

Heads Up

In This Issue:

- Introduction
- Overview of Significant Changes to Consolidation Model
- Elements of Control: Power
- Elements of Control: Exposure, or Rights, to Variable Returns
- Elements of Control: Ability to Use Power to Affect Returns
- Other Considerations in Consolidation Analysis
- Joint Control Under IFRS 11
- Joint Operations and Joint Ventures
- Distinction Between Joint Operations and Joint Ventures
- Separate Financial Statements
- Disclosure of Interests in Other Entities
- Effective Date and Transition
- Appendix: Comparison Between U.S. GAAP and IFRSs — Consolidation

IASB Consolidation Model: Take Five!

New IFRSs Issued on Consolidation

Introduction

On May 12, 2011, the IASB issued the following new and amended guidance (the “package of five”) on consolidated financial statements and joint arrangements:

- IFRS 10,¹ which replaces IAS 27² and SIC-12.³
- IFRS 11.⁴
- IFRS 12.⁵
- IAS 27 (Revised 2011),⁶ which has been amended for the issuance of IFRS 10 but retains the current guidance on separate financial statements.
- IAS 28 (Revised 2011),⁷ which has been amended for conforming changes on the basis of the issuance of IFRS 10 and IFRS 11.

Each of the standards in the “package of five” is effective for annual periods beginning on or after January 1, 2013; earlier application is permitted as long as each of the other standards in this group is also early applied. See the [Effective Date and Transition](#) section for further details.

Editor’s Note: The consolidations project began as a joint project between the FASB and IASB to develop improved, converged consolidation standards that would apply to all entities (i.e., variable interest entities (VIEs), voting interest entities, and investment companies). However, the boards ultimately decided not to converge on all aspects of this topic, mainly because of differences of opinion on “control with less than a majority of the voting rights” and the consideration of “potential voting rights.” The FASB is currently working on a narrower project to clarify whether a decision maker is acting as a principal or as an agent. The differences between U.S. GAAP and IFRSs related to consolidation are discussed throughout this *Heads Up* and summarized in the [appendix](#).

¹ IFRS 10, *Consolidated Financial Statements*.

² IAS 27, *Consolidated and Separate Financial Statements*.

³ SIC-12, *Consolidation — Special-Purpose Entities*.

⁴ IFRS 11, *Joint Arrangements*.

⁵ IFRS 12, *Disclosure of Interests in Other Entities*.

⁶ IAS 27, *Separate Financial Statements*.

⁷ IAS 28, *Investments in Associates and Joint Ventures*.

Overview of Significant Changes to Consolidation Model

Under IFRS 10, control is the single basis for consolidation, irrespective of the nature of the investee; this standard therefore eliminates the risks-and-rewards approach in SIC-12.

IFRS 10 identifies the following three elements of control:

- “[P]ower over the investee.”
- “[E]xposure, or rights, to variable returns from involvement with the investee.”
- “[T]he ability to use power over the investee to affect the amount of the investor’s returns.”

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

Editor’s Note: In developing IFRS 10, the IASB identified the following four areas of current divergence in the determination of whether an investee should be consolidated:

- When an investor controls an investee with less than a majority of the voting rights.
- Special-purpose entities and application of the “economic substance” notion in SIC-12.
- Issues related to principal-versus-agent relationships.
- Consideration of protective rights.

Paragraph BC3 of the Basis for Conclusions of IFRS 10 indicates that the IASB considered that a perceived difference in emphasis between IAS 27 and SIC-12 “had led to inconsistent application of the concept of control.” Thus, the IASB decided to withdraw the separate guidance in SIC-12.

Note that while the IASB’s guidance on this topic is not converged with U.S. GAAP, certain elements of control under IFRS 10 are consistent with the guidance on determining the primary beneficiary under the current VIE model in ASC 810-10.⁸ Under this guidance, a reporting entity has a controlling financial interest in a VIE if it has both “the power to direct the activities of a VIE that most significantly impact the VIE’s economic performance” and the obligation to absorb losses or the right to receive returns of the VIE that could potentially be significant to the VIE.

Elements of Control: Power

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

Paragraphs B3 and B4 of IFRS 10 state that an investor should consider the following factors in determining whether it has power over an investee:

- The “purpose and design of the investee.”
- The relevant activities of the investee and “how decisions about those activities are made.”
- Whether the investor’s rights “give it the current ability to direct the relevant activities.”
- “[W]hether the investor is exposed, or has rights, to variable returns from its involvement with the investee.”

⁸ FASB Accounting Standards Codification Subtopic 810-10, *Consolidation: Overall*.

- “[W]hether the investor has the ability to use its power over the investee to affect the amount of the investor’s returns.”
- The investor’s “relationship with other parties.”

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

Editor’s Note: Paragraph B13 of IFRS 10 gives the following example of two or more investors that have rights to direct different relevant activities of an entity:

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

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

In this particular example, the investors would also consider:

- a. the uncertainty of, and effort required in, obtaining regulatory approval (considering the investor’s record of successfully developing and obtaining regulatory approval of medical products); and
- b. which investor controls the medical product once the development phase is successful.

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

An investor may have a special relationship with an investee that indicates that it has power over the investee. Paragraph B19 of IFRS 10 gives the following examples of special relationships between an investor and investee that may indicate power:

- The “investee’s key management personnel . . . are current or previous employees of the investor.”
- The “investee’s operations are dependent on the investor.”
- A “significant portion of the investee’s activities either involve or are conducted on behalf of the investor.”

- The “investor’s exposure, or rights, to returns from its involvement with the investee is disproportionately greater than its voting or other similar rights.”

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

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

Editor’s Note: Considering the design of the entity, including relevant activities that occur upon a change in circumstances or in the future, may be pertinent to entities that manage receivables only upon the event of default (i.e., special servicers to a trust managing commercial mortgage-backed securities). Because the relevant activities for such entities are generally the management of the defaulted receivables, no substantive decisions may need to be made before a default. Therefore, the party that has the ability to manage the defaulted receivables may have power over the investee even before there are any defaults.

Paragraph B22 of IFRS 10 specifies that in assessing power, an entity considers only substantive rights and rights that are not protective. For a right to be substantive, it must give its holder the practical ability to exercise the right when the decisions about the relevant activities of the investee need to be made. Rights do not need to be currently exercisable to be substantive. Also, substantive rights held by other parties may prevent the investor from controlling the investee. Paragraph B23 of IFRS 10 indicates that factors for an investor to consider in assessing whether a right is substantive include whether there is a:

- Barrier that would prevent the holder from exercising the right (e.g., from incurring a substantial penalty or fee if the right were exercised).
- Mechanism that gives parties the practical ability to permit the investor to exercise its right.
- Benefit from the investor’s exercising that right (e.g., by exercising an “in the money” call option).

Protective Rights

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

Control With Less Than a Majority of Voting Rights

IFRS 10 clarifies that an investor can have power over an investee even if it does not hold a majority of the voting rights. For example, an investor may have power through (1) a contractual arrangement, (2) holding voting rights, (3) holding potential voting rights, or (4) a combination of the above.

Paragraph B39 of IFRS 10 states that a “contractual arrangement between an investor and other [investors] can give the investor the right to exercise voting rights sufficient to give the investor power, even if the investor does not have voting rights sufficient to give it power.” For example, a contractual arrangement may give the investor the (1) ability to “direct enough other vote holders on how to vote to enable the investor to make decisions about the relevant activities” or (2) current ability to direct the operating and financial activities of an investee.

Paragraph B42 of IFRS 10 stipulates that an investor that holds less than a majority of the voting rights should also consider the “size of the investor’s holding of voting rights relative to the size and dispersion of holdings of the other vote holders” and any additional facts and circumstances that may be relevant (e.g., voting patterns at previous shareholders’ meetings).

Editor’s Note: The assessment of these factors may prove quite challenging in practice because it is likely to involve significant judgment. However, although IFRS 10 does not include any “bright lines” on this matter, paragraph B43 does contain the following example of an investor that holds less than a majority of the voting rights:

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

Note that the FASB decided not to import the concept of effective control into U.S. GAAP (i.e., control with less than 50 percent of the voting rights when the entity is controlled by vote). Thus, this aspect of the guidance on voting interest entities in U.S. GAAP will not be converged with that in IFRSs.

An investor would also need to consider potential voting rights held either by itself or by other parties. Paragraph B50 of IFRS 10 indicates that potential voting rights are considered only when they are substantive and “alone, or in combination with other rights, can give an investor the current ability to direct the relevant activities.”

Editor’s Note: Paragraph B50 of IFRS 10 contains the following two examples of an investor that holds potential voting rights:

Example 9

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

Example 10

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

Note that the FASB decided not to amend the guidance in U.S. GAAP on potential voting rights because it does not believe that such rights give an investor the current ability to direct the relevant activities that significantly affect the entity’s returns. Therefore, the guidance on potential voting rights in U.S. GAAP will continue to differ from that in IFRSs.

Principal-Versus-Agent Relationships

IFRS 10 introduces guidance on assessing whether an entity with decision-making rights is a principal or an agent. Paragraph B58 describes an agent as a party that has been “engaged to act on behalf and for the benefit of another party” (the principal). However, this paragraph clarifies that an investor “is not an agent simply because other parties can benefit from” the investor’s decision making.

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

The FASB also plans to propose guidance that would help entities assess whether a decision maker is acting as a principal or as an agent. The guidance would apply to all entities applying the current VIE guidance as well as partnerships subject to the guidance in ASC 810-20.⁹ The guidance proposed by the FASB is expected to be similar, but not identical, to the assessment under IFRS 10. However, the FASB will need to expose the proposed guidance for public comment and to redeliberate (and possibly change) the guidance on the basis of the feedback it receives. Therefore, it will not be possible to tell whether the guidance on this topic under U.S. GAAP is consistent with that in IFRSs until the FASB finalizes its guidance.

The principal-versus-agent guidance may allow the FASB to eliminate the deferral of Statement 167 for certain investment funds, since entities would be allowed to use a more qualitative approach in determining whether a decision maker (e.g., an investment manager) is acting as a principal or as an agent. The changes would also allow for the consideration of removal rights, even when those rights require the agreement of multiple parties. Under the current VIE model, removal rights are not considered in the consolidation analysis unless a single entity has the unilateral ability to exercise those rights. This qualitative assessment would also allow a general partner to consider its economics when determining whether it should consolidate a partnership.

The FASB plans to issue an exposure draft on the principal-versus-agent guidance in the second quarter of 2011 and a final standard in the second half of 2011.

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

- The scope of the decision maker’s authority over the investee.
- Rights held by other parties.
- The remuneration that the decision maker is entitled to (including whether this remuneration is commensurate with the services provided and whether any nonstandard terms are included).
- The “decision maker’s exposure to variability of returns from other interests that it holds in the investee.”
- The rights of a single party to remove the decision maker.

Under paragraph B61 of IFRS 10, all of the above criteria must be evaluated as part of this determination unless a single party has the unilateral ability to “remove the decision maker without cause” (commonly referred to as “kickout” or “removal” rights). In such cases, the decision maker would be deemed an agent and the party holding those removal rights would be deemed the principal. However, if removal rights are shared among multiple investors, an investor would need to consider each of the factors above in performing the principal/agent assessment. Paragraph B65 indicates that the “greater the number of parties required to act together” to remove the decision maker, the less that factor should be weighted.

⁹ FASB Accounting Standards Codification Subtopic 810-20, *Consolidation: Control of Partnerships and Similar Entities*.

Editor’s Note: IFRS 10 provides a number of examples illustrating the assessment of whether an investment manager is acting as a principal or as an agent.

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

Relationships With Other Parties

IFRS 10 also provides guidance on when an investor may have a relationship with another party in which the investor directs the other party to act on the investor’s behalf (referred to as a “de facto agent”). Paragraph B75 lists the following examples of de facto agents:

- Related parties (as defined in IAS 24¹⁰).
- An investor that received its interest in the investee as a result of a loan or contribution from the investor.
- An investor that “has agreed not to sell, transfer, or encumber its interests in the investee” without the prior approval of another investor.
- A “party that cannot finance its operations without subordinated financial support from the investor.”
- An investee that shares a majority of its board or key management personnel with an investor.
- A “party that has a close business relationship with the investor” (e.g., a service provider and a significant client).

Editor’s Note: The guidance on considering an investor’s relationship with other parties is necessary because of the relationship that a group may have with an investee. An investor and its de facto agents may each have power and economic involvements that, when considered in isolation, may not result in a conclusion that either party has control but that together result in such a conclusion.

Elements of Control: Exposure, or Rights, to Variable Returns

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

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

¹⁰ IAS 24, *Related Party Disclosures*.

Elements of Control: Ability to Use Power to Affect Returns

The third consideration in the assessment of control is the interaction between the first two control components. To have control over an investee, an investor must have not only (1) the power over an investee and exposure or rights to variable returns from its involvement with the investee, but also (2) the ability to use its power over the investee to affect its returns from its involvement with the investee.

Other Considerations in Consolidation Analysis

Whether a Portion of an Investee Can Be Deemed a Separate Entity

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

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

Continuous Assessment

IFRS 10 requires a continuous reassessment of an investor’s control over an investee. This reassessment would take into account both changes in an investor’s power over the investee and changes in the investor’s exposure or rights to variable returns. It would be performed if there is a change in facts and circumstances and as of each reporting period.

Joint Control Under IFRS 11

IFRS 11 defines a joint arrangement as an “arrangement of which two or more parties have joint control” and clarifies that joint control exists only when “decisions about the relevant activities require the unanimous consent of the parties that control the arrangement collectively.”

Editor’s Note: The concept of joint control includes control by more than two parties, but not when decisions may be reached by more than one combination of those parties. Paragraph B8 of IFRS 11 gives the following example to illustrate this point:

Assume an arrangement has three parties: A has 50 per cent of the voting rights in the arrangement and B and C each have 25 per cent. The contractual arrangement between A, B and C specifies that at least 75 per cent of the voting rights are required to make decisions about the relevant activities of the arrangement. Even though A can block any decision, it does not control the arrangement because it needs the agreement of either B or C. In this example, A, B and C collectively control the arrangement. However, there is more than one combination of parties that can agree to reach 75 percent of the voting rights (i.e., either A and B or A and C). In such a situation, to be a joint arrangement the contractual arrangement between the parties would need to specify which combination of the parties is required to agree unanimously to decisions about the relevant activities of the arrangement.

Joint Operations and Joint Ventures

IFRS 11 establishes two types of joint arrangements, joint operations and joint ventures, which are distinguished by the rights and obligations of the parties to the arrangement. In a joint operation, the parties to the joint arrangement (referred to as “joint operators”) have rights to the assets and obligations for the liabilities of the arrangement. By contrast, in a joint venture, the parties to the arrangement (referred to as “joint venturers”) have rights to the net assets of the arrangement.

IFRS 11 requires that a joint operator recognize its share of the assets, liabilities, revenues, and expenses in accordance with applicable IFRSs; however, a joint venturer would account for its interest by using the equity method of accounting under IAS 28 (Revised 2011). The option of proportional consolidation in IAS 31¹¹ has not been retained.

Editor’s Note: The mechanics of equity accounting, as detailed in IAS 28, have not changed, and the accounting for joint operations is consistent with the current treatment of jointly controlled operations and jointly controlled assets.

IFRS 11 applies to all parties that have an interest in a joint arrangement, not just to those that have joint control. Therefore, all parties that have an interest in a joint operation should recognize their share of the assets, liabilities, revenues, and expenses arising from that interest. However, the accounting for an interest in a joint venture will depend on whether the party has joint control. A party that has joint control or significant influence over a joint venture will use the equity method to account for its interest; however, a party that does not have such control or influence will apply IFRS 9¹² (or IAS 39,¹³ as applicable). Hence, upon adopting IFRS 11, all parties to a joint arrangement must evaluate whether the arrangement meets the definition of a joint operation or a joint venture.

Editor’s Note: The terms “joint arrangement” and “joint operation” are not defined in U.S. GAAP. ASC 323¹⁴ only addresses jointly controlled entities that are not VIEs or otherwise within the scope of ASC 810. Other types of joint venture arrangements (e.g., collaborative arrangements) are addressed in other guidance. Under U.S. GAAP, a “corporate joint venture” is defined as an entity that has a separate and specific business purpose or project operated for the mutual benefit of its members and that is characterized by the presence of joint control among the venturers (members). Under the VIE model in ASC 810-10, power is considered shared “if two or more unrelated parties together have the power to direct the activities of a VIE that most significantly impact the VIE’s economic performance and if decisions about those activities require the consent of each of the parties sharing power.”

Distinction Between Joint Operations and Joint Ventures

The existence of a separate vehicle is a necessary, but not sufficient, condition for a joint arrangement to be considered a joint venture.

IFRS 11 clarifies that, in the absence of a separate vehicle, the parties to a joint arrangement have direct rights to, and obligations for, the assets and liabilities of the arrangement and that the arrangement will therefore be classified as a joint operation in such cases. In an arrangement with a separate vehicle, an investor should consider all relevant facts and circumstances in determining whether the parties to the arrangement have rights to the net assets of the arrangement.

Editor’s Note: This is a significant change from the requirements of IAS 31, which treats the establishment of a separate legal vehicle as the key factor in the determination of the existence of a jointly controlled entity.

The following three paragraphs discuss factors that an investor should consider in determining whether an arrangement is a joint venture or a joint operation under IFRS 11:

Legal Form of the Separate Vehicle

In certain joint arrangements conducted through a separate vehicle, the liability of the parties to the arrangement is not limited. In such cases, the joint arrangement would be considered a joint operation. However, a joint arrangement that limits the liability of

¹¹ IAS 31, *Interests in Joint Ventures*.

¹² IFRS 9, *Financial Instruments*.

¹³ IAS 39, *Financial Instruments: Classification and Measurement*.

¹⁴ FASB Accounting Standards Codification Topic 323, *Investments — Equity Method and Joint Ventures*.

the parties would not necessarily be considered a joint venture, because the terms of the contractual arrangement or other facts and circumstances may affect whether the parties have limited liability.

Terms of the Contractual Arrangement

Contractual arrangements between the parties to a joint arrangement may counteract the legal form of the vehicle. For example, parties may have direct rights to the assets and obligations for the liabilities of the arrangement even though the legal form of the vehicle would normally shelter the investor from having a direct obligation for its liabilities. This would be the case if the contractual arrangement between the parties establishes that all parties to the arrangement are directly liable for third-party claims or establishes a sharing of revenues and expenses on the basis of the relative performance of the parties.

Other Facts and Circumstances

When a separate vehicle is used and the terms of the contractual arrangement do not indicate that the joint arrangement is a joint operation, the parties should consider any other relevant facts and circumstances in determining the type of arrangement. For example, if a separate vehicle is formed to hold the assets and liabilities of the joint arrangement and the parties to the joint arrangement are committed to purchase the entire output of the arrangement, the arrangement is a joint operation because the parties have rights to all of the economic benefits generated by the assets of the arrangement. Another indicator that such an arrangement is a joint operation is that the parties are required to fund the settlement of the liabilities because the arrangement depends on the parties exclusively for the generation of cash flows. However, if output were sold to third parties because the arrangement assumed demand, inventory, and credit risks, the arrangement would be a joint venture.

Editor's Note: It is possible that an investment that previously met the definition of a jointly controlled entity under IAS 31 would be a joint operation under IFRS 11. In addition, upon adopting IFRS 11, an investor that previously accounted for an interest in a joint operation under IFRS 9 (or IAS 39, as applicable) because it did not have joint control would have to recognize directly its share of assets, liabilities, revenues, and expenses associated with the joint operation.

Separate Financial Statements

Joint operations are accounted for in the same manner in the separate financial statements as in the consolidated financial statements (i.e., the investor recognizes directly its share of assets, liabilities, revenues, and expenses related to the joint operations).

Joint ventures, like investments in associates and in subsidiaries, are accounted for in the separate financial statements of the venturer either at cost or under IFRS 9 (or IAS 39, as applicable), as permitted by IAS 27.

Disclosure of Interests in Other Entities

IFRS 12 integrates the disclosure requirements on interests in other entities, currently included in several standards, and contains additional requirements on a number of topics.

Significant Judgments and Assumptions

Under IFRS 12, an entity should disclose information about significant judgments and assumptions it has used in determining (1) whether it has control, joint control, or significant influence over another entity and (2) the type of joint arrangement when the arrangement has been structured through a separate vehicle. An entity should also provide these disclosures when changes in facts and circumstances affect the entity's conclusion during the reporting period.

Editor’s Note: IFRS 12 gives examples of the judgments and assumptions that must be disclosed. These examples (which include the basis for concluding that holding more than half of the voting rights of an entity does not result in control or, conversely, that control is achieved with less than half the voting rights) illustrate that an entity should take particular care in explaining departures from the assumed correlation between voting rights and level of influence over an entity.

Interests in Subsidiaries

Paragraph 10 of IFRS 12 indicates that a parent entity should disclose information regarding:

- The composition of the group.
- Noncontrolling interests (including summarized financial information about each subsidiary with material noncontrolling interests).
- Significant restrictions on the parent’s ability to access or use the assets and settle the liabilities of its subsidiaries.
- The nature of, and changes in, the risks associated with interests in consolidated structured entities.
- The effects of changes in the parent’s ownership interest that did or did not result in a loss of control during the reporting period.

Disclosure is also required “[w]hen the financial statements of a subsidiary . . . are as of a date or for a period that is different from that of the consolidated financial statements.”

Interests in Joint Arrangements and Associates

Paragraph 20 of IFRS 12 indicates that an entity should disclose information about “the nature, extent, and financial effects of its interests in joint arrangements and associates,” including information about contractual relationships with the other parties to the joint arrangements or other investors that have interests in associates. An entity should also disclose “the nature of, and changes in, the risks associated with its interests in joint ventures and associates.”

Interests in Unconsolidated Structured Entities

IFRS 12 defines a structured entity as an “entity that has been designed so that voting or similar rights are not the dominant factor in deciding who controls the entity.” Examples of structured entities include securitization vehicles, asset-backed financings, and certain investment funds.

IFRS 12 requires extensive disclosures regarding the nature and extent of an entity’s interests in unconsolidated structured entities and the risks associated with those interests, including:

- The nature, purpose, size, and activities of the structured entity.
- How the structured entity is financed.
- The carrying amounts of assets and liabilities related to interests in unconsolidated structured entities and how they compare to the maximum exposure to loss from those interests.
- Any support provided to an unconsolidated structured entity when there is no contractual obligation to do so (including the reasons for providing such support).

Editor’s Note: In finalizing the requirements of IFRS 10, the Board decided that this type of “reputational risk” is not in itself an appropriate basis for consolidating an entity. However, IFRS 12’s disclosure requirements for unconsolidated structured entities were designed, in part, to help an entity assess its exposure to reputational risk.

Aggregation of Information

IFRS 12 requires granular information about a number of topics (e.g., regarding each material joint arrangement and each subsidiary with noncontrolling interests that are material to the group) and specifies that information about interests in subsidiaries, joint ventures, joint operations, associates, and unconsolidated structured entities be presented separately. However, IFRS 12 does permit some aggregation of information within these classes of entities.

In addition, IFRS 12 indicates that disclosures would be most beneficial to financial statement users if they are sufficiently, but not excessively, detailed. Aggregation is permitted, but only if it does not obscure the information provided.

Editor’s Note: When discussing the appropriate level of aggregation, IFRS 12 indicates that an entity should consider (1) quantitative and qualitative information about the risks and returns of each entity and (2) the overall significance of the entity.

Effective Date and Transition

Each of the standards in the “package of five” is effective for annual periods beginning on or after January 1, 2013; earlier application is permitted as long as each of the other standards in the group is also early applied. However, entities are permitted to incorporate any of the disclosure requirements in IFRS 12 into their financial statements without early adopting IFRS 12 or the other standards in the group.

Editor’s Note: The IASB expressed concerns that requiring early application of all standards in the “package of five” may discourage entities from providing the disclosures mandated by IFRS 12 before the required effective date. Therefore, IFRS 12 clarifies that entities are encouraged to provide any or all of the required disclosures before the effective date and that this will not result in a requirement to apply the other components of the “package of five.”

Transition for IFRS 10

IFRS 10 requires retrospective application in accordance with IAS 8,¹⁵ subject to certain transitional provisions.

Paragraph C4 of IFRS 10 states that when the initial application of IFRS 10 results in consolidation of an investee that was not previously consolidated, an investor should “measure the assets, liabilities, and noncontrolling interests in that previously unconsolidated investee on the date of initial application as if that investee had been consolidated . . . from the date when the investor obtained control of that investee on the basis of the requirements of [IFRS 10]” (if the investee is a business, this would mean applying IFRS 3¹⁶ as of that date). However, if this is impracticable, the investor should apply the requirements of IFRS 3 and the “deemed acquisition date shall be the beginning of the earliest period for which application of IFRS 3 is practicable, which may be the current period.”

When, because of the initial application of IFRS 10, an investee that was previously consolidated is no longer consolidated, an investor should measure its “interest in the investee . . . at the amount at which the interest would have been measured if the requirements of IFRS 10” had always been effective. Further, paragraph C5 of IFRS 10 states that “[i]f measurement of the retained interest is impracticable . . . , the investor shall apply the requirements of this IFRS for accounting for a loss of control” at the start of the reporting period in which the IFRS is adopted.

Transition for IFRS 11

When adoption of IFRS 11 requires a change in accounting, the impact of the change is calculated as of the beginning of the earliest period presented and the comparative periods are restated.

¹⁵ IAS 8, *Accounting Policies, Changes in Accounting Estimates and Errors*.

¹⁶ IFRS 3, *Business Combinations*.

In adopting IFRS 11, an entity must adjust the financial statements in two circumstances:

Before — IAS 31	After — IFRS 11	Accounting as of the Beginning of the Earliest Period
Jointly controlled entity accounted for under the equity method	Joint operation	<ul style="list-style-type: none"> • Derecognize the equity method investment. • Recognize assets (goodwill if any) and liabilities arising from the joint operation. • If the amount of net assets recognized exceeds the carrying amount of the equity method investment derecognized, the excess reduces goodwill to the extent that it exists, with any remaining excess recognized against retained earnings. • If the amount of net assets recognized is less than the carrying amount of the equity method investment derecognized, the difference is recognized against retained earnings.
Jointly controlled entity accounted for by using proportionate consolidation	Joint venture	<ul style="list-style-type: none"> • Derecognize assets (including goodwill if any) and liabilities. • Recognize equity method investment at the carrying amount of the net assets derecognized. • Perform an impairment test and recognize the impairment loss, if any, as an adjustment of retained earnings.

Appendix: Comparison Between U.S. GAAP and IFRSs — Consolidation

	U.S. GAAP	IFRSs
Determining when to consolidate	There are two different models for determining when consolidation is appropriate. If a reporting entity has an interest in a VIE, it must apply the VIE consolidation model under ASC 810-10, which is based on power and economics. If a reporting entity has an interest in an entity that is not a VIE, it must apply the control-based consolidation model (the voting interest model) under ASC 810-10.	An investor determines whether it is the parent (and therefore the consolidating entity) by assessing whether it controls one or more investees. This analysis focuses on three elements of control: power over the investee, exposure/rights to variable returns, and the ability of the investor to use its power to affect the amount of its returns.
Definition of control	Under the voting interest model in ASC 810-10, a controlling financial interest is defined as “ownership of a majority voting interest” in another entity. ASC 323-10 further indicates that the power to control another entity may exist in other contracts or agreements outside of a controlling financial interest. The VIE model in ASC 810-10 states that a reporting entity has a controlling financial interest if it has both of the following characteristics: (1) the power to direct the activities of the entity that most significantly affect the entity’s economic performance and (2) the obligation to absorb losses of the entity that could potentially be significant to the entity or the right to receive benefits from the entity that could potentially be significant to the entity.	Paragraph 6 of IFRS 10 states that an “investor controls an investee when [the investor] is exposed, or has rights, to variable returns from its involvement with the investee and has the ability to affect those returns through its power over the investee.”
Variable interest entity	An entity is a VIE if any one of the following three conditions is met: <ul style="list-style-type: none"> • The total equity investment at risk is not sufficient to permit the entity to finance its activities without additional subordinated financial support. • The holders of the equity investment at risk lack either of the following: <ul style="list-style-type: none"> ◦ The power to direct the activities of the entity that significantly affect the entity’s economic performance. ◦ The obligation to absorb losses or right to receive residual returns of the entity. • The voting rights of some investors are disproportionate to their obligation to absorb losses/receive returns, and substantially all of the activities are on behalf of the investor with disproportionate voting rights. <p>If an entity does not meet the definition of a VIE, the voting rights model in ASC 810-10 should generally be applied.</p>	Not specifically defined. Under IFRS 10, there is a single consolidation model that applies to all entities. However, paragraph B8 of IFRS 10 states that an “investee may be designed so that voting rights are not the dominant factor in deciding who controls the investee In such cases, an investor’s consideration of the purpose and design of the investee shall also include consideration of the risks to which the investee was designed to be exposed, the risks it was designed to pass on to the parties involved with the investee and whether the investor is exposed to some or all of those risks.” In addition, IFRS 12 requires extensive disclosures regarding the nature and extent of an entity’s interests in unconsolidated “structured entities.”
Shared power	If a reporting entity determines that control is shared among multiple unrelated parties involved with a VIE, no party consolidates the VIE. Under the VIE model in ASC 810-10, power is considered shared if (1) two or more unrelated parties together have the power to direct the VIE’s most significant activities and (2) decisions about those activities require the consent of each of the parties sharing power.	If two or more investors collectively control an investee (i.e., they must act together to direct the activities that significantly affect the returns of the investee), neither party controls the investee. For more information, see IFRS 11, IAS 28, or IFRS 9.

	U.S. GAAP	IFRSs
Potential voting rights	Under the voting interest model in ASC 810-10, an entity is not required to consider potential voting rights when determining whether control is present; rather, such potential voting rights may indicate control. The VIE model in ASC 810-10 does not specifically address the impact of potential voting rights on the determination of which party has the power to direct the most significant activities of an entity. However, forward starting rights (e.g., call options and put options conveyed pursuant to contracts in existence as of the balance sheet date) are often central to the design of an entity and should not be disregarded in the primary-beneficiary analysis.	When assessing whether it has power, an investor should consider its own potential voting rights in addition to those held by other parties. Paragraph B48 of IFRS 10 states that “[p]otential voting rights are rights to obtain voting rights of an investee, such as those arising from convertible instruments or options, including forward contracts.”
Consolidation with less than half of the voting rights	Under the voting interest model, control is generally indicated by direct (or indirect) ownership of more than 50 percent of the outstanding voting shares of another entity. However, ASC 810-10-15-8 notes that “power to control may also exist with a lesser percentage of ownership, for example, by contract, lease, agreement with other stockholders, or by court decree.” In the absence of any contractual arrangement, the voting interest model generally does not permit “effective control” through less than half of the voting rights.	An investor with less than a majority of the voting rights may still have power to direct the relevant activities and, therefore, to consolidate the entity. Power through less than half of the voting rights can arise, for example, through: <ul style="list-style-type: none"> • Contractual arrangements between the investor and other vote holders. • Rights arising from other contractual arrangements. • The investor’s voting rights. • The “size of the investor’s holding of voting rights related to the size and dispersion” of voting rights held by others and other facts and circumstances, such as voting patterns at previous shareholders’ meetings. • Potential voting rights. • Any combination of the above factors.
Delegated power	Under current U.S. GAAP, a decision maker or service provider should assess the factors in ASC 810-10-55-37 to determine whether it has a variable interest in a VIE. Under ASC 810-20, a general partner is presumed to control a limited partnership. Note that the FASB plans to propose guidance that would help entities assess whether a decision maker is acting as a principal or as an agent. The guidance would apply to all entities applying the current VIE guidance as well as partnerships subject to the guidance in ASC 810-20. The guidance proposed by the FASB is expected to be similar, but not identical, to the assessment under IFRS 10. However, the FASB will need to expose the proposed guidance for public comment and to redeliberate (and possibly change) the guidance on the basis of the feedback it receives. Therefore, it will not be possible to tell whether the guidance under U.S. GAAP is consistent with that in IFRSs until the FASB finalizes its guidance.	A decision maker should consider the overall relationship between itself and other parties involved with the investee to determine whether the investor is acting as a principal or as an agent. As part of this analysis, the decision maker should consider the following factors: <ul style="list-style-type: none"> • The scope of its decision-making authority over the investee. • The rights held by other parties. • The remuneration it is entitled to. • Its exposure to variability of returns from other interests that it holds in the investee.
Consideration of related parties	When determining the primary beneficiary under the VIE model in ASC 810-10, a reporting entity with a variable interest in a VIE is required to treat variable interests held by its related parties and de facto agents as its own interests.	An investor should consider the nature of its relationships with other parties when assessing control.

	U.S. GAAP	IFRSs
Reconsideration	<p>Under the VIE model:</p> <ul style="list-style-type: none"> • An interest holder should reconsider whether an entity is a VIE if certain specified triggering events occur. • A reporting entity should continually reconsider which interest holder is the VIE's primary beneficiary. <p>Although not specifically addressed in the voting interest model, a reporting entity should generally reassess whether it controls an entity when facts and circumstances change.</p>	<p>An investor should reassess whether it controls an investee if facts and circumstances indicate that there are changes to one or more of the three elements of control.</p>
Exception for preparing consolidated financial statements	<p>There is no exception for preparing consolidating financial statements when either (1) a parent controls a subsidiary or (2) a reporting entity is determined to be the primary beneficiary of a VIE.</p>	<p>A parent may elect not to consolidate a controlled subsidiary if specific conditions are met. If the election is made, the parent must account for its investment in a subsidiary not held for sale at cost or fair value in accordance with IAS 39. Note that this guidance is consistent with the previous guidance in IAS 27.</p>
Presentation requirements for certain consolidated entities	<p>Under the VIE model in ASC 810-10, the primary beneficiary of a VIE is required to separately present, on the face of the balance sheet, (1) assets of the consolidated VIE that can only be used to settle obligations of the VIE and (2) liabilities of the consolidated VIE for which creditors do not have recourse to the general credit of the primary beneficiary.</p>	<p>While separate presentation is not required in the statement of financial position, IFRS 12 requires an entity to disclose:</p> <ul style="list-style-type: none"> • Significant restrictions on its ability to access or use the assets and settle the liabilities of the group. • The nature and extent to which protective rights of noncontrolling interests can significantly restrict the entity's ability to access or use the assets and settle the liabilities of the group. • The carrying amounts in the consolidated financial statements of the assets and liabilities to which those restrictions apply.
Different reporting dates	<p>Consolidation is not prohibited if a parent and subsidiary have different reporting periods. When a difference in reporting periods is less than three months, it is usually acceptable for a parent to consolidate a subsidiary on the basis of the subsidiary's financial statements; however, the difference is not to exceed three months. The parent should evaluate material events occurring during any reporting time lag (i.e., the period between the subsidiary's year-end reporting date and the parent's balance sheet date) to determine whether the effects of such events should be disclosed or recorded in the parent's financial statements.</p>	<p>A parent is prohibited from consolidating a subsidiary with a different reporting period unless it is impractical for the subsidiary to have the same reporting period as the parent (or to produce financial information as of the same date of the parent's financial statements). If it is impractical for a subsidiary to have the same reporting period as its parent, the difference can be no greater than three months and adjustments should be made for significant transactions. Note that this guidance is consistent with the previous guidance in IAS 27.</p>
Consolidated accounting policies	<p>In the consolidated financial statements, the accounting policies of a subsidiary do not need to be conformed with those of a parent.</p>	<p>In the consolidated financial statements, the accounting policies of a subsidiary must be conformed with the accounting policies of a parent. Note that this guidance is consistent with the previous guidance in IAS 27.</p>
Considerations for investment companies	<p>Under the current guidance in ASC 946,¹⁷ entities that meet certain criteria may account for their investments at fair value. Note that the FASB and IASB are currently considering a project that would amend the definition of an investment company under U.S. GAAP.</p>	<p>IFRSs currently do not provide guidance on investment companies; therefore, all investments are consolidated. However, the FASB and IASB are currently considering a project that would allow an investment company (that meets certain criteria) to account for its underlying investments at fair value.</p>

¹⁷ FASB Accounting Standards Codification Topic 946, *Financial Services — Investment Companies*.

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