

IAS Plus Update.

Proposals for a new Standard on consolidation

On 18 December 2008, the International Accounting Standards Board (IASB) published Exposure Draft 10 (ED 10) **Consolidated Financial Statements**, which proposes a new Standard to replace the requirements of IAS 27 **Consolidated and Separate Financial Statements** dealing with consolidation and also SIC-12 **Consolidation – Special Purpose Entities**. ED 10 is the result of the IASB's work to date on its consolidation project, which was added to the Board's active agenda in 2003 and which has been accelerated in the light of the global financial crisis and recommendations made by the Financial Stability Forum and others.

Comments on ED 10 are requested by 20 March 2009, which is an unusually short 90-day comment period for such a comprehensive ED. Further round table discussions will be hosted by the IASB during the comment period, and the target is to issue a final Standard in the second half of 2009.

The Board aims to allow a minimum of one year between the issue of the final Standard and its implementation date – which suggests that the Standard is unlikely to be effective before 2011 accounting periods.

Overview of proposals

The objective of ED 10 is to develop a **single source of authoritative guidance** on consolidation accounting. Its key proposals are for:

- a **revised definition of control**, including additional application guidance; and
- **enhanced disclosures** about consolidated and unconsolidated entities.

The Board's intent in revising the definition of control is to make the definition more robust, and to address perceived inconsistencies between IAS 27 (which focuses on control) and SIC-12 (which focuses on risks and rewards). Currently, difficulties can arise in practice in determining whether particular entities are within the scope of IAS 27 or SIC-12, resulting in inconsistencies in the application of the consolidation guidance and potential for arbitrage between the two consolidation models. ED 10 sets out to eliminate these perceived inconsistencies.

While in the majority of 'straightforward' circumstances, the assessment as to whether or not an entity should be consolidated would not be different under the proposals as compared to the current guidance, situations more likely to be affected include:

- special purpose entities (or 'structured entities' as defined in the ED);
- where control is being assessed in the absence of majority voting rights; and
- where control is being assessed having regard to potential voting rights.

The project has not addressed detailed consolidation procedures or the accounting treatment for changes in ownership interests and, consequently, much of the detailed text of IAS 27 (as revised in 2008) would be carried forward to the new Standard word-for-word. Neither are any changes proposed regarding which entities are required to prepare consolidated financial statements.

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Once the requirements regarding consolidation are removed to the new Standard, IAS 27 would be renamed and restructured to deal only with separate financial statements (with no changes proposed for the requirements in this regard).

Revised definition of control

Under the proposals, control would be defined as follows.

A reporting entity controls another entity when the reporting entity has the **power to direct the activities** of that other entity to generate **returns** for the reporting entity. [ED 10.4, emphasis added].

The key elements of this definition, which are discussed in turn below, are (a) the power to direct the activities of the other entity, and (b) the right to obtain returns. When assessing control, a reporting entity would be required to consider power and returns together and how the reporting entity can use its power to affect the returns. The assessment of control would be carried out on a continuous basis.

Power to direct the activities

The 'power to direct the activities' of another entity is intended to be a wider concept than IAS 27's reference to the 'power to govern the financial and operating policies' of another entity. The Basis for Conclusions for ED 10 states that the power to govern the strategic operating and financing policies of an entity is only one way in which power to direct its activities can be achieved. Other means of achieving such power include having voting rights, having options or convertible instruments, by means of contractual arrangements, or a combination of these.

Such power could be achieved through the reporting entity's involvement in establishing the activities of the other entity, or through the ongoing decision-making that affects the activities of the other entity. For example, where the activities or transactions in which an entity may participate are restricted by its constitution, the entity may have no need for a governing board or other corporate governance structure to direct its activities because it is unlikely that strategic operating and financing policy decisions would need to be made on an ongoing basis. However, control over the entity could have been achieved by participation in its establishment.

Having the 'power' to direct the activities of another entity does not mean that the reporting entity must actively use that power. Therefore, the definition of control is focused more on the ability to exercise control than on the actual exercise of that control. For example, a passive shareholder holding majority voting rights that does not regularly use its voting powers would be considered to control the investee by virtue of its power to choose at any time to direct the activities of the investee by exercising its voting rights.

This is one of the most crucial aspects of the revised definition and is one that is likely to give rise to extensive debate. Critics consider that the Board is not consistent in its application of this principle – that the ED sometimes requires a demonstration of the ability to direct activities (e.g. in the case of options or convertible instruments – see below) whereas in other circumstances it does not require any demonstration of power (e.g. in the circumstances described in the previous paragraph).

'Returns'

The proposed revised definition refers to the generation of 'returns' for the reporting entity (rather than the reporting entity obtaining 'benefits' as under the current IAS 27 definition). This is a very deliberate change in terminology so as to clarify that the term is intended to encompass both positive and negative returns for the parent (the term 'benefits' used in the current Standard is sometimes interpreted to encompass only positive returns). The ED envisages that such returns are not limited to quantifiable returns; they can accrue to the reporting entity in various forms, including dividends, fees, know-how, cost savings, synergies etc.

When assessing control, a reporting entity would be required to consider power and returns together and how the reporting entity can use its power to affect the returns.

‘Control’ is not shared

The expanded application guidance to support the revised definition clarifies that ‘control’ is not shared – only one party can control an entity within the meaning of the proposed Standard, albeit that other entities may have rights to protect their interests.

The ED retains the presumption that holding more than half of the voting rights in another entity results in the power to direct its activities, and includes significant additional guidance regarding situations where the reporting entity holds less than a majority of the voting rights and where structured entities are involved.

Holding less than a majority of the voting rights

Under the proposals, a reporting entity could have the power to direct the activities of another entity (despite holding less than half of the voting rights in that other entity) in circumstances where the reporting entity nevertheless has more voting rights than any other party and those voting rights are sufficient to give it the ability to determine the other entity’s strategic operating and financing policies.

By way of example, the ED refers to circumstances where the reporting entity is a dominant shareholder

that holds less than a majority of the voting rights and all the other shareholders are widely dispersed and are not organised in such a way that they actively co-operate when they exercise their votes. This guidance addresses the concept of ‘de facto’ control, which has led to controversy under IAS 27.

The ED notes that a reporting entity could also have the power to direct the activities of another entity by means of other arrangements, which are considered in detail in the proposed application guidance to be issued with the revised Standard. ED 10 Appendix B9 includes the list of indicators set out below to consider in situations where an entity holds less than the (absolute) majority of voting rights.

Under the proposals, a reporting entity could have the power to direct the activities of another entity despite holding less than half of the voting rights.

Indicators of control in the absence of majority voting rights

- 1) The reporting entity can dominate the governing body, and therefore determine the strategic operating and financing policies. Examples of indicators are:
 - a) dominating the process of electing members of the entity’s governing body or obtaining proxies from other holders of voting interests; and
 - b) appointing members to fill vacancies on the entity’s governing body until the next election.
- 2) The reporting entity can appoint, hire, reassign or dismiss the entity’s key management personnel.
- 3) The reporting entity shares resources with the entity. For example, the entity and the reporting entity might have the same members of their governing bodies, or share key management personnel or other staff.
- 4) The reporting entity has the ability to direct the entity to enter into significant transactions that benefit the reporting entity.
- 5) The reporting entity has access to the residual assets of the entity, such as:
 - a) by dissolving the entity and redirecting the use of its assets; or
 - b) having access, under a statute or an agreement, to the entity’s resources.

Options and convertible instruments

Regarding potential voting rights, IAS 27 focuses on rights that are currently exercisable. The Standard requires that, if the options or convertible instruments that give rise to the potential voting rights are currently exercisable, the potential voting rights should generally be treated as if they are current voting rights for the purposes of assessing control.

ED 10 proposes a more general requirement that a reporting entity should consider whether the power to obtain voting rights achieved through holding options or convertible instruments, taken in conjunction with other relevant facts and circumstances, gives it the power to direct the activities of another entity. It would not be necessary for such instruments to be currently exercisable for them to have an impact on the assessment of control. Nor would all currently exercisable instruments automatically affect the assessment of control.

It would not be necessary for options or convertible instruments to be currently exercisable for them to have an impact on the assessment of control.

Structured entities

Structured entities are considered separately from 'normal' consolidation situations in ED 10. The Board sees 'structured entities' as being similar to special purpose entities, which currently fall within the scope of SIC-12. Although the intention is to develop a single accounting model for consolidation and, therefore, the ability to control would be assessed for structured entities in the same manner as for other entities, the Board considers that additional application guidance is needed related to the assessment for structured entities.

Whether or not an entity that is controlled by the reporting entity meets the definition of a 'structured entity' (see below) would not affect its accounting treatment under the proposals. However, it is important from a disclosure perspective where it is determined that an entity is a 'structured entity' but that it is not controlled by the reporting entity because additional disclosure requirements would apply (see next page).

ED 10 proposes to define a structured entity as "an entity whose activities are restricted to the extent that those activities are not directed as described in paragraphs 23-29 [of the Standard]". The paragraphs referred to deal with the general requirements regarding the assessment of an entity's power to direct the activities of another entity. Therefore, a structured entity is defined as one for which control cannot be assessed in a typical manner, such as by assessing voting rights or control of the entity's governing body.

The ED provides additional factors to consider when assessing whether control exists over such structured entities. It emphasises that the arrangements for the sharing of returns and how any decisions are made about the activities of the structured entity are key features to be analysed. The ED would require that all fact and circumstances be considered in assessing the existence of control and suggests for consideration the (non-exhaustive) list of factors set out on the next page.

Factors to consider in the analysis of control of structured entities (list not exhaustive)

- 1) The purpose and design of the structured entity.
- 2) The reporting entity's returns from its involvement with the structured entity (generally, the more a reporting entity is exposed to variability of return the more likely it is that it has power).
- 3) The activities of the structured entity, including the extent to which the strategic operating and financing policies that direct those activities have been predetermined (usually, such activities are limited and pre-determined).
- 4) Related arrangements.
- 5) The reporting entity's ability to change the restrictions or predetermined strategic operating and financing policies.
- 6) Whether the reporting entity acts as an agent for other parties, or another party acts as its agent.

Agency relationships

ED 10 provides additional guidance for assessing control in agency situations. An agent acts on behalf of another party (the 'principal'). While an agent might have power to direct the activities of an entity, it has to act in the best interest of the principal. Therefore, if a reporting entity solely acts as an agent, it cannot have control because its power over an entity does not enable it to benefit from the returns of that entity.

Agents can receive a fixed fee from the principal for providing services to it. However, if the remuneration for the agent is performance-related, it can be difficult to distinguish an agency from a control relationship. In such circumstances, an entity would have to decide whether the variability of return is comparable to that of an investor.

Disclosures

ED 10 proposes a series of new disclosure objectives, designed to enable users of the reporting entity's financial statements to evaluate:

- 1) the basis of control and the related accounting consequences;
- 2) the interest that the non-controlling interests have in the group's activities;
- 3) the nature and financial effect of restrictions that are a consequence of assets and liabilities being held by subsidiaries; and
- 4) the nature of, and risks associated with, the reporting entity's involvement with structured entities that the reporting entity does **not** control.

To meet these objectives, detailed disclosure requirements are set out in paragraphs B30-B47 of the Application Guidance. The ED also contains a 'catch-all' clause such that, if the specific disclosures set out in the Application Guidance do not meet the objectives set out above, a reporting entity would be required to disclose whatever additional information is necessary to meet those objectives.

The proposed disclosures are extensive and run to almost six pages in the ED. They could prove quite burdensome, particularly in respect of structured entities that the reporting entity determines that it does not control (see 4 above) and for which it might not have access to detailed information.

Convergence with US GAAP

ED 10 is not part of a joint project with the US Financial Accounting Standards Board (FASB). However, the FASB is currently reviewing its consolidation standard for variable interest entities under Interpretation 46(R). The FASB has issued a proposal to require that, in the consideration as to whether control is exercised over such an entity, control be assessed qualitatively as well as quantitatively. Although the overall approach is generally consistent with ED 10, there are some differences. For example, ED 10 would apply to all entities as opposed to only variable interest entities under Interpretation 46(R).

Effective date and transition

The effective date of the final Standard will be set when it is approved by the Board. As discussed on the front page of this newsletter, it is not expected to be effective before 2011 accounting periods.

The Board has acknowledged that retrospective application of the Standard could give rise to significant costs and difficulties.

It is therefore proposed that:

- when application of the requirements of the Standard for the first time results in a reporting entity consolidating an entity that was not previously consolidated, the requirements of IFRS 3 *Business Combinations* would be applied, with the deemed acquisition date being the date of first applying the new Standard (unless the acquisition date as defined in IFRS 3 is after the date of first applying the new Standard); and
- when application of the requirements of the Standard for the first time results in a reporting entity no longer consolidating an entity that was previously consolidated, the date of first applying the new Standard would be treated as the date on which the reporting entity loses control of that entity (unless the date of losing control is after the date of first applying the new Standard).

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