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

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Why we undertook the project

**Issues – IAS 27 / SIC12**

- Inconsistencies in practice
  - Tension between IAS 27 (control) and SIC 12 (risk and rewards)
  - Inconsistent application

- Disclosures and financial crisis
  - Sufficient guidance for structured entities?
  - Reputational risk as a basis for consolidation?
  - Inadequate disclosures?

**Solution – IFRS 10, 12**

- A single control model for all entities
- Clear principle of control
- Additional application guidance

- SIC 12 performed well. Use of existing principles to create a sound foundation for SPEs
- Enhanced disclosures particularly for unconsolidated structured entities
Definition of control:
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.

✓ Single consolidation model for all entities, including structured entities
✓ Consolidation based on control – ‘power so as to benefit’ model
  ▪ Controller must have some exposure to risks and rewards.
  ▪ Exposure is an indicator of control but is not control of itself
  ▪ Power arises from rights—voting rights (either majority or less than a majority), potential voting rights, other contractual arrangements, or a combination thereof.
Control <50% voting rights

- Entity can control with less than 50% of voting rights.
- Factors to consider include:
  - Size of the holding relative to the size and dispersion of other vote holders
  - Substantive potential voting rights
  - Other contractual rights
- If the above not conclusive consider additional facts and circumstances that provide evidence of power (e.g., voting patterns at previous board meeting, etc.)
- If no evidence of power, entity does not control

Example: Control <50% voting rights

- Investor A owns 40% of voting rights and, via shareholding, has appointed the Chairman and CEO of Investee
- Does Investor A control Investee?
  - If the other investors are widely dispersed (there are thousands of other investors)?
  - If there are only two other investors?
  - If other investors holding 40% actively participate in shareholders meetings?
- What if Investor A sells 10% of its shareholding?
Structured entities

General principles apply for assessing control for all types of entities (ie...)

- Consider the purpose and design
- Identify the activities of the investee that significantly affect the returns of the investee (ie the relevant activities)
- Identify how decisions about relevant activities are made
- Determine whether the rights of the investor give it the ability to direct the relevant activities
- Determine whether the investor is exposed, or has rights, to the variability associated with the returns of the investee
- Determine whether the investor has the ability to use its power over the investee to affect its own returns

Example: Structured entities

- Investor A transfers receivables to securitisation vehicle and appoints Servicer B to manage day-to-day cash flow streams
- Investor A can step in and manage the receivables upon default
- Investor A holds notes issued by Securitisation vehicle
- Does Investor A control Securitisation vehicle?
Agency relationships

Consider all of the following factors:
- scope of the decision-making authority
- rights held by other parties (i.e., kick-out rights)
- remuneration of the decision-maker
- other interests that the decision maker holds in the investee

Example: Agency relationships

- Decision-maker A has broad decision-making powers
- Can be removed by simple majority vote of investors
- Remunerated via market-based fee – 1% of assets under management and 20% of profits over a hurdle
- Does Decision-maker A control Investment trust if it has:
  - no equity interest?
  - equity interest of 2%?
  - equity interest of 20%?
Investment entities

Final amendments to IFRS 10: Published October 2012

An investment entity is one:

- Whose only substantive activities are investing for returns that are earned solely from investment income and/or capital appreciation
- That manages and evaluates performance of investments on a fair value basis

Accounting

- An investment entity measures investments in subsidiaries, JVs and associates at fair value
- Any parent of an investment entity (that is not an investment entity) consolidates subsidiaries, and measures JVs and associates of its investment entity subsidiary at fair value
Scope

Combined disclosure standard for:

- Subsidiaries
- Joint arrangements
- Associates
- Unconsolidated structured entities

Disclosure objective

To disclose information that helps users of financial statements evaluate:

(a) the nature of, and risks associated with, an entity’s interests in other entities, and
(b) the financial effects of those interests on the entity’s financial position, financial performance and cash flows
Subsidiaries

- The composition of the group
- Involvement of NCI in the group’s activities (including profit or loss allocation and summarised financial information for subsidiaries with large NCI)
- The effect of significant or unusual restrictions on assets and liabilities
- The nature of, and changes in, the risks associated with structured entities

Unconsolidated structured entities

Nature of interests in unconsolidated structured entities
- eg nature, purpose, size, activities and financing
- For sponsors not providing other risk disclosures
  - Type of income earned
  - The carrying amount of all assets transferred

Nature of, and changes in, the risks associated with an entity’s interests
- Carrying amount of the assets and liabilities recognised
- Maximum exposure to loss and comparison to carrying amounts
- Non-contractual support provided
IFRS 10 and IFRS 12

Effective date

- Annual periods beginning on or after 1 January 2013
- Investment entities amendment effective 1 January 2014 (early application permitted)

Transition relief

- No retrospective adjustment required for entities disposed of in the comparative period(s)
- Requirement to present adjusted comparatives limited to immediately preceding period
- Comparative disclosures relating to unconsolidated structured entities not required when IFRS 12 first applied

Thank you
Agenda

Overview
What is an investment entity?
Limitations to exception from consolidation
Implementation issues:
  o Litigation and property funds
  o Technology/R&D funds
  o Master-feeder structures
  o Sovereign wealth funds
  o Local regulatory requirements
Overview

- Amendments to IFRS 10, IFRS 12 and IAS 27
  - Effective 1 January 2014
  - Early application permitted – subject to endorsement by EU
  - Endorsement expected Q3 2013

**PROVIDES EXCEPTION TO CONSOLIDATION**

Investment in subsidiary measured at **FAIR VALUE THROUGH PROFIT OR LOSS**

- Specific disclosure requirements in amendments
- IFRS 12 disclosure requirements also apply

What is an investment entity?

- Definition of an Investment Entity
  - Obtains funds from one or more investors
  - Purpose to provide them with investment management services
  - Business purpose to invest solely for capital appreciation and investment income
  - Measures and evaluates performance of investments on fair value basis
**What is an investment entity (2)**

**Determining whether the definition is met**

- Business purpose test
  - How presents itself to investors. Activities and services

- Exit strategy
  - How capital appreciation will be realised. Eg IPO, trade sale, private placement, sales of assets, collecting term debt

- Earnings from investments
  - Must not receive benefits unavailable to unrelated parties, Eg rights to acquire or use technology or products/services

- Fair value measurement
  - Primary measure for substantially all investments, both to evaluate investments and in financial statements

**Definition of an investment entity (3)**

**Permitted activities**

- Investment-related services
  - Advisory and administrative services to investors and 3rd parties
  - Management services to investees
  - Financial support to investees

- Permitted if extension of operations
  - Even if substantial

- Exemption not permitted if separate substantive activity
  - Judgement required where mixed business model
  - Where services provided by subsidiary as a separate substantive activity, would consolidate
**Typical characteristics of an investment entity**

- More than one investment/more than one investor
  - Single investment can be OK, eg in start up, liquidation temporarily
- Unrelated investors
  - Less likely will obtain benefits other than capital appreciation
- Ownership interests
  - Typically in form of equity or similar giving a pro rata share of net assets. Can have different classes.

ABSENCE OF ANY TYPICAL CHARACTERISTICS DOES NOT DISQUALIFY FROM INVESTMENT ENTITY CLASSIFICATION

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**Limitations to exception from consolidation**

Investment entity will normally not consolidate subsidiaries

BUT

WILL consolidate subsidiaries providing services relating to investment activities

PARENT of investment entity consolidates all entities it controls

INCLUDING

ALL subsidiaries controlled through the investment entity

FAIR VALUE UNDER IAS 39/ IFRS 9

UNLESS PARENT IS INVESTMENT ENTITY
**Implementation issues – business purpose**

**Litigation and property funds**

<table>
<thead>
<tr>
<th>Litigation</th>
<th>Property</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fund invests in contractual claims</td>
<td>Fund invests in real estate assets and companies which own, manage and lease out assets</td>
</tr>
<tr>
<td>Advances money to litigants</td>
<td>Return based on lawsuit result</td>
</tr>
<tr>
<td>Return based on lawsuit result</td>
<td>Return based on dividends, share of profits and capital appreciation</td>
</tr>
<tr>
<td>Measure investments at fair value</td>
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</tr>
</tbody>
</table>

**What might prevent qualification as investment entity?**

Level of involvement in operating and strategic decisions of investees:
- Making decisions on when to proceed with litigation or settle
- Participation in property and asset management activities (maintenance, capital expenditure, marketing and tenant selection)

**Implementation issues – business purpose**

**Technology/R&D funds**

- Option to buy Technology
- 70% TechCorp
- 30% Unrelated investors
- New Opportunities Tech Fund
- Technology start-up companies
- Investment adviser

- TechCorp holds fair value options to acquire investments held by NOTF
- Likely to exercise if businesses or technology developed would benefit operations of TechCorp
- No plans for exiting investments identified by fund

**Would TechCorp qualify as investment entity?**

No – no exit strategy and benefits other than capital appreciation
**Implementation issues – exit strategy**

**Master-feeder structures**

- Feeder funds invest in master fund
- No plan to exit master fund

**Absence of exit strategy mean not qualify as investment entity?**

If master fund has exit strategy for investments, feeders can still qualify

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**Implementation issues – single investor**

**Sovereign wealth funds**

- Government sets up sovereign wealth fund as separate legal entity
  - Manages income from natural resources
  - Funds future pensions and significant state capital projects
  - Fund employs team of professional investment managers
  - Public and internal reports on fair value basis

**Is the sovereign wealth fund an investment entity?**

Yes:
- Set up to provide investment management services to investor
- Objective of capital appreciation and investment income
- Measures investments on fair value basis and reports funds on same
- One investor (government) but in substance investing funds of citizens
Implementation issues – presentation
Local regulatory requirements

• Some jurisdictions require line-by-line consolidated financials

  For an investment entity:
  Would this comply with IFRS?

• We think “No”
  ❑ IFRS 10 says an investment entity “shall not consolidate”
  ❑ Fair value approach is mandatory
  ❑ Financial statements produced for regulatory requirements
    o Could describe as “Special purpose”
    o Not “in compliance with IFRS”

Questions?
Implementing IFRS 10 and IFRS 12
A practitioner’s perspective

David Bradbery
Technical Accounting Group, EMEA Head
June 2013

Overview

<table>
<thead>
<tr>
<th>IFRS 10 - Consolidation</th>
<th>IFRS 12 - disclosure</th>
</tr>
</thead>
<tbody>
<tr>
<td>Consolidation of entities where parent has power, variability and the ability to affect returns through its power</td>
<td>Extensive new disclosures relating to structured entities either in which you hold an interest or have sponsored</td>
</tr>
<tr>
<td>Principal versus agent – kick out rights no longer prevail</td>
<td>Definition of ‘interest’ very broad and includes Trading portfolio</td>
</tr>
<tr>
<td>Constant reassessment of consolidation</td>
<td>Disclosure required where you have, have to, or intend to provide support to a Structured Entity (SE), including consolidated SEs</td>
</tr>
<tr>
<td>Modified retrospective application – full application with some reliefs but only 1 year of comparatives</td>
<td>Increased disclosures relating to consolidated group – including restrictions, non controlling interests and significant judgements on which entities to consolidate</td>
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Barclays Status

Adopted from 1 Jan 2013, restatement document issued May 2013

Barclays Status

In progress – next milestone full dry run after H2
Key elements for running a successful implementation project

- Senior Sponsorship
- Ownership & accountability
- Governance & resources
- Awareness & training
- Communicating progress
- Dependencies
- Competing projects: CRD IV, CoRep, Netting, EDTF, IFRS 9
- Timetable, milestones, monitoring
- Decentralisation
- Throughout the project
- Capital, FINREP

Themes
- IFRS 10 and IFRS 12 are both significant projects
- Information required is dispersed in Businesses
- New and challenging requirements
- Many competing projects - including Business As Usual
- Clear vision of end state essential

Key lessons from IFRS 10

- Communication
- "Golden source" Identification of entities
- Combine with IFRS 12?
- Process for ongoing reassessment
- Revisiting consolidation decisions under SIC 12
- Early auditor engagement and agreement to Policy decisions
- Buy – in: obtaining appropriate co-operation and sponsorship
Financial impacts of IFRS 10

- Barclays consolidated 79 new entities and deconsolidated 63 entities
- Reduced equity by £477m
- Reduced gross assets by £145m
- Increased liabilities by £332m

The main sources of newly consolidated entities were:
- Investment funds, where our management fees, the lack of practical kick out rights and performance guarantees provided meant we had power and exposure to variability
- Securitisation vehicles where more junior tranches had been eliminated due to the performance of the collateral. The assets, measured at FV, were less than the loans carried at amortised cost
- Investment funds contributed increase in liabilities for amounts due to unit holders.

Key lessons so far from IFRS 12

- Funds and trusts
- Overlap with FINREP
- “Golden source” For identifying unconsolidated SEs
- Discussion with peers
- Internal communication
- Population completeness
- Trading portfolio items – appropriate disclosures
- Data capture and storage
- Auditors’ input

DO NOT UNDERESTIMATE IFRS 12
Implementing IFRS 10 and IFRS 12,
A practitioner’s perspective

David Bradbery
Technical Accounting Group, EMEA Head
June 2013