

New consolidation standard – lessons learned from the first year of application

We have just completed the first year of applying the new standard, IFRS 10 – *Consolidated Financial Statements*, and what has become evident is that applying the new guidance to assess control is not always an easy task.

Why the need for a new standard to assess control?

The global financial crisis highlighted the lack of transparency around off-balance sheet structures and the request for enhanced disclosures. This well-known event accelerated the IASB's consolidation project that was already underway.

The IASB's consolidation project was initiated as a result of the perceived inconsistency between IAS 27 – *Consolidated and Separate Financial Statements*, which used control as a basis for consolidation, and SIC 12 – *Consolidation – Special Purpose Entities*, which focused on risks and rewards as a basis for consolidation. The focus on risks and rewards in SIC 12 resulted in “bright lines” being applied that lead to structuring opportunities for entities that wished to achieve a particular accounting outcome.

The previous standards also resulted in divergence in practice due to the inconsistent application of assessing control in a number of areas, for example, control with less than a majority of the voting rights (“de facto” control), how to assess the effect of protective rights, assessment of agency relationships, etc. These inconsistencies resulted largely from the lack of guidance in the previous standards.

Convergence with US GAAP was also a consideration of the project.

The outcome of the IASB's project is IFRS 10 and IFRS 12 – *Disclosure of interests in other entities*.

IFRS 10 requirements

The standard provides a new definition of control that applies to all types of entities. The revised definition of control focuses on the need to have both power and variable returns before control is present. Power is the current ability to direct the activities that significantly influence returns. Returns must vary and can be positive, negative or both.

Under the new definition, entities need to assess whether it has **all** of the following:

- Power over an investee
- Exposure, or rights, to variable returns from an investee, and
- The ability to use its power to affect the reporting entity's return.

Application challenges

On initial reading, the new definition seems straight-forward. However, the first year of application highlighted a number of areas where the standard has proven to be challenging to apply and for some entities has resulted in some surprising outcomes.

Power over an investee

The first challenging area encountered relates to assessing power and the identification of the relevant activities of the investee, i.e. those activities that most significantly affect the returns from the investee. When a reporting entity assesses whether it has control over an investee one of the factors it must consider is whether it has the power to direct the relevant activities of that investee. For entities governed by voting rights, relevant activities have a similar meaning as financial and operating policies. It is also relatively simple to identify the relevant activities in such entities.

However, complexities arise in the assessment of power over structured entities that previously were considered to be “autopilot” SPEs, for example securitization structures, asset backed financing, employee share incentive trusts, community trusts and BEE vehicles. It became evident that for these types of structures assessing who has power becomes quite challenging. In some instances the power element lies outside the governing structure of the entity itself, for example, in most employee share incentive trusts, the sponsor’s remuneration committee will decide which employees will benefit from the shares held in the share incentive trust and how the benefits will be earned. IFRS 10 does make provision for such decisions to be made outside the structure. In this case the decisions made by the board of trustees of the trust is considered to relate merely to administrative matters and do not relate to the relevant activities of the trust. Similarly, for some structures, management of the credit risk of the structure due to the funding arrangements in place would be considered to be the relevant activity that most significantly affects returns of the structure.

It therefore becomes important to firstly understand the purpose and design of any investee, especially structured type entities where voting rights are not the dominant factor in assessing power. This first step is essential to ensure that the relevant activities of the investee are correctly identified and it is understood how and where decisions about those relevant activities are made.

The standard provides a range of indicators to assess control in circumstances where the assessment is not a straight-forward majority of voting rights scenario and refers to instances where the reporting entity has the practical ability to direct the relevant activities unilaterally, without having the contractual right to do so. The standard further refers to indicators where a special relationship exists between the investee and the reporting entity that suggest that the reporting entity has more than a passive interest in the investee.

What makes the guidance difficult to apply is that meeting a single indicator does not necessarily mean that the power criterion is met. The question then becomes when considering all of the factors together, when is the threshold of having sufficient power met? And further, how do you assess power where the structure is merely an extension of the reporting entity? The standard eludes to “de facto”relationships, where individuals or entities effectively act on behalf of another but has no specific guidance on when the investee is set up and is acting solely on behalf the reporting entity.

To make it even more complex, some structures have instruments such as call options and put options in place which also need to be taken into account in the power assessment. These

instruments held by the reporting entity may indicate that there is again more than a passive interest in the investee.

Exposure, or rights, to variable returns from an investee

Another complex area encountered in applying the standard relates to the assessment of exposure to variable returns and how to assess the variability of these returns. In order for a reporting entity to have exposure to variable returns under IFRS 10, the reporting entity needs to absorb variability from the investee, rather than contributing variability to the investee. For example, if the reporting entity borrows money from the investee at a plain vanilla interest rate, the reporting entity is contributing to the variability of the investee in the form of its own credit risk and accordingly is not exposed to variable returns from the investee.

In addition, a reporting entity could for example be exposed to the returns indirectly from its involvement with an investee. An example is returns that are not available to other interest holders, for instance if the reporting entity benefits from a positive image through its involvement in the set-up of a community trust which is named after the reporting entity and whose objective is to give donations as stipulated in the trust deed and to continuously support this vehicle to ensure it operates as intended.

In assessing variability of returns, the substance of the arrangement should be considered, irrespective of the legal form. For example fixed interest on a loan, still exposes the reporting entity to variable returns due to the exposure of the reporting entity to credit risk, i.e. the risk that the investee will default on payments in terms of the loan.

In addition, variable returns would include non-financial returns, for example BEE credentials earned from a BEE vehicle, reputational risk arising from a community trust sponsored by the reporting entity and BEE credentials earned from such structures. It is not always clear how to assess the non-financial returns and when the exposure to non-financial returns are considered to be sufficient to conclude that the reporting entity has control over the investee. Many argue that such returns should not be considered as they are not as a result of the performance of the investee. But reading IFRS 10 the IASB made it clear that the intention in considering variable returns was meant to be a wide concept. This is all good and well but how do you assess these non-financial returns? Again the purpose and design is key in the assessment in this regard.

Has the application of the standard resulted in more change than expected?

The initial indications were that the new definition of control and application guidance in the new standard was not expected to result in widespread change in the consolidation decisions made by IFRS reporting entities. This is because IFRS 10 was built on concepts and principles that existed in the previous standards. The most significant change was expected to be in the financial services industry, especially entities with fund management activities.

Our experience this far shows that as expected, companies that are most affected by the new standard are the banking and insurance groups. This is mainly due to the new guidance provided to assess agency relationships, i.e. understanding when a fund manager with decision-making rights is primarily engaged to act on behalf and for the benefit of the investors and therefore does not control

the fund when it exercises its decision-making authority. Another area where changes have been identified is the treatment of cell captive arrangements, due to the new guidance on assessing control over specified assets and whether a deemed separate entity exists.

As for the rest, it would seem as if the adoption of the new standard did not result in significant changes in their reported results. However, additional disclosures are seen in most financial statements, due to the new IFRS 12 disclosure requirements.

What has become evident is that the process that has to be followed by any reporting entity to understand if they have control or not of every investment or structured entity they have set up, is quite extensive. All reporting entities have to understand and consider the new guidance and apply it to their specific circumstances. Reporting entities have to relook at their internal legal documents, for example contracts of purchase, management agreements, trust deeds, shareholder agreements, Memorandum of Incorporations (MOIs), etc. to ensure that the legal documents correctly reflect the reality of how the relevant activities of the investee is managed and how they have been accounted for previously versus how they should account for them now.

In conclusion

As is the case with principles based standards, applying the new guidance requires judgment to be applied. Reporting entities should ensure that the significant judgments applied in assessing control is appropriately communicated to the governing structure within the group, and also to the users of its financial statements by including appropriate disclosures in its financial statements as required by IFRS 12.

The practical application complexities mentioned above have the potential to again result in inconsistent application of the standard. However, it is our understanding that the IASB did not want to create rules to assess control. The intention of the guidance provided is to result in more appropriate consolidation that will better reflect the economic substance of the relationship between a reporting entity and an investee.

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