Paul Pacter: Improving disclosures about intercompany investments

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In May 2011 the IASB issued IFRS 12 D *isclosure of Interests in Other Entities* as part of a suite of new standards that address intercompany investments. IFRS 12 contains the note disclosures that companies must make about their interests in subsidiaries, joint arrangements (eg joint ventures), associates and unconsolidated structured entities. It takes effect from 1 January 2013, although companies may elect to apply it earlier.

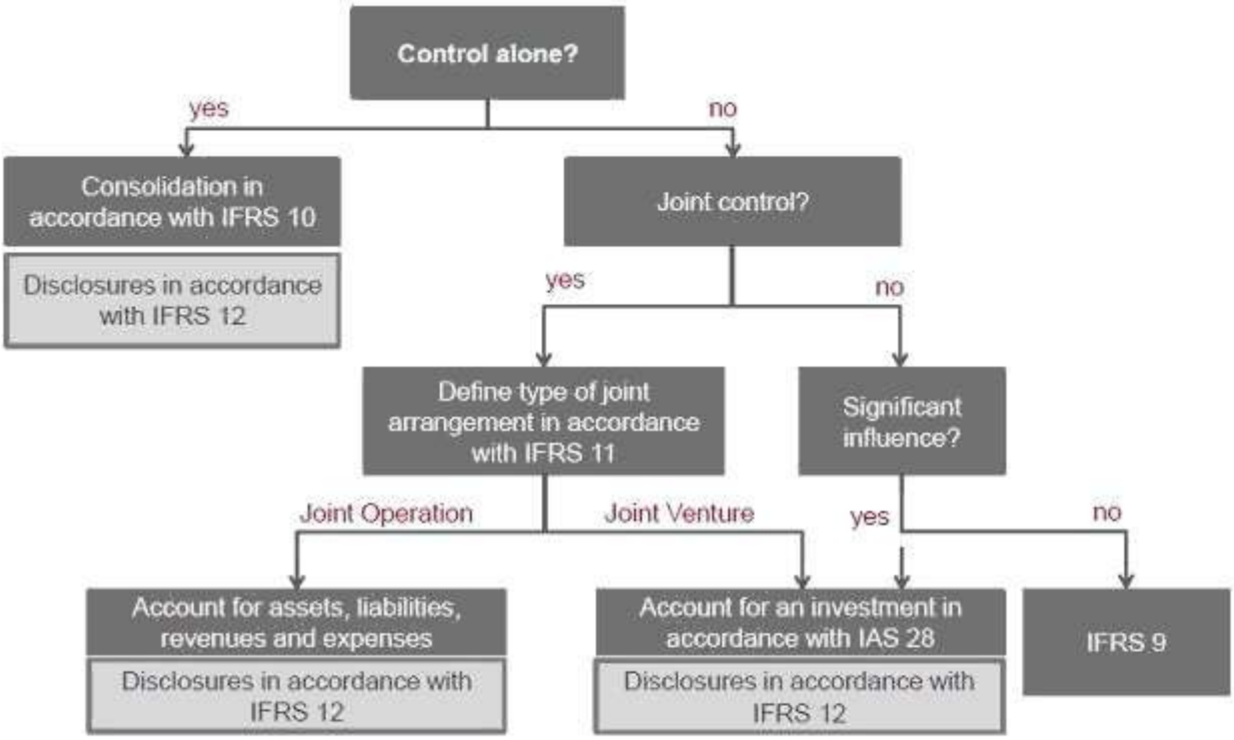
IFRS 12 requires four broad categories of disclosures—namely, information about:

1. **the significant judgements and assumptions** a company has made in deciding whether it has control, joint control or significant influence over another entity;
2. a company's interests in **subsidiaries**;
3. a company's interests in **joint arrangements and associates**; and
4. the nature, extent, and risks relating to a company's interests in **unconsolidated structured entities**.

From an investor's perspective, this fourth category is probably IFRS 12's biggest disclosure enhancement. Information about unconsolidated structured entities was not explicitly required before, and was largely unavailable in financial statements prepared in accordance with earlier IFRSs.

IFRS 12 was part of a suite of three new standards, issued concurrently, that address intercompany investments. The other two were IFRS 10 *Consolidated Financial Statements* and IFRS 11 *Joint Arrangements*. The existing standards that cover the accounting for investments in associates and passive investments of less than 20 per cent were largely unaffected. **Click here** to see more information on those standards.

The following diagram illustrates the interaction between the IFRSs that cover investments in other entities:



Objective of IFRS 12

The objective of IFRS 12 is to require the disclosure of information that enables users of a company's financial statements to evaluate:

- the nature of a company's interests in subsidiaries, joint arrangements, associates, and unconsolidated structured entities;
- the risks associated with those interests; and
- the effects of those interests on its financial position, financial performance and cash flows.

Most often, a company's interest in another entity is evidenced by holding equity or debt instruments. But that is not always the case. Such interests also include other forms of involvement, for example, providing funding, liquidity support, credit enhancements and guarantees. The IFRS 12 disclosures apply to all of those involvements.

Before looking more closely at the specific requirements of IFRS 12, there is an important point to bear in mind. The IFRS 12 disclosures are a **minimum.** Each entity is required to assess whether the disclosures required by IFRS 12 and other IFRSs, taken together, provide sufficient information to evaluate the nature, risks and effects of the company's interests in other entities. If the conclusion from that assessment is that further disclosures are needed, a company must present them to comply with IFRS 12.

Figure 1 below summarises the minimum required descriptive disclosures and **Figure 2** summarises the minimum required financial information.

Significant judgements and assumptions

IFRS 12 requires a company to disclose the significant judgements and assumptions made in deciding whether it has control, joint control or significant influence over another entity.

In deciding whether one entity controls another, IFRS 10 requires the company to assess whether it currently has the power to direct the activities of the other entity for its own benefit. If it does have that power, it must prepare consolidated financial statements, even if the company has less than a 50 per cent voting interest. Similarly, a company must consider any substantive **potential** voting rights that it holds (via options, warrants, contingent issuance agreements and the like) in deciding whether it has 'de facto control' over another entity. Clearly, those assessments involve judgements, and IFRS 12 requires companies to disclose those judgements and related assumptions.

Likewise, disclosure would be required if a company concludes that it should not consolidate another entity because it is acting as an agent of another party rather than on its own behalf (for example, a company that manages an investment fund by contract).

IFRS 12 also covers disclosures about investments in joint arrangements. If a company is a party to a joint arrangement, IFRS 11 requires the company to determine whether the investee is a joint venture (in which case the equity method set out in IAS 28 *Investments in Associates* applies) or a joint operation (in which case IFRS 11 requires the investor to account for its share of the various assets, liabilities, revenue and expenses of the joint operation). IFRS 12 requires companies to explain the basis on which they made the joint venture versus joint operation decision.

Information about a company's interests in subsidiaries

For subsidiaries, the objective is to disclose information that enables users of a company's consolidated financial statements to understand and evaluate:

- the composition of the group;
- the interest that non-controlling interests have in the group's activities and cash flows;
- the nature and extent of significant restrictions on its ability to access or use assets, and settle liabilities, of the group;
- the nature of, and changes in, the risks associated with its interests in consolidated structured entities;
- the consequences of changes in its ownership interest in a subsidiary that do not result in loss of control; and
- the consequences of losing control of a subsidiary during the reporting period.

Information about a company's interests in joint arrangements and associates

For joint arrangements and associates, the objective is to disclose information that enables users of a company's financial statements to evaluate:

- the nature, extent, and financial effects of its interests in joint arrangements and associates, including details of its contractual relationship with the other investors with joint control of, or significant influence over, joint arrangements and associates.
- the risks associated with its interests in joint ventures and associates.

Figure 1 – Required descriptive and other disclosures

	Subsidiary that is wholly owned	Subsidiary that is less than wholly owned	Joint operation	Joint venture	Associate
Name of subsidiary, joint arrangement, or associate		✓	✓	✓	✓
Nature of relationship			✓	✓	✓
Principal place of business and country of incorporation		✓	✓	✓	✓
Proportion of ownership and voting rights held by non-controlling interest		✓			

(NCI)					
Method of accounting (equity method or fair value)				✓	✓
Fair value, if equity method is used and investee is quoted				✓	✓
Profit or loss allocated to NCI		✓			
Accumulated NCI		✓			
Unrecognised losses for equity method investments				✓	✓
Restrictions on access to a subsidiary's assets	✓	✓			
Risks associated with consolidated structured entities	✓	✓			
Changes in ownership interest that do not result in loss of control	✓	✓			
Consequences of losing control in the period	✓	✓			
Dividends paid to NCI		✓			
Dividends received				✓	✓
Different reporting date of investor and investee	✓	✓		✓	✓
Commitments				✓	✓
Contingent liabilities				✓	✓

Figure 2 – Required summarised financial information

	Subsidiary that is wholly owned	Subsidiary that is less than wholly owned	Joint operation	Joint venture	Associate
Current assets		✓		✓	✓
Cash and cash equivalents included in current assets				✓	
Non-current assets		✓		✓	✓
Current liabilities		✓		✓	✓
Current financial liabilities included in current liabilities				✓	

(excluding payables and provisions)					
Non-current liabilities		✓		✓	✓
Non-current financial liabilities included in non-current liabilities (excluding payables and provisions)				✓	
Revenue		✓		✓	✓
Depreciation and amortisation				✓	
Interest income				✓	
Interest expense				✓	
Income tax expense or income				✓	
Profit or loss from continuing operations				✓	✓
Post-tax profit or loss from discontinued operations				✓	✓
Profit or loss		✓			
Other comprehensive income				✓	✓
Total comprehensive income		✓		✓	✓

Information about a company's interests in unconsolidated structured entities

The disclosures that IFRS 12 requires about unconsolidated (ie off-balance-sheet) structured entities are all new. Our previous standards had nothing similar. The objective here is to ensure that users of financial statements are able to:

- understand the nature and extent of a company's interests in unconsolidated structured entities; and
- evaluate the risks associated with those interests.

To meet the first objective, a company would disclose (among other things) the nature, purpose, size and activities of the structured entity and how those activities are financed. Even if a company no longer has an interest in an unconsolidated structured entity at the reporting date, some disclosures will be required if the company set up and sponsored the structured entity in the first place.

To meet the second objective, a company would present a tabular (or other) summary that includes:

- the carrying amounts (and line items) of the assets and liabilities recognised in its financial statements relating to its interests in unconsolidated structured entities.
- the company's estimate of its maximum exposure to losses from those interests, and how that estimate was made. If the company cannot quantify its maximum exposure to loss from unconsolidated structured entities, it must disclose that fact and the reasons.

If, during the reporting period, a company has voluntarily provided financial or other support to an unconsolidated structured entity in which it previously had, or currently has, an interest (for example, by purchasing assets of or instruments issued by the structured entity), it must disclose the type, amount, and reasons for that support.

Additionally, if a company intends to provide financial or other support to an unconsolidated structured entity, or to assist that structured entity in obtaining financial support, it must disclose that fact.

Related disclosures in other IFRSs

Companies also need to provide other disclosures about interests in other entities. For example, parents and subsidiaries are related parties under IAS 24 *Related Party Disclosures*, as are investors and their associates and joint ventures. IAS 24 requires disclosures about related party transactions and also about relationships between a parent and its subsidiaries, even if there are no transactions between them. In addition, IFRS 7 *Financial Instruments: Disclosures* requires various disclosures about the nature and extent of risks arising from financial instruments.

Respond to the author