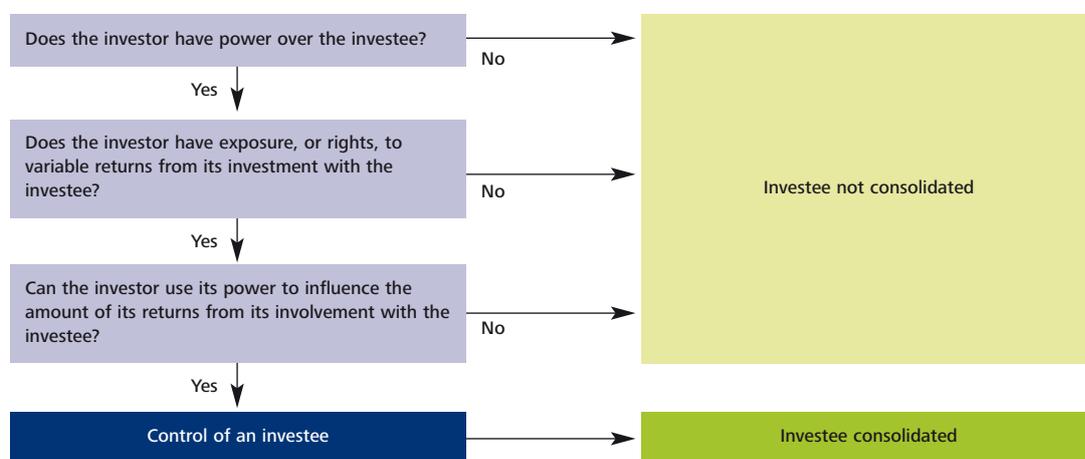
Assessment of control

IFRS 10 uses control as the single basis for consolidation, replacing the risks and rewards focused approach included in SIC-12. The standard identifies the following three elements of control:

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

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

IFRS 10 Consolidation Assessment



Power over the investee

The first step in the consolidation assessment requires an investor to assess whether it has power over the investee. IFRS 10 defines power as "existing rights that give the current ability to direct the relevant activities" and adds that the relevant activities are those that significantly affect the investee's returns. The standard provides examples of rights that may give an investor power over an investee, including:

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

For fund managers of real estate investment funds, the determination of whether their power influences their returns will depend on whether the manager is a principal or an agent ...

Exposure, or rights, to variable returns

The second step in the consolidation assessment requires an investor to assess whether it is exposed, or has rights, to variable returns from its involvement with the investee. IFRS 10 clarifies that variable returns are returns that are not fixed and have the potential to vary as a result of the performance of an investee. The standard provides examples of returns which include:

- dividends, other distributions (such as interest payments on debt securities) and changes in the value of the investor's investment in that investee;
- servicing and management fees, fees and exposure to loss from providing credit or liquidity support, residual interests in the investee's assets and liabilities on liquidation of that investee, tax benefits and access to future liquidity; and
- returns that are not available to other interest holders.

Link between power and returns

The third and final step in the consolidation assessment considers the interaction between the first two steps. Specifically, can the investor use its power to influence its returns from its involvement with the investee?

For fund managers of real estate investment funds, the determination of whether their power influences their returns will depend on whether the manager is a principal or an agent engaged to act on the behalf of, and for the benefit of, other investors. An agent would not control the fund. A real estate fund manager, in assessing whether it is a principal or agent, would consider the following factors:

- the scope of its decision-making authority over the investee;
- the rights held by other parties;
- the remuneration to which it is entitled in accordance with the remuneration agreement(s); and
- its exposure to variability of returns from other interests that it holds in the investee.

For real estate investment funds, the 'relevant activities' are likely to be the investment decisions that are made by the fund manager. The determination as to whether the fund manager is a principal and therefore can use its power to influence its return, will be based, in part, on whether removal rights held by the fund's investors are substantive. IFRS 10 indicates a decision maker would be an agent if a single party holds substantive removal rights that allow the party to remove the decision maker without cause. However, the greater the number of parties required to act together to remove the decision maker, the less weighting that should be placed on that factor.

All facts and circumstances need to be considered in determining whether removal rights held by more than one party are substantive. For example, certain real estate fund structures may provide investors the right to elect a board of directors that provide the investors a mechanism to exercise collectively the investors' rights including the ability to remove the real estate fund manager. Important factors to consider in making this determination include, among other items, which parties appoint the board of directors, whether the board members are independent or are related parties to the real estate fund manager, what mechanism exists for the investors to exercise their voting rights (e.g., established annual general meetings) and if there are any barriers for investors to exercise their voting rights.

In assessing the remuneration, a real estate fund manager cannot be an agent unless its fee is commensurate with the services provided and the arrangement that includes customary terms. The greater the fee and exposure to variability relative to the expected returns from the activities of the investee, the more likely the fund manager is a principal.

Observation

Asset management agreements in the real estate industry often include complex fee structures which may include annual management, debt arrangement, development, disposal, fund management, performance and project management fees. For example, annual management fees may be based on the amount of assets under management in some arrangements, but based on gross or net rental income in others, while performance fees may contain hurdle rates while others are based on actual returns. This may complicate the assessment of 'market' terms and may require significant judgement.

IFRS 10 also discusses when an investor's relationships with other parties may result in those parties acting on behalf of the investor (as 'de facto agents' of the investor).

In assessing the exposure to variability of returns, a real estate fund manager should consider that the greater the magnitude of, and variability associated with, its overall economic interests (including remuneration), the higher the likelihood the real estate fund manager is a principal. Additionally, if the exposure to variability of returns of the real estate fund manager is different from that of other investors (e.g., because of subordination of interests), real estate fund managers should consider how that may influence their decisions as a real estate fund manager. IFRS 10 includes examples that are intended to illustrate the application of the general concepts of the principal-agent guidance rather than creating "bright-lines" of, for example, the level of equity exposure which would lead to the determination that a real estate fund manager is acting as a principal. A significant amount of judgement may be required in determining whether a fund manager is a principal or agent.

IFRS 10 also discusses when an investor's relationships with other parties may result in those parties acting on behalf of the investor (as 'de facto agents' of the investor). The standard clarifies that the arrangements with other parties need not be contractual and provides examples of parties who might act as 'de facto agents' of the investor:

- the investor's related parties;
- a party that received its interest in the investee as a contribution or loan from the investor;
- a party that has agreed not to sell, transfer or encumber its interests in the investee without the investor's prior approval (except for situations in which the investor and the other party have the right of prior approval and the rights are based on mutually agreed terms by willing independent parties);
- a party that cannot finance its operations without subordinated financial support from the investor;
- an investee for which the majority of the members of its governing body or for which its key management personnel are the same as those of the investor; and
- 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.

When a fund manager identifies other parties as 'de facto agents', the fund manager would consider the other investors' decision-making rights and exposure, or rights, to variable returns together with its own interests when assessing whether it controls the assets or fund.

Examples

IFRS 10 provides the following examples to illustrate the provisions of the IFRS 10 consolidation model in assessing principal-agent relationships:

The decision maker establishes, markets and manages a fund that provides investment opportunities to a number of investors. The decision maker (fund manager) must make decisions in the best interests of all investors and in accordance with the fund's governing agreements. Nonetheless, the fund manager has wide decision-making discretion. The fund manager receives a market-based fee for its services equal to 1 per cent of assets under management and 20 per cent of all the fund's profits if a specified profit level is achieved. The fees are commensurate with the services provided.

Although it must make decisions in the best interests of all investors, the fund manager has extensive decision-making authority to direct the relevant activities of the fund. The fund manager is paid fixed and performance-related fees that are commensurate with the services provided. In addition, the remuneration aligns the interests of the fund manager with those of the other investors to increase the value of the fund, without creating exposure to variability of returns from the activities of the fund that is of such significance that the remuneration, when considered in isolation, indicates that the fund manager is a principal.

The above fact pattern and analysis applies to examples A–C described below. Each example is considered in isolation.

Example A

The fund manager also has a 2 per cent investment in the fund that aligns its interests with those of the other investors. The fund manager does not have any obligation to fund losses beyond its 2 per cent investment. The investors can remove the fund manager by a simple majority vote, but only for breach of contract.

The fund manager's 2 per cent investment increases its exposure to variability of returns from the activities of the fund without creating exposure that is of such significance that it indicates that the fund manager is a principal. The other investors' rights to remove the fund manager are considered to be protective rights because they are exercisable only for breach of contract. In this example, although the fund manager has extensive decision-making authority and is exposed to variability of returns from its interest and remuneration, the fund manager's exposure indicates that the fund manager is an agent. Thus, the fund manager concludes that it does not control the fund.

Example B

The fund manager has a more substantial pro rata investment in the fund, but does not have any obligation to fund losses beyond that investment. The investors can remove the fund manager by a simple majority vote, but only for breach of contract.

In this example, the other investors' rights to remove the fund manager are considered to be protective rights because they are exercisable only for breach of contract. Although the fund manager is paid fixed and performance-related fees that are commensurate with the services provided, the combination of the fund manager's investment together with its remuneration could create exposure to variability of returns from the activities of the fund that is of such significance that it indicates that the fund manager is a principal. The greater the magnitude of, and variability associated with, the fund manager's economic interests (considering its remuneration and other interests in aggregate), the more emphasis the fund manager would place on those economic interests in the analysis, and the more likely the fund manager is a principal.

For example, having considered its remuneration and the other factors, the fund manager might consider a 20 per cent investment to be sufficient to conclude that it controls the fund. However, in different circumstances (i.e., if the remuneration or other factors are different), control may arise when the level of investment is different.

Example C

The fund manager has a 20 per cent pro rata investment in the fund, but does not have any obligation to fund losses beyond its 20 per cent investment. The fund has a board of directors, all of whose members are independent of the fund manager and are appointed by the other investors. The board appoints the fund manager annually. If the board decided not to renew the fund manager's contract, the services performed by the fund manager could be performed by other managers in the industry.

Although the fund manager is paid fixed and performance-related fees that are commensurate with the services provided, the combination of the fund manager's 20 per cent investment together with its remuneration creates exposure to variability of returns from the activities of the fund that is of such significance that it indicates that the fund manager is a principal. However, the investors have substantive rights to remove the fund manager – the board of directors provides a mechanism to ensure that the investors can remove the fund manager if they decide to do so.

In this example, the fund manager places greater emphasis on the substantive removal rights in the analysis. Thus, although the fund manager has extensive decision-making authority and is exposed to variability of returns of the fund from its remuneration and investment, the substantive rights held by the other investors indicate that the fund manager is an agent. Thus, the fund manager concludes that it does not control the fund.

The objective of IFRS 12 is to require disclosure that helps users of financial statements evaluate:

- the nature of, and risks associated with, an entity's interests in other entities; and
- the effect of those interests on the entity's financial position, financial performance and cash flows.

Effective date and transition

IFRS 10 is effective for annual periods beginning on or after 1 January 2013. The adoption of IFRS 10 requires retrospective application. The impact of retrospective application is summarised as follows:

Consolidation of an entity not previously consolidated

- Retrospective application of IFRS 3 *Business Combinations* from the date of control.
- If impracticable, apply IFRS 3 at the earliest possible date.
- Impact on transition recognised in equity.

De-consolidation of a previously consolidated entity

- Retrospective application from the date of involvement with the investee or the date at which control is lost.
- If impracticable, application at the earliest possible date.
- Application of IAS 27(2004) or IAS 27(2008) based on the date at which control is lost.

Disclosures

IFRS 12 provides disclosure requirements for an entity's interests in subsidiaries, joint arrangements, associates and unconsolidated structured entities. The objective of IFRS 12 is to require disclosure that helps users of financial statements evaluate:

- the nature of, and risks associated with, an entity's interests in other entities; and
- the effect of those interests on the entity's financial position, financial performance and cash flows.

An entity that has an interest in one or more other entities should disclose the following:

- Significant judgements and assumptions: An entity should disclose information about significant judgements and assumptions it has made in determining whether it has control, joint control or significant influence.
- Interests in subsidiaries: An entity should disclose information regarding the composition of the group, non-controlling interests, significant restrictions on the parent's ability to access or use the assets and settle the liabilities of subsidiaries and the effects of changes in ownership interest that did or did not result in a loss of control during the reporting period.
- Interests in consolidated structured entities: An entity should disclose the terms of any contractual agreements that could require the parent or its subsidiaries to provide financial support, including events or circumstances that could expose the reporting entity to loss.
- Interests in unconsolidated structured entities: An entity should disclose information about the nature and extent of the entity's interests in unconsolidated structured entities and the risks associated with those interests, including nature, purpose, size and activities of the structured entity, how the structured entity is financed, the carrying amounts of assets and liabilities relating to interests in unconsolidated structured entities and how they compare to the maximum exposure to loss from those interests and any support provided to an unconsolidated structured entity when there is no contractual obligation to do so.

IFRS 12 requires that for each material interest, the information would be provided separately. However, it also permits aggregation of some information within each class of entity, so long as the level of detail provided through disclosures satisfies the needs of the users of the financial statements but does not result in excessive detail. It outlines that consideration should be given to both qualitative and quantitative information about the risks and returns of each entity when considering the level of aggregation.

Other considerations

- Internal information systems: Real estate entities may need to review their internal information systems to determine if there is a need to modify their internal systems and processes to gather necessary information to comply with new disclosure requirements.
- Performance: Real estate entities should consider the implications of the change in the presentation of financial results on key performance indicators (e.g., leverage ratios, gross margin ratios, return on assets ratios), debt covenants, existing contracts (e.g., covenants, remuneration agreements) and regulatory disclosures.
- New and existing contracts: Real estate entities will need to consider the affects of IFRS 10 as they negotiate new contractual arrangements and modify existing arrangements.
- Tax consequences: Changes to consolidation conclusions may affect profit (loss) before tax. Entities will also need to consider if there are any further tax implications from adopting IFRS 10.

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Designed and produced by The Creative Studio at Deloitte, London. 13481A

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