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IN THE HEADLINES
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Consolidation: a new single control model

IFRS 10 *Consolidated Financial Statements* introduces a new approach to determining which investees should be consolidated. It was issued by the IASB[1] on 12 May 2011 as part of its new suite of consolidation and related standards, also replacing existing requirements for joint ventures (now joint arrangements) and making limited amendments in relation to associates. Here we focus on IFRS 10.

IFRS 10 provides a single model to be applied in the control analysis for all investees:

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.

Highlights

- Single control model introduced to assess whether to consolidate an investee
- Substantive potential voting rights held by the investor and other parties taken into account when assessing control
- *De facto* control explicitly included in new control model
- Agent vs principal concept explicitly introduced
- New requirements effective in annual periods beginning on or after 1 January 2013

Our forthcoming publication *First Impressions: IFRS 10 Consolidated Financial Statements* will provide more details about the requirements and discuss some of the potential application issues. Speak to your usual KPMG contact if you would like copies.

How this new single control model could affect you

The main changes from IAS 27 and SIC-12, and the related potential impacts, are summarised below.

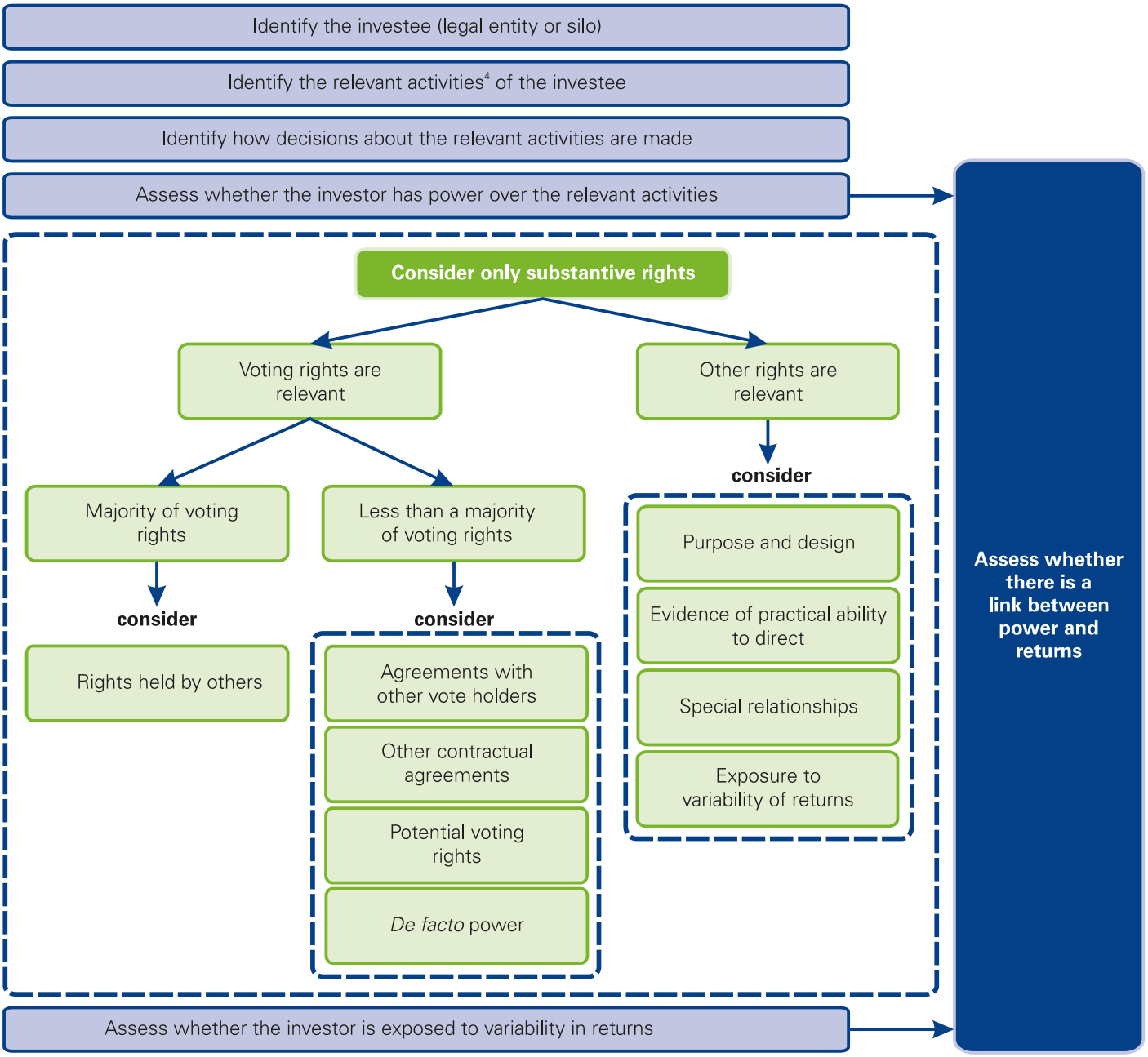
Key changes	Potential impacts
Judgemental approach	The approach comprises a series of indicators of control, but no hierarchy is provided: preparers are required to analyse all facts and circumstances and apply their judgement in making the control assessment. For example, the standard emphasises the need to understand the design and purpose of an investee and stresses the need to take into account evidence of power, which are likely to be highly judgemental areas. Therefore, IFRS 10 is likely to be a difficult standard to apply across many sectors and first-time implementation efforts may be significant (staff training, impact assessment, policy development etc).
Single control model applies to all investees	The control conclusion could change for SPEs[2] currently in the scope of SIC-12. As a result, entities in the financial services and real estate sectors could be impacted. The change in the control model also could affect groups with investments in concession vehicles in the infrastructure sector.
Identification of investee activities explicitly required	The control conclusion could change in respect of investees in which several investors each have the ability to direct different activities.
***De facto* control included in the model**	More investees could be consolidated if an entity currently assesses the ability to control on a legal or contractual basis under IAS 27, which is, in our experience, the more common application of the standard. Beyond this, there will be other practical consequences for preparers. For instance, the assessment of *de facto* control requires knowledge about the investor's substantive rights and also insight into other shareholders. In practice, it may be challenging for an entity to gather this information, especially at the point at which the dominant shareholding position is established. As a consequence, at the date the investor acquires a dominant (but not a majority) interest in an investee, it may conclude that it does not have *de facto* control over the investee, and might eventually do acquisition-like accounting twice: for the first time, when it acquires significant influence through the dominant but non-controlling interest in order to equity-account for the investment; and again when it concludes that it has *de facto* control.
Control assessment based on substantive potential voting rights as opposed to currently exercisable potential voting rights	This is likely to change the control conclusion in some cases: currently exercisable potential voting rights might not be considered substantive and *vice versa*. Determining whether rights are substantive under IFRS 10 will require more judgement than determining whether they are currently exercisable under IAS 27. Also, it appears that the intent of the party writing or purchasing the potential voting right would be taken into account in the analysis. Management will need to monitor potential voting rights to determine whether they are substantive, which could include the need to assess the investor's practical ability to exercise those rights, for example.
Exposure or right to variability in returns replaces concept of benefits	Variability in returns is a much broader concept than ownership-type benefits and is not solely a risks and rewards analysis. As a result it may impact the control conclusion, particularly when benefits under IAS 27 were interpreted as ownership-type benefits and those benefits were widely dispersed.

Key changes	Potential impacts
Agent vs principal guidance explicitly introduced	A number of indicators are provided to analyse whether a decision maker is acting as agent or principal when directing the activities of an investee. While all facts and circumstances require consideration, some entities may find it difficult to assess whether their remuneration is commensurate with that of other service providers or whether the removal rights held by other parties are substantive. Entities in the funds sector, as well as asset managers, are likely to be particularly impacted by this guidance.
Guidance provided on when an investor would assess power over silos instead of over a legal entity	Such explicit guidance does not exist in IAS 27 or SIC-12, which is likely to change the control conclusion over a silo[3] and the entity in which a silo is housed in some cases. Entities in the financial services and potentially the real estate sectors could be particularly impacted by this change.
***Protective rights* are defined and explicit guidance on *kick-out rights* is introduced**	Guidance is provided on the rights of other parties; such guidance does not exist in IAS 27. In our experience, preparers of IFRS financial statements generally use the guidance on participating rights and protective rights in US GAAP. However, the definition of protective rights in US GAAP is different from IFRS 10. As a consequence, the analysis could differ from current practice. Entities in the funds and real estate sectors could be particularly impacted by this guidance.

The new single control model at a glance

IFRS 10 supersedes IAS 27 *Consolidated and Separate Financial Statements* and SIC-12 *Consolidation – Special Purpose Entities* and provides a single model to be applied in the control analysis for all investees, including entities that currently are SPEs in the scope of SIC-12.

The diagram below presents the logical flow that an investor will follow to assess whether it controls an investee. However, IFRS 10 does not prescribe any order to be followed for the analysis and does not require an investor to go through all of the steps presented in the diagram.



Control is assessed on a continuous basis, i.e. it is reassessed as facts and circumstances change. A change in market conditions does not trigger a reassessment of the control conclusion unless it changes one or more of the elements of control, e.g. whether potential voting rights are substantive.

The investor determines whether other parties that have an interest in the investee are acting on behalf of the investor. When this is the case, the investor considers the decision-making rights held by these parties together with its own to assess whether it controls the investee.

Some of the steps presented in the diagram require more detailed information.

Consider only substantive rights

Only substantive rights held by the investor and others are considered. To be substantive, rights need to be exercisable when decisions about the relevant activities need to be made, and their holder needs to have a practical ability to exercise the rights.

Protective rights are related to fundamental changes in the activities of an investee or apply only in exceptional circumstances. They cannot give their holder power or prevent others from having power.

Identify *de facto* power

The investor *de facto* has power over the investee when its rights are sufficient to give it power as it has the practical ability to direct the relevant activities unilaterally. Assessing whether an investor *de facto* has power over an investee is a two-step process:

- In the first step, the investor considers all facts and circumstances including the size of its holding of voting rights relative to the size and dispersion of the holdings of other vote holders. As a result, if the investor holds significantly more rights than any other vote holder and the other shareholdings are widely dispersed, the investor may have sufficient information to conclude that it has power over the investee. In other cases, it may be clear that the investor does not control the investee. If the first step is not conclusive, then additional facts and circumstances are analysed in a second step.
- In the second step, the investor considers whether the other shareholders are passive in nature as demonstrated by voting patterns at previous shareholders' meetings. The investor also considers the factors normally used to assess power when the investee is controlled by rights other than voting rights. If, after this second step, the conclusion is not clear, then the investor does not control the investee.

Assess exposure to variability in returns

Returns are defined broadly and include distributions of economic benefits and changes in the value of the investment, as well as fees, remunerations, tax benefits, economies of scale, cost savings and other synergies.

Assess the link between power and returns

In order to have control, an investor needs to have the ability to use its power over the investee to affect returns for the investor's own benefit, i.e. there needs to be a link between power and returns.

An investor that has decision-making power over an investee determines whether it acts as an agent or as a principal when assessing whether it controls an investee. If the decision maker is an agent, then the link between power and returns is absent and the decision maker's delegated power is deemed to be held by its principal(s).

To determine whether it is an agent, the decision maker considers:

(1) whether a single party holds substantive rights to remove the decision maker without cause; if this is the case, then the decision maker is an agent;

(2) whether its remuneration is on arm's length terms; if this is not the case, then the decision maker is a principal; and

(3) the overall relationship between itself and other parties through a series of factors if neither (1) nor (2) is conclusive. These factors include:

- the scope of its decision-making authority over the investee;
- substantive rights held by other parties;
- the decision maker's remuneration (level of linkage with the investee's performance); and
- its exposure to variability of returns because of other interests that it holds in the investee.

Different weightings are applied to each of the factors depending on particular facts and circumstances. The last two factors, i.e. remuneration and other interests held, are sometimes considered in aggregate in IFRS 10 and referred to as the decision maker's *economic interests*. The greater the magnitude of and variability associated with its economic interests, the more likely that the decision maker is a principal.

Adoption in periods beginning on or after 1 January 2013

IFRS 10 is effective for annual periods beginning on or after 1 January 2013. Early adoption is permitted provided that the entire suite of consolidation standards is adopted at the same time. Entities are encouraged to provide information required by IFRS 12 before the effective date, and this early disclosure would not compel the entity to apply either IFRS 12 in its entirety or the other new standards.

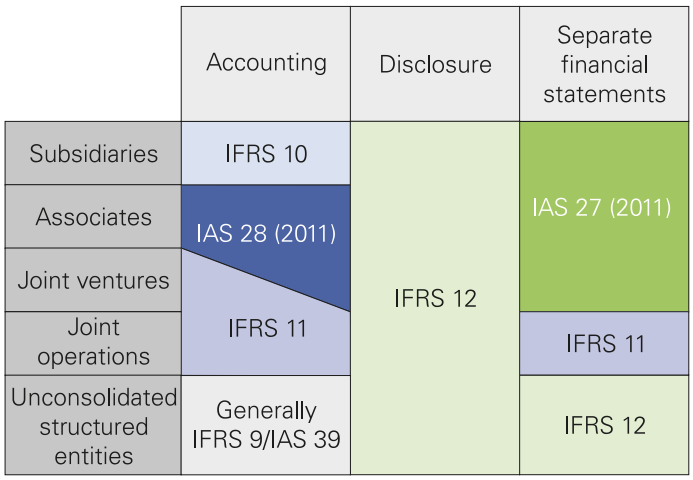
IFRS 10 is applied retrospectively when there is a change in the control conclusion between IAS 27/SIC-12 and IFRS 10. There are specific requirements when retrospective application is impracticable.

Summary of changes from the staff draft

IFRS 10 is largely consistent with the staff draft that was posted to the IASB website on 29 September 2010. Our Briefing Sheet 214 (October 2010) summarised the requirements of the staff draft and the key changes from IAS 27 (2008) and SIC-12. If you are interested in an overview of the changes between the staff draft and IFRS 10, then click here to download it from our website.

The new suite of consolidation standards

The diagram below shows the five new or amended standards issued and their respective scopes.



Our publication *In the Headlines: No more proportionate consolidation for joint ventures* provides an overview of IFRS 11 *Joint Arrangements* and IAS 28 (2011) *Associates and Joint Ventures*; and our publication *In the Headlines: Extensive disclosures about interests in other entities* provides an overview of IFRS 12. Overall, IAS 27 (2011) *Separate Financial Statements* carries forward the existing accounting and disclosure requirements for separate financial statements, with some minor clarifications.

As part of the consolidation project the IASB also intends to issue, during the second quarter of 2011, an exposure draft proposing changes related to the consolidation of investees by investment companies.

Abbreviations and definitions

1 IASB: International Accounting Standards Board

2 SPE: special purpose entity

3 Silo: portion of an entity that is treated as a deemed separate entity. The assets, liabilities and equity of the silo are ring-fenced from the overall entity

4 Relevant activities: activities of the investee that significantly affect the investee's returns

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