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QAU Alert

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Alert on:

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PFRS 10: CONSOLIDATED FINANCIAL STATEMENTS

Introduction

The Financial Reporting Standards Council (FRSC) approved in June 2011, the adoption of IFRS 10, *Consolidated Financial Statements*, issued by the International Accounting Standards Board (IASB) as PFRS 10, *Consolidated Financial Statements*.

IFRS 10 is developed to eliminate perceived conflict on concept of consolidation between IAS 27, *Consolidated and Separate Financial Statements*, (amended in 2008) and SIC-12, *Consolidation – Special Purpose Entities*. IAS 27 (amended in 2008) requires consolidation of entities based on control whereas SIC-12 mandates consolidation of entities based on risks and rewards.

The new standard is applicable to annual periods beginning on or after **January 1, 2013**. Earlier application is permitted. The FRSC has submitted PFRS 10 to the Board of Accountancy for approval.

Definition of Control

PAS 27 definition of control:

"Control is the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities."

PFRS 10 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."

Three Elements of Control

Power over the investee	Exposure or rights to variable returns	Ability to use power to affect investor's returns
✓ Arises from **rights** (voting or potential voting rights, other contractual agreements, or combination thereof) ✓ Power refers to current ability to direct **relevant activities** –those that will significantly affect the returns. ✓ Rights must be substantive. ✓ Protective rights must be ignored.	✓ Now uses the term **return** which includes both positive and negative returns. ✓ Encompasses not only direct returns but also synergistic returns. ✓ Exposure to risk and rewards is only an **indicator** of control (not control itself)	✓ Power is not enough, need to have ability to use such power to affect returns. ✓ An entity with decision-making rights needs to determine whether it is acting as a **principal or agent.** ✓ Agent does **not** have control.

Control Assessment

Factors to consider when determining control:

- Three elements of control
- Purpose and design of the investee
- The investee's relevant activities and how decisions are made; and
- Nature of entity's relationship with other parties

Application Guidance on the Factors to Consider in Determining Control:

<u>Less than majority voting rights and potential voting rights:</u>

An entity may have power even when it owns less than 50% voting rights, through:

- Contractual arrangements with other investors
- Other decision-making rights arising from other contractual agreement
- The relative proportion of existing voting rights (de facto control)
- Potential voting rights
- Combination of the above

<u>Potential voting rights:</u>

- Potential voting rights are only considered if they are substantive.
- In order to be substantive:
  - These rights need to be exercisable in time to affect decisions on relevant activities and
  - The holder must have the practical ability to exercise the right, (i.e., purpose and design of rights, barriers that prevent exercise, and incentives to exercise)

<u>Voting rights are not the dominant factor in deciding who controls the investee:</u>

- Will be relevant to many special purpose vehicles

- The following are the considerations in assessing control:
  - Purpose and design of the investee
  - Involvement and decisions made as part of investee's design
  - Indicators of investor's practical ability to direct relevant activities unilaterally
  - Dependency on the investor for funding or provision of critical assets, technology or employees

<u>Delegated power – Agency relationship:</u>

- This applies to situations where decision-making rights are delegated to another entity.
- The entity with the decision-making rights needs to determine whether it is acting as a principal or an agent.
- This provides factors to consider in making the determination such as:
  - Scope of its decision-making authority
  - Rights held by other parties
  - Remuneration of the decision maker
  - Exposure to variability of returns from its other interest in the investee

<u>Investor has control over specified assets of an investee:</u>

- In specific circumstance, it may be appropriate to consolidate a portion of an investee as a deemed separate entity:
  - Condition: if and only if all of the assets, liabilities and equity of the deemed separate entity are ring-fenced.
- The decision to consolidate is then determined by identifying:
  - The activities that significantly affect the returns of the deemed separate entity and
  - How those activities are directed

Other PFRS 10 Requirements

- Continuous assessment
  - Decision to consolidate needs to be reassessed when events indicate changes in one or more of the 3 elements of control.
  - An investor may gain or lose power over an investee without the investor being involved in that event
- Transition provisions for the measurement of the:
  - Assets, liabilities and non-controlling interest of a previously unconsolidated subsidiary which is now required to be consolidated under PFRS 10.
  - Retained interest in an investee (previously consolidated) which is no longer consolidated under PFRS 10.

Effect Analysis:

Current Consolidation Requirements	PFRS 10
• **PAS 27 provides the definition and indicators of control based mainly on power such as voting rights**	• **A single consolidation model for all entities.**
• **SIC 12 provides guidance for special purpose vehicles/entities. Focuses on risks and rewards**	• **A new principles-based definition of control.**
• **Results in inconsistent application**	• **Additional application guidance.**
• **Inadequate disclosures**	• **Updated disclosure requirements (PFRS 12).**

Example:

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.

<u>Previous Guidance</u>

Because PAS 27 provided only limited guidance regarding control with less than a majority of voting rights, it was observed that there were 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 PAS 27. If Investor A did not consolidate Investee B, it would not be required to make any particular disclosures about that relationship.

<u>PFRS 10 and PFRS 12 Guidance</u>

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 (i.e. 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.

PFRS 11: JOINT ARRANGEMENT

Main Features:

- Establishes principles applicable to the accounting for all joint arrangements
- Accounting is based on the parties' **rights and obligations** (economic substance)
- Replaces PAS 31's three categories with **two new categories**
- Accounting options are eliminated
- Additional disclosure requirements (PFRS 12)

Perceived deficiencies of PAS 31:

- The legal form of the arrangement was the critical determinant of the accounting.
- An entity has choice of accounting for interest in jointly controlled entities (proportionate consolidation or equity accounting).

PFRS 11, *Joint Arrangement*, content summary :

Objective	• To establish principles for the financial reporting of interests in arrangements that are controlled jointly.
Scope	• Financial statements of all entities that are party to the joint arrangement (those that share joint control and others that participate but do not control)
Principle	• Control defined in PFRS 10 plus unanimous consent of controlling parties determines the relationship • Accounting follows the substance of the arrangement
Definitions	• control • joint control • joint operation • joint venture

Key Assessment :

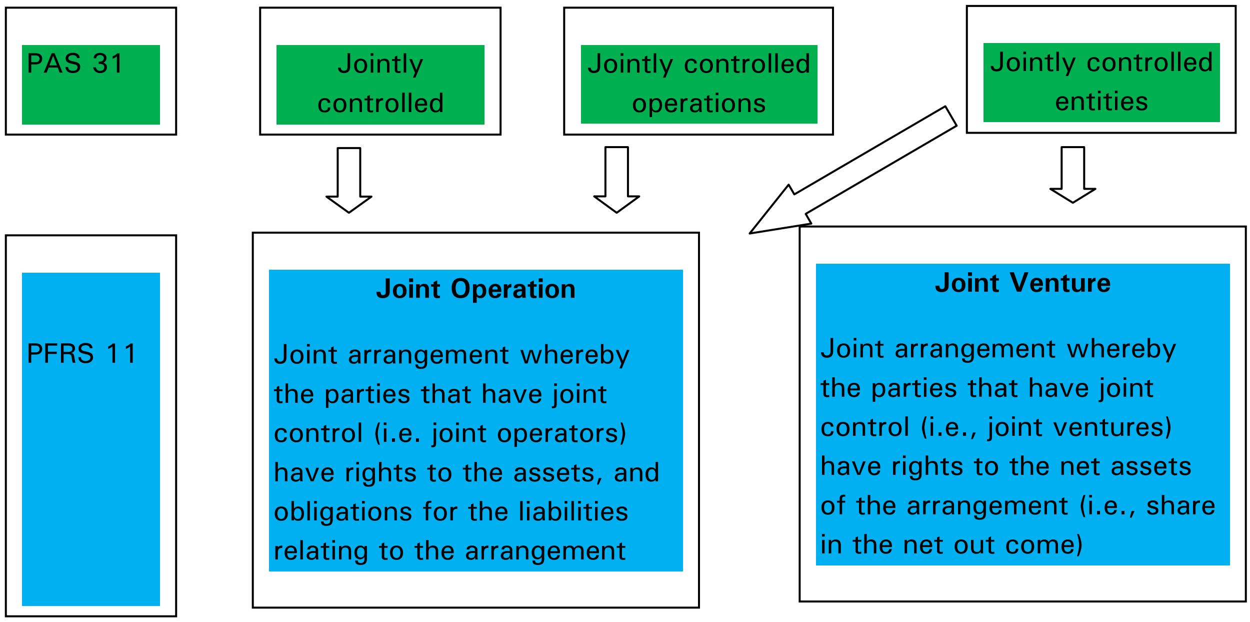
Is there joint control?	• Whether the arrangement gives all the parties control of the arrangement collectively (apply PFRS 10's control concept).
Is it a joint arrangement?	• Whether decisions about the relevant activities require unanimous consent of all parties that collectively control the arrangement.

The parties to the agreement must act together to control the activity and, therefore, exercise joint control and they must continue to have joint control throughout the life of the arrangement.

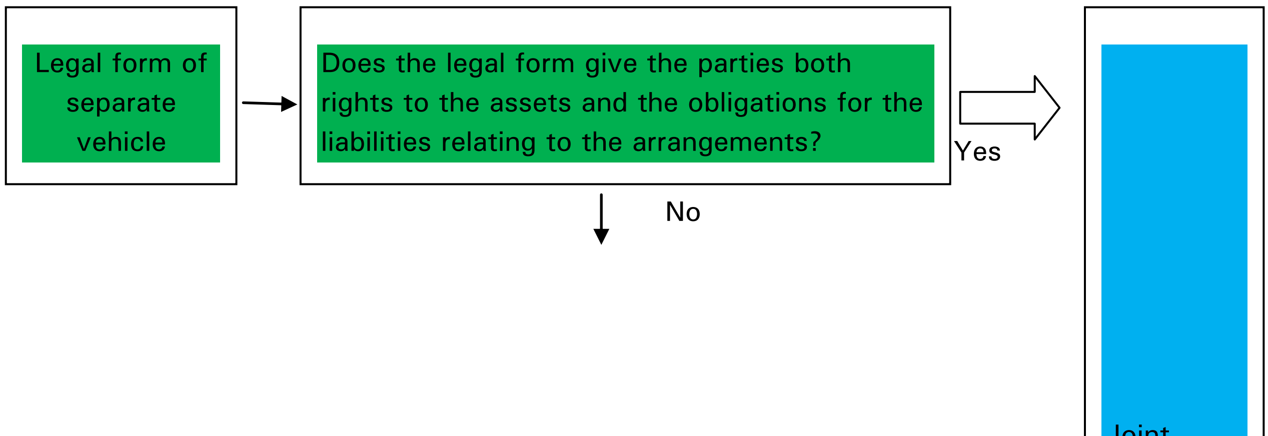
What is a Joint Arrangement?

A joint arrangement is an arrangement over which two or more parties (investors) have contractually agreed to share joint control. Joint control only exists where decisions regarding those activities that significantly affect the returns of the arrangement require the unanimous consent of the parties sharing control.

Types of Joint Arrangement :



Classifying Joint Arrangements – the separate vehicle :



Terms of contractual arrangements

Does the legal form give the parties both rights to the assets and obligations for the liabilities relating to the arrangements?

Yes

No

If relevant, other facts and circumstance

Is the vehicle designed so that:

- Its activities primarily aim to provide the parties with output?, and
- The vehicle depends on the parties on a continuing basis for settling its liabilities?

Yes

No

Joint Venture.

Practical Implications :

Old PAS 31

New PFRS 11 Categories

Jointly controlled assets

Venturer recognizes

- Its share of the assets and liabilities
- Its share of income and expenses

Jointly operations

Joint operators recognize:

- Its assets and liabilities including its share of those held jointly
- Its revenue from the sale of its share of the output of the joint

Jointly controlled operations

Venturer recognizes

- Its share of the assets it controls and liabilities it incurs
- Expenses it incurs and its share of income

Jointly controlled entities

Venturer has a choice between:

- Proportionate consolidation and
- Equity accounting

Assess the substance

Jointly ventures

- Joint venturers must use equity method

Separate Financial Statements of Investors that share joint control :

Joint Venture

- Accounted either at cost or PFRS 9, in accordance with PAS 27.10

Joint Operator

- Applies the same accounting as in consolidated Financial Statements, (Accounts for its interest in the underlying assets and liabilities)

Other interest in Joint Arrangements :

Interest in Joint Venture

- Accounted for in accordance with PFRS 9, unless investor has significant influence, in which case PAS 28, Investment in Associates, applies
- In separate financial statements, accounted for either at cost or under PFRS 9, in accordance with PAS

Interest in Joint Operation

- Accounted for in same way as a joint operator if the investor has rights and is exposed to the underlying assets and liabilities.
- Same treatment in separate financial statements.

Transition Provisions :

- Apply retrospectively, so restate the beginning of the earliest prior period presented
- Measurement of the initial investment in joint ventures previously accounted for using proportionate consolidation
  - Aggregate of the carrying amount of the net assets, including goodwill
- Measurement of the initial investment in joint operations previously accounted for using the equity method
  - Disaggregate the equity method carrying amount into the joint operator's share of each of the assets and liabilities of the arrangement, including goodwill
- In both cases, disclose a breakdown of the reconciliation between the newly disaggregated or disaggregated amounts and previous carrying amounts.

PFRS 12: DISCLOSURE OF INTERESTS IN OTHER ENTITIES

PFRS 12 prescribes all of the disclosure requirements for subsidiaries, joint arrangements, associates and unconsolidated structured entities.

A reporting entity should disclose information that helps users of financial statements to understand:

- ✓ The significant judgments and assumptions (and changes) made by the reporting entity in determining whether it controls (or does not control) another entity.
- ✓ The interest that the non-controlling interests have in the group's activities.
- ✓ The effect of restrictions on the reporting entity's ability to access and use assets or settle liabilities of consolidated entities.
- ✓ The nature of, and changes in, the risks associated with the reporting entity's interests in consolidated structured entities, joint arrangements, associates and unconsolidated structured entities.

New disclosure requirements include quantitative summarized financial information for:

- ✓ Each subsidiary that has a material non-controlling interest (including dividends paid, assets, liabilities, profit or loss, OCI and cash flows).
- ✓ Each individually material joint venture (including dividends received, assets, liabilities, profit or loss, OCI and specified expenses) and in total for other joint ventures (including carrying value, profit or loss, and OCI).
- ✓ Each individually material associate (including dividends received, assets, liabilities, profit or loss, OCI and specified expenses) and in total for other associates (including

carrying value, profit or loss, and OCI).

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