STAFF PAPER

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Project	**Preparing Effects Analyses**		
Paper topic	Appendix A: Illustrative examples of Effects Analyses		
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Purpose

1. Appendix A contains examples from the Effects Analyses that have been issued (Business Combinations, Consolidation, Joint Arrangements and Investment Entities) or in draft Effects Analyses in current projects (eg the Leases Exposure Draft (ED)). These examples are provided to illustrate how the IASB discusses the likely effects of a change in IFRS, on the basis of the consultation and research that we have carried out.

2. We have illustrated the potential effects on the basis of the guidance in the Draft Due Process Handbook.

> 3.74 In forming its judgement on the evaluation of the likely effects, the IASB considers:
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> (a) how the proposed changes are likely to affect how activities are reported in the financial statements of those applying IFRSs;
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> (b) how those changes improve the comparability of financial information between different reporting periods for an individual entity and between different entities in a particular reporting period;
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> (c) how the changes will improve the quality of the financial information and its usefulness in assessing the future cash flows of an entity;

(d) the benefit of better economic decision-making as a result of improved financial reporting;

(e) the likely effect on compliance costs for preparers, both on initial application and on an ongoing basis; and

(f) how the likely costs of analysis for users (including the costs of extracting data, identifying how the data has been measured and adjusting data for the purposes of including them in, for example, a valuation model) are affected. The IASB should take into account the costs incurred by users of financial statements when information is not available and the comparative advantage that preparers have in developing information when compared with the costs that users would incur to develop surrogate information.

[Invitation to Comment *IASB and IFRS Interpretations Committee Due Process Handbook* (issued in May 2012)]

How the changes are likely to affect how activities are reported in the financial statements of those applying IFRSs

3. We think that there should be a discussion on the key contentious issues that arose during the development of each Standard. Such a discussion would help in framing explanations of the likely changes on the activities reported in the financial statements as a result of a change to a Standard. The IASB can demonstrate how it addressed these issues by using the following methods:

    (a) using a 'what-if' analysis to explain how particular transactions in standards could change. In Example 1, many respondents to the ED on IFRS 3 *Business Combinations* were concerned that the requirements in IFRS 3 could have an adverse effect on reported equity. We used the data gathered from 600 largest listed entities in Europe to demonstrate that those assertions were not supported by the data.

    (b) how the new Standard could potentially affect key ratios used in assessing financial performance and financial position. Example 2

gives an illustration on how the IASB's proposals on the Leases project could affect key ratios.

(c) the likely effect of a Standard on the industries that are likely to be most affected. In Example 3 below, we summarise how the requirements in IFRS 11 *Joint Arrangements* could affect key industries. This is based on the outreach activities, which provided us with access to contractual information or documentation supporting real arrangements from a variety of industries and geographical locations.

Example 1

We analysed the reported equity of the 600 largest listed entities in Europe at 31 March 2007. Our analysis suggests that the concerns expressed by respondents about the possible widespread, and substantial, erosion of equity as a consequence of buying the non-controlling interest are not supported by the data we observed.

…

We assessed the 600 companies in the Dow Jones STOXX 600[1]. As a first step we assessed the relative level of non-controlling interests to total equity (which includes the non-controlling interests). … The data reveal that 26 per cent of the STOXX companies do not have non-controlling interests. A further 25 per cent of the STOXX companies have non-controlling interests equivalent to less than 1 per cent of equity. Hence, approximately 50 per cent of the IFRS entities examined have non-controlling interests of less than 1 per cent of equity. ….

We analysed the financial statements of the 22 companies with the largest percentage of non-controlling interests relative to total equity, to get a better understanding of the reasons why their non-controlling interests were a relatively higher portion of total equity than other entities. The two main reasons for non-controlling interests constituting a high proportion of total equity appear to be:

+ underperformance of those parts of the group in which there are no non-controlling interests; and

[1] The Dow Jones STOXX 600 Index represents large, mid-size and small capitalisation companies across 18 European countries: Austria, Belgium, Denmark, Finland, France, Germany, Greece, Iceland, Ireland, Italy, Luxembourg, the Netherlands, Norway, Portugal, Spain, Sweden, Switzerland and the United Kingdom.

+ the investment strategy of the parent entity—entities that fund a lot of their operations using non-controlling equity providers.

The observed proportion of non-controlling interests as a percentage of equity is lower than the comment letters suggested.

We also performed further simulations based on the data of those 22 companies as if the non-controlling interests were acquired. These are the companies for which acquiring non-controlling interests should have the largest effect on equity.

For each of the 22 companies we collected market capitalisation data and calculated the market-to-book ratio. The reported non-controlling interests were then multiplied by this ratio to give a proxy for the fair value of the non-controlling interests. Using the ratio in this way assumes that the market-to-book ratio is the same for all segments of the group, including those segments in which there are non-controlling interests. The actual multiple is unlikely to be the same, and the resulting measure is not likely to be the same as the fair value of the non-controlling interests. Nevertheless we think that using the market to book ratio for the controlling interest as the ratio of non-controlling interests market to book is sufficient for the purposes of our analysis.

We then assumed that the parent acquired all of the non-controlling interests, paying out an amount equal to our fair value proxy. The result is a hypothetical measure of what the reported equity might be if all of the non-controlling interests were acquired by the parent.

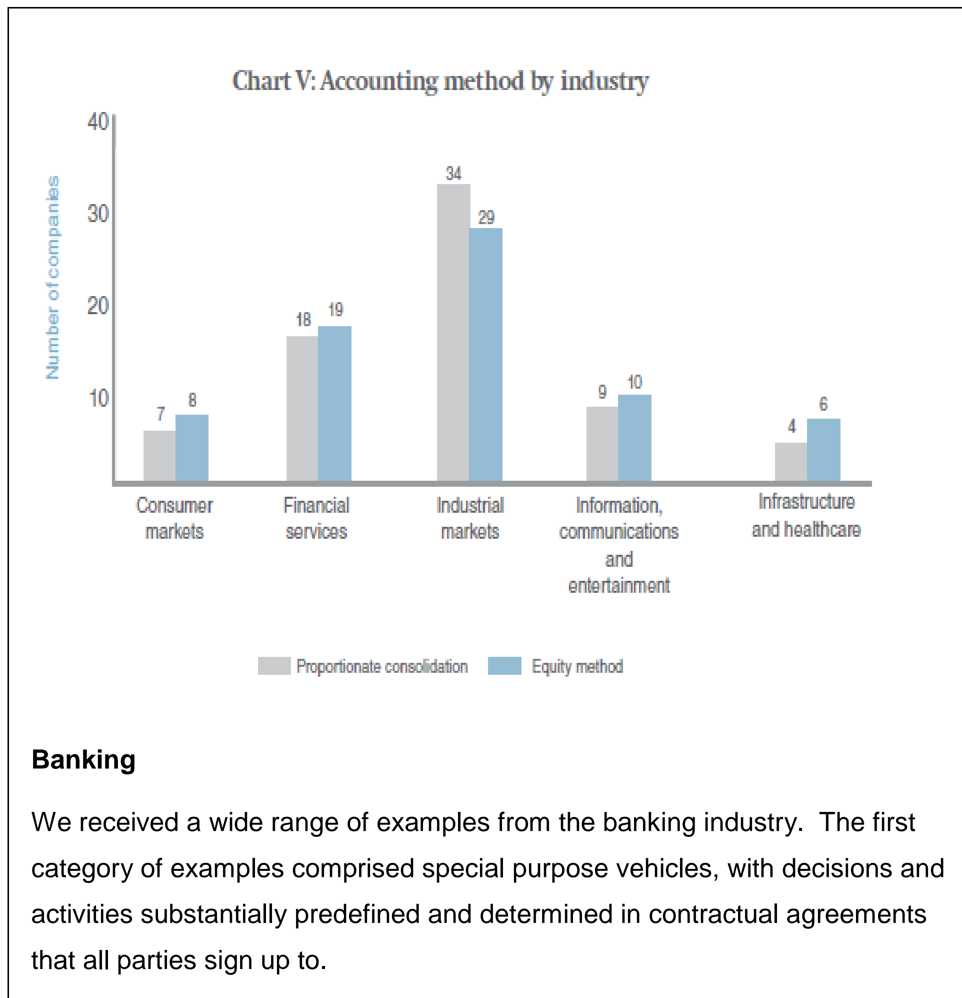
As would be expected, equity was reduced in all cases. This is neither a surprise nor a concern. Acquiring non-controlling interests should reduce the reported equity of a group—because assets are transferred out of the entity to the non-controlling interests holders (for example, cash paid to acquire the shares). This is the outcome we expect for any transaction with owners. A cash dividend has the same effect on leverage as acquiring non-controlling interests.

Our analysis also tells us that concerns about the possible widespread, and significant, erosion of equity as a consequence of buying out the non-controlling interests are not supported by the data.

Example 2

Name of ratio	What it measures	How it is calculated	Expected effect	Explanation
Gearing (leverage)	long-term solvency	liabilities/equity	increase	increase as reported debt increases (and equity reduces)
Current ratio	liquidity	current assets/current liabilities	decrease	decrease as current lease liabilities will be reported (ie current liabilities will increase) and no new current assets will be reported
EBITDAR	profitability	profit before interest, tax, depreciation, amortisation and operating lease expense	no change	same as it excludes all lease-related expenses

Example 3



Banking

We received a wide range of examples from the banking industry. The first category of examples comprised special purpose vehicles, with decisions and activities substantially predefined and determined in contractual agreements that all parties sign up to.

When analysing these examples we concluded that, from the fact patterns received, it was not obvious that those arrangements were within the scope of

IFRS 11 (ie it was not obvious that those arrangements were joint arrangements). These examples needed to be examined by first taking into consideration the guidance on assessing control in IFRS 10 *Consolidated Financial Statements*. The examples required special care to identify the relevant activities undertaken in those special purpose vehicles and the nature of the parties' decisions-making rights about the relevant activities (ie whether protective rights or whether parties had rights that gave them power).

Our assessment was that those arrangements were more likely to be within the scope of IFRS 10 as it was not evident that all parties involved shared control and that all decisions about the relevant activities required the unanimous consent of the parties sharing control.

…

Energy

Joint arrangements are common arrangements in this industry and we received a wide range of examples.

When undertaking the outreach activities we observed that a significant number of arrangements in this industry are not structured through separate vehicles. IAS 31 classifies these arrangements as either jointly controlled operations or jointly controlled assets. These arrangements will be classified as 'joint operations' in accordance with IFRS 11 and their accounting will remain unchanged. We expect that the majority of arrangements structured in separate vehicles that can be considered in their own right will be classified as 'joint ventures' in accordance with IFRS 11. A survey conducted by KPMG of the IFRS financial statements of 33 companies in the oil and gas sector across 14 countries found that just over half of the companies accounted for jointly controlled entities using the equity method, with the remainder applying proportionate consolidation. This might initially indicate that for over half of those companies the new requirements in IFRS 11 might not cause any change if those arrangements are classified as 'joint ventures' in accordance with IFRS 11.

…

How those changes improve the comparability of financial information

4. One of the key criteria in improving financial reporting is to improve the comparability of information provided. In Example 4 below we illustrate how IFRS 10 *Consolidated Financial Statements* could result in more consistent application and appropriate consolidation decisions.

Example 4

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).

How the changes will improve the quality of the financial information and its usefulness in assessing the future cash flows of an entity

5. In Example 5 below, in the IFRS on *Investment Entities (Amendments to IFRS10, IFRS 12 and IAS 27)*, we discussed how consolidating cash flows of a subsidiary that is an investment entity may hinder users' ability to predict the cash flows that may be passed on to investors.

Example 5

Consolidated financial statements of an investment entity emphasise the financial position, operations and cash flows of the investee, rather than merely those of the investment entity. The consolidation exception will reduce the information about the cash flows of those subsidiaries. However, the main business purpose of an investment entity is to invest funds solely for capital appreciation, investment income or both. The relevant cash flows relating to these activities are those of the investment entity itself. Consolidating the cash flows of a subsidiary may hinder users' ability to predict the cash flows that may be passed on to investors. The IASB therefore believes that these amendments will improve the quality of the financial information reported by an investment entity and will make that information more useful in assessing the future cash flows of the investment entity.

6. In Example 6, in the draft discussion on the effects of the IASB's proposals on the Leases project, we discuss how essential the predictive value of information about

lease liabilities is. We also discuss why disclosure is not a good-quality substitute for recognition.

Example 6

> Providing information about lease assets and liabilities will make financial reporting more relevant than when IAS 17 is applied. Information about lease liabilities (together with the disclosure proposals) has predictive value because it provides information about future cash outflows in relation to leases, which is useful for decision-making.
>
> Some argue that disclosure of lease commitments, similar to that required by IAS 17, already provides quality financial information and is helpful in assessing future cash flows. While the disclosures provided for operating leases in line with IAS 17 also have predictive value, that information is not as useful on its own because it is only shown on an undiscounted basis. This also makes it less comparable and incomplete compared with information provided for other financial liabilities that are recognised and therefore measured on a present-value basis.
>
> …
>
> An argument that is sometimes used to support the view that there is no need to recognise lease assets and liabilities is that many users of financial statements already make adjustments to the financial statements to include lease assets and liabilities on a present value basis, and use adjusted financial statements for their decision-making. The information provided by IAS 17, however, is not sufficient for users to make these adjustments. Consequently, they use estimates and shortcuts (eg to determine discount rate and allocate future minimum lease payments between individual periods) when making adjustments to financial statements. The result is that different users arrive at different conclusions, all of which may be very different from the lessee’s actual financial position.

The benefit of better economic decision-making as a result of improved financial reporting

7. In Example 7 below, in the *Business Combinations Effects Analysis*, we:

   (a) explained how simplifying the accounting for goodwill in a step acquisition (ie an acquisition in which an entity obtains control of a

business in two or more steps) could provide more useful information to users; and

(b) explained how permitting an acquirer to choose between the two methods of measuring non-controlling interests by using the method required by the original IFRS 3, or measuring at fair value, may not be as useful to users.

Example 7

Users Topic	Assessment	Effect	Analysis
Accounting for goodwill	Increased usefulness	Positive	Goodwill will represent the additional amount the acquirer has paid over the value of the net identifiable assets of the business to gain a controlling interest at the date control was achieved. Previously, goodwill was an accumulation of cost differences at each step.
Measuring non-controlling interests	Increased usefulness	Neutral	Users tell us that information about the acquisition-date fair value of non-controlling interests would be helpful in estimating the value of shares of the parent, not only at the acquisition date but also at future dates. For those entities choosing to measure non-controlling interests in this way we assess that users will have more useful information. However, we have assessed the effect as being neutral because measuring non-controlling interests at fair value is an option.

8. In Example 8, we explain why providing an exception to consolidation in *Investment Entities* provides more useful information.

Example 8

One of the essential features of an investment entity is that, in order to make better investment decisions, it measures and evaluates substantially all of its investments on a fair value basis. Presenting consolidated financial statements does not reflect this method of management. Requiring an investment entity to account for its investments in subsidiaries at fair value provides a better insight into the information that management uses to evaluate the performance of its investments.

In addition, investors in an investment entity are typically entitled to a proportionate share of the net assets of the entity when they withdraw their investment. Reporting the fair value of substantially all of the net assets of the investment entity allows the investors to more easily identify the value of their share of those net assets. As a result, the IASB expects significant benefits for most users of investment entity financial statements arising from the provision of more fair value information.

However, some respondents in some jurisdictions object to the consolidation exception because it undermines the control based approach to consolidation used in IFRS 10. These respondents noted that a consolidation exception would deprive financial statement users of information about the activities of subsidiaries and the economic effects of the relationships between an investment entity and its subsidiaries. In addition, some respondents expressed concern that a consolidation exception may encourage structuring to avoid consolidation, which would result in a loss of such information to users.

The IASB acknowledges these arguments, but notes that the consolidation exception has been introduced in response to comments from users that the most useful information for an investment entity is the fair value of its investments. Users also commented that consolidated financial statements of an investment entity may hinder users' ability to assess an investment entity's financial position and results, because it emphasises the financial position, operations and cash flows of the investee, rather than those of the investment entity.

In developing these amendments, the IASB deliberately restricted the population of entities that would qualify for the consolidation exception. In particular, the IASB prohibited the use of the consolidation exception by non-investment entity parents of investment entities, in order to address respondents' concerns about structuring and to restrict the use of the

> exception to situations where fair value information would be more relevant than information arising from the consolidation of subsidiaries.

The likely effect on compliance costs for preparers, both on initial application and on an ongoing basis

9. Providers of financial information expend most of the effort involved in collecting, processing, verifying and disseminating financial information. An effects analysis should contain the major costs that we expect a preparer to incur when applying a new Standard.

10. For example, in the *Effects Analysis on Joint Arrangements*, we identified the following areas as being those that will represent the highest costs and benefits for those most closely affected:

    (a) Classification of the types of joint arrangement. Please refer to Example 9 for the illustration of this cost.

    (b) Transition provisions: from proportionate consolidation to the equity method or from the equity method to accounting for assets and liabilities.

    (c) Additional disclosures.

Example 9

> IFRS 11 requires an entity to determine the type of joint arrangement in which it is involved (ie a 'joint operation' or a 'joint venture') by considering the structure of the arrangement and, when it is structured through a separate vehicle, the legal form of the separate vehicle, the terms of the contractual arrangements and, when relevant, other facts and circumstances. IAS 31 did not require an entity to assess the type of joint arrangement in which it was involved, because the classification of the arrangements was determined only by consideration of their structure.

Preparers		
Costs	Nature of the costs	Analysis
Education and training costs	These costs will be one-off because they will be incurred only on implementation of the IFRS.	Preparers will incur training and education costs to ensure appropriate implementation of the requirements.
Higher preparation costs due to the need for analysis of the arrangements	In most cases, these costs will be one-off (ie incurred on transition only and whenever new joint arrangements are established). Only when facts and circumstances change will an entity have to reassess the type of joint arrangement in which it is involved.	Preparers are likely to have higher preparation costs because IAS 31 does not require carrying out an assessment of the parties' rights and obligations to determine the classification of the arrangements. This assessment may require entities to exercise judgement. However, in most cases this assessment should be straightforward. Please note that such an assessment would be required only when the parties have structured their joint arrangements through a separate vehicle.
Actions taken to mitigate the costs	As it is the case whenever a new IFRS is issued, we are aware that implementing IFRS 11 would cause entities to incur educational and training costs, as well as costs to perform the assessment for the classification of the joint arrangements, which was not required by IAS 31. To lessen the costs of implementing IFRS 11, we have developed extensive application guidance and illustrative examples to help entities to apply the requirements.	

In particular, we learnt that a major player in the construction industry with revenues amounting to approximately €12.2 billion has initiated the process of classifying its joint arrangements. This preparer has 577 joint arrangements. From its initial assessment it has estimated that approximately 500 of its joint arrangements are joint operations and that 66 are joint ventures. The classification for the remaining 11 joint arrangements will require further assessment and analysis. Only one of these 11 joint arrangements is material to the reporting entity.

11. In the *Consolidation Effects Analysis*, we 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 assessment of control (see Example 10 below to see how we analysed the likely costs for an entity to assess control); and

    (c) transition provisions.

Example 10

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.

Consequences foreseen	**Nature of the cost/benefit**	**Analysis**
Higher preparation costs because of the assessment of control	The 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

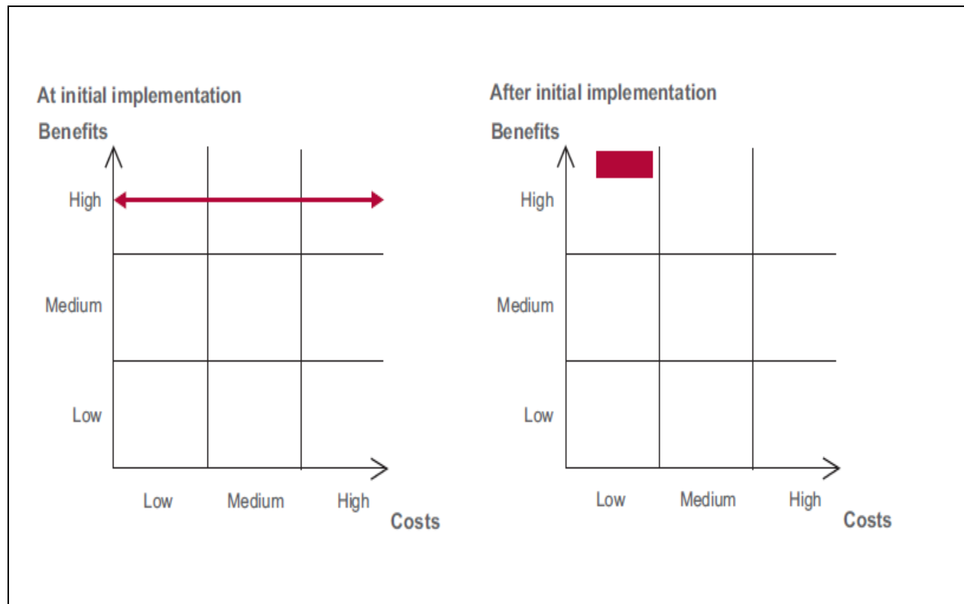
Consequences foreseen	Nature of the cost/benefit	Analysis
		judgement required when assessing control under IFRS 10.
More consistent understanding of control and consolidation requirements	Permanent	IFRS 10 provides a more clearly articulated definition of control and additional application guidance 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.



How the likely costs of analysis for users are affected

12. Users of financial information also incur costs of analysing and interpreting the information provided. Providing information that is relevant and faithfully represented helps users to make decisions with more confidence and results in more efficient functioning of capital markets and lower cost of capital for the economy as a whole.

13. In Example 11 below, we explain the cost that could be incurred by users when there is a possible change in classification in joint arrangements as a result of IFRS 11. We also discuss the actions to mitigate this cost.

Example 11

Costs	Nature of costs	Analysis
Education and training costs	These costs will be one-off because they will be incurred only on implementation of the IFRS.	Users will incur training costs to ensure appropriate understanding of the requirements.

Costs	Nature of costs	Analysis
Actions taken to mitigate the costs	As it is the case whenever a new IFRS is issued, we are aware that implementing IFRS 11 would cause users to incur educational and training costs to gain an appropriate understanding of the new requirements. To lessen the costs to users for understanding the principles in IFRS 11, we have developed extensive application guidance and illustrative examples.	

14. In Example 12 below, we explain the likely effect of the costs to users as a result of *Investment Entities (Amendments to IFRS10, IFRS 12 and IAS 27).*

Example 12

The likely effect of these amendments on the costs of analysis for users of financial statements is expected to be outweighed by the benefits of improved reporting, given that these amendments have been developed on request from users. However, the extent of the benefit will depend on existing practice.

In general, these amendments will provide improved information about the fair values of investments and the way in which the fair value is measured. Such information could reduce the cost of analysis by providing information more directly to users of financial statements. However, in many cases, investment entities already provide investors with fair value information, although this is often done in an alternative report rather than in the financial statements. This serves to emphasise that the main benefit of the changes is a reduction in costs to preparers because it eliminates what they see as a cumbersome reporting requirement that has little value.

For analysts or potential investors that use financial statements to analyse investment entities from different countries, the existing problems of diversity in accounting models creates costs that would be reduced by standardised accounting requirements.

In addition, the IASB expects that the requirement to apply the consolidation exception retrospectively will mitigate some of the transition costs for users. However, some of the transition reliefs will mean that users may receive less information on transition. In particular, the fact that investment entities will be required to provide only one period of comparative information may affect

users who might otherwise receive more than one period of comparative information. However, again, the IASB expects the benefits to outweigh the costs incurred as a result of the implementation of these amendments.