September 2011

Effect analysis

IFRS 10 *Consolidated Financial Statements* and IFRS 12 *Disclosure of Interests in Other Entities*

IFRS™

The IASB's approach to effect analysis

Before we issue new requirements, or make amendments to existing IFRSs, we consider the costs and benefits of what we are proposing. This includes an assessment of both the costs incurred by preparers of financial statements and the costs incurred by users of financial statements when information is not available. We also consider the comparative advantage that preparers have in developing information that users would otherwise have to develop themselves.

What is the measurement bar for our assessment?

We expect our standards to have economic effects, and we understand that those effects may be beneficial for some entities and detrimental to others. For example, a change in financial reporting requirements might affect the cost of capital for individual entities by changing the absolute or relative level of information asymmetry associated with those entities.

We assess these associated costs and benefits by reference to the overall objective of financial reporting. We try to understand how the changes will contribute towards the development of a single set of high quality global accounting standards by improving the allocation of capital. We therefore also consider the benefit of better economic decision-making as a result of improved financial reporting.

The boundaries of our assessment

a) Uncertainties

The assessment is undertaken before the requirements have been applied. This means that we cannot be certain about the actual effects until after the new requirements have been applied for some time. This is why the IASB is committed to undertaking post-implementation reviews two years after implementation.

In the longer term, we encourage academic researchers to perform empirical research into the way in which our standards are incorporated into economic decisions. Some studies focus on the role of accounting information in the capital markets, thereby providing us with insights into how accounting information is incorporated into share prices. Other studies focus on how changes to IFRSs affect the behaviour of parties, such as management. We expect to consider relevant research as part of our post-implementation review.

b) A broad range of geographical and transactional circumstances

IFRSs are applied around the world. Consequently the circumstances in which entities operate vary considerably and the legal and cultural environments will have an impact on the effects of the proposed changes. This poses a limitation on what can be expected from a cost-benefit and effect analysis.

It is unlikely that we could prepare an assessment that met the needs of every jurisdiction. Some jurisdictions incorporating IFRSs into their legal framework require, or elect to prepare, some form of regulatory impact assessment before a new IFRS, or an amendment to an existing IFRS, is brought into law. The requirements vary between jurisdictions, and in some cases have broader policy factors in mind than the effect on preparers and users.

c) Each effect analysis will vary

The information we provide in a given effect analysis will depend on the nature of the project or standard we are assessing. For example, the way in which we demonstrate both the existence and extent of problems and the way in which our standards address them will necessarily vary depending on what those problems and situations are.

In the case of our joint arrangements project, we eliminated an existing accounting option and so were able to use reported information to demonstrate the diversity in practice that existed because of that accounting option. In the case of this project, consolidations, we have clarified how a group is determined. It is not possible, in this case, to use reported information to identify diversity in practice or the reporting effect of the new requirements.

Instead, we have provided evidence of diversity by taking a transactional approach. We identified, through extensive consultation, common fact patterns for which we observed inconsistent application of IAS 27 and SIC-12. The effect analysis includes some of those fact patterns and describes the different accounting outcomes we observed.

continued overleaf

What are the benefits of our assessment?

Our assessment can provide jurisdictions with input to their processes. For example, we can document what we learned during the development of an IFRS about the likely costs of both implementing a new requirement and continuing to apply it. We gain insight into the costs and benefits of standards through our consultations, by both consultative publications (discussion papers, exposure drafts etc) and communications with interested parties (outreach activities, meetings etc).

Our expectation is that the assessment that follows will assist jurisdictions in meeting their requirements.

Qualitative assessment

Our evaluations of costs and benefits are necessarily qualitative rather than quantitative. This is mainly for two reasons:

1. Quantifying costs and, particularly, benefits is inherently difficult. Although some have attempted this type of analysis, there is a lack of sufficiently well-established and reliable techniques for a complete and robust quantitative assessment.
2. A quantitative assessment would disregard specific circumstances and would be limited in the scope of its assessment. It could risk overlooking important aspects and could potentially be misleading.

Consequently, we think that a broader qualitative analysis in the form of extensive outreach to preparers and users, complemented with field-testing of the requirements, will produce more valuable insights. We perform such outreach and field testing throughout the development of our standards.

The input that we receive through this analysis allows us to create what we think are 'typical examples' of situations in which these requirements would apply and the resulting effects.

Summary

IFRS 10 *Consolidated Financial Statements* establishes principles for the preparation and presentation of consolidated financial statements when a reporting entity controls one or more investees. IFRS 12 *Disclosure of Interests in Other Entities* sets out disclosure requirements for reporting entities that have an interest in a subsidiary, joint arrangement, associate or unconsolidated structured entity.

IFRS 10 provides a single consolidation model that applies to all types of entities. The standard was published to deal with divergence in practice when applying IAS 27 *Consolidated and Separate Financial Statements* and SIC-12 *Consolidation—Special Purpose Entities*. While the basic consolidation model and principles in IAS 27 and SIC-12 were sound, they were not always applied consistently. Different interpretations of some of the requirements in IAS 27 and SIC-12 developed, and it was often difficult to assess which standard (IAS 27 or SIC-12) to apply to some entities.

IFRS 10 builds on the concepts in IAS 27 and SIC-12 and combines them into a single consolidation model, based on the principle of control. The use of a single consolidation model that applies to all entities removes uncertainty about which guidance to apply to different entities. The consolidation model in IFRS 10 clarifies requirements that were either implicitly embedded or only briefly addressed in IAS 27 and SIC-12 and provides additional application guidance.

IFRS 12 contains disclosure requirements for a reporting entity's special relationships with other entities. The standard was published to respond to users' requests for improvements to those disclosures. In addition, the global financial crisis that started in 2007 highlighted the lack of transparency about the risks to which reporting entities were exposed from their involvement with 'off balance sheet vehicles', including those that they had set up or sponsored. IFRS 12 contains enhanced disclosure requirements about a reporting entity's interests in subsidiaries, joint arrangements and associates as well as new disclosure requirements about unconsolidated structured entities. Those disclosure requirements are expected to give users better information to help them identify the profit or loss and cash flows available to a reporting entity and, thus, to evaluate the value of a current or future investment in that entity.

Effect Analysis

This document aims to provide the reader with an analysis of the effects of IFRS 10 *Consolidated Financial Statements* and IFRS 12 *Disclosure of Interests in Other Entities*.

We have carried out this analysis by identifying typical scenarios to highlight those areas where we expect the most significant effects from applying IFRS 10 and IFRS 12 as compared to IAS 27 *Consolidated and Separate Financial Statements* and SIC-12 *Consolidation—Special Purpose Entities*.

This effect analysis is composed of the following sections:

Why we issued IFRS 10 and IFRS 12

A single consolidation model

IFRS 10 introduces a consolidation model that builds upon the requirements and concepts in IAS 27 and SIC-12. The consolidation model in IFRS 10 applies to all investees.

Like IAS 27 and SIC-12, the consolidation model in IFRS 10 is based on control. A reporting entity is required to consolidate an investee when that entity controls the investee. However, IFRS 10 more clearly articulates the principle of control so that it can be applied to all investees. It defines control as consisting of three elements: power, exposure to variable returns, and an investor's ability to use power to affect its amount of variable returns. The principle of control and its three elements are explained in detail throughout the standard and the application guidance (including the application examples). IAS 27 and SIC-12 did not contain a detailed discussion of the concept of control, nor did they provide application guidance.

Additional application guidance

IFRS 10 includes application guidance regarding situations in which control is difficult to assess, including situations involving agency relationships, relationships with entities that are designed so that voting rights are not the dominant factor in assessing control (hereafter referred to as 'structured entities'), potential voting rights and control without a majority of voting rights. As will be explained further in this document, we have learned that our constituents have developed different mechanisms and 'bright lines' to deal with the assessment of control in those situations and that those guidelines can differ between entities and across jurisdictions. We think that the requirements and guidance in IFRS 10 will lead to more consistent accounting in those situations by detailing what a reporting entity must consider in assessing control. This should reduce the need for individual constituents, such as preparers or accounting firms, to develop their own guidance on the assessment of control. This should also improve consistency and comparability in financial reporting.

Diversity in practice

Through our outreach, we confirmed that there are several causes of inconsistent application of IAS 27 and SIC-12 that have resulted in diversity in practice. Some reporting entities found it difficult to determine which investees were within the scope of IAS 27 and which were within the scope of SIC-12. Because the requirements for assessing control are different in IAS 27 (focusing on power to govern financial and operating policies) and SIC-12 (focusing more on exposure to a majority of risks and rewards), in some cases, a reporting entity reached different consolidation conclusions depending on whether that entity applied IAS 27 or SIC-12.

There was also a lack of guidance within the individual standards themselves that led to inconsistent application in practice. For example, IAS 27 provided limited guidance regarding control without a majority of voting rights and how to assess the effect of protective rights when assessing control. In the absence of guidance, application of the requirements in IAS 27 in those circumstances differed between jurisdictions. In addition, SIC-12 provided no guidance regarding the weighting of the different indicators of control. This has sometimes led to different accounting outcomes depending on which indicators a reporting entity focused on when assessing control of special purpose entities.

IFRS 10 addresses those inconsistencies by containing a single consolidation model and more application guidance. We expect that this will lead to more consistent application in practice, providing benefits for both preparers (by removing doubts about scope and how to apply the control principle) and users (more consistent, and therefore comparable, financial information). In addition, the disclosure requirements are expected to lead to better information for users about investees that are consolidated, and also about the risks to which a reporting entity is exposed from its involvement with investees that are not consolidated.

continued

Moving away from 'bright lines'

Another criticism of IAS 27 and SIC-12 was that the requirements led to a focus on 'bright lines' and provided structuring opportunities rather than focusing on the nature of a reporting entity's relationship with an investee. We found that this arose for a number of reasons. For example, SIC-12 led, at times, to a quantitative assessment of whether an investor had a majority of risks and rewards. IAS 27 focused primarily on whether an investor had a majority of the voting rights in an investee. IAS 27 also specified that potential voting rights were to be included in the assessment of control only when they were currently exercisable. In some cases, this led to a focus on the date of exercise without considering whether the terms and conditions of the instruments were substantive.

IFRS 10 sets out a single consolidation model based on the principle of control. Academic research has shown that structuring opportunities are more widely available and used when accounting standards include rules and 'bright lines' rather than clearly articulated principles.*

Some constituents might wonder whether the new requirements in IFRS 10 will lead to more consolidation or less. Although that is not possible to quantify, we think the requirements in IFRS 10 will lead to more appropriate consolidation; that is, entities will consolidate investees only when they control them but, at the same time, will consolidate all investees that they control.

We note that, in situations in which a reporting entity ceases to consolidate an investee that it previously consolidated under IAS 27 but had transferred financial instruments to that investee, the derecognition requirements in IAS 39 *Financial Investments: Recognition and Measurement*/IFRS 9 *Financial Instruments* will require those financial assets to be recognised by the reporting entity if that entity retains risks and rewards associated with those financial instruments. Consequently, it is important to consider the derecognition requirements in IFRS 9 together with the consolidation requirements of IFRS 10 when assessing the overall effect of cases in which a reporting entity is an originator of financial assets transferred to a structured entity.

* Demski, J. S. (2002): Enron et al. – a comment, in: Journal of Accounting and Public Policy, Vol. 21 (2002), p. 129-130.
Haskins, M. /Sack, R. (2005): Calling all parties: Now is the time to come to the aid of the balance sheet, in: Business Horizons, 48. Jg. (2005), p. 325-335.
Nelson, M. /Elliott, J. /Tarpley, R.: Evidence from Auditors about Managers' and Auditors' Earnings Management Decisions, in: The Accounting Review (Supplement 2002).
Schipper, K. (2003): Commentary: Principles-Based Accounting Standards, in: Accounting Horizons, Vol. 17 (2003), p. 61-72.

Improved disclosure requirements

One of the most important changes to financial reporting that arises from IFRS 10 and IFRS 12 is the improved disclosure requirements about both consolidated and unconsolidated entities. Previously, IAS 27 and SIC-12 contained limited disclosure requirements for subsidiaries and no disclosure requirements for unconsolidated structured entities. That lack of guidance was a frequent criticism of IAS 27 and SIC-12. The Financial Stability Board, regulators and others identified disclosures about risks associated with structured entities and other 'off balance sheet' entities as an area that urgently needed improvement. Users also requested improvements to risk disclosures, as well as other disclosures about consolidated entities.

IFRS 12 provides comprehensive disclosure requirements about a reporting entity's interest in other entities. We believe that this will address many of the criticisms about insufficient disclosure in this area in recent years. The new information should help users to evaluate the nature of, and risks associated with, a reporting entity's interest in other entities and the effects of those interests on its financial position, financial performance and cash flows.

We have heard overwhelming support from the user community for the disclosure requirements in IFRS 12 and feel confident that they represent an improvement to the quality of financial reporting.

Gathering evidence

We consulted extensively throughout the development of IFRS 10 and IFRS 12 and received a large volume of feedback on the requirements. The evaluation of the likely effects of IFRS 10 and IFRS 12 is based on the feedback received. A summary of the outreach we performed follows.

ED 10, IFRS 10, IFRS 12 and the related staff drafts

Before publishing IFRS 10 and IFRS 12, we issued an exposure draft (ED 10 *Consolidated Financial Statements)* of the proposed requirements. Additionally, before the publication of both ED 10 and IFRS 10, we posted staff drafts of the full documents on our public website. The staff draft of IFRS 10 was available for seven months before its publication.

We received a range of comments on those drafts, concerning both the consolidation requirements in IFRS 10 and the disclosure requirements in IFRS 12. Importantly, these comments also included different fact patterns from constituents around the world. That feedback helped us to assess the effect of the requirements on our constituents.

Obtaining feedback throughout the process helped to improve the drafting of the requirements in IFRS 10 and IFRS 12 and to educate constituents about those requirements.

Round-table meetings

We held round-table meetings before and after the publication of ED 10 and the staff draft of IFRS 10 to discuss the proposed requirements including the disclosure requirements and the drafting of the standard. At these meetings, we discussed the principle of control, de facto control, potential voting rights, agent/principal relationships and control of structured entities. Those round-table meetings were held in London, Tokyo, Toronto and Norwalk and gave us the opportunity to hear the views of constituents from around the world. Constituents from a wide variety of backgrounds attended these meetings, both as participants and as observers. Each meeting had over 25 participants and many more observers (see project time line on page 14).

Targeted outreach

We engaged in targeted outreach with some users of IFRSs who were likely to be most affected by the requirements, including preparers and auditors from the financial services industry. Those parties interacted with us throughout the project. They gave us documentation on a confidential basis of different fact patterns to which the requirements would apply. This information provided us with invaluable material with which to test the robustness of the requirements.

Investor outreach

We discussed the requirements of IFRS 10 and IFRS 12 with investors and others from the user community to receive feedback on the effects of the requirements, especially the disclosure requirements in IFRS 12. We also developed a specific questionnaire for users that focused on de facto control, potential voting rights and agency relationships. That questionnaire was distributed to users with different backgrounds from around the world. That feedback helped us develop an understanding of the information that investors are seeking to help assess the financial effects of a reporting entity's relationships with other entities.

Other outreach

We also discussed the requirements of IFRS 10 and IFRS 12 at a variety of other venues, including with our advisory council, the Global Preparers Forum, the Capital Markets Advisory Committee, World Standard Setters meetings, specific industry focus groups and the IFRS Foundation and at other conferences. By engaging in that kind of outreach throughout the process, we received input on the effects of the requirements throughout the period during which those requirements were being developed.

Project time line

2003

Comprehensive project on consolidation requirements added to the agenda

2008

July 2008
Staff draft of the exposure draft published

Sept 2008
Round tables on the staff draft

Dec 2008
Exposure draft published

2009

May 2009
Comment letter summary presented

June 2009
Round tables in London, Tokyo, Toronto

Oct 2009
FASB joins the project

2010

Sept 2010
Staff draft of IFRS 10 published

Oct 2010
Round tables in Norwalk

2011

May 2011
IFRS 10 and IFRS 12 issued

2013

1 Jan 2013
IFRS 10 and IFRS 12 become mandatory

2016

Post-implementation review

Summarising our outreach

Although it would not be possible to express in numbers all of the outreach we performed during the development of IFRS 10 and IFRS 12, we did communicate with a wide variety of constituents from around the world.

We think that it would be most helpful to summarise the outreach that we performed by type of constituent, topic discussed and geographical region. We held in-depth discussions with these participants, discussing their thoughts on the effects of IFRS 10 and IFRS 12 in the context of certain topics. We discussed all of the most critical and contentious areas of IFRS 10 and IFRS 12 in the course of our outreach. In addtion, we targeted our outreach so that we spoke with those constituents who had most experience in each of the topics discussed (for example, speaking with leading asset managers regarding agent/principal relationships).

Summary of outreach by topic and type of constituent							
	The control model	**Power/ relevant activities**	**De facto control**	**Potential voting rights**	**Agent/ principal**	**Control of structured entities**	**Disclosure**
Users	29	18	25	24	25	19	34
Preparers—banks	26	7	6	6	19	33	27
Preparers—insurers	13	2	1	1	14	2	1
Preparers—asset managers	-	-	-	-	5	-	-
Preparers—other	28	3	18	3	4	16	4
Regulators	3	-	-	-	2	3	2
Accounting firms	6	6	6	6	6	6	6
Other	15	12	16	11	13	14	14
Participants—Total	**120**	**48**	**72**	**51**	**88**	**93**	**88**
Participants—Europe	81	25	41	25	51	66	58

Questions about IFRS 10 and IFRS 12

Are there new consolidation requirements?

Some may be concerned that IFRS 10 introduces new concepts and consolidation requirements when compared to IAS 27 and SIC-12. On the contrary, IFRS 10 does not introduce new concepts. Instead, it builds on the control guidance that existed in IAS 27 and SIC-12 but adds additional context, explanation and application guidance that is consistent with the definition of control.

For example, IFRS 10 contains guidance regarding potential voting rights. Considering potential voting rights when assessing control is not new; IAS 27 already required that potential voting rights be considered if they were currently exercisable. However, this requirement was not always consistent with the definition of control in IAS 27. Potential voting rights were sometimes considered in the consolidation assessment when they did not actually affect a reporting entity's control of an investee, and vice versa. IFRS 10 provides a more principles-based approach to the consideration of potential voting rights when assessing control, requiring that they are to be considered if they are substantive. IFRS 10 also contains additional application guidance regarding potential voting rights that is, again, consistent with the principle of control in IFRS 10.

Similarly, although the concept of control without a majority of voting rights was implicit in IAS 27, the standard did not provide explicit guidance or examples about that concept. As a result, inconsistent interpretations of that concept existed in practice. IFRS 10 clarifies that control can indeed exist without a majority of voting rights and provides factors to consider in making this assessment and examples of such circumstances.

Finally, IAS 27 and SIC-12 implicitly required the continuous assessment of control. IFRS 10 now explicitly includes that requirement and provides application guidance describing situations in which a reporting entity would gain or lose control.

However, we do think that IFRS 10 will change the way in which a reporting entity will assess control of structured entities. IFRS 10 requires that a reporting entity will focus on all three elements of control when assessing control of any entity, including a structured entity, and should not focus only on risks and rewards, which sometimes was the case when applying SIC-12.

Will there be more or less consolidation?

Some reporting entities will need to consolidate investees that they have previously been able to keep 'off balance sheet' by using the brighter lines found in IAS 27 and SIC-12. In other cases, reporting entities will no longer consolidate some investees that were previously consolidated. Whether a reporting entity will have to consolidate more or fewer investees will depend on the nature of its interests in its investees.

At a very basic level, however, most consolidation decisions should be unaffected by the new consolidation model in IFRS 10. Change is most likely to occur around the margins, in the cases of the more complex structures. IFRS 10 provides more guidance about the factors to consider in such structures that involve potential voting rights, agency relationships, relationships with structured entities and control without a majority of voting rights. As will be illustrated later in this document, we found through our outreach that it was in those areas that inconsistent application and structuring opportunities were most pervasive.

Put simply, this effect analysis focuses on the appropriateness of consolidation; that is, whether the application of IFRS 10 will result in consolidation that will better reflect the relationship between a reporting entity and an investee, rather than on whether the changes will result in more consolidation or less. We think that the analysis that follows in this document illustrates that IFRS 10 will result in more appropriate consolidation; reporting entities will consolidate investees only when they control them. At the same time, they will consolidate all investees that they truly control.

One of the factors that contributes most to appropriate consolidation is a clearer definition of power, which is one of the elements of control. Power depends upon an assessment of all existing rights that a reporting entity and other investors have in relation to the activities of an investee. IFRS 10 also clarifies that power exists when a reporting entity 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. Because of this, we think that power will often be present in investees that had traditionally been considered to be 'autopilot' structures. By articulating a clear principle of power and control, the opportunities for reporting entities to avoid consolidation by, for example, only focusing on risks and rewards, is reduced because the analysis now depends on a full analysis of a reporting entity's relationship with an investee.

Costs of reassessment

Some constituents have expressed concerns about the costs of reassessing control. We do not think that this will create significant additional costs for preparers. A reporting entity will have to reassess whether it controls an investee only when facts and circumstances indicate there may have been a change to one of the three elements of control. Although not explicitly stated, similar reassessment requirements existed in IAS 27, and, by extension, in SIC-12. Other constituents were concerned that preparers would have to continuously track changes in individual factors that might affect control, such as the exercise price of potential voting rights, and the size and dispersion of voting rights that the reporting entity and other entities hold in an investee or voting patterns at shareholder meetings. However, IFRS 10 requires a holistic view of control; all factors affecting control need to be considered in the assessment. Consequently, we do not think that it will be necessary to constantly monitor and track changes in each factor that might affect control. The circumstances that will trigger reassessment should be obvious to a reporting entity.

In addition, IFRS 10 makes clear that the assessment of control should not be a 'hunting' exercise for which the holder of the largest shareholding or of potential voting rights is presumed to have control in the absence of evidence to the contrary. If a reporting entity controls an investee, that conclusion is reached on the basis of an assessment of the rights that the reporting entity holds, and on evidence that is sufficient to conclude that those rights give the reporting entity power over the investee, exposure or rights to variable returns, and the ability to use that power to affect the returns that it receives.

Analysing the likely effects: illustrating the outcomes

As described previously, the consolidation model in IFRS 10 is based upon concepts and principles that existed in IAS 27 and SIC-12. However, IFRS 10 more fully explains the existing principles and provides more guidance about how to apply those principles. It also articulates the principle of control so that it can be applied to all types of entities, thereby removing the differing emphases that existed in IAS 27 and SIC-12.

Because the accounting requirements are not changing dramatically, it is more difficult to isolate effects of the new requirements in IFRS 10. However, we were informed that the requirements in IAS 27 and SIC-12 were, at times, inconsistently applied or gave rise to structuring opportunities (see the 'Diversity in practice' and 'Moving away from 'bright lines'' sections). We therefore analysed our new requirements to see whether they would, in fact, result in more consistent application and in more appropriate consolidation decisions.

Our analysis is presented as a series of examples, grouped into the two issues that represented the greatest problems with previous guidance:

- diversity in practice for similar or identical fact patterns; and
- a reliance on 'bright lines' in the control assessment.

As we performed outreach, staff and board members were given examples, based on real transactions and relationships, that demonstrated these problems. We used those transactions to field test the effects of IFRS 10. Again, we thought that such a transactional focus was appropriate for analysing IFRS 10 because the effects for each reporting entity will depend on the specific relationships that the reporting entity has with its investees. Because the implementation of IFRS 10 will have different effects for different entities, it would neither be meaningful nor possible at this stage to obtain information showing the overall effects for particular types of entities or for particular territories.

The examples illustrate the application of both previous guidance (IAS 27 and SIC-12) and the new requirements in IFRS 10 and IFRS 12. Although based on actual fact patterns, the examples have been simplified to illustrate the requirements and inconsistencies in current practice. They have also been generalised to for confidentiality reasons.

The following examples are not intended to serve as a complete list of all cases where IFRS 10 and IFRS-12 might have an effect. Instead, they are intended to serve as a selection of cases illustrating the most significant effects of the new requirements.

All examples that are used in this document are independent of each other.

Addressing diversity in practice

As discussed earlier in this document, perceived inconsistencies between the consolidation guidance in IAS 27 and SIC-12 resulted in diversity in practice. We have evaluated the application of the requirements of IFRS 10 and IFRS 12 to assess whether they would provide more consistency.

Control without a majority of voting rights

IFRS 10 provides explicit guidance regarding the possibility of control without a majority of voting rights. In IFRS 10, control depends on a reporting entity's practical ability to direct the relevant activities of an investee unilaterally.

IAS 27 focused on control with a majority of voting rights. We were informed that it was unclear, when assessing control, whether a reporting entity should follow a legal approach (a strict focus on voting and other contractual rights) or an economic approach (a wider view taking into account the reporting entity's practical ability to direct activities through the rights it holds) for assessing control. In some jurisdictions, investees were consolidated with less than 50 per cent of the voting rights and where the reporting entity held no other contractual rights that guaranteed power, while in others they were not consolidated.

Moreover, IAS 27 provided only limited guidance regarding the particular circumstances that would result in control without a majority of voting rights. We have learned that the lack of guidance in this area has led to further diversity in practice across and within the jurisdictions that applied the economic approach.

We think the guidance in IFRS 10 will improve financial reporting by leading to more consistent and appropriate consolidation decisions in situations in which no one party holds more than 50 per cent of the voting rights of an investee.

Examples overleaf

IFRS 10 should reduce diversity in practice by providing a clearer principle of control, explicitly stating that a reporting entity can control an investee with less than a majority of voting rights and providing application guidance and examples on how to assess control when no single investor holds more than 50 per cent of the voting rights of an investee.

Example 1

Scenario

An investor holds 48 per cent of the equity (and related voting rights) of an investee. The remaining equity and 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. 70 per cent of the voting rights of the investee have been cast at recent relevant shareholder meetings, with the exception of one meeting when 78 per cent of the voting rights were cast. Decisions taken at that meeting included changing the financing arrangements entered into by the investee that could affect future dividend payments to shareholders. There are no other contractual arrangements that would affect the assessment of power.

Previous guidance

Because IAS 27 provided only limited guidance regarding control without a majority of voting rights, we have observed inconsistent consolidation conclusions in this case. We understand that different jurisdictions drew different 'bright lines' regarding control without a majority of voting rights, often depending on previous GAAP requirements. In some jurisdictions, the investor would have been deemed to control the investee with 48 per cent of the voting rights, while in others, the investor would not. If the investor consolidated the investee, it would be required to make disclosures about the nature of its relationship with the investee. If the investor did not consolidate the investee, it would not be required to make any particular disclosures about that relationship.

IFRS 10 and IFRS 12

According to IFRS 10, given the level of shareholder participation and considering the size and dispersion of shareholdings, the investor with 48 per cent of the voting rights would conclude that it controls the investee; its rights are sufficient to give it power over the investee (ie it has the practical ability to direct the relevant activities of the investee unilaterally), it has exposure to variable returns and the ability to affect those variable returns through its voting rights.

According to IFRS 12, there are a number of disclosures that the investor would be required to make to help users understand and evaluate the nature of its relationship with the investee. Those disclosures would include disclosures about significant judgements it has made in determining that it has control of the investee and disclosures about non-controlling interests in the investee (eg summarised financial information about the investee).

IFRS 10 should reduce diversity in practice by providing application guidance on the inclusion of contractual rights in the assessment of control. A reporting entity should consider all substantive rights that it has in relation to an investee, including voting and other contractual rights, as well as the rights of other parties, when assessing control.

Example 2

Scenario

Investor A, whose business is the production and sale of cheese, establishes and initially owns 100 per cent of an operation, Investee B, which also produces and sells cheese. Investor A then decides to make Investee B a publicly traded entity, retaining 30 per cent of the equity (and related voting rights) of Investee B. The other 70 per cent of the voting rights are widely distributed among thousands of shareholders, none individually holding more than 1 per cent of the voting rights. At the time of retaining the 30 per cent voting interest, Investor A also signed a contract with Investee B that allows Investor A to manage and operate all of the activities of Investee B. Investee B has no employees of its own. A supermajority vote of 75 per cent is required to cancel the management and operations contract with Investor A.

Previous guidance

Because IAS 27 provided only limited guidance regarding control with less than a majority of voting rights, we have observed inconsistency in practice in accounting for this case. Some would focus on the 30 per cent voting interest to say that Investor A does not control Investee B because it does not have a majority of the voting rights. Others would focus on Investor A's contractual rights to direct the activities of Investee B and conclude that Investor A controls Investee B and should consolidate that entity. If Investor A consolidated Investee B without holding a majority of voting rights, it would be required to disclose the nature of its relationship with Investee B according to the disclosure requirements of IAS 27. If Investor A did not consolidate Investee B, it would not be required to make any particular disclosures about that relationship.

IFRS 10 and IFRS 12

According to IFRS 10, given the ability of Investor A to direct the relevant activities of Investee B through the combination of the contractual arrangement and the 30 per cent voting interest, Investor A would conclude that it controls Investee B and thus should consolidate that entity. Investor A would consider all of its rights, both voting and contractual, relating to Investee B in its control assessment. Investor A's 30 per cent shareholding prevents other parties from changing the contractual arrangement Investor A uses to direct the relevant activities of Investee B (ie the contract between Investor A and Investee B cannot be changed without Investor A's approval).

According to IFRS 12, there are a number of disclosures that Investor A would be required to make to help users understand and evaluate the nature of its relationship with Investee B. These disclosures are described in Example 1.

Investees previously within the scope of SIC-12

SIC-12 provided consolidation guidance related to special purpose entities and included four indicators of control of a special purpose entity. The interpretation did not provide any guidance about the weighting of the indicators in SIC-12 and we observed that different reporting entities made different judgements in similar fact patterns about how to apply those indicators.

Investees previously within the scope of SIC-12 will now be assessed for consolidation using the consolidation model in IFRS 10. IFRS 10 provides application guidance on how the requirements are applied in many situations, including the assessment of control of investees previously within the scope of SIC-12.

Reporting entities will be able to use the single consolidation model and the increased guidance and application examples to make more consistent and appropriate consolidation decisions.

IFRS 10 should reduce diversity in practice by providing application guidance on the inclusion of contractual rights in the assessment of control. A reporting entity should consider all substantive rights that it has in relation to an investee, including voting and other contractual rights, as well as the rights of other parties, when assessing control.

Example

Scenario

Bank A enters into a credit default swap with Investee B, an entity created for the purpose of providing investment opportunities to investors. The credit default swap passes credit risk to Investee B in return for a fee paid by Bank A. Investee B issues notes linked to the credit risk transferred in the credit default swap to multiple unrelated investors and uses the proceeds from those notes to invest in a portfolio of high-quality financial assets; that portfolio serves as collateral. There are very few, if any, decisions to be made after initially setting up Investee B. Neither Bank A nor the investors have any voting or other rights that give them the ability to direct activities that significantly affect Investee B's returns.

Previous guidance

We have observed inconsistency in practice in applying SIC-12 to this example. Whether Bank A should consolidate Investee B or not would typically depend on the *purpose* for which Investee B was deemed to have been created, or on the risks and rewards to which Bank A was exposed.

Application of SIC-12 based on the deemed purpose:

a) Bank A holds the assets on which it obtains credit protection:

Some concluded that Bank A entered into the transaction in order to obtain credit protection on exposure that it previously held and that the activities of Investee B were being conducted on behalf of Bank A. Consequently, Bank A would consolidate Investee B despite the fact that it has very little ongoing decision making ability and very little exposure to risks and rewards arising from its involvement with Investee B. If Bank A consolidated Investee B, it would be required to make disclosures about the nature of its relationship with Investee B

b) Bank A does not hold the assets on which it obtains credit protection:

We also learned that, in this situation, others concluded Investee B was created to enable investors to be exposed to particular credit risk. In this case, Bank A would have no pre-existing exposure to the credit risk covered by the credit default swap and would treat the swap as a trading position; it would benefit from exploiting the opportunity to arbitrage different markets in return for paying a fixed fee to Investee B. Those holding this view would conclude that Investee B is not controlled by Bank A or by any other entity. If Bank A did not consolidate Investee B, it would not be required to make any particular disclosures about that relationship.

Example continued overleaf

Example *continued*

Application of SIC-12 based on risks and rewards:

We also understand there was a different interpretation of SIC-12 in this fact pattern that would depend on the risks and rewards indicators rather than the purpose for which Investee B was created. Following this interpretation, the investor holding the majority of the notes (if there was one) would consolidate Investee B irrespective of whether or not the investor had pre-existing exposure. If no investor held the majority of the notes, no one would consolidate Investee B. Again, if Bank A did not consolidate Investee B, it would not be required to make any particular disclosures about that relationship.

IFRS 10 and IFRS 12

According to IFRS 10, Bank A would not consolidate Investee B because it does not direct the relevant activities of Investee B; there are no relevant activities because there are no decisions to be made after initially setting up Investee B that would significantly affect Investee B's returns. In addition, Bank A has little, if any, exposure to variable returns from its involvement with Investee B. However, Bank A would recognise the credit default swap that it has with Investee B.

However, if the high quality financial assets in Investee B's portfolio serve as more than collateral, Bank A would need to closely assess the purpose and design of Investee B to see what the relevant activities are and whether Bank A does, in fact, have the power to direct those relevant activities. For example, the assessment of the purpose and design of Investee B may lead to the conclusion that Bank A has rights to manage the financial assets in Investee B's portfolio that give it the ability to direct activities that significantly affect Investee B's returns. In that case, Bank A is likely to have exposure to variable returns and would therefore consolidate Investee B.

According to IFRS 12, if the financial assets in Investee B's portfolio serve purely as collateral and if Bank A is deemed to have an interest in Investee B, Bank A would be required to make disclosures about its interest in Investee B, which is likely to be considered an unconsolidated structured entity. Bank A would disclose information that would help users to understand the nature and extent of its interest in Investee B and the risks associated with that interest (including amounts representing Bank A's maximum exposure to loss from Investee B).

According to IFRS 12, if the financial assets in Investee B's portfolio serve as more than collateral and Bank A consolidates Investee B, there are a number of disclosures that Bank A would be required to make to help users to understand and evaluate the nature of its relationship with Investee B. Those disclosures are described in Example 1 on page 22.

Agency relationships

It can be difficult to assess whether a fund manager or asset manager that has been delegated decision-making rights actually controls the fund or entity that it manages. Neither IAS 27 nor SIC-12 contained specific guidance about situations in which power is delegated to an agent, and we observed that there was confusion in practice about how to evaluate such agency relationships within the context of assessing control.

It was often difficult to determine whether those relationships were within the scope of IAS 27 or SIC-12, and a different consolidation outcome could be reached depending on which standard was applied. If IAS 27 was applied, accounting firms and others drew different 'bright lines' in terms of when a fund manager would be deemed to control a fund that it managed. If SIC-12 was applied, there was a 50 per cent 'bright line' drawn for this decision. IFRS 10 provides guidance regarding the determination of whether a decision-maker acts as a principal or as an agent.

IFRS 10 should reduce diversity in practice by providing a principle regarding agency relationships, and application guidance and examples on how to apply that principle. IFRS 10 also provides a range of factors to consider when determining whether a decision maker is an agent; those factors include the scope of decision-making authority, the rights held by other parties, the decision maker's remuneration and the decision maker's exposure to variable returns from other interests that it holds in the investee.

Example

Scenario

Fund Manager A has a 45 per cent shareholding in Fund B, which it also manages within defined parameters. The constitution of the fund defines the fund's purpose and sets out the investment parameters within which the fund manager can invest. The constitution also requires Fund Manager A to act in the best interests of the shareholders. Within the defined parameters, however, the investment manager (Fund Manager A) has discretion about the assets in which Fund B will invest.

Previous guidance

We have observed that there were differing views on whether this relationship would be within the scope of IAS 27 or SIC-12. Those who viewed this relationship as being within the scope of IAS 27 concluded that Fund Manager A should consolidate Fund B because it had the power to govern the operating and financing activities of Fund B so as to obtain benefits from those activities. Fund Manager A would be required to make disclosures regarding the nature of its relationship with Fund B because it consolidated Fund B without a majority of voting rights. However, we understand that others viewed this relationship as being within the scope of SIC-12. In that case, Fund Manager A would not consolidate Fund B because it was not exposed to the majority of the risks and rewards arising from Fund B. In that case, Fund Manager A would not be required to make any particular disclosures about that relationship.

IFRS 10 and IFRS 12

According to IFRS 10, Fund Manager A would conclude that it controls Fund B because it has the power to direct Fund B's relevant activities through directing the investment decisions, has exposure to variable returns from Fund B, and can use its power to affect the amount of its returns.

According to IFRS 12, there are a number of disclosures that Fund Manager A would be required to make to help users understand and evaluate the nature of its relationship with Fund B. Those disclosures are described in Example 1 on page 22. In addition, Fund Manager A would need to disclose any significant risks associated with Fund B, including the terms of any contractual arrangements that require it to provide financial support to Fund B.

Potential voting rights

IAS 27 specified that potential voting rights should be included in the assessment of control only if they are currently exercisable. We are aware that structuring opportunities arose from that requirement. For example, some potential voting rights were structured so that they were temporarily not currently exercisable at the reporting date. We are aware that diversity in practice arose because some constituents followed a strict interpretation of the 'currently exercisable' requirement while others looked at the substance of the potential voting rights. IFRS 10 clarifies that potential voting rights should be included in the assessment of control if they are substantive. This assessment is based on the purpose, design, terms and conditions of the potential voting rights and the investor's expectations and reasons for agreeing to those terms and conditions.

IFRS 10 also provides additional application guidance and examples regarding potential voting rights. This should lead to more consistent and appropriate consolidation decisions.

IFRS 10 should reduce diversity in practice by providing application guidance on potential voting rights and clarifying that they should be included in the assessment of control when they are substantive.

Example

Scenario

Investor A holds 40 per cent of the voting rights of Investee B as well as an option to acquire another 20 per cent of the voting rights from Investor C, who holds 30 per cent of the voting rights. The option is exercisable during 51 weeks in each calendar year; however, it is not exercisable during the last week of every year. The option is exercisable for a nominal amount. Decisions about the relevant activities of Investee B require the approval of a majority of the votes cast at relevant shareholders' meetings, whiich are generally held during the first or second quarter of the year.

Previous guidance

We have observed that some would look at the substance of the potential voting rights and conclude that they should be considered in the assessment of control because they are exercisable for the vast majority of the reporting period. Those holding this view would conclude that Investor A should consolidate Investee B taking into account Investor A's current and potential voting rights. Investor A would be required to make disclosures regarding the nature of its relationship with Investee B since it consolidated Investee B without a majority of its voting rights. However, we understand that others would apply a more literal interpretation of IAS 27 and conclude that the potential voting rights should not be included in the assessment of control because they are not currently exercisable at the reporting date. As a result, Investor A should not consolidate Investee B because it holds only 40 per cent of the voting rights of Investee B at the reporting date. Investor A would not be required to make any particular disclosures about its relationship with Investee B.

IFRS 10 and IFRS 12

According to IFRS 10, Investor A would look at the purpose and design of the potential voting rights, and their terms and conditions, to assess whether they are substantive. In this case, Investor A would conclude that the potential voting rights are substantive because they are, in effect, currently exercisable (they are exercisable for the vast majority of the reporting period) and their terms and conditions are such that Investor A has an economic incentive to exercise (that is, the nominal fee is not a barrier to exercise and, in general, exercising would be beneficial to Investor A). Additionally, the potential voting rights are exercisable when relevant decisions need to be made. In arriving at that conclusion, Investor A would consider the purpose and design of the potential voting rights in a broad sense and would not simply focus on the conditions existing at the end of the reporting period. Therefore, Investor A would consolidate Investee B because it has the current ability to direct the relevant activities of Investee B, is exposed to variable returns from Investee B, and can use its power to affect those variable returns.

According to IFRS 12, there are a number of disclosures that Investor A would be required to make to help users understand and evaluate the nature of its relationship with Investee B. Those disclosures are described in Example 1 on page 22.

Moving away from ‘bright lines’

As discussed earlier in this document, another criticism of IAS 27 and SIC-12 was that their requirements led to a focus on ‘bright lines’ and provided structuring opportunities rather than focusing on the nature of a reporting entity’s relationship with an investee.

We have evaluated the application of the requirements of IFRS 10 and IFRS 12 to assess whether they would result in consolidation decisions that accurately reflect the nature of the relationship between a reporting entity and an investee.

The following five examples use different scenarios to highlight how IFRS 10 will reduce the use of ‘bright lines’ when accounting for the relationship between a reporting entity and its investee.

IFRS 10 should reduce the use of 'bright lines' by requiring an assessment of the relevant activities of an investee rather than which investor, if any, obtains a majority of the rewards or is exposed to a majority of the risks of the investee.

Example 1

Scenario

Investor A transfers receivables to Investee B, an entity created solely for the purpose of purchasing and servicing those receivables. Investee B fully funds the acquisition of the receivables by issuing two different tranches of debt: a senior tranche (90 per cent of the debt) to the market and a junior tranche (10 per cent of the debt) to Investor A. There are few, if any, activities to perform once Investee B is set up unless the counterparties to the receivables default on payment. However, Investor A retains the customer relationships and is responsible for managing those receivables in the event of default. A third-party servicer collects the cash flows from the receivables and passes them to the investors.

Previous guidance

We are aware that Investee B was likely to have been considered to be an 'autopilot' structure, with activities that were almost completely predetermined when the entity was established. Consequently, the assessment of control under SIC-12 would have focused primarily on whether Investor A retained a majority of the risks and rewards of Investee B. If Investor A's holding of the junior tranche of debt exposed it to a majority of the risks and rewards of Investee B, Investor A would have consolidated Investee B. If Investor A consolidated Investee B, it would be required to make disclosures about the nature of its relationship with Investee B.

IFRS 10 and IFRS 12

According to IFRS 10, Investor A would conclude that it has power over Investee B because it has the ability to manage the receivables upon default. This is the only relevant activity when will significantly affect Investee B's returns—Investor A has the ability to make decisions about that activity at the only time that decisions need to be made. Investor A would also have exposure to variable returns from Investee B because of its holding of the junior tranche of debt and its ability to use its power to affect those returns. Thus, Investor A would conclude that it controls Investee B and should consolidate it irrespective of whether it is exposed to the majority of risks and rewards of Investee B.

According to IFRS 12, there are a number of disclosures that Investor A would be required to make to help users understand and evaluate the nature of its relationship with Investee B. Those disclosures are described in Example 1 on page 22.

IFRS 10 should reduce the use of 'bright lines' because it requires that, if a reporting entity has control of an investee, it should consolidate that investee regardless of whether it is exposed to the majority of risks and rewards from that investee.

Example 2

Scenario

An investment vehicle is created to purchase a portfolio of financial assets, funded by debt and equity instruments issued to a number of investors. The equity tranche is designed to absorb the first losses incurred by the portfolio and to receive residual returns of the investment vehicle. Investor A holds 35 per cent of the equity tranche and is also the asset manager, managing the vehicle's asset portfolio within portfolio guidelines. This includes decisions about the selection, acquisition and disposal of the assets within those portfolio guidelines and the management upon default of any asset in the portfolio. Investor A also receives market-based fixed and performance-related fees for its asset management services.

Previous guidance

In applying SIC-12, we are aware that some would conclude that Investor A should not consolidate the investment vehicle. This is because Investor A holds 35 per cent of the equity and is therefore not exposed to the majority of the risks and rewards. In addition, we are aware that some also argued that the investment vehicle was created for the benefit not only of Investor A but of all investors. If Investor A did not consolidate the investment vehicle, Investor A would not be required to make any particular disclosures about that relationship.

IFRS 10 and IFRS 12

According to IFRS 10, Investor A would conclude that it controls the investment vehicle and should consolidate it. Investor A has the ability to direct the relevant activities, has rights to variable returns from the performance of the vehicle and has the ability to use its power to affect the returns it receives.

According to IFRS 12, there are a number of disclosures that Investor A would make to help users understand and evaluate the nature of its relationship with the consolidated investment vehicle. Those disclosures are described in Example 1 on page 22.

IFRS 10 should reduce the use of 'bright lines' because it requires that, when assessing control, a reporting entity must determine which activities significantly affect the investee's returns.

Example 3

Scenario
Corporation A, a credit card company, enters into an arrangement with Investee B whereby it transfers a pool of short-term credit card receivables to Investee B. Those receivables must meet particular criteria relating to credit quality. Investee B fully funds the acquisition of the receivables by issuing securities to market investors that are backed by the credit card receivables. Investee B issues two different tranches of securities: the senior tranche is issued to market investors, while the junior tranche is issued to Corporation A. The senior tranche receives priority in the event of default; the junior tranche is expected to absorb a majority of the risks and rewards of Investee B. This is a revolving structure; that is, Corporation A continuously transfers receivables to Investee B as the original receivables are settled. Corporation A retains ongoing customer relationships with the counterparties to the credit card receivables. Corporation A maintains the responsibility for managing recoverability of the receivables in default by renegotiating the terms of current outstanding receivables or future transactions with those customers. A third party servicer is employed to collect the receivables and pass the cash flows on to Investee B.
Previous guidance
We have observed that, in applying SIC-12, Corporation A would consolidate Investee B for two reasons: Investee B would be considered to have been created on behalf of Corporation A, and Corporation A is exposed to the majority of risks and rewards from Investee B's activities. Corporation A would be required to make disclosures about the nature of its relationship with Investee B.

Example 3 continues overleaf

Example 3 *continued*

IFRS 10 and IFRS 12

According to IFRS 10, there would be no change in the consolidation decision; Corporation A would conclude that it controls and should consolidate Investee B. Although a third party has responsibility for servicing the credit card receivables and collecting the related cash flows, Corporation A has power over Investee B through its ability to direct the relevant activities. IFRS 10 requires the consideration of all contractual activities that are closely related to an investee in the assessment of control. In this case, the relevant activities include determining the receivables to be transferred to Investee B and what happens on default of those receivables. The third-party servicer simply collects the cash flows and passes them to Investee B. Those activities are not relevant activities because they do not require substantive decisions to be made that could significantly affect Investee B's returns. It is Corporation A that maintains the relationships with the customers from whom the receivables arise. That relationship management helps to prevent default (ie Corporation A can renegotiate payments so that customers will not default) and, in the event that default occurs, Corporation A will avoid or renegotiate the terms of future transactions with those customers, which affects the composition of the pool of receivables transferred to Investee B. Corporation A also has discretion in determining the receivables transferred to Investee B. In addition, Corporation A is exposed to variable returns from the activities of Investee B by holding the junior tranche of securities issued by Investee B and can use its power to affect the returns it receives. Consequently, Corporation A concludes that it controls and should consolidate Investee B.

According to IFRS 12, there are a number of disclosures that Corporation A would make to help users understand and evaluate the nature of its relationship with Investee B. Those disclosures are described in Example 1 on page 22.

IFRS 10 should reduce the use of 'bright lines' because it requires that an investor who has the majority of voting rights or exposure to risks and rewards but does not have the power to direct the relevant activities of an investee should not consolidate that investee.

Example 4

Scenario

Fund Manager A sets up and subsequently manages a mutual fund, Fund B, which is created to maximise profit for its investors. Fund Manager A determines the investment policy and strategy for the mutual fund. There are multiple investors in Fund B: Corporation C owns 55 per cent of the shares, and the rest of the shares are distributed among the other investors, with none of them individually holding more than 1 per cent of the shares. The rights held by the investors (including Corporation C) are protective in nature; for example none of the investors can unilaterally change the investment policy and strategy of Fund B, and nor can the investors remove Fund Manager A without cause. The investors can redeem their interests at any time within particular limits established in the fund's constitution. Fund Manager A receives a market-based management fee of 2 per cent of the net asset value in the fund, which is commensurate with the services that Fund Manager A provides to Fund B.

Previous guidance

We observed that some have concluded that Fund B was within the scope of SIC-12 and Corporation C would consolidate Fund B because it is exposed to the majority of risks and rewards of the fund. Consolidation would depend on exposure to risks and rewards rather than the rights that Corporation C holds (as under IAS 27). We understand that Corporation C would not make any disclosures about its relationship with Fund B.

IFRS 10 and IFRS 12

According to IFRS 10, Corporation C concludes that it does not control Fund B. Although Corporation C has a majority of the voting rights, those rights are protective in nature and do not give Corporation C the ability to direct the relevant activities of Fund B. Fund Manager A has the ability to direct the relevant activities of Fund B by having the ability to makeinvestment decisions within the investment parameters of the fund. However, Fund Manager A should not consolidate Fund B because Fund Manager A is acting as an agent for the investors in Fund B; it receives market-based remuneration that is commensurate with the services it provides to the Fund and has no other interests in Fund B. Fund Manager A's 2 per cent management fee increases its exposure to variability of returns from the activities of Fund B without creating exposure that is of such significance that it indicates Fund Manager A is a principal. Fund B is not consolidated by any party.

According to IFRS 12, Corporation C and Fund Manager A would be required to make disclosures about Fund B, which is likely to be considered a structured entity. Corporation C and Fund Manager A would make disclosures that would help users understand the nature and extent of their respective interests in Fund B and the risks associated with those interests. For example, Corporation C would disclose information about its exposure to risks from Fund B and also explain why it does not control Fund B even though it holds a majority of the voting rights. Fund Manager A would also disclose information about any exposure to risk that it might have from its involvement with Fund B.

IFRS 10 should reduce the use of 'bright lines' because it requires that potential voting rights must be considered when assessing control if they are substantive rather than only when they are currently exercisable. This shifts the focus from the exercise date to the economic characteristics of potential voting rights.

Example 5

Scenario

Investor A holds 70 per cent of the voting rights of Investee C, with Investor B holding the remaining 30 per cent of the voting rights as well as an option to acquire half of the voting rights of Investor A. The option can be exercised over the next two years but is exercisable at a fixed price that is currently deeply out of the money, and the option is expected to remain out of the money over the course of the three-year period.

Previous guidance

According to IAS 27, we have observed that Investor B would consolidate Investee C because currently exercisable potential voting rights are considered to be equivalent to holding voting rights when assessing control, regardless of the other terms and conditions associated with potential voting rights. If Investor B consolidated Investee C, it would be required to make disclosures about the nature of its relationship with Investee C.

IFRS 10 and IFRS 12

According to IFRS 10, Investors A and B would look at the purpose and design of the potential voting rights, and their terms and conditions, to assess whether they are substantive. In this case, Investors A and B would conclude that the potential voting rights are not substantive because the exercise price creates a barrier to exercise during the exercise period. Therefore, Investor A would consolidate Investee C because it has the current ability to direct the relevant activities of that investee.

According to IFRS 12, there are a number of disclosures that Investor A would have to make to help users understand and evaluate the nature of its relationship with Investee C. Those disclosures would include disclosures about non-controlling interests in Investee C and significant judgements it has made in determining that it controls Investee C, including the terms and conditions of the potential voting rights that Investor B holds.

In addition, Investor B would be required to make disclosures about its interests in Investee C. Investor B would make disclosures that would help users to understand the nature and extent of its interest in Investee C and the risks associated with that interest. For example, Investor B would disclose the reasons why it has concluded that it does not control Investee C, which may mean disclosing information about the terms and conditions of the potential voting rights it holds.

Cost-benefit analysis

The implementation of IFRS 10 and IFRS 12 should create benefits for users and preparers, but those benefits will not be without cost. We have analysed the costs and benefits of the main changes introduced by IFRS 10 and IFRS 12, focusing on the areas where those changes are expected to be most significant.

We have identified the following areas as being those likely to have the most significant effect in terms of costs and benefits for users and preparers:

(a) improved disclosures;

(b) the control assessment; and

(c) transition provisions.

This analysis is necessarily qualitative rather than quantitative because of the nature of the outreach that we have performed.

There will be different costs and benefits for any entity implementing IFRS 10 and IFRS 12; these depend on the nature and volume of the reporting entity's relationships with other entities. It is not possible to create generalised qualitative information that could be applied to all entities.

Improved disclosures

The disclosure requirements of IFRS 12 represent an improvement to, and an increase in, the financial information provided about a reporting entity's interests in subsidiaries, joint arrangements, associates and unconsolidated structured entities. The improved requirements are designed to provide users with information to help them to gain a better understanding of the extent of the activities carried out by a reporting entity through its relationships with other entities. The new information that is disclosed should provide users with information that is useful when performing equity analysis and valuations.

Users		
Consequences foreseen	**Nature of the cost / benefit**	**Analysis**
Increased usefulness of financial information reported	Permanent	The additional disclosures required by IFRS 12 should help users to evaluate the nature, extent and financial effects of a reporting entity's interests in other entities and the nature of the risks associated with those interests, particularly for unconsolidated structured entities. Often under current requirements there are virtually no disclosures in financial statements about a reporting entity's involvement with structured entities. The feedback we have received from users regarding disclosure requirements about unconsolidated structured entities was overwhelmingly positive. These disclosure requirements are similar to current US GAAP requirements that are highly regarded by users. Users should also have a better understanding of consolidated information through the new disclosure requirements for subsidiaries with non-controlling interests. Users have been requesting this information for some time.
Reduction of information asymmetry among capital market participants	Permanent	The provision of supplementary information about a reporting entity's interests in subsidiaries, joint arrangements, associates and unconsolidated structured entities should reduce information asymmetry among participants in capital markets.

These new disclosure requirements may represent costs for preparers complying with the additional disclosures. In our analysis, however, we have found that these costs should be somewhat mitigated because they will only apply to particular subsets of entities and because reporting entities are likely to already have some of the new information required. Additionally, relatively few respondents who commented on the *Request for Views on Effective Date and Transition Methods* indicated that there would be significant costs in implementing the disclosure requirements in IFRS 12. Those costs that were mentioned usully pertained to one-time implementation costs.

In addition, we think that an important benefit of the improved disclosures resulting from IFRS 12 will be the lower cost of capital. Academic research has shown that more transparent information leads to more efficient capital allocation because of a better assessment of risk and better pricing. This, in turn, will lead to a lower cost of capital.

Preparers		
New disclosure requirement	**Type of entity affected**	**Likely costs**
Disclosures about the control assessment	Entities that have complex relationships with other entities will incur higher costs because more judgement is involved to assess control.	The entities affected are likely to incur costs on and after initial implementation because most of these disclosures did not exist in previous guidance. However, these costs should be limited. The requirement is simply asking for disclosure of the assessment of control when that assessment is more difficult; the cost is associated with disclosing the information and not with gathering the information to be disclosed. A reporting entity will gather that information when performing the control assessment.
Disclosures about consolidated structured entities	Entities that are obliged to provide financial support to consolidated structured entities will be required to make these disclosures under IFRS 12.	The entities affected are likely to incur costs on and after initial implementation because these disclosures did not exist in previous guidance.

continued overleaf

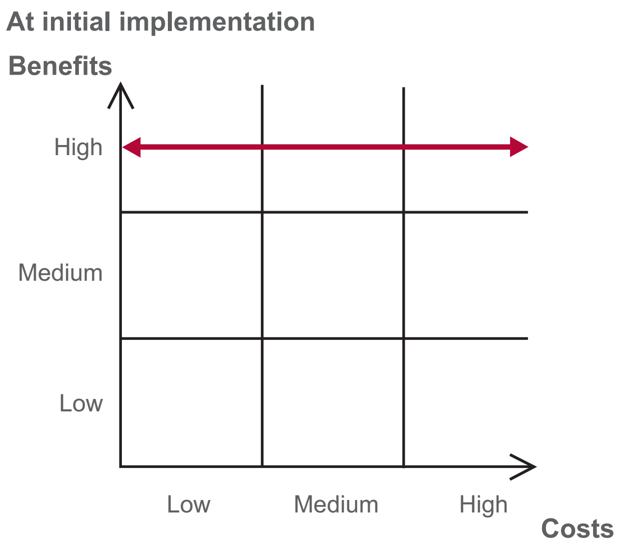
continued

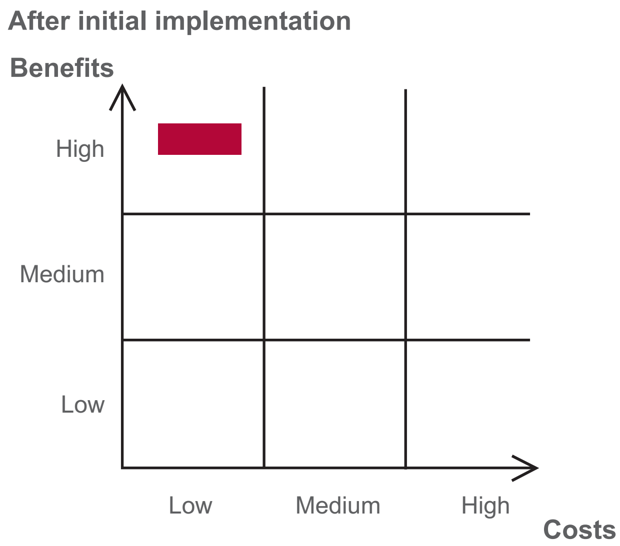
Preparers		
New disclosure requirement	**Type of entity affected**	**Likely costs**
Improved disclosure requirements for subsidiaries with material non-controlling interests	Only entities that consolidate subsidiaries with material non-controlling interests will be required to make these disclosures under IFRS 12.	The entities affected are likely to incur costs on and after initial implementation because these disclosures did not exist in previous guidance. However, these costs should be mitigated because the additional information required is likely to exist in preparing consolidated financial statements. Moreover, we performed research (in the course of issuing IFRS 3 *Business Combinations*) indicating that relatively few entities have individually material non-controlling interests. Consequently, we expect the impact of these requirements to be fairly limited.
Disclosures about unconsolidated structured entities	Entities that have interests in unconsolidated structured entities will be required to make these disclosures under IFRS 12.	The entities affected are likely to incur costs on and after initial implementation because these disclosures did not exist in previous guidance. However, these costs should be mitigated because entities with interests in unconsolidated structured entities should already have at least some of the information required to help them assess and manage their exposure to risk. The cost should ultimately depend on the nature and complexity of an entity's relationship with unconsolidated structured entities.

Costs and benefits of the improved disclosure requirements

As the tables show, the *benefits* of the improved disclosure requirements will be high both during and after initial implementation. We think that the implementation *costs* of the improved disclosure requirements could vary significantly between different entities depending on the nature and complexity of the relationships that a reporting entity has with other entities, in particular with structured entities.

We that think it is appropriate that those reporting entities that have more complex relationships with other entities will incur higher costs. Nevertheless, the majority of costs should be incurred on initial implementation; the ongoing costs will be lower, although again they will be dependent on the nature and complexity of the relationships that a reporting entity has with other entities.





Control assessment

IFRS 10 requires that a reporting entity should consolidate any investee that it controls. Control is the basis for consolidation for all types of investees. IFRS 10 also provides guidance on assessing control in circumstances where the assessment has proven to be difficult. These circumstances include control without the majority of voting rights, relationships with structured entities, and the presence of potential voting rights.

Although there will probably be initial costs associated with implementing IFRS 10 because of the differences between the requirements of IFRS 10 and the requirements of IAS 27 and SIC-12, we do not think there will be significantly higher costs after initial implementation. Many of the differences between IFRS 10 and IAS 27 and SIC-12 relate to the assessment of features that are commonly found in more complex relationships, eg agency relationships and potential voting rights.

Reporting entities who have relationships with investees that include those features are more likely to have analysed those relationships already and to have well-documented information about them, which should ease the burden of implementation. Additionally, relatively few respondents who commented on the *Request for Views on Effective Date and Transition Methods* indicated that there would be significant costs in implementing the requirements of IFRS 10. Those costs that were mentioned usually pertained to one-time implementation costs.

Some constituents have expressed concerns about the costs of reassessing control. As explained in the 'Costs of reassessment' section, we do not think this will create significant additional costs for preparers.

Users		
Consequences foreseen	**Nature of the cost/benefit**	**Analysis**
Significant increase in comparability and usefulness	Permanent	IFRS 10 sets out a single consolidation model for all types of entities. There should no longer be a different assessment on the basis of whether an investee is within IAS 27 (with the focus on the power to govern the operating and financing policies) or SIC-12 (with the focus on risks and rewards). Users' decisions involve choosing between alternatives, for example investing in one entity or another. Consequently, information about a reporting entity is more useful if it can be compared with other entities. The single consolidation model in IFRS 10 should increase comparability and, therefore, usefulness.
Enhanced verifiability and understandability	Permanent	The consolidation model and accompanying guidance in IFRS 10 should result in consolidation decisions that reflect more faithfully the underlying substance of the relationships, rather than percentage ownership interests.

continued overleaf

continued

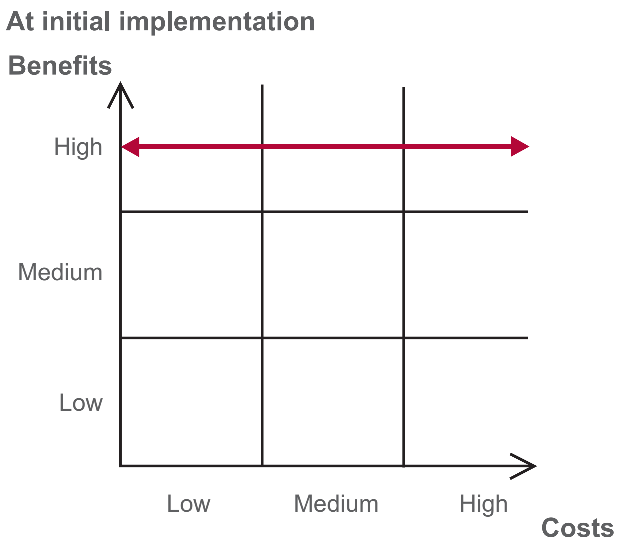
Preparers		
Consequences foreseen	**Nature of the cost/benefit**	**Analysis**
Higher preparation costs because of the assessment of control	This cost will primarily be a non-recurrent cost (incurred on transition only).	Preparers are likely to have higher preparation costs when initially applying IFRS 10 because the consolidation model for structured entities has been changed from the requirements of SIC-12, and there has been additional guidance and clarification added to the requirements of IAS 27 for traditional operating entities. If SIC-12 was previously applied in a way that focused on a quantitative assessment of risks and rewards, there is likely to be more judgement required in the control decision under IFRS 10. When SIC-12 was previously applied in a way that considered multiple factors and indicators, there may be a similar amount of judgement required when assessing control under IFRS 10.
More consistent understanding of control and consolidation requirements	Permanent	IFRS 10 provides a more clearly articulated definition of control and additional application guidance designed to clarify the application of control in various circumstances. Preparers will now be able to rely on a single consolidation model that is applied to all types of entities and should reach more consistent conclusions about consolidation. There is no longer a need to initially assess whether an investee is within the scope of IAS 27 or of SIC-12. The provision of additional application guidance for situations in which control is difficult to assess, including guidance for control without a majority of voting rights, agency relationships and potential voting rights, should help preparers in making their consolidation decisions.

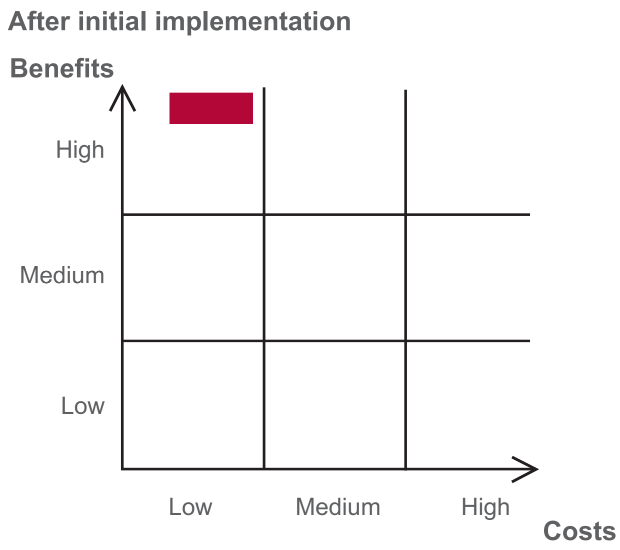
Costs and benefits of the control assessment

As the tables show, the *benefits* of the consolidation model in IFRS 10 will be high both during and after initial implementation.

We think that the implementation *costs* of the control assessment could vary significantly between different entities depending on the nature and complexity of the relationships that a reporting entity has with both traditional operating entities and structured entities.

We think that it is appropriate that those reporting entities that have more complex relationships with other entities will incur higher costs. Nevertheless, the majority of costs should be incurred on initial implementation; the ongoing costs should be low, although again they will be dependent on the nature and complexity of the relationships that a reporting entity has with other entities.





Transition provisions

Because the definition of control in IFRS 10 has changed from the definition in IAS 27 and SIC-12, a reporting entity may begin or cease to consolidate an investee on initial application of IFRS 10. Consequently, IFRS 10 contains transition provisions. A reporting entity is required to apply the requirements of IFRS 10 retrospectively. IFRS 10 contains simplified transition provisions for when it would be impracticable to measure or obtain the information required to apply the requirements retrospectively.

Users		
Consequences foreseen	**Nature of the cost/benefit**	**Analysis**
Increase in consistency	Non-recurrent	Retrospective information should give users more comparable information.

Preparers		
Consequences foreseen	**Nature of the cost/benefit**	**Analysis**
Cost of transitioning to the new requirements	Non-recurrent	Preparers that cease consolidation under IFRS 10 are unlikely to incur transition costs apart from the initial assessment of control. Some preparers that begin consolidation under IFRS 10 may not incur significant costs if they previously used the equity method to account for those investees and should therefore have the information necessary to begin consolidation. Transition costs are likely to be highest for preparers who begin consolidating structured entities that were previously not consolidated. In addition, in order to facilitate the adoption of IFRS 10, the transition provisions contain some simplifications for preparers when it would be impractical to measure or obtain the information required to apply the requirements retrospectively. The simplifications should mitigate cost. Preparers are also likely to incur costs to understand and implement the new consolidation model in IFRS 10.
Benefit of early application	Non-recurrent	Early application will mainly benefit first-time adopters of IFRS because it gives them flexibility in finding an effective and efficient way to apply IFRSs.

Important information

This effect analysis has been compiled by the staff of the IFRS Foundation for the convenience of interested parties.

The views expressed within this document are those of the staff who prepared the document. They do not purport to represent the views of the IASB and should not be considered as authoritative. Comments made in relation to the application of IFRSs or US GAAP do not purport to be acceptable or unacceptable application of IFRSs or US GAAP.

Official pronouncements of the IASB are available in electronic form to eIFRS subscribers. Printed editions of IFRSs are available for ordering from the IASB website at www.ifrs.org.

International Accounting Standards Board (IASB)
The IASB is the independent standard-setting body of the IFRS Foundation

30 Cannon Street | London EC4M 6XH | United Kingdom
Telephone: +44 (0)20 7246 6410 | Fax: +44 (0)20 7246 6411
Email: info@ifrs.org | Web: www.ifrs.org

Publications Department
Telephone: +44 (0)20 7332 2730 | Fax: +44 (0)20 7332 2749
Email: publications@ifrs.org

Printed on 100 per cent recycled paper