



IFRS IN PRACTICE

IFRS 10 Consolidated Financial Statements

2022/2023

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1. Introduction

In May 2011 the International Accounting Standards Board (IASB) published a package of five standards (consolidation package) which set out the requirements for consolidation, joint arrangements and disclosure of interests in other entities.

The standards are:

- IFRS 10 *Consolidated Financial Statements*
- IFRS 11 *Joint Arrangements*
- IFRS 12 *Disclosure of Interests in Other Entities*.

In addition, the following standards were revised and renamed:

- IAS 27 *Separate Financial Statements*
- IAS 28 *Investments in Associates and Joint Ventures*.

IFRS 10 applies to all entities that control one or more entities. However, there is an exception to consolidating particular subsidiaries of an investment entity, which is covered in section 4 of this publication.

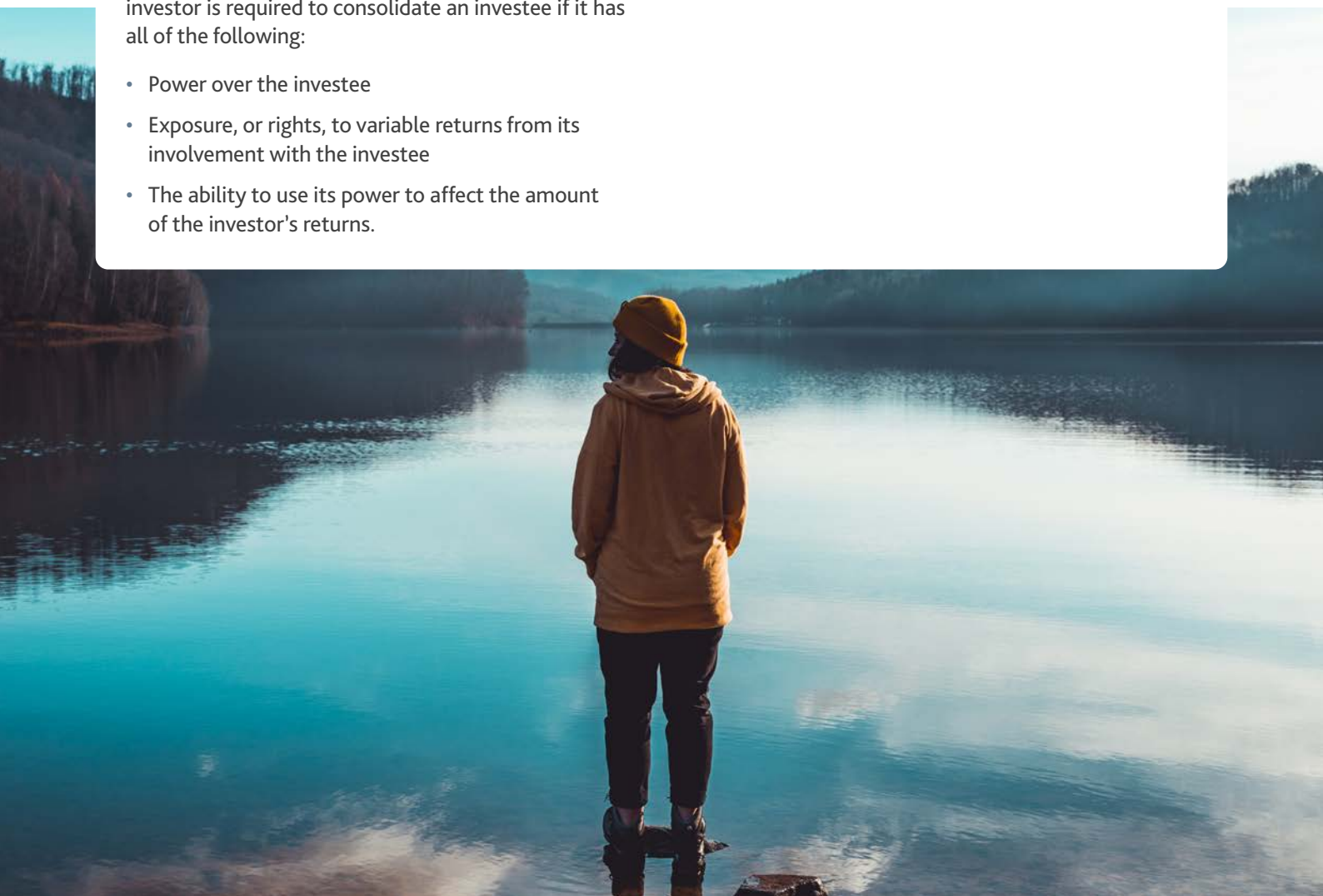
IFRS 10 contains a single control model whereby an investor is required to consolidate an investee if it has all of the following:

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

This publication also includes a section on disclosures that are to be made in consolidated financial statements as required by IFRS 12. The main purpose of these disclosures is to provide information that helps users of a reporting entity's financial statements understand the nature of, and risks associated with, its interests in other entities and the effects of those interests on the reporting entity's financial position, financial performance and cash flows. IFRS 12 in addition requires additional disclosures for structured entities regardless of whether an investor is required or not required to consolidate a structured entity.

1.1. Effective Date

IFRS 10 together with the other standards in the 'consolidation package' was effective for annual periods beginning on or after 1 January 2013. The consolidation package was endorsed for use in the EU at the end of 2012 with an effective date of 1 January 2014.



1.2. Amendments

Since the issuance of IFRS 10 in May 2011, five amendments to the standard have been made. All of these examples have been endorsed by the European Union, except the September 2014 amendments. As the mandatory effective date of the September 2014 amendments has been deferred by the IASB, the amendments are not mandatory for any entity applying IFRS. An entity applying IFRS as issued by the IASB may choose to adopt these standards, since despite the amendments not being mandatorily effective, they may be adopted on an elective basis.

In June 2012, the IASB issued amendments to IFRS 10, IFRS 11, and IFRS 12 to clarify the transition guidance in IFRS 10. The amendments also provide additional transition relief in IFRS 10, IFRS 11 and IFRS 12 limiting the requirement to provide adjusted comparative information to only the preceding comparative period. Furthermore, for disclosures related to unconsolidated structured entities, the amendments remove the requirement to present comparative information for periods before IFRS 12 is first applied. These amendments were effective for annual periods beginning on or after 1 January 2013.

In October 2012, the IASB issued amendments to IFRS 10, IFRS 12 and IAS 27 to introduce an exception for investment entities from the principle that all subsidiaries are consolidated. The amendments define an investment entity and require an investment entity to measure subsidiaries at fair value through profit or loss in accordance with [IFRS 9 Financial Instruments](#). The amendments also set out disclosure requirements for investment entities. The amendments were effective for annual periods beginning on or after 1 January 2014.

In September 2014, IASB issued amendments to IFRS 10 and IAS 28 which include requiring a full gain or loss to be recognised when a transaction between an investor and its associate or joint venture involves assets that constitute a business. The amendments also require that a partial gain or loss be recognised when

a transaction between an investor and its associate or joint venture involves assets that do not constitute a business. The amendments were effective for annual periods beginning on or after 1 January 2016.

In December 2014, the IASB issued amendments to IFRS 10, IFRS 12 and IAS 28 to address issues that have arisen in the context of applying the consolidation exception for investment entities.

The amendments were to be applied retrospectively and were effective for annual periods beginning on or after 1 January 2016.

In December 2015, the IASB issued amendments to IFRS 10 and IAS 28 to defer the effective date of the September 2014 amendments to IFRS 10 and IAS 28 indefinitely until the research project on the equity method has been concluded. Accordingly, the amendments to IFRS 10 and IAS 28 have been returned to the 'IFRSs issued but not yet effective' section.

In June 2022, as an update to the post implementation review (PIR) of IFRS 10, 11 and 12 conducted by the IASB from 2019 to 2022, the IASB concluded that the requirements set out in the Standards are working as intended and meeting their objectives. The assessment, which included seeking feedback from various stakeholders, identified the following low priority topics, which the IASB has stated will be considered for the next agenda consultation if they are considered to be a high priority at that time:

- Subsidiaries that are investment entities;
- Transactions that change the relationship between an investor and an investee;
- Transactions that involve 'corporate wrappers';
- Collaborative arrangements outside the scope of IFRS 11; and
- Additional disclosures about interests in other entities.



2. Scope

2.1. General

IFRS 10 requires a parent entity to present consolidated financial statements.

A parent is defined in IFRS 10. Appendix A as 'An entity that controls one or more entities'.

Consolidated financial statements are defined as 'the financial statements of a group, in which the assets, liabilities, equity, income, expenses and cash flows of the parent and its subsidiaries are presented as those of a single economic entity'.

2.2. Exemptions

A parent is not required to prepare consolidated financial statements if it meets all of the following conditions (IFRS 10.4):

- It is a wholly owned subsidiary or is a partially owned subsidiary of another entity and all of its owners, including those not otherwise entitled to vote, have been informed about, and do not object to, the parent not presenting consolidated financial statements
- Its debt or equity instruments are not traded in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local and regional markets)

It did not file, nor is it in the process of filing, its financial statements with a securities commission or other regulatory organisation for the purpose of issuing any class of instruments in a public market

- Its ultimate or any intermediate parent produces financial statements that are available for public use and comply with IFRSs, in which subsidiaries are consolidated or are measured at fair value through profit or loss in accordance with this IFRS.

If an entity is considering making use of this exemption, care is required when determining whether the first condition has been met. It would appear that, provided all owners have been notified that it is proposed that consolidated financial statements are not prepared and no notice of objection has been received, an entity that complies with the other requirements could make use of the exemption. However, IFRS 10 sets no time limit for objections, meaning that a parent that prepares only separate financial statements could receive an objection at the time of approval of its financial

statements, or even afterwards. It would therefore appear advisable to obtain explicit consent, even though this is not a requirement of IFRS 10.

In addition, IFRS 10's requirement to consolidate all subsidiaries does not apply to:

- Post-employment benefit plans or other long-term benefit plans to which IAS 19 *Employee Benefits* applies; and
- A parent that is an investment entity if it is required to measure all of its subsidiaries at fair value through profit or loss (see section 4).

The exemption for employee benefit plans is restrictive, in that it applies only to those plans that fall within the scope of IAS 19. This means that, for example, employee share trusts and similar entities do fall within the scope of entities to be considered for consolidation in accordance with IFRS 10, as they fall within the scope of IFRS 2 *Share-based Payment* and not IAS 19.



BDO Comment

An entity may be a parent, and therefore be required to prepare consolidated financial statements (assuming the exemption criteria above are not satisfied), despite the entity only being a parent for a portion of a financial reporting period. For example, an entity has one subsidiary, which it disposes of during the reporting period. In our view, if the financial statements are prepared in accordance with IFRS as issued by the IASB, then the entity was a 'parent' during the reporting period, and therefore must consolidate the subsidiary up until it loses control of the subsidiary. For entities applying IFRS as endorsed by the European Union, this conclusion may differ because of the 4th and 7th EU Directives, since these are generally considered to apply the requirements at a point in time (i.e. is the entity a parent as at the reporting date, regardless of whether it was a parent during the financial reporting period).

3. Control

3.1. The single control model

3.1.1. Definition

IFRS 10 has a single control model for all entities. 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. (IFRS 10.6)'

Control is the sole basis for consolidation. The structure of the investee is not relevant. Consequently, the requirements of IFRS 10 apply to all investor/investee relationships, including 'structured entities' (sometimes referred to as special purpose entities).

3.1.2. Assessment of control

IFRS 10.7 notes that an investor controls an investee if it has all of the following:

- Power over the investee (whether or not that power is used in practice)
- Exposure, or rights, to variable returns from its involvement with the investee
- The ability to use its power to affect the amount of the investor's returns.

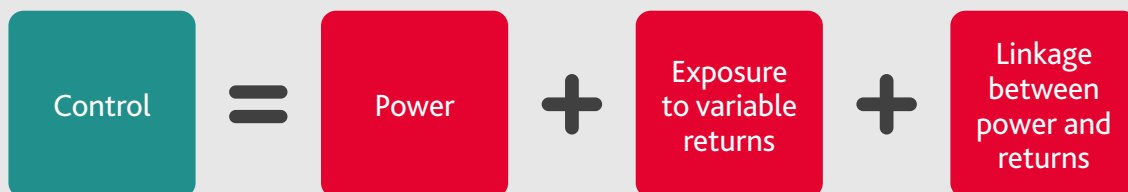
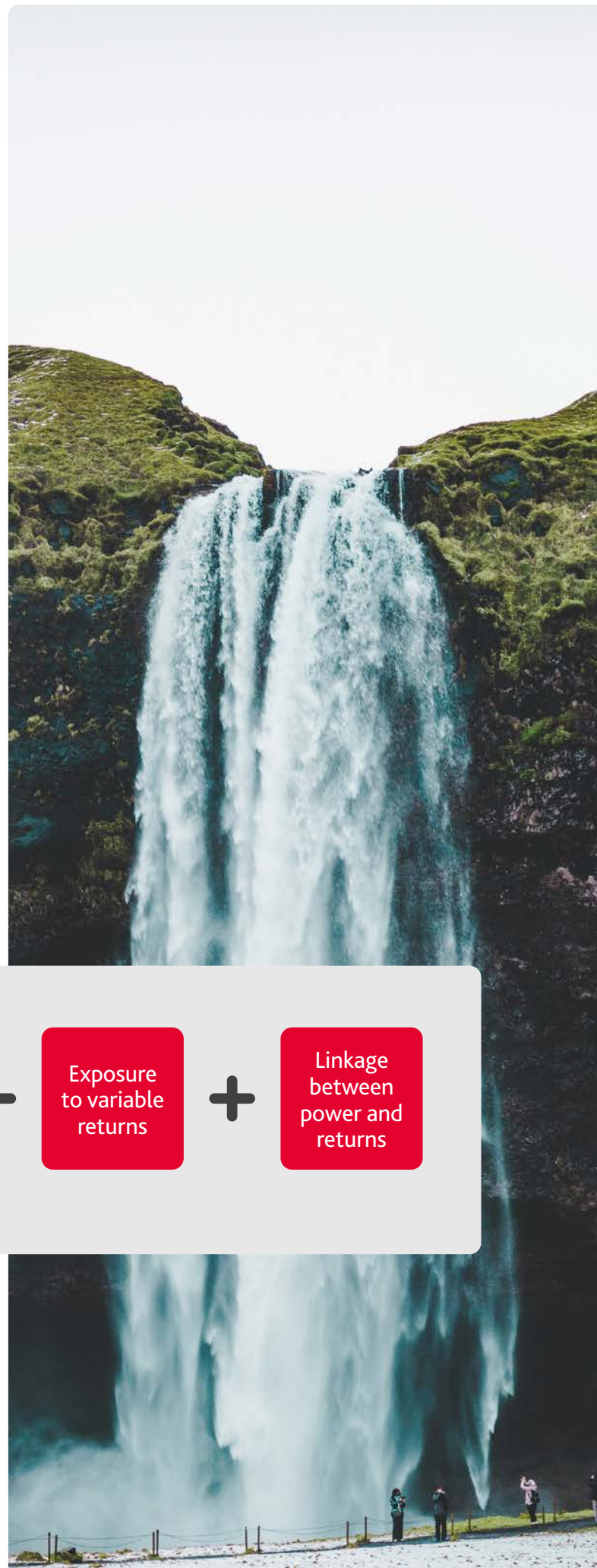


Figure 1: Assessment of control



An investor must satisfy all three of the criteria set out above. Under IFRS 10, even if an investor has substantial exposure to variable returns of another entity, this is not sufficient by itself to conclude that control exists. It is not necessary for an investor to be exposed to a majority of the benefits (or returns) of an investee in order for that investee to be accounted for as a subsidiary.

All facts and circumstances are required to be considered when an investor assesses whether it controls another entity. The following factors may assist in the determination (IFRS 10.B3):

- The purpose and design of the investee
- What the relevant activities are and how decisions about those activities are made
- Whether the rights of the investor give it the current ability to direct the relevant activities
- Whether the investor is exposed, or has rights, to variable returns from its involvement with the investee
- Whether the investor has the ability to use its power over the investee to affect the amount of the investor's returns.

In addition to focusing on an investor's exposure to variable returns, and its ability to affect those returns by exercising its power over the investee, IFRS 10 includes the concept of 'relevant activities' (see section 3.2). These are defined as:

'...activities of the investee that significantly affect the investee's returns.' (IFRS 10 Appendix A).

This is a concept that requires careful analysis. Although in some cases, relevant activities will be straightforward to identify and attribute, in others the approach will be more complex. In all cases, it will be necessary to analyse the activities of an investee in order to determine which of its activities most significantly affect its profit or loss, and link this to an analysis of whether the investor has control over those activities.

3.1.3. Purpose and design

In its assessment of whether it controls an investee, an investor is required to consider the purpose and design of the investee. This includes:

- Identification of the relevant activities
- How decisions about the relevant activities are made
- Who has the current ability to direct those activities
- Who receives returns from those activities.

It should be noted that 'current ability' refers to the ability to take decisions when they need to be made. This means that decisions over relevant activities extend to those which will or may require decisions in the future.

In many cases, investors own equity instruments in investees that give the holder proportionate voting rights and a proportionate share in the returns generated by the investee. In those circumstances, provided no additional contractual agreements about decision making are in place, the control assessment will be based around which investor is able to exercise sufficient voting rights to achieve control over the relevant activities. This will often be achieved through holding a majority of the voting rights.

3.1.4. Continuous assessment

IFRS 10 contains an explicit requirement for investor/investee relationships to be reassessed on a continuous basis to determine whether there has been a change in facts and circumstances. For example, after the onset of the global financial crisis, a number of special purpose entities that had not previously been consolidated were subsequently consolidated, due to obligations crystallising that had previously been considered to have a remote risk of arising in practice.

However, because certain parts of the analysis required by IFRS 10 can be highly judgemental, in particular when an investee is not wholly owned, the requirement for continuous reassessment can be complex.

IFRS 10 gives examples of when an investor would need to revisit its control assessment. These include:

- **Changes in Power** - An investor can gain power over an investee because decision-making rights held by another party or parties that previously prevented the investor from controlling an investee have lapsed (IFRS 10.B82)
- **Changes affecting exposure to variable returns** - For example, an investor that has power over an investee can lose control of an investee if the investor ceases to be entitled to receive returns or to be exposed to obligations (IFRS 10.B83)
- **Changes in the linkage between power and returns** - Changes in the relationship between the investor and other parties can mean that an investor no longer acts as an agent, even though it has previously acted as an agent, and vice versa (see section 3.5.1 for a discussion of principal/agent relationships). For example, if changes to the rights of the investor, or of other parties, occur, the investor is required to reconsider its status as a principal or an agent (IFRS 10.B84). The initial assessment of control or its status as a principal or an agent would however not change because of a change in market conditions (e.g. a change in the investee's returns driven by market conditions), unless the market changed one of the three criteria above or the overall relationship between the principal and the agent (IFRS 10.B85).



3.2. Relevant activities

3.2.1. Definition

Relevant activities are defined as:

'...activities of the investee that significantly affect the investee's returns' (IFRS 10 Appendix A).

The concept of relevant activities is a key part of the analysis required by IFRS 10. While in many cases these will be straightforward to identify, in others careful consideration will be required. This is particularly the case for structured entities, where the relevant activities only take place in specified circumstances (such as recovery action taken on the occurrence of default of specified debts).

3.2.2. Identification

In order to identify relevant activities, an investor considers the purpose and design of an investee. In other words, relevant activities depend on the business model of an investee and how revenue is generated. Investees will usually have a range of operating and financing activities that significantly affect their returns.

Examples of relevant activities and the ability to direct those activities are:

Relevant Activities (IFRS 10.B11)

- Selling and purchasing of goods or services
- Managing financial assets during their life (including upon default)
- Selecting, acquiring or disposing of assets
- Researching and developing new products or processes
- Determining a funding structure or obtaining funding.

Decisions about relevant activities (IFRS 10.B12)

- Establishing operating and capital decisions of the investee, including budgets
- Appointing and remunerating an investee's key management personnel or service providers and terminating their services or employment.

Example 1 shows an example of how control could be assessed.



Example 1 – Assessing control over relevant activities [IFRS 10.B13 Application Example 2]

An investment vehicle (the investee) is created and financed with a debt instrument held by an investor (the debt investor) and equity instruments held by a number of other investors.

The equity tranche is designed to absorb the first losses and to receive any residual return from the investee.

One of the equity investors who holds 30% of the equity is also the asset manager. The investee uses its proceeds to purchase a portfolio of financial assets, exposing the investee to the credit risk associated with the possible default of principal and interest payments of the assets.

The transaction is marketed to the debt investor as an investment with minimal exposure to the credit risk associated with the possible default of the assets in the portfolio because of the nature of these assets and because the equity tranche is designed to absorb the first losses of the investee.

The returns of the investee are significantly affected by the management of the investee's asset portfolio, which includes decisions about the selection, acquisition and disposal of the assets within portfolio guidelines and the management upon default of any portfolio assets. All those activities are managed by the asset manager until defaults reach a specified proportion of the portfolio value (ie when the value of the portfolio is such that the equity tranche of the investee has been consumed). From that time, a third-party trustee manages the assets according to the instructions of the debt investor.

Assessment

Managing the investee's asset portfolio is the relevant activity of the investee.

The asset manager has the ability to direct the relevant activities until defaulted assets reach the specified proportion of the portfolio value; the debt investor has the ability to direct the relevant activities when the value of defaulted assets surpasses that specified proportion of the portfolio value.

The asset manager and the debt investor each need to determine whether they are able to direct the activities that most significantly affect the investee's returns, including considering the purpose and design of the investee as well as each party's exposure to variability of returns.

On inception of the structure, it would be expected that the equity tranche would be significant, in order that the debt holder considered there to be little potential for the equity tranche to be insufficient to absorb anticipated losses. Consequently, the asset manager would consolidate the investee.

If more than one investor has power over relevant activities, the investor that directs the most significant activities will have power over an investee under IFRS 10. The significance of an activity is assessed with reference to its potential to affect returns.

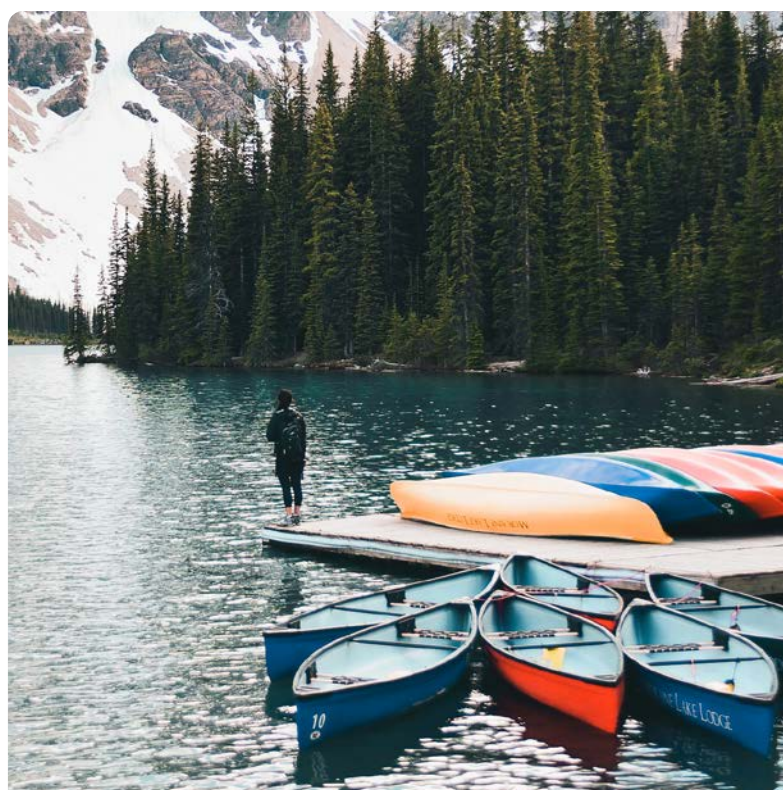


BDO Comment

For many investees this criterion will be straightforward to assess. For entities where the power over an investee's relevant activities is shared by multiple investors or that have predetermined activities the assessment may be highly judgmental.

IFRS 10.B13 includes an example with two investors, one responsible for development and regulatory approval of medical product and the other for manufacturing and marketing. The example only provides a list of factors that should be considered but does not conclude which of the investors has control.

In addition, care will be required in circumstances in which two or more investors appear to share control in determining whether one of the investors has control (and therefore applies IFRS 10) or the arrangement instead gives rise to joint control (and falls within the scope of IFRS 11).



3.2.3. *Relevant activities of structured entities*

A structured entity raises funds from the issue of various grades of fixed rate notes and uses the proceeds to acquire a portfolio of high credit quality variable rate residential mortgage loans. The loans are capable of being prepaid, and in practice a small proportion are expected to be prepaid either in whole or in part. The cash flow differences between the variable rate interest receivable and fixed rate interest payable are hedged using interest rate swaps. The activities that have the most significant effect on the structured entity's returns are:

- Sourcing and acquiring the residential mortgage loans
- Monitoring prepayment rates
- Determining how the arrangement is hedged
- Investing excess funds to generate interest income (which could arise from prepaid mortgages)
- Managing mortgage assets in the event of default.

3.2.4. *Can a structured entity have no relevant activities?*

Although they might appear to have been set up on 'autopilot' with no substantive decisions to be taken subsequently, in practice there are very few structured entities that do not have any relevant activities. However, if there really were no decisions at all, then no investor would control (and therefore consolidate) the structured entity. This is regardless of whether an investor sponsored or designed the structured entity and had exposure to variable returns.

However, it is necessary to consider the meaning of relevant activities very broadly. For example, in a true autopilot structure, if one party to the arrangement has the unilateral ability to wind up the structured entity at any time, that would be regarded as a relevant activity as that party would have the ability to affect returns by cancelling the arrangement. Alternatively, an arrangement might have activities that are contingent on specified future events. The following example illustrates this point.



Example 2 – Relevant activities contingent on a future event [IFRS 10.B53 Application Example 11]

An investee's only business activity, as specified in its founding documents, is to purchase receivables and service them on a day to day basis for its investors. The servicing on a day to day basis includes the collection and passing on of principal and interest payments as they fall due. Upon default of a receivable, the investee automatically puts the receivable to an investor as agreed separately in a put agreement between the investor and the investee. The only relevant activity is managing the receivables on default because it is the only activity that can significantly affect the investee's returns. Managing the receivables before default is not a relevant activity because it does not require substantive decisions to be made that could significantly affect the investee's returns – the activities before default are predetermined and amount only to collecting cash flows as they fall due and passing them to investors. Therefore, only the investor's right to manage the assets on default should be considered when assessing the overall activities of the investee that significantly affect the investee's returns. In this example, the design of the investee ensures that the investor has decision-making authority over the activities that significantly affect the returns at the only time that such decision-making authority is required. The terms of the put agreement are integral to the overall transaction and the establishment of the investee. Therefore, the terms of the put agreement together with the founding documents of the investee lead to the conclusion that the investor has power over the investee even though the investor takes ownership of the receivables on default and manages the defaulted receivables outside the legal boundaries of the investee.



3.3. Power

3.3.1. Rights that give power

An investor has power over an investee if it has existing rights that give it the current ability to direct the relevant activities. Only substantive rights (see 3.3.4) are considered, with protective rights (see 3.3.3) being disregarded. (IFRS 10.10 and B9). The distinction between substantive and protective rights can be significant in the analysis of which investor (if any) has the unilateral power to control an investee.

The fact that an investor directs relevant activities is an indicator that the investor has power, but it is not conclusive. For example, another party might have power over an investee but choose, for whatever reason, not to make use of it (IFRS 10.12).

3.3.2. Current ability to direct

An investor only needs to have the ability to control relevant activities, and it is not relevant whether the investor actually exercises this ability. IFRS 10 clarifies that power exists when an investor has the ability to direct the relevant activities of an investee, even if those relevant activities occur only when particular circumstances arise or specific events occur (IFRS 10.B53).

3.3.3. Protective rights

Protective rights are defined as:

'Rights designed to protect the interest of the party holding those rights without giving that party power over the entity to which those rights relate. (IFRS 10 Appendix A).'

Because of the way in which 'power' is analysed in accordance with IFRS 10, the distinction between substantive and protective rights is important. An investor that only holds protective rights, which meet the definition, has no power over an investee and consequently does not control the investee. The standard follows the logic that protective rights are designed to protect interests of the holder without giving it power over the investee and cannot prevent another party from having power over an investee (IFRS 10.B27).

Protective rights relate to fundamental changes to the activities of an investee or apply in exceptional circumstances. The fact that a right only arises in exceptional circumstances however is not in itself conclusive that it is a protective right (IFRS 10.B26).

Examples of protective rights in the standard are (IFRS 10.B28):

- A lender's right to restrict borrower's activities (if these could change credit risk significantly to the detriment of the lender)
- Capital expenditure greater than that required in the ordinary course of business requiring approval by non-controlling interest holders
- Issue of debt or equity instruments requiring approval by non-controlling interest holders
- A lender's right to seize assets of a borrower in the event of default.



BDO Comment

At its September 2013 meeting, the IFRS Interpretation Committee ('the Committee') issued an agenda decision in respect of a question concerning whether an assessment of control should be reassessed when facts and circumstances change, where rights that were previously determined to be protective, change. This may occur, for example, upon a breach of covenant in a borrowing arrangement that causes a borrower to default, triggering the ability to exercise rights by the investor that had previously been determined as protective in nature. The Committee concluded that IFRS 10, paragraph 8 requires an investor to 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 (i.e. power, exposure to variable returns and linkage between power and returns), which would include an assessment of the rights of the investor.

3.3.4. Substantive rights

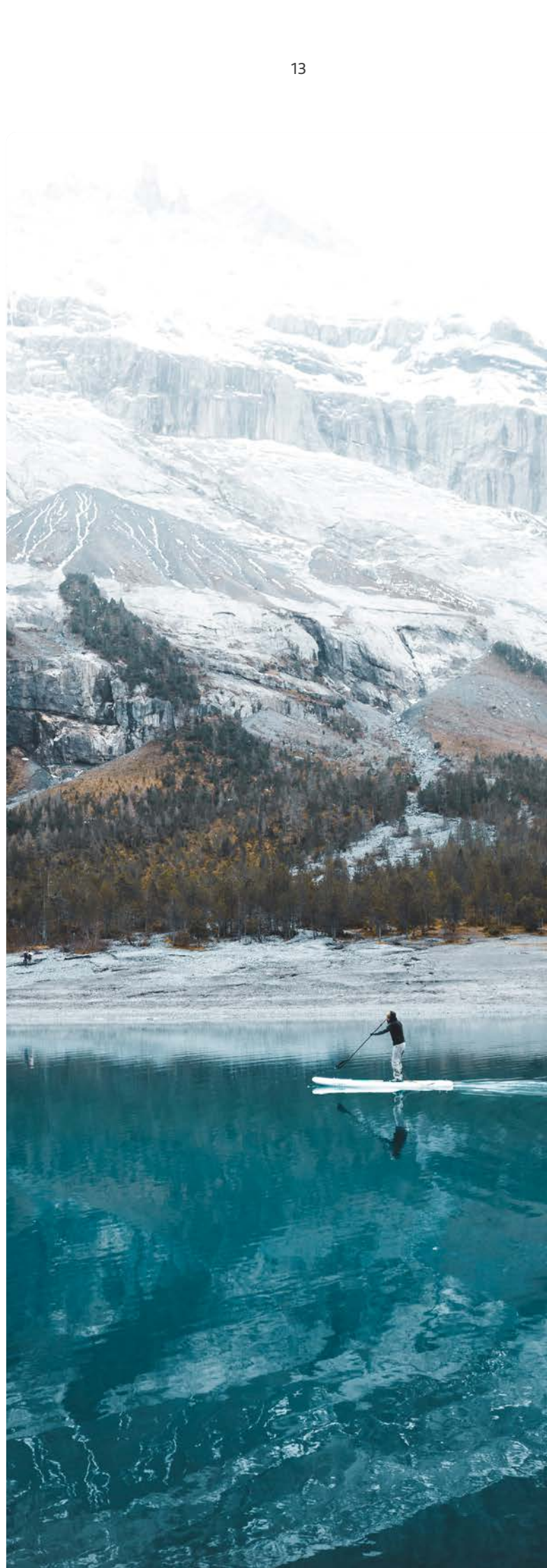
Only substantive rights are considered when power is assessed. In order for a right to be substantive, the holder must have the practical ability to exercise the right. The standard requires that substantive rights held both by the investor and by others are assessed (IFRS 10.B22).

IFRS 10 acknowledges the assessment of whether rights are substantive requires judgment. It provides examples of factors that need to be considered, split into the headings 'barriers to exercise', 'agreement of other parties required' and 'exercise benefits right holder' (IFRS 10.B23).

Barriers to exercise

The existence of any barriers (economic or otherwise) that prevent the holder from exercising the rights are required to be considered. Examples of such barriers include but are not limited to (IFRS 10.B23):

- Financial penalties and incentives
- An exercise or conversion price that creates a financial barrier (for example, the exercise price of options that would give the holder sufficient voting rights to obtain control of an entity may be deeply out of the money and therefore uneconomic to exercise – see section 3.3.8)
- Terms and conditions that make it unlikely that the right is exercised (e.g. a condition that sets a very narrow limit to the timing of exercise)
- The absence of an explicit, reasonable mechanism to allow the holder to exercise its rights (this might link to the founding documents of an investee, or applicable laws and regulations)
- An inability for the holder to obtain the information necessary to exercise its rights
- Operational barriers or incentives (e.g. in circumstances where there is a manager of an entity, the absence of other managers willing or able to provide specialised services or provide the services and take on other interests held by the incumbent manager)
- Legal or regulatory requirements (e.g. where a foreign investor is prohibited from exercising its rights).



Agreement of other parties required

When exercising a right requires the agreement of more than one party, the following factors should be considered:

- Whether a mechanism is in place that provides the parties with the practical ability to exercise the right. The absence of such a mechanism would indicate that the rights may not be substantive
- The number of parties that have to agree on the exercise of the rights. The more parties that are required to agree to the exercise of the rights, the less likely it is that those rights are substantive
- Removal rights exercisable by an independent board of directors are more likely to be substantive than if the same rights were exercisable individually by a large number of investors.

Exercise benefits right holder

There is a further question of whether the party holding the right would benefit from its exercise. For example, for potential voting rights, the terms and conditions are more likely to be substantive when the instrument is in the money, or the holder would benefit in other ways (for example, from realising synergies).

To be substantive, rights also need to be exercisable when decisions about the relevant activities are made. This will always be the case when rights are currently exercisable. However, a right can also be substantive if it is not currently exercisable but is exercisable when the relevant activities are made. The example below illustrates how the 'exercisable' criteria is applied.



Example 3 – Exercisable substantive rights [Based on IFRS 10.B24 Application Example 3]

Company A (the investee) is controlled through equity share voting rights.

Company A has annual shareholder meetings at which decisions to direct the relevant activities are made. The next shareholders' meeting is scheduled in eight months. However, shareholders that individually or collectively hold at least 5% of the voting rights can call a special meeting to change the existing policies over the relevant activities, but a requirement to give notice to the other shareholders means that such a meeting cannot be held for at least 30 days.

Policies over the relevant activities can be changed only at special or scheduled shareholders' meetings. This includes the approval of material sales of assets as well as the making or disposing of significant investments.

Scenario 1

An investor (Company X) holds a majority of the voting rights in Company A.

Company X's voting rights are substantive because X is able to make decisions about the direction of the relevant activities when they need to be made.

The fact that it takes 30 days before Company X can exercise its voting rights does not stop it having power. Company X has both the practical ability to exercise its rights and those are exercisable when decision about the direction of relevant activated need to be made.

Scenario 2

An investor (Company Y) holds an option to acquire the majority of shares in Company A. The option is exercisable in 25 days and is deeply in the money.

Company Y has rights that are essentially equivalent to the majority shareholder (Company X) in Scenario 1.

Company Y can make decisions about the direction of the relevant activities when they need to be made as the option is exercisable within 25 days which is before a meeting could be convened (30 days). So, the existing shareholders are unable to change the existing policies over the relevant activities. This and the fact that the option is deeply in the money means it is substantive. It gives Company Y the current ability to direct the relevant activities even before the option is exercised.



Scenario 3

An investor (Company Z) is party to a forward contract to acquire the majority of shares in Company A. The forward contract's settlement date is in six months time.

Company Z does not have a substantive right at the moment as it does not have the current ability to direct the relevant activities. The existing shareholders have the current ability to direct the relevant activities because they can change the existing policies over the in six months' time.

However, Company Z may conclude that it has control once it gets within 30 days of the settlement date.

Substantive rights that are exercisable by other parties can prevent an investor from having control. This is the case even if other investors cannot initiate decisions. It is sufficient for another investor to have the ability to approve or block decisions about relevant activities. These rights are however not considered if they are merely protective (IFRS 10.B25).

Some investees are designed so that the direction of their activities and returns is predetermined until a particular circumstance arises or an event occurs. This means that only those activities that relate to that event will significantly affect returns and thus are relevant. The fact that the circumstances or events have not happened does not mean that the rights are only protective (IFRS 10.B53).

Relevant activities that are subject to direction by others (e.g. government, court or administrator) are not considered in the control assessment even if the investor holds a majority of voting rights. This is because the investor's rights are not considered substantive (IFRS 10.B37). However, this does not automatically mean that an entity that is subject to direction by a government, court or administrator cannot be controlled by an investor. Instead, it is necessary to establish whether that direction results in the government, court or administrator having power over the most significant relevant activities. Consequently, although the guidance in IFRS 10 might initially appear conclusive, judgement is still required.

3.3.5. Voting rights

An investor concludes that it has control over an investee if it owns the majority of shares of its investee that have equal voting rights attached, and those shares have a proportionate entitlement to a share of the returns of the investee. However, this is subject to whether another party holds potential voting rights which, if acquired, would result in that other party having control (see section 3.3.8).

IFRS 10 also provides guidance for cases where an investor does not hold the majority of voting rights.

3.3.6. Majority held

An investor is required to consolidate an investee if it holds more than 50% of the voting rights through shares – which is the most common consolidation scenario. This assumes that decisions about relevant activities are determined by majority vote; the threshold could be different if, for example, a 75% majority is required. The rights either need to entitle the holder to vote on the relevant activities or to select the majority of the board that directs the relevant activities (IFRS 10.B35).

This scenario will apply to almost all subsidiaries that are held by means of ordinary shares that have voting rights attached.

3.3.7. Majority not held

IFRS 10 notes that an investor can have power even if it holds less than the majority of voting rights. The standard provides specific guidance for the following scenarios (IFRS 10.B38):

- Contractual agreements with other vote holders
- Rights from other contractual arrangements (economic dependencies)
- De-facto control
- Potential voting rights
- A combination of the above.



Contractual agreements with other vote holders (IFRS 10.B39)

A contractual arrangement between an investor and other vote holders can give the investor the right to exercise voting rights sufficient to give power. An example of this would be the scenario where a contract enables an investor to require enough other vote holders to vote in that investor's favour when decisions about relevant activities are made.

Another common scenario is where an entity is controlled by its board of directors, and the make-up of the board of directors contractually determined by one specified investor.

Rights from other contractual arrangements (IFRS 10.B40)

Other decision-making rights, in combination with voting rights, can give an investor the current ability to direct the investee's relevant activities. For example, rights in a contractual arrangement, when combined with voting rights, may allow an investor to direct operating activities of an investee that significantly affect the investee's returns.

However, an economic dependency of an investee on an investor (e.g. a relationship between a supplier and its main customer) in the absence of any other rights is not sufficient for an investor to have power over an investee.

De-facto control

IFRS 10 explicitly includes the concept of 'de facto' control, where an investor with less than a majority of voting rights has power over an investee.

The primary focus of the analysis under IFRS 10 remains on whether an investor has sufficient voting rights to give that investor the practical ability to direct the relevant activities. This involves an assessment of the size of its holding of voting rights relative to the size and dispersion of holdings of the other vote holders. An investor therefore considers the following indicators:

- The more voting rights an investor holds, the more likely the investor is to have existing rights that give it the current ability to direct the relevant activities
- The more voting rights an investor holds relative to other vote holders, the more likely the investor is to have existing rights that give it the current ability to direct the relevant activities

- The more parties that would need to act together to outvote the investor, the more likely the investor is to have existing rights that give it the current ability to direct the relevant activities (IFRS 10.B42)
- Whether the investor, other investors or other parties hold potential voting rights
- The effect of any contractual arrangements
- All other facts and circumstances, including voting patterns at previous shareholders' meetings.

Also, the lower the quorum required at the shareholder meeting, the more likely it is that an investor with a significant (but still a minority) shareholding will have rights that give it the current ability to direct the relevant activities.

There is an important distinction to be drawn about voting patterns. IFRS 10 makes it clear that the focus is on the number of vote holders that have participated in the past and the absolute proportion of voting rights that have historically been exercised. It is not on whether other vote holders have voted in the same way as the investor.

If the criteria set out below are met, it may be clear that the investor has power over the investee, and no further analysis is needed (also see Example 4 below, which is example 4 in the standard):

- Direction of relevant activities is determined by majority vote
- The investor holds significantly more voting rights than any other vote holder or organised group of vote holders
- Other shareholdings are widely dispersed (IFRS 10.B43/B44).

Other circumstances may require further judgement, and IFRS 10 includes a number of application examples to illustrate the analysis that is required.





Example 4 – De-facto control: Large minority shareholding with other numerous and widely dispersed investors

An investor acquires 48% of the voting rights of an investee. The remaining voting rights are held by thousands of shareholders, none individually holding more than 1% 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% 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.

In other situations, the guidance above is not conclusive and further analysis of additional facts and circumstances is required. The fewer voting rights the investor holds, and the fewer parties that would need to act together to outvote the investor, the more reliance is placed on additional facts and circumstances to assess whether the investor's rights are sufficient to give it power (IFRS 10.B45). An investor has no power if additional facts and circumstances still do not provide a clear answer (IFRS 10.B46).

Additional facts and circumstances to be analysed include indicators of a special relationship with the investee, which suggest more than a passive interest and voting patterns. As noted above, when voting patterns of previous shareholders meetings are analysed, the standard requires only the number of other shareholders that attended (to calculate the majority of votes required to unilaterally make decision) to be considered, but not their voting patterns (i.e. it is not relevant for the analysis if other shareholders voted in the same way as the investor). Examples 4 to 7 (examples 5 to 8 from the standard) illustrate how additional rights, and voting patterns, are taken into consideration.



Example 5 - De-facto control: Large minority shareholding with modest number of other investors

Investor A holds 40 per cent of the voting rights of an investee and twelve other investors each hold 5 per cent of the voting rights of the investee. A shareholder agreement grants investor A the right to appoint, remove and set the remuneration of management responsible for directing the relevant activities. To change the agreement, a two-thirds majority vote of the shareholders is required. In this case, investor A concludes that the absolute size of the investor's holding and the relative size of the other shareholdings alone are not conclusive in determining whether the investor has rights sufficient to give it power. However, investor A determines that its contractual right to appoint, remove and set the remuneration of management is sufficient to conclude that it has power over the investee. The fact that investor A might not have exercised this right or the likelihood of investor A exercising its right to select, appoint or remove management shall not be considered when assessing whether investor A has power.



Example 6 - De-facto control: Large minority shareholding with only two other investors

Investor A holds 45 per cent of the voting rights of an investee. Two other investors each hold 26 per cent of the voting rights of the investee. The remaining voting rights are held by three other shareholders, each holding 1 per cent. There are no other arrangements that affect decision making. In this case, the size of investor A's voting interest and its size relative to the other shareholdings are sufficient to conclude that investor A does not have power. Only two other investors would need to co-operate to be able to prevent investor A from directing the relevant activities of the investee.





Example 7 – De-facto control: Large minority shareholding with eleven other equal shareholders

An investor holds 45 per cent of the voting rights of an investee. Eleven other shareholders each hold 5 per cent of the voting rights of the investee. None of the shareholders has contractual arrangements to consult any of the others or make collective decisions. In this case, the absolute size of the investor's holding and the relative size of the other shareholdings alone are not conclusive in determining whether the investor has rights sufficient to give it power over the investee. Additional facts and circumstances that may provide evidence that the investor has, or does not have, power shall be considered.



Example 8 - De-facto control: Moderate minority shareholding with several other minor investors and remaining investors being numerous and widely dispersed

An investor holds 35 per cent of an investee. Three other shareholders each hold 5 per cent of the voting rights of the investee. The remaining voting rights are held by numerous other shareholders, none individually holding more than 1 per cent of the voting rights. None of the shareholders has arrangements to consult any of the others or make collective decisions. Decisions about the relevant activities of the investee require the approval of a majority of votes cast at relevant shareholders' meetings - 75 per cent of the voting rights of the investee have been cast at recent relevant shareholders' meetings. In this case, the active participation of the other shareholders at recent shareholders' meetings indicates that the investor would not have the practical ability to direct the relevant activities unilaterally, regardless of whether the investor has directed the relevant activities because a sufficient number of other shareholders voted in the same way as the investor.

3.3.8. Potential voting rights

Potential voting rights are rights to obtain voting rights of an investee (e.g. convertible instruments, options and forward contracts). Potential voting rights always affect at least two parties, and could result in one investor (that currently holds less than the majority of voting rights and would otherwise conclude that it does not control the investee) consolidating the investee and another investor (that currently holds the majority of voting rights and would otherwise conclude that it does control the investee) not consolidating the investee (IFRS 10.B47).

IFRS 10 also requires an investor to consider the purpose and design of the instrument, as well as the purpose and design of any other involvement the investor has with the investee. This includes an assessment of the various terms and conditions of the instrument as well as the investor's apparent expectations, motives and reasons for agreeing to those terms and conditions (IFRS 10.B48).

Substantive potential voting rights alone, or in combination with other rights, can give an investor the current ability to direct the relevant activities (IFRS 10.B50). Figure 2 shows a basic scenario where Entity B has power over Entity S as a result of its potential voting rights.

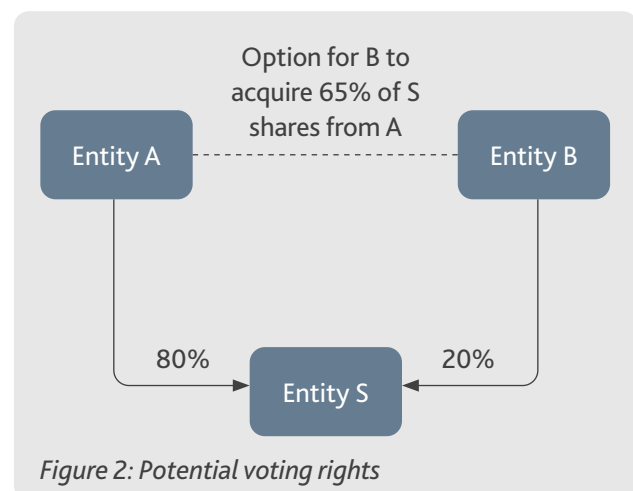


Figure 2: Potential voting rights



Potential voting rights need, as with all other rights, to be substantive. They are regarded as substantive when an investor has the practical ability to exercise its right when decisions about relevant activities are made. The following facts or circumstances would mean that the entity does not have the practical ability and hence the potential voting rights would not be regarded as substantive:

- Options are deeply out-of-the-money
- Legal barrier to exercising options
- Barriers to entry (e.g. an investor has no resources to actually manage the business where the current management is reluctant to cooperate with the investor holding the potential voting rights).

It should be noted that options that are simply out of the money (rather than being deeply out of the money) may be taken into account. For example, options that are out of the money might enable an investor to acquire a majority stake (which could attract a control premium), or the exercise might enable costs savings and synergies to be obtained. IFRS 10 does not contain any 'bright line' guidance and so all relevant facts and circumstances need to be considered. The requirement in IFRS 10 for continuous reassessment also means that the conclusion reached about whether potential voting rights should, or should not, be taken into account may change.

It is necessary to consider all relevant facts and circumstances when reaching a conclusion as to whether potential voting rights are required to be taken into account.

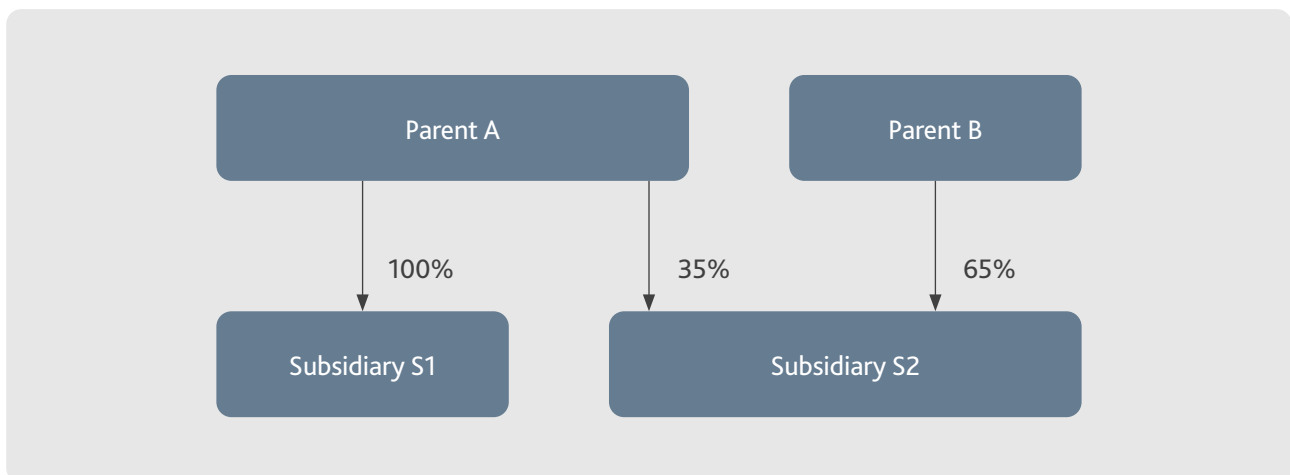


Example 9: Potential voting rights

Parent A holds stakes in subsidiaries S1 and S2 which both operate in the same industry sector. Parent A holds a controlling interest in S1 and a 35% interest in S2. The remaining 65% interest in S2 is held by Parent B.

S1 is much larger than S2 in terms of market share. Its products account for a market share of 40% whereas S2 only accounts for 15%.

Parent A also holds options to acquire a further 40% interest in S2 from Parent B. The options are in the money but the competition authority has stated that it would only permit A to acquire the additional 40% share in S2 if A disposes of its controlling interest in S1.



In this example Parent B is likely to have control over S2.

If Parent A exercises its options (potential voting rights) it would be required to sell its wholly owned subsidiary S1. This would result in a significant negative economic effect. The fact that S1's (that would be required to be disposed of) turnover is nearly treble S2's turnover is a significant economic barrier to overcome. In the absence of other facts or circumstances Parent A's options are considered to be non-substantive. It would be too disadvantageous for A to exercise its options.

In practice all facts and circumstance are required to be assessed and judgement will be required to assess whether barriers to exercise potential voting rights are substantive.

3.3.9. Other rights

Power will usually arise from voting rights granted by equity instruments. However, for the purposes of IFRS 10 the focus is on rights that give an investor the current ability to direct the relevant activities.

Other rights that, either individually or in combination, can give an investor power include but are not limited to (IFRS 10.B15):

- Rights to appoint, reassign or remove members of an investee's key management who have the ability to direct the relevant activities
- Rights to appoint or remove another entity that directs the relevant activities
- Rights to direct the investee to enter into, or veto any changes to, transactions
- Decision-making rights specified in a management contract.

These rights link to decisions that need to be taken on an investee's operating and financing activities on an ongoing basis, and it is those rights in combination with voting rights that are likely to give an investor power.

In some cases, voting rights will not have a significant effect on an investee's returns. This can arise when voting rights relate to administrative tasks only and contractual arrangements determine the direction of the relevant activities. In those cases, the investor needs to assess other rights that could give power to direct the investee's relevant activities.

IFRS 10 acknowledges that in some cases, it may be difficult to determine whether an investor's rights are sufficient to give it power. In those cases, it is necessary to consider additional evidence to determine whether it has the practical ability unilaterally to direct the investee's relevant activities.

Practical ability to direct (IFRS 10.B18)

Consideration is given, but is not limited, to the following indicators together with the existence of any special relationships (see below) and the extent of the investor's exposure to variability of returns from the investee:

- The investor can, without having the contractual right to do so, appoint or approve the investee's key management personnel who have the ability to direct the relevant activities

- The investor can, without having the contractual right to do so, direct the investee to enter into, or can veto any changes to, significant transactions for the benefit of the investor
- The investor can dominate either the nominations process for electing members of the investee's governing body or the obtaining of proxies from other holders of voting rights
- The investee's key management personnel are related parties of the investor (for example, the chief executive officer of the investee and the chief executive officer of the investor are the same person)
- The majority of the members of the investee's governing body are related parties of the investor.

Special relationships (IFRS 10.B19)

In some cases there will be indications of a special relationship between an investor and an investee that suggests the investor has more than a passive interest in the investee. This relationship, either by itself or in combination with other rights, could result in the investor being judged to have sufficient rights to have power over the investee. Although a special relationship is not necessarily conclusive that the criterion is met, the following are indicators that the investor may have power:

- The investee's key management personnel who have the ability to direct the relevant activities are current or previous employees of the investor
- The investee's operations are dependent on the investor, such as in the following situations:
 - The investee depends on the investor to fund a significant portion of its operations
 - The investor guarantees a significant portion of the investee's obligations
 - The investee depends on the investor for critical services, technology, supplies or raw materials
 - The investor controls assets such as licenses or trademarks that are critical to the investee's operations
 - The investee depends on the investor for key management personnel, such as when the investor's personnel have specialised knowledge of the investee's operations.
- A significant portion of the investee's activities either involve or are conducted on behalf of the investor (IFRS 10.B19).

Exposure to return

Having a large exposure to variability of returns is an indicator that the investor has power. This is because, the greater an investor's exposure, or rights, to variability of returns from its involvement with an investee, the greater is the incentive for the investor to obtain rights sufficient to give it power. However, while a large exposure indicates that the investor may have power, the extent of the investor's exposure on their own is not conclusive (IFRS 10.B20).

The same analysis applies in cases where the investor's exposure, or rights, to returns from its involvement with the investee is disproportionately greater than its voting or other similar rights. For example, in some cases an investor that holds less than half of the voting rights of an investee could be entitled, or exposed, to more than half of the returns of the investee. This might be the case where an investor has both an equity interest and a substantial holding of debt instruments in an investee (IFRS 10.B19).

Purpose and design of the investee

In assessing the purpose and design of an investee, an investor is required to consider the involvement and decisions made at the investee's inception as part of its design and evaluate whether the transaction terms and features of the involvement provide the investor with rights that are sufficient to give it power.

It is important to note that an investor's involvement in the design of an investee alone is not sufficient to give an investor control. However, involvement in the design may indicate that the investor had the opportunity to obtain rights that are sufficient to give it power over the investee (IFRS 10.B51).

IFRS 10.B8 notes that some investees are designed in a way that means voting rights are not the most relevant factor in deciding who controls the investee. This may be the case when any voting rights relate to administrative tasks only and the relevant activities are directed by means of contractual arrangements. These types of arrangement are likely to relate to structured entities as defined in IFRS 12.

In cases where it is determined that voting rights are not the most relevant factor in determining control, an investor is required to give consideration to the purpose and design of the investee and to analyse 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. Consideration of the risks includes both downside and upside risk. (IFRS 10.B8).

Contractual arrangements

An investor is required to consider contractual arrangements such as call, put and liquidation rights established at the investee's inception. When these contractual arrangements involve activities that are closely related to the investee, then these activities are considered to be, in substance, an integral part of the investee's overall activities. This applies, even though they may occur outside the legal boundaries of the investee.

As a result, explicit or implicit decision-making rights embedded in contractual arrangements that are closely related to the investee need to be considered as relevant activities when determining whether an investor has power over an investee (IFRS 10.B52).

Particular circumstances

For some investees, relevant activities occur only when particular circumstances arise or events occur. The investee may be designed so that its activities and returns are predetermined unless and until those particular circumstances arise or events occur.

In those cases, only the decisions about the investee's activities when those circumstances or events occur can significantly affect its returns and thus be relevant activities. The circumstances or events need not have occurred for an investor with the ability to make those decisions to have power. The fact that the right to make decisions is contingent on circumstances arising or an event occurring does not, in itself, make those rights protective. For an example, see section 3.2.4.



3.4. Exposure to variable returns

The second criterion an investor has to meet to have control over an investee is to be exposed to variable returns from the investee. Returns are variable if they are not fixed and have the potential to vary as a result of the performance of an investee. These returns can be positive, negative or both positive and negative (IFRS 10.15).

Examples of returns are:

- Dividends
- Interest from debt securities
- Changes in the value of the investee
- Fees for servicing an investee's assets or liabilities
- Fees and exposure to loss from providing credit or liquidity support
- Residual interests in the investee's assets and liabilities on liquidation
- Tax benefits
- Access to future liquidity
- Returns that are not available to other interest holders that enhance the value of the investor's other assets, such as:
 - Economies of scale cost savings
 - Sourcing scarce products
 - Access to proprietary knowledge
 - Limiting some operations or assets (IFRS 10.B57).

IFRS 10 does not require an investor to be exposed to all (or even a majority of) variable returns of the investee. For example, non-controlling interests sharing returns with the investor do not preclude an investor from meeting the 'exposure to variable returns' criterion (IFRS 10.16).

Variable returns of an arrangement are assessed widely, and not simply on the basis of the legal form. This can result in returns that appear, initially, to be fixed but are considered to be variable for the purposes of IFRS 10. The following examples illustrate how variability is assessed for two forms of returns:

Bond with fixed interest rate payments

The holder of a bond is contractually entitled to fixed interest payments. However from an IFRS 10 perspective the interest payments are regarded as variable returns. This is because they are subject to default risk and in substance expose the investor to the credit risk of the issuer of the bond. The investor could receive all, some or none of the interest payments in the case of default.

Fixed fees

Fixed fees for managing an investee's assets are variable returns because they expose the investor to the performance risk of the investee. The amount of variability depends on the investee's ability to generate sufficient income to pay the fee (IFRS 10.B56).

3.5. Link between power and variable returns

The third control criterion requires an investor to have the ability to use its power to affect the investor's variable returns. This criterion is included in the standard to address principal-agent relationships. IFRS 10 does not provide other examples where there is no link between power and variable returns.

In practice managed funds fall within this category. The key question is whether a fund is required to be consolidated by the fund manager.

3.5.1. Principal – Agent relationships

An investor with decision-making rights is required to assess whether it has the ability to use its rights to affect the investee's returns. An investor will be considered a principal if the investor is able to use its rights to influence returns. This means that the investor is required to consolidate the investee because they meet all three criteria. An agent will not be able to consolidate the investee in this case because an agent does not meet the third criterion. This is because an agent is primarily engaged to act on behalf and for the benefit of another party (or parties). Figure 3 shows the principal-agent classification (IFRS 10.17/18).



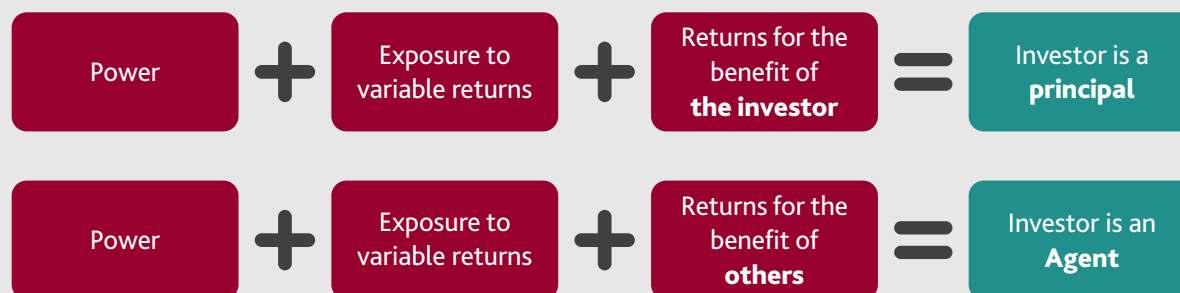


Figure 3: Link between power and returns (principal-agent classification)

Removal rights

A single party holding substantive rights to remove the decision maker (such as a fund manager) without cause at any time will always result in the decision maker being classified as an agent. If more than one party holds removal right together and no single party can remove the decision maker on its own, other factors are also required to be considered. IFRS 10 notes that the higher the number of investors with removal rights who would need to act together, the more weight is required to be given to these other factors (see below) (IFRS 10.B65).



BDO Comment

IFRS 10 is not entirely clear about whether the rights of an investor to close a fund are required to be treated in the same way as removal rights. It is therefore not clear whether the right of an investor to close a fund would result in the decision maker being classified as an agent by default.

Scope of decision making authority

The following points are required to be considered when analysing the authority granted to a decision maker:

- The scope of activities permitted according to the arrangement or by law
- The amount of discretion the decision maker has about making decisions (IFRS 10.B62).

When analysing the above, the decision maker is required to consider:

- The purpose and design of the investee
- The risks to which the investee was designed to be exposed
- The risks it was designed to pass on to the parties involved
- The level of involvement the decision maker had in the design of an investee (e.g. if a decision maker was significantly involved in the design of the investee (including the scope of decision-making authority), that involvement may indicate that the decision maker had the opportunity and incentive to obtain rights that result in the decision maker having the ability to direct the relevant activities) (IFRS 10.B63).

However, involvement in the design of an investee by itself does not result in a conclusion of control.

Rights held by other parties

Apart from removal rights, other substantive rights held by other parties can also affect the decision maker's ability to direct relevant activities.

For example a decision maker that is required to get approval for decisions about relevant activities from a small group of investors would generally be classified as an agent. This is because the decision maker does not have independent discretion to make decisions about relevant activities (IFRS 10.B66).



Remuneration

IFRS 10.B68 notes that:

'The greater the magnitude of, and variability associated with, the decision maker's remuneration relative to the returns expected from the activities of the investee, the more likely the decision maker is a principal.'

In other words, a key question to address is whether the decision maker only receives remuneration at a market rate, without the potential for additional payments, or is the nature of the remuneration more like the return of an investor that is exposed to the business risk of the investee.

To be classified as an agent, a decision maker's remuneration has to be commensurate with the service provided (i.e. there should be an adequate ratio between the service and the compensation). In addition, the agreement should not include any terms or condition that one would normally not find in a similar arrangement at arms' lengths. However, meeting those two conditions in isolation is not sufficient to conclude that a decision maker is an agent and other facts and circumstances are also required to be considered (IFRS 10.B69/70).

Exposure to variability of returns from other interests

A decision maker (such as a fund manager) may, in addition to or instead of receiving remuneration for services, hold other interests in an investee (such as an investment in the investee) or provide guarantees with respect to the performance of the investee. In those circumstances, the decision maker is required to consider its exposure to variable returns from all sources when assessing whether it is an agent. Holding other interests in an investee indicates that the decision maker may be a principal (IFRS 10.B71).

In evaluating its exposure to variability of returns from other interests in the investee a decision maker is required to consider the following:

- The greater the magnitude of, and variability associated with, its economic interests, considering its remuneration and other interests in aggregate, the more likely the decision maker is a principal
- Whether its exposure to variability of returns is different from that of the other investors and, if so, whether this might influence its actions.

The decision maker is required to evaluate its exposure relative to the total variability of returns of the investee (IFRS 10.B71/72).



BDO Comment

IFRS 10 includes specific guidance for principal-agent relationships, and does not include any minimum threshold for the amount of a fund manager's exposure to returns. Instead, all it requires is exposure to 'variability' in returns which is significant enough to result in the fund manager's return being potentially greater than a market rate of remuneration. This could result in a different control assessment for some funds. The scenarios provided in Example 10 below are taken from Application Examples 14-14D in IFRS 10, which all relate to a fact pattern that concerns the question of control by a fund manager over a fund. The numerical figures in the example are specific to the facts and circumstances in the examples and do not establish 'bright lines' or guidelines by which entities should conclude when a sufficient exposure to variable returns exists in combination with the other two elements of control to constitute control. In all principal-agent assessments, including those involving an investment manager, it is important to consider all relevant facts and circumstances and weigh the relevant factors appropriately in concluding.

IFRS 10 does not establish what amount of exposure to variable returns is sufficient to conclude that control exists in numerical terms (e.g. x% is sufficient to conclude), given that power and linkage exists in the particular fact pattern. This is because any numerical exposure to variable returns (e.g. a set percentage) must be weighed against the other facts and circumstances, including the ability of the other investors to remove the entity possessing power to direct the relevant activities. Although the numerical exposure that can be derived from the examples noted below range from 22% (scenario 2) to 37% (scenario 4) of the profits of the fund, these should not be interpreted as 'floors' or 'limits' to be used when determining when sufficient exposure to variable returns exist; they are for illustrative purposes only. In some situations the linkage cannot be quantified just by the numerical exposure since there is a specific business relationship or a synergy between the parties.

For example, an investment manager may have unilateral power over the relevant activities of a fund, and significant exposure to variable returns in excess of the market-based fee it earns for its management services. Despite this, if the other investors in the fund have sufficiently strong 'kick out rights' (e.g. right to remove the investment manager), it would generally be concluded that the investment manager does not control the fund, regardless of the other facts and circumstances.

Conversely, weak 'kick out rights' combined with the fund manager possessing the right to direct the relevant activities of the fund may not result in the fund manager controlling the fund. This may occur if the fund manager's exposure to variable returns is limited to fees for services provided that are commensurate with the services provided (i.e. they are 'at market'). In this case, the fund manager is acting as an agent for the other investors in the fund.

When the factors indicate that the exposure to variable returns and the kick-out rights are more subtly balanced than in the examples provided below, professional judgment will need to be exercised with appropriate disclosure. See section 5 for the disclosure requirements of IFRS 12, which include disclosure of judgments made relating to whether an entity does or does not control another entity.

The example below indicates how the criteria set out above could be applied in practice.



Example 10 – Application of 'linkage' criteria [IFRS 10.B72 Application Example 14 – 14D]

Basic Scenario

A fund manager (the decision maker) establishes markets and manages a fund that provides investment opportunities to a number of investors.

The fund manager must make decisions in the best interests of all investors and in accordance with the fund's governing agreements but has wide decision-making discretion.

The fund manager receives a market-based fee for its services equal to:

- 1% of assets under management, and
- 20% of all the fund's profits if a specified profit level is achieved.

The fees are commensurate with the services provided.

Analysis

The fund manager is likely to be an agent.

Although it must make decisions in the best interests of all investors, the fund manager has extensive decision-making authority to direct the relevant activities of the fund.

The investors do not hold substantive rights that could affect the fund manager's decision-making authority.

The fund manager is paid fixed and performance-related fees that are commensurate with the services provided.

In addition, the remuneration aligns the interests of the fund manager with those of the other investors to increase the value of the fund, without creating exposure to variability of returns from the activities of the fund that is of such significance that the remuneration, when considered in isolation, indicates that the fund manager is a principal.

Scenario 2

Same facts as in basic scenario plus:

- Fund manager has 2% investment in fund but no obligation to fund losses beyond its 2% investments
- Investors can remove the fund manager by a simple majority vote, but only for breach of contract.

Analysis

The fund manager is likely to be an agent.

The fund manager's 2% investment increases its exposure to variability of returns from the activities of the fund without creating exposure that is of such significance that it indicates that the fund manager is a principal.

The other investors' rights to remove the fund manager are considered to be protective rights because they are exercisable only for breach of contract.

Scenario 3

Same facts as in basic scenario plus:

- Fund manager has a substantial investment in the fund but no obligation to fund losses beyond its substantial investments
- Investors can remove the fund manager by a simple majority vote, but only for breach of contract.

Analysis

The fund manager is likely to be a principal.

The other investors' rights to remove the fund manager are considered to be protective rights because they are exercisable only for breach of contract.

The combination of the fund manager's substantial investment together with the remuneration (albeit the latter is a market rate) could create exposure to variability of returns from the activities of the fund that is of such significance that it indicates that the fund manager is a principal.

Scenario 4

Same facts as in basic scenario, plus:

- The fund has a board of directors, all of whose members are independent of the fund manager and are appointed by the other investors. The board appoints the fund manager annually. If the board decided not to renew the fund manager's contract, the services performed by the fund manager could be performed by other managers in the industry
- The fund manager has a 20% investment in the fund but no obligation to fund losses beyond its 20% investments.

Analysis

The fund manager is likely to be an agent.

Although the fund manager is paid fixed and performance-related fees that are commensurate with the services provided, the combination of the fund manager's 20% investment together with its remuneration creates exposure to variability of

returns from the activities of the fund that is of such significance that it indicates that the fund manager is a principal.

However, the investors have substantive rights to remove the fund manager. The board of directors provides a mechanism to ensure that the investors can remove the fund manager if they decide to do so.

In the analysis, greater weight is given on the substantive removal rights. Thus, although the fund manager has extensive decision-making authority and is exposed to variability of returns of the fund from its remuneration and investment, the substantive rights held by the other investors indicate that the fund manager is an agent.

3.5.2. De facto agents

An investor is required to combine its rights and the rights of a de facto agent when it assesses whether it controls an investee. A de facto agent in IFRS 10.73 is described as a party that is acting on the investor's behalf.

IFRS 10 acknowledges that this determination of a de facto agent is judgemental and that the relationship between the investor and the parties and also how the parties interact with each other and the investor is required to be taken into consideration (IFRS 10.B73).

Such a relationship does not necessarily need a contractual arrangement. A party is a de facto agent when the investor has the ability to direct that party to act on the investor's behalf (IFRS 10.B74).

IFRS 10.B75 provides a list of examples of parties that might act as de facto agents:

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

- A party that has a close business relationship with the investor, such as the relationship between a professional service provider and one of its significant clients.

This guidance is not intended to imply that the parties listed above always act for the investor. When assessing whether a party acts as de facto agent judgement, including careful consideration of the nature of the relationship and the way that the parties interact with each other, will be required.

3.6. Specific topics

3.6.1. Silos

IFRS 10 contains guidance which requires an investor to consolidate a portion of an investee (a silo) if the investor is deemed to have control over that portion. As a result, specified assets and liabilities held by a legal entity may be consolidated as a 'deemed separate entity'.

The requirements for silos are likely to affect the finance, real estate and insurance industry (e.g. captive insurance entities or 'multi-seller conduits'). A common example is where a bank sets up a wholly owned subsidiary, through which a large number of securitisation transactions are processed. For each securitisation, the assets and liabilities are entirely ring fenced from the assets and liabilities of all of the other securitisations.

In order for a silo to exist, all of the following conditions have to be met (IFRS 10.B77):

- The liabilities of a silo can only be settled with its specified assets
- Only parties with the specified liability or liabilities have rights (or obligations) related to the assets or to the residual cash flows from those assets
- In substance, none of the returns from the silo can be used by the remaining investee(s)
- None of the liabilities of the silo can be paid using assets outside the boundary of the silo.

An investor in a silo that meets the criteria set out above is required to assess whether it controls the silo based on the same control criteria that apply to other entities. This means that an investor will have to identify whether it has exposure or rights to variable returns from its involvement in the silo and the ability to use its power over the silo to affect its returns (IFRS 10.B78).

An investor only consolidates the silo - not the remainder of the investee. The other party (or parties) that have interest(s) in the investee exclude the siloed

portion from the entity when assessing control and, if required, will only consolidate the remaining part of the investee (or one or more other silos) (IFRS 10.B79).

3.6.2. Structured entities

Structured entities are defined in IFRS 12:

'An entity that has been designed so that voting or similar rights are not the dominant factor in deciding who controls the entity, such as when any voting rights relate to administrative tasks only and the relevant activities are directed by means of contractual arrangements. (IFRS 12 Appendix A)'

A structured entity often has some or all of the following features or attributes:

- Restricted activities
- A narrow and well-defined objective, such as:
 - To effect a tax-efficient lease
 - To carry out research and development activities
 - To provide a source of capital or funding to an entity
 - To provide investment opportunities for investors by passing on risks and rewards associated with the assets of the structured entity to investors.
- Insufficient equity to permit the structured entity to finance its activities without subordinated financial support
- Financing in the form of multiple contractually linked instruments to investors that create concentrations of credit or other risks (tranches) (IFRS 12.B22).

Examples of entities that are regarded as structured entities include, but are not limited to:

- Securitisation vehicles (a vehicle created to take over various types of contractual debt (e.g. mortgages). The vehicle in exchange issues securities to investors)
- Asset-backed financings (A financial security backed by collateral)
- Some investment funds.

An entity is required to assess whether or not it controls a structured entity based on the principles set out in IFRS 10.

IFRS 12 requires additional disclosures for structured entities regardless of whether an investor is required to consolidate one or more structured entities. The amount of disclosure differs, with this being more extensive for an entity's interests in unconsolidated structured entities. However, the general disclosures for consolidated entities also apply to consolidated structured entities.

Consolidated structured entities

Investors in consolidated structured entities are, in addition to the general disclosure requirements of IFRS 12, required to provide information about the nature of their risks associated with their interest in the consolidated structured entity.

In order to achieve this, investors are required to disclose the terms of any contractual arrangements that could require them (or their subsidiaries) to provide financial support to a consolidated structured entity. This includes events or circumstances that could expose the reporting entity to a loss (IFRS 12.14).

Financial or other support (e.g. purchasing assets of, or instruments issued by the structured entity) may have been provided to the consolidated structured entity without the investor having a contractual obligation to do so (e.g. due to reputational risk). An entity is required to disclose the type and amount of support provided (including situations in which the parent or its subsidiaries assisted the structured entity in obtaining financial support) and the reasons for providing the support (IFRS 12.15). In addition a reporting entity in addition is also required to provide the same information for current intentions to provide such support (IFRS 12.17).

In the case where a reporting entity concludes that it is required to consolidate a structured entity as a result of providing financial support without having a contractual obligation to do so the reporting entity is required to provide an explanation of the relevant factors it considered to reach that decision (IFRS 12.B16).

Unconsolidated structured entities

The purpose of disclosures about unconsolidated structured entities is firstly to help users of financial statements to understand the nature and extent of an entity's interests in unconsolidated structured entities. Secondly, disclosures are required to assist in an evaluation of the nature of, and changes in, the risks associated with the interests in unconsolidated structured entities. Such information is required even when the entity only had a contractual arrangement in

the structured entity in previous periods that no longer exists at the reporting date (e.g. it was sponsoring the structured entity) (IFRS 12.24/25).

Nature of interests

An entity is required to disclose qualitative and quantitative information about its interests in unconsolidated structured entities. This includes, but is not limited to, the following information (IFRS 12.26):

- Nature
- Purpose
- Size
- Activities
- How the structured entity is financed.



An entity is required to classify its sponsoring activities into relevant categories (IFRS 12.28).

Nature of risk

An entity is required to disclose in tabular format, unless another format is more appropriate, a summary of:

- The carrying amounts of the assets and liabilities recognised in its financial statements relating to its interests in unconsolidated structured entities
- The line items in the statement of financial position in which those assets and liabilities are recognised
- The amount that best represents the entity's maximum exposure to loss from its interests in unconsolidated structured entities
- How the maximum exposure to loss is determined. If an entity cannot quantify its maximum exposure to loss from its interests in unconsolidated structured entities it is required to disclose that fact and the reasons
- A comparison of the carrying amounts of the assets and liabilities of the entity that relate to its interests in unconsolidated structured entities and the entity's maximum exposure to loss from those entities. (IFRS 12.29)

If an entity has sponsored an unconsolidated structured entity for which it does not provide information listed in the previous paragraph (as required by IFRS 12.29) e.g. because it does not have an interest in the entity at the reporting date, the entity is required to disclose (IFRS 12.27):

- How it has determined which structured entities it has sponsored
- Income from those structured entities during the reporting period, including a description of the types of income presented
- The carrying amount (at the time of transfer) of all assets transferred to those structured entities during the reporting period.

If during the reporting period an entity has, without having a contractual obligation to do so, provided financial or other support to an unconsolidated structured entity in which it previously had or currently has an interest (e.g. purchasing assets or instruments issued by the structured entity), the entity is required to disclose:

- The type and amount of support provided, including situations in which the entity assisted the structured entity in obtaining financial support
- The reasons for providing the support.

Disclosure is also required of any current intentions to provide financial or other support, including intentions to assist in obtaining financial support (IFRS 12.31).

3.6.3. Franchises

IFRS 10 specifically addresses franchises in paragraphs B29 to B33. IFRS 10.B29 describes a franchise agreement as being an arrangement that often gives the franchisor:

- Rights that are designed to protect the franchise brand
- Certain decision-making rights with respect to the operations of the franchisee.

IFRS 10.B30 notes that the franchisor's rights do not necessarily result in a current ability to direct the relevant activities. This means that the franchisor will usually not control a franchisee simply because there is a franchise arrangement in place; other factors are required. It is also noted that a franchise arrangement in general does not restrict other parties' (e.g. the franchisee's) ability to make decisions about relevant activities. The lower the level of financial support provided by the franchisor and the lower the franchisor's exposure to variability of returns from the franchisee the more likely it is that the franchisor has only protective rights (IFRS 10.B33).

It is necessary to distinguish between the current ability to make decisions that significantly affect the franchisee's returns (which the franchisor usually does not have) and the ability to make decisions that protect the franchise brand (which the franchisor usually has). A franchisor does not have power over the franchisee if other parties have existing rights that give them the current ability to direct the relevant activities of the franchisee (IFRS 10.B31).

This is because the franchisee has made a unilateral decision when they entered into the franchise agreement to operate its business in accordance with the terms of the franchise agreement, but for its own account (IFRS 10.32).

3.7. Accounting requirements

The general accounting requirements in IFRS 10 include:

Consolidation procedures

1. Like items of assets, liabilities, equity, income, expenses and cash flows of the parent and its subsidiaries are combined
2. The carrying amount of the parent's investment in each subsidiary and the parent's portion of its interest in the equity of each subsidiary is eliminated
3. Intragroup assets and liabilities, equity, income, expenses and cash flows relating to transactions between entities of the group are eliminated in full (profits or losses resulting from intragroup transactions that are recognised in assets, such as inventory and fixed assets are also eliminated in full) (IFRS 10.B86).

Uniform accounting policies

The consolidated financial statements are required to be prepared with uniform accounting policies. This means that like transaction or events should be accounted for in a similar way by the parent and its subsidiaries (IFRS 10.19).

If a member of the group uses accounting policies other than those adopted in the consolidated financial statements adjustments are required to that member's financial statements to ensure conformity with the group's accounting policies (IFRS 10.B87).

Reporting date

The financial statements of the parent and its subsidiaries used for consolidation purposes should have the same reporting date. When a subsidiary has different year end it is required to make adjustments to its financial statements to match the parents reporting date unless it is impracticable (this would be the case if the entity cannot make the adjustments after making every reasonable effort to do so) (IFRS 10.B92).

If it is impracticable to make adjustments a parent is permitted to consolidate the subsidiary using its most recent financial statements adjusted for the effects of significant transactions or events that have occurred between the different reporting dates. The difference between the parent's and the subsidiary's reporting date in any case cannot be more than three months. The length of the reporting periods and the difference between the dates is required to be the same from period to period (IFRS 10.B93).

Start and end of consolidation

Consolidation of an investee is required to start from the date on which an investor obtains control of an investee and cease when the investor loses control of the investee (IFRS 10.20).

IFRS 3 *Business Combinations* provides guidance on when a parent obtains control over subsidiary when it meets the definition of a business.

Potential voting rights

Potential voting rights are relevant when control is assessed. However, IFRS 10 requires that profit or loss and changes in equity are allocated to non-controlling interests on the basis of existing ownership interests (IFRS 10.B89). In an extreme scenario where a parent consolidates a subsidiary because it controls it by means of 100% potential voting rights, all profit or loss and changes in equity would be allocated to non-controlling interests.

In circumstances in which an entity has, in substance, an existing ownership interest as a result of a transaction that currently gives it access to returns associated with an ownership interest, the proportion allocated to the parent and non-controlling interests is determined by taking into account the eventual exercise of those potential voting rights that currently give the entity access to returns (IFRS 10.B90). These circumstances are relatively unusual, but might arise when an entity holds a combination of equity instruments, potential voting rights and derivatives that give it exposure to equity-like returns. Other arrangements might include contractual terms, under which a restriction on an entity's ability to pay dividends could result in potential voting rights having an entitlement to returns.

If an investee is a subsidiary and is consolidated by a parent entity, then in the parent entity's financial statements, instruments containing potential voting rights which in substance currently give access to returns are outside the scope of IFRS 9. All other instruments containing potential voting rights are accounted for in accordance with IFRS 9 (IFRS 10.B91).

3.7.1. Non-controlling interests

A parent is required to present its non-controlling interests in the consolidated statement of financial position within equity but separately from the equity of the owners of the parent (IFRS 10.22).

Profit or loss, and each component of other comprehensive income, are required to be attributed to the owners of the parent and to non-controlling interests. An allocation is made to non-controlling interests even if this results in the non-controlling interests having a deficit balance (IFRS 10.B94).

Changes in a parent's interest in a subsidiary that do not result in the parent losing control of the subsidiary are regarded as transactions with owners in their capacity as owners and are therefore accounted for in equity (IFRS 10.23). This will usually be changes in ownership holdings between over 50% and 100% ownership. The difference between the amount by which the non-controlling interests are adjusted and the fair value of the consideration paid or received is directly recognised in equity (IFRS 10.B96).

3.7.2. Loss of control

The loss of control in a subsidiary is usually straightforward to identify, and typically results from a single event (such as a disposal of a subsidiary). A parent might however lose control in a subsidiary in two or more transactions. IFRS 10.B97 provides indicators when such arrangements are required to be accounted for as a single transaction.

A parent is required to account for the arrangements as a single transaction if one or more of the conditions set out below are met:

- They are entered into at the same time or in contemplation of each other
- They form a single transaction designed to achieve an overall commercial effect
- The occurrence of one arrangement is dependent on the occurrence of at least one other arrangement
- One arrangement considered on its own is not economically justified, but it is economically justified when considered together with other arrangements (e.g. when a disposal of shares is priced below market and is compensated for by a subsequent disposal priced above market).

If a parent loses control it is required to derecognise its subsidiary. The accounting requirements are as follows:

Derecognise

- Assets (including any goodwill) and liabilities of the former subsidiary
- Carrying amount of any non-controlling interest.

Recognise

- Fair value of the consideration received
- Any investment retained in the former subsidiary at its fair value and subsequently accounts for it in accordance with relevant IFRSs. That fair value shall be regarded as the fair value on initial recognition of a financial asset in accordance with IFRS 9 or, when appropriate, the cost on initial recognition of an investment in an associate or joint venture
- Gain or loss attributable to the former controlling interest.

Reclassify

- Amounts recognised in other comprehensive income in relation to the subsidiary are reclassified to profit or loss and are included in the gain or loss on disposal of the subsidiary, or are transferred directly to retained earnings on the same basis as would be required if the parent had directly disposed of the related assets or liabilities (IFRS 10.B98). Examples include financial assets measured at fair value through other comprehensive income in accordance with IFRS 9 (but not investments in equity instruments that are optionally classified as at fair value through other comprehensive income), and property, plant and equipment accounted for under the revaluation model.

In September 2014, the IASB issued amendments to IFRS 10 and IAS 28 to address an acknowledged inconsistency between the requirements in IFRS 10 and those in IAS 28, in dealing with the sale or contribution of assets between an investor and its associate or joint venture. The main consequence of the amendments is that a full gain or loss is recognised when a transaction involves a business (whether it is housed in a subsidiary or not). A partial gain or loss is recognised when a transaction involves assets that do not constitute a business, even if these assets are housed in a subsidiary.

However, in December 2015, the IASB issued an amendment to defer the effective date of the September 2014 amendments to IFRS 10 and IAS 28 indefinitely until the research project on the equity method has been concluded. Accordingly, the amendments to IFRS 10 and IAS 28 have been returned to the 'IFRSs issued but not yet effective' section.

4. Investment Entities

On 31 October 2012 the International Accounting Standards Board (IASB) issued *Investment Entities (Amendments to IFRS 10, IFRS 12 and IAS 27(2011))* (the amendments) which introduced an exception to the principle that all subsidiaries are required to be consolidated.

Applying the requirements of IFRS 10 to investment entities can be complex. To accompany the guidance provided below, please see the Section 6, Appendix B to this publication for the following three flowcharts:

1. Assessing whether an entity meets the definition of an 'investment entity';
2. Applying IFRS 10 for investment entities; and
3. Applying IFRS 10 for non-investment entities.

IFRS 10 define an investment entity and require a parent that is an investment entity to measure its investments in particular subsidiaries at fair value through profit or loss in its consolidated and separate financial statements. They also introduce disclosure requirements for investment entities into IFRS 12 *Disclosure of Interests in Other Entities* and amend IAS 27(2011) *Separate Financial Statements*.

An investment entity is an entity whose business purpose is to make investments solely for capital appreciation, investment income, or both, and that evaluates the performance of those investments on a fair value basis. The most common types of investment entities are private equity organisations, venture capital organisations, pension funds, sovereign wealth funds, investment funds and other similar entities.

The amendments result from proposals in an Exposure Draft (the ED) published in August 2011. The project was undertaken jointly by the IASB and the US Financial Accounting Standards Board (FASB) (the boards) in the hope of achieving as similar guidance as possible. While the boards reached many common decisions, as a result of an initial scope difference, and other jurisdictional differences, the boards came to different decisions in a number of areas.

On 18, December 2014 the IASB issued amendments to IFRS 10, IFRS 12 and IAS 28 to address issues that had arisen in the context of applying the consolidation exception for investment entities, as follows:

- the amendments confirm that the exemption from preparing consolidated financial statements for an intermediate parent entity is available to a parent entity that is a subsidiary of an investment entity, even if the investment entity measures all of its subsidiaries at fair value;
- a subsidiary that provides services related to the parent's investment activities should not be consolidated if the subsidiary itself is an investment entity;
- when applying the equity method to an associate or a joint venture, a non-investment entity investor in an investment entity may retain the fair value measurement applied by the associate or joint venture to its interests in subsidiaries; and
- an investment entity measuring all of its subsidiaries at fair value provides the disclosures relating to investment entities required by IFRS 12.



4.1. Definition of an investment entity

See Flowchart #1 in the appendix for a diagrammatic illustration of the definition of an investment entity.

See Flowchart #2 in the appendix for a diagrammatic illustration of the application of IFRS 10 for investment entities and Flowchart #3 for non-investment entities.

An investment entity is an entity that meets all of the following criteria (the definition, IFRS 10.27):

- It obtains funds from one or more investors for the purpose of providing those investor(s) with investment management services
- It commits to its investor(s) that its business purpose is to invest funds solely for returns from capital appreciation, investment income, or both
- It measures and evaluates the performance of substantially all of its investments on a fair value basis.

In assessing whether it meets the definition of an investment entity, an entity is required to consider whether it has the following typical characteristics (IFRS 10.28):

- It has more than one investment
- It has more than one investor
- It has investors who are not related parties of the entity
- It has ownership interests in the form of equity or similar interests.

At its March 2017 meeting, the IFRS Interpretation Committee (the Committee) issued an agenda decision in respect of a question it had received regarding the investment entity requirements of IFRS 10, including how an entity applies the definition of an investment entity. One of the questions posed to IFRIC was whether an entity qualifies as an investment entity if it possesses all three elements in the definition of an investment entity (IFRS 10.27), but lacks one or more of the typical characteristics (IFRS 10.28). The Committee concluded that if an entity possesses all three of the elements included in the definition of an investment entity, then it is an investment entity, regardless of whether it does not have one or more of the typical characteristics of an investment entity. Therefore, not meeting one or more of the typical characteristics does not preclude an entity from being an investment entity. However, it does

indicate that additional judgement is required in determining whether the entity meets the definition of an investment entity.

Accordingly, an investment entity that does not meet one or more of the typical characteristics is required to disclose the reasons for concluding that it is nevertheless an investment entity (see disclosures below).

An entity is not disqualified from qualifying as an investment entity simply because:

- It provides investment-related services (e.g. investment advisory services, investment management, investment support and administrative services), either directly or through a subsidiary, to third parties as well as to its investors, even if those activities are substantial to the entity, subject to the entity continuing to meet the definition of an investment entity.
- If it provides management services, strategic advice and financial support to an investee, directly or through a subsidiary, but only if these activities are undertaken to maximise the investment return (capital appreciation or investment income) from its investees and do not represent a separate substantial business activity or a separate substantial source of income to the investment entity.

At its March 2014 meeting, the IFRS Interpretation Committee (the Committee) issued an agenda decision, which clarified the definition of 'investment-related services or activities' for subsidiaries that act as intermediate holding companies for tax optimisation purposes. Such subsidiaries may be created to own all or part of the portfolio of investments in the group structure, which is done for tax purposes, with no substantive activity or operations in the subsidiary itself. The determination of whether such subsidiaries provide investment-related services is consequential, as it affects whether such entities are consolidated by an investment entity parent or not. If a subsidiary provides investment-related services, the investment entity parent shall consolidate that subsidiary rather than account for it at fair value through profit or loss. The Committee concluded that if a subsidiary has 'no activity', then it does not provide investment-related services or activities, and therefore the parent should account for the subsidiary at fair value through profit or loss, as the exception requiring consolidation of subsidiaries of an investment entity parent (IFRS 10.32) does not apply.

4.2. Exception from consolidation

Other than as noted below, an investment entity is prohibited from consolidating its subsidiaries or applying IFRS 3 when it obtains control of another entity. Instead, an investment entity is required to measure its subsidiaries at fair value through profit or loss in accordance with IFRS 9. The subsidiary would also be measured at fair value through profit or loss in the investment entity's separate financial statements.

An investment entity may have a subsidiary that is not itself an investment entity and whose main purpose and activities are providing investment related services to the investment entity or other parties. That subsidiary is required to be consolidated by the investment entity and the requirements of IFRS 3 are applied to the acquisition of any such subsidiary. This includes subsidiaries that provide investment-related services to third parties as well as to its investors or management services, strategic advice and financial support to an investee. The effect of this requirement is that the investment entity's financial statements will be as if it provided the investment related services itself. If the subsidiary that provides the investment-related services or activities is itself an investment entity, the investment entity parent shall measure that subsidiary at fair value through profit or loss in accordance with paragraph 31.

Under the IASB amendments (but not the FASB's), a non-investment entity parent of an investment entity is required to consolidate all subsidiaries that it controls, including those controlled by and measured at fair value in the investment entity. The parent entity of an investment entity is only exempt from the consolidation requirement if the parent entity qualifies as an investment entity itself.

4.3. Application Guidance

An entity is required to consider all facts and circumstances when assessing whether it is an investment entity, including its purpose and design. The amendments add additional application guidance to IFRS 10 describing the three elements of the definition and four typical characteristics.

The entity commits to its investor(s) that its business purpose is to invest funds solely for returns from capital appreciation, investment income, or both

Evidence of the entity's business purpose includes documents such as an offering memorandum, publications and other corporate/ partnership documents relating to the entity's investment objectives or the way the entity presents itself to other parties such as potential investors or investees.

An entity that has a business purpose inconsistent with that of an investment entity will not meet the definition. For example, an entity whose objective is to jointly develop, produce or market products with its investees has a business purpose inconsistent with that of an investment entity because the entity will earn returns from the development, production or marketing activity in addition to returns from its investment.

Exit strategies and business purpose

One feature that differentiates an investment entity from other entities is that it does not plan to hold its investments indefinitely; it holds them for a limited period and has an exit strategy to realise capital appreciation from substantially all of its equity investments, non-financial asset investments (e.g. investment property) and any debt instruments that have the potential to be held indefinitely.



This does not mean that there is a requirement to have a specific exit strategy for each individual investment but there should be different potential strategies for different types or portfolios of investments.

The strategies should include a substantive time frame for exiting the investments. Exit mechanisms that are only put in place for default events, such as a breach of contract or non-performance, are not considered exit strategies for this purpose.

IFRS 10.B85G includes a number of examples for exit strategies.

In addition, an investment entity parent may have an investment in another investment entity subsidiary. The investment entity parent need not have an exit strategy for its investment in the subsidiary, provided that the investment entity subsidiary has appropriate exit strategies for its own investments.

Earnings from investments are solely returns from capital appreciation, investment income, or both

This requirement is not met if the entity or another member of the group containing the entity obtains, or has the objective of obtaining, other benefits from the entity's investments that are not available to other parties that are not related to the investee.

Examples would include:

- Acquiring, using, exchanging or exploiting of the processes, assets or technology of an investee or having disproportionate, or exclusive, rights to acquire assets, technology, products or services of any investee
- Joint arrangements (as defined in IFRS 11) or other agreements between the entity or another group member and an investee to develop, produce, market or provide products or services
- Financial guarantees or assets provided by an investee to serve as collateral for borrowing arrangements of the entity or another group member (an investment entity would still be able to use an investment in an investee as collateral for any of its borrowings)
- An option held by a related party of the entity to purchase, from that entity or another group member, an ownership interest in an investee of the entity
- Transactions between the entity or another group member and an investee that are on terms that are unavailable to unrelated parties, that are not at fair value or that represent a substantial portion of one of the parties business activity

- An entity is not disqualified from being an investment entity merely because it has a strategy to invest in more than one investee in the same industry, market or geographical area in order to benefit from synergies that increase the capital appreciation and investment income from those investees and those investees trade with each other.

Substantially all of the entity's investments are measured and performance evaluated on a fair value basis

A distinguishing characteristic of an investment entity is that fair value results in the most relevant information for evaluating performance, both for investors and for management. An investment entity is required to report fair value information to investors and to key management personnel (as defined in IAS 24 *Related Party Disclosure*). Key management personnel are expected to use fair value as the primary measurement attribute to evaluate the performance of substantially all of its investments and to make investment decisions.

An investment entity is also required to measure substantially all of its investments at fair value whenever fair value is required or permitted in accordance with IFRSs. For example:

- Investment property (Fair value model in IAS 40 *Investment Property*)
- Associates and joint ventures (Exemption from equity method in IAS 28)
- Financial assets (IFRS 9).

The fair value requirement only applies to investments. Non-investment assets (e.g. head office property and related equipment) and financial liabilities are not required to be measured at fair value.

Typical characteristic - More than one investment

An investment entity will usually hold several investments in order to diversify risks and maximise returns. These can be held directly or indirectly (e.g. through another investment). However, an investment entity is not required to hold multiple investments at all times throughout its existence.

Situations in which holding a single investment does not preclude an entity being an investment entity include:

- The entity is in its start-up period, has not identified suitable investments and, therefore, has not executed its investment plan
- Investments disposed of have not yet been replaced

- The entity is established to pool investors' funds to invest in a single investment when that investment is unobtainable by individual investors (e.g. when the required minimum investment is too high for an individual investor)
- The entity is in the process of liquidation.

Typical characteristic - More than one investor

An entity that has more than one investor is less likely to obtain benefits other than capital appreciation or investment income from its investments. However the Board acknowledges that there are circumstances in which an investment entity may have a single investor. These include:

- An investment entity formed by, or for, a single investor that represents or supports the interests of a wider group of investors (e.g. a pension fund, government investment fund or family trust)
- When an entity only temporarily has a single investor, including:
 - The entity is within its unexpired initial offering period and is actively identifying suitable investors
 - The entity has not yet identified suitable investors to replace ownership interests that have been redeemed
 - The entity is in the process of liquidation.

Typical characteristic - Unrelated investors

Having investors that are not related parties (as defined in IAS 24) makes it less likely that the entity, or other members of the group containing the entity, obtain benefits other than capital appreciation or investment income.

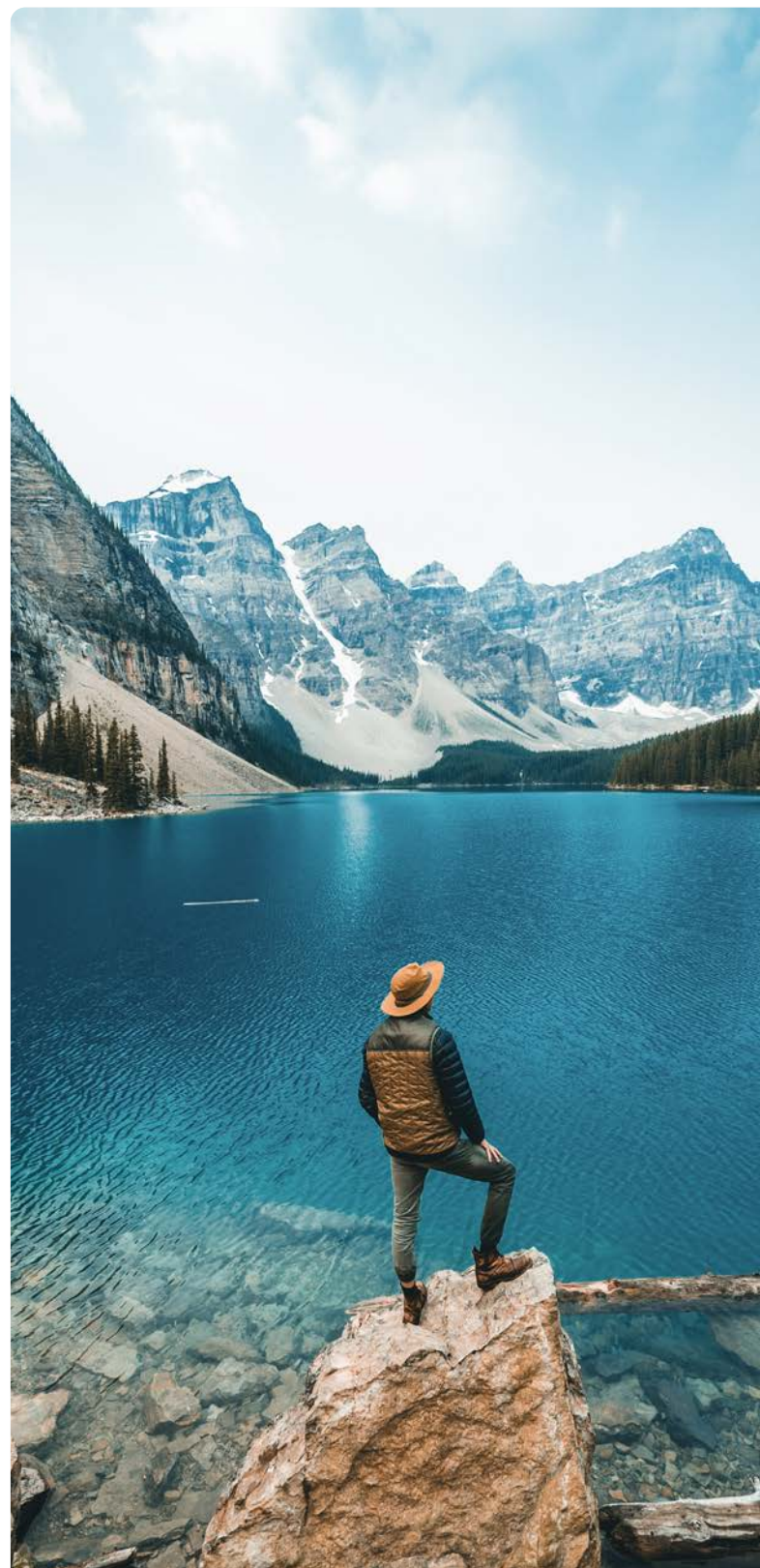
However, an entity may still qualify as an investment entity even though its investors are related to the entity. For example, an investment entity may set up a separate 'parallel' fund for a group of its employees (such as key management personnel) or other related party investor(s), which mirrors the investments of the entity's main investment fund. This 'parallel' fund may qualify as an investment entity even though all of its investors are related parties.

Typical characteristic - Ownership interests

Ownership interests are usually in the form of equity or similar interests (e.g. partnership interests), to which proportionate shares of the net assets of the investment entity are attributed.

However, having different classes of investors, some of which have rights only to a specific investment or groups of investments or which have different proportionate shares of the net assets, does not preclude an entity from being an investment entity.

An entity with ownership interests in the form of debt that, in accordance with other applicable IFRSs, do not meet the definition of equity, may still qualify as an investment entity, provided that the debt holders are exposed to variable returns from changes in the fair value of the entity's net assets.



4.4. Reassessment

An investment entity is required to reassess its investment entity status if facts and circumstances indicate that its status has changed. The change of the status of an investment entity is accounted for prospectively from the date the change in status occurs.

When an entity loses its investment entity status it applies IFRS 3 to subsidiaries previously measured at fair value through profit or loss. The date of the change of status is the deemed acquisition date and the fair value of the subsidiary at that date is the deemed consideration. This recognises the change in status in the same way as a business combination achieved in stages in IFRS 3. The difference between the deemed consideration, the amount of any non-controlling

interest and the acquisition date amounts of the identifiable assets acquired and liabilities assumed (measured in accordance with IFRS 3) is recognised as goodwill or a bargain purchase.

When an entity becomes an investment entity, it ceases to consolidate its subsidiaries at the date of the change of status except for any subsidiary that it is required to continue to consolidate as noted above (e.g. subsidiaries that provide services that relate only to the investment entity's own investment activities). The investment entity accounts for the change in status as a deemed disposal or loss of control under IFRS 10 with any resulting gain or loss being recognised in profit or loss.



4.5. Disclosures

IFRS 12 requires an investment entity to disclose the significant judgements and assumptions that it has made in determining that it is an investment entity. If an investment entity does not have all of the typical characteristics of an investment entity it is required to disclose the reasons for concluding that it is nevertheless an investment entity.

Other disclosures include:

- The fact that investments in one or more subsidiaries are accounted for at fair value through profit or loss and not by consolidation
- The facts and reasons for an entity becoming, or ceasing to be, an investment entity
- The effect of a change of status on the financial statements when an entity becomes an investment entity (total fair value, total gain or loss and identification of the line item in which the gain or loss has been recognised)
- Specified information about unconsolidated subsidiaries (e.g. name, place of business, percentage held). An investment entity that is a parent of another investment entity is required to provide this information about unconsolidated subsidiaries that are controlled by its investment entity subsidiary
- The nature and extent of significant restrictions on the ability of an unconsolidated subsidiary to transfer funds to the investment entity (e.g. cash dividends or repayment of loans or advances)
- Any current commitments or intentions to provide financial or other support to an unconsolidated subsidiary, including commitments or intentions to assist the subsidiary in obtaining financial support
- Details of financial or other support provided to unconsolidated subsidiaries by the investment entity or its subsidiaries without having a contractual obligation to do so
- The terms of contractual arrangements that could require the entity (or its unconsolidated subsidiaries) to provide financial support to an unconsolidated, controlled, structured entity, including circumstances that could expose the reporting entity to a loss
- Details of financial or other support provided to an unconsolidated, structured entity that resulted in the investment entity controlling the structured entity, where the financial or other support was provided by the investment entity (or its unconsolidated subsidiaries) without having a contractual obligation to do.

5. Disclosure requirements in IFRS 12

The objective of IFRS 12 *Disclosure of Interests in Other Entities* is to require a reporting entity to disclose information that helps users of its financial statements understand:

- The nature of, and risks associated with, its interests in other entities (whether these are subsidiaries, joint operations, joint ventures, associates or interests in structured entities that are not consolidated)
- The effects of those interests on the reporting entity's financial position, financial performance and cash flows.

IFRS 12 sets out disclosure requirements, including those related to unconsolidated structured entities where a lack of transparency about entities' exposures to related risks was highlighted by the global financial crisis.

For investees consolidated under IFRS 10 *Consolidated Financial Statements*, the disclosure requirements in IFRS 12 are:

- Significant judgements and assumptions (and changes to those judgements and assumptions) in determining that it has control of another entity (IFRS 12.7(a)). These may include:
 - Why it does not control another entity even though it holds more than half of the voting rights of the other entity (IFRS 12.9(a))
 - Why it controls another entity even though it holds less than half of the voting rights of the other entity (IFRS 12.9(b))
 - Why it is an agent or a principal (IFRS 12.9(c)).
- Composition of the group (IFRS 12.10(a)(i))
- Non-controlling interests (NCI) in the group's activities and cash flows (IFRS 12.10(a)(ii)). For each of its subsidiaries that have material NCI (IFRS 12.12):
 - Name
 - Principal place of business (and country of incorporation if different from the principal place of business)
 - Proportion of ownership interests held by NCI
 - Proportion of voting rights held by NCI, if different from the proportion of ownership interests held
 - Profit or loss allocated to NCI of the subsidiary during the reporting period
- Accumulated controlling interests of the subsidiary at the end of the reporting period
- Summarised financial information about the subsidiary (e.g. dividends paid to NCI, current assets, non-current assets, current liabilities, non-current liabilities, revenue, profit or loss and total comprehensive income).
- Significant restrictions (e.g. statutory, contractual and regulatory restrictions) on the ability to access or use the assets and settle the liabilities of the group, such as:
 - Those that restrict the ability of a parent or its subsidiaries to transfer cash or other assets to (or from) other entities within the group
 - Guarantees or other requirements that may restrict dividends and other capital distributions being paid, or loans and advances being made or repaid, to (or from) other entities within the group (IFRS 12.13(a)).
- The nature and extent to which protective rights of NCI can significantly restrict the entity's ability to access or use the assets and settle the liabilities of the group (such as when a parent is obliged to settle liabilities of a subsidiary before settling its own liabilities, or approval of NCI is required either to access the assets or to settle the liabilities of a subsidiary) (IFRS 12.13(b))
- The carrying amounts in the consolidated financial statements of the assets and liabilities to which those restrictions apply (IFRS 12.13(c))
- The terms of contractual arrangements that could require the parent or its subsidiaries to provide financial support to a consolidated structured entity, including events or circumstances that could expose the reporting entity to a loss (e.g. liquidity arrangements or credit rating triggers associated with obligations to purchase assets of the structured entity or provide financial support) (IFRS 12.14)
- A schedule that shows the effects on the equity attributable to owners of the parent of any changes in its ownership interest in a subsidiary that do not result in a loss of control (IFRS 12.18)
- Any gain or loss as a result of losing control of a subsidiary during the reporting period and if a portion of the investment is retained the gain or loss as a result of remeasuring the retained interest to its fair value. The line item where the total gain or loss is included (IFRS 12.18).

6. Appendix A - Definitions

6.1. Definitions IFRSs 10, 11 and 12, and IASs 24, 27 and 28

Associate (IAS 28)	An associate is an entity over which the investor has significant influence.
Consolidated financial statements (IFRS 10)	The financial statements of a group in which the assets, liabilities, equity, income, expenses and cash flows of the parent and its subsidiaries are presented as those of a single economic entity.
Control of an investee (IFRS 10)	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.
Decision maker (IFRS 10)	An entity with decision-making rights that is either a principal or an agent for other parties.
Equity method (IAS 28)	The equity method is a method of accounting whereby the investment is initially recognised at cost and adjusted thereafter for the post-acquisition change in the investor's share of the investee's net assets. The investor's profit or loss includes its share of the investee's profit or loss and the investor's other comprehensive income includes its share of the investee's other comprehensive income.
Group (IFRS 10)	A parent and its subsidiaries.
Income from a structured entity (IFRS 12)	Income from a structured entity includes, but is not limited to, recurring and non-recurring fees, interest, dividends, gains or losses on the remeasurement or derecognition of interests in structured entities and gains or losses from the transfer of assets and liabilities to the structured entity.
Interest in another entity (IFRS 12)	An interest in another entity refers to contractual and non-contractual involvement that exposes an entity to variability of returns from the performance of the other entity. An interest in another entity can be evidenced by, but is not limited to, the holding of equity or debt instruments as well as other forms of involvement such as the provision of funding, liquidity support, credit enhancement and guarantees. It includes the means by which an entity has control or joint control of, or significant influence over, another entity. An entity does not necessarily have an interest in another entity solely because of a typical customer supplier relationship.
Investment entity (IFRS 10)	An entity that: <ul style="list-style-type: none"> (a) obtains funds from one or more investors for the purpose of providing those investor(s) with investment management services; (b) commits to its investor(s) that its business purpose is to invest funds solely for returns from capital appreciation, investment income, or both; and (c) measures and evaluates the performance of substantially all of its investments on a fair value basis.

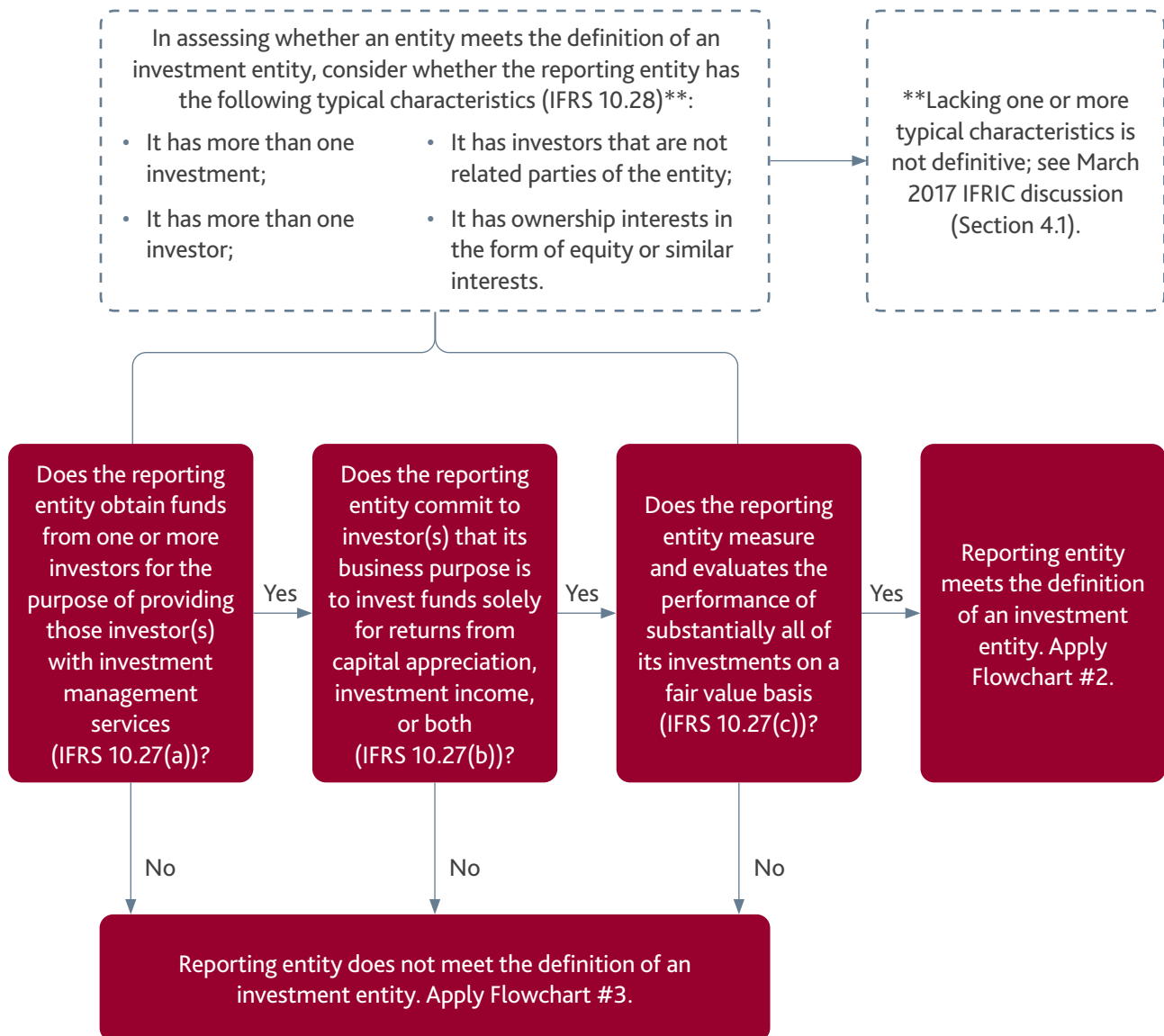
Joint arrangement (IFRS 11)	An arrangement of which two or more parties have joint control.
Joint control (IFRS 11)	The contractually agreed sharing of control of an arrangement, which exists only when decisions about the relevant activities require the unanimous consent of the parties sharing control.
Joint operation (IFRS 11)	A joint arrangement whereby the parties that have joint control of the arrangement have rights to the assets, and obligations for the liabilities, relating to the arrangement.
Joint operator (IFRS 11)	A party to a joint operation that has joint control of that joint operation.
Joint venture (IFRS 11)	A joint arrangement whereby the parties that have joint control of the arrangement have rights to the net assets of the arrangement.
Joint venturer (IFRS 11)	A party to a joint venture that has joint control of that joint venture.
Key management personnel (IAS 24)	Key management personnel are those persons having authority and responsibility for planning, directing and controlling the activities of the entity, directly or indirectly, including any director (whether executive or otherwise) of that entity.
Non-controlling interest (IFRS 10)	Equity in a subsidiary not attributable, directly or indirectly, to a parent.
Parent (IFRS 10)	An entity that controls one or more entities.
Party to a joint arrangement (IFRS 11)	An entity that participates in a joint arrangement, regardless of whether that entity has joint control of the arrangement.
Power (IFRS 10)	Existing rights that give the current ability to direct the relevant activities.
Protective rights (IFRS 10)	Rights designed to protect the interest of the party holding those rights without giving that party power over the entity to which those rights relate.
Related party (IAS 24)	<p>A related party is a person or entity that is related to the entity that is preparing its financial statements (referred to as the 'reporting entity'):</p> <p>(a) A person or a close member of that person's family is related to a reporting entity if that person:</p> <ul style="list-style-type: none"> (i) Has control or joint control of the reporting entity (ii) Has significant influence over the reporting entity (iii) Is a member of the key management personnel of the reporting entity or of a parent of the reporting entity. <p>(b) An entity is related to a reporting entity if any of the following conditions applies:</p> <ul style="list-style-type: none"> (i) The entity and the reporting entity are members of the same group (which means that each parent, subsidiary and fellow subsidiary is related to the others) (ii) One entity is an associate or joint venture of the other entity (or an associate or joint venture of a member of a group of which the other entity is a member)

Related party (IAS 24)	<ul style="list-style-type: none"> (iii) Both entities are joint ventures of the same third party (iv) One entity is a joint venture of a third entity and the other entity is an associate of the third entity (v) The entity is a post-employment benefit plan for the benefit of employees of either the reporting entity or an entity related to the reporting entity. If the reporting entity is itself such a plan, the sponsoring employers are also related to the reporting entity (vi) The entity is controlled or jointly controlled by a person identified in (a) (vii) A person identified in (a)(i) has significant influence over the entity or is a member of the key management personnel of the entity (or of a parent of the entity) (viii) The entity, or any member of a group of which it is a part, provides key management personnel services to the reporting entity or to the parent of the reporting entity.
<i>continued</i>	
Relevant activities (IFRS 10)	For the purpose of this IFRS, relevant activities are activities of the investee that significantly affect the investee's returns.
Removal rights (IFRS 10)	Rights to deprive the decision maker of its decision-making authority.
Separate financial statements (IAS 27)	Separate financial statements are those presented by a parent (ie an investor with control of a subsidiary) or an investor with joint control of, or significant influence over, an investee, in which the investments are accounted for at cost or in accordance with IFRS 9 <i>Financial Instruments</i> .
Separate vehicle (IFRS 11)	A separately identifiable financial structure, including separate legal entities or entities recognised by statute, regardless of whether those entities have a legal personality.
Significant influence (IAS 28)	Significant influence is the power to participate in the financial and operating policy decisions of the investee but is not control or joint control of those policies.
Structured entity (IFRS 12)	An entity that has been designed so that voting or similar rights are not the dominant factor in deciding who controls the entity, such as when any voting rights relate to administrative tasks only and the relevant activities are directed by means of contractual arrangements.
Subsidiary (IFRS 10)	An entity that is controlled by another entity.



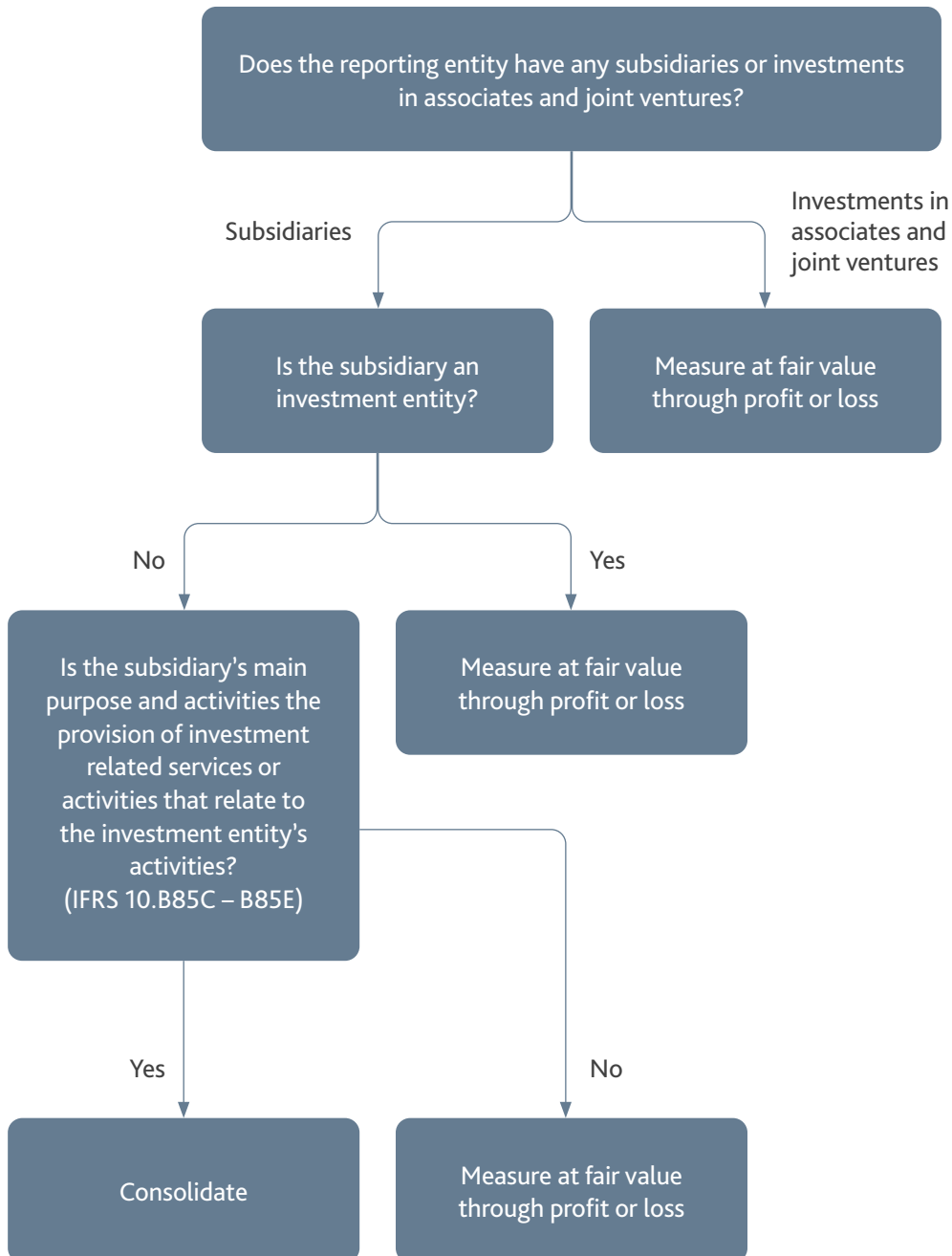
Appendix B – IFRS 10 Flowcharts

Flowchart #1 - Assessing Whether an Entity Meets the Definition of an 'Investment Entity'



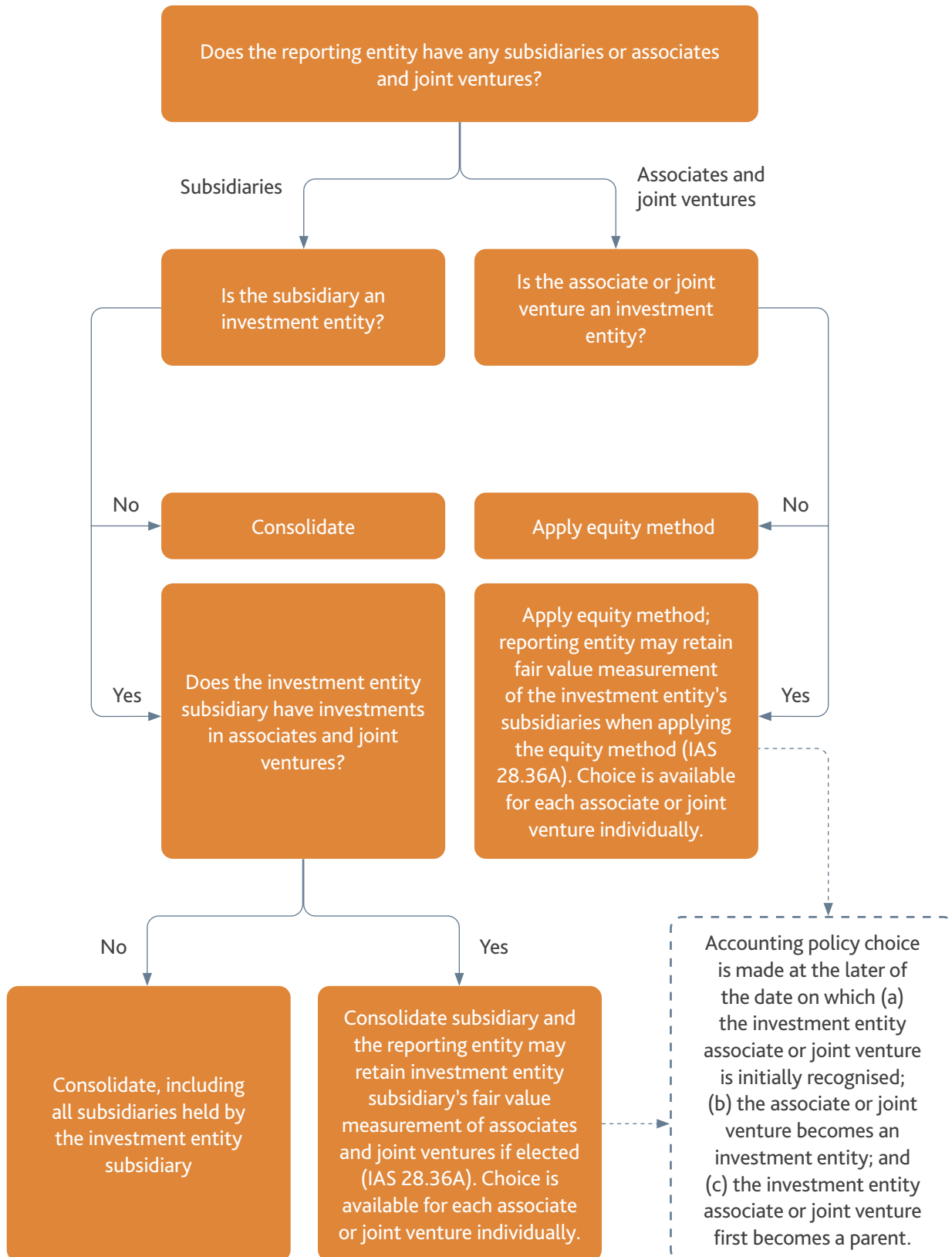
Appendix B – IFRS 10 Flowcharts

Flowchart #2 - Applying IFRS 10 for Investment Entities



Appendix B – IFRS 10 Flowcharts

Flowchart #3 - Applying IFRS 10 for Non-Investment Entities



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