

STAFF PAPER

12-13 March 2013

IFRS Interpretations Committee Meeting

Project	IFRS 10 <i>Consolidated Financial Statements</i>		
Paper topic	Effect of protective rights on an assessment of control		
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Purpose of this paper

1. In August 2012, the IFRS Interpretations Committee (‘the Interpretations Committee’) received a request for clarification about IFRS 10 *Consolidated Financial Statements*. IFRS 10 defines the principle of control and establishes control as the basis for determining which entities are consolidated in the consolidated financial statements. An important element of control in IFRS 10 is power. The submission relates to protective rights, and the effect of those rights on power over the investee, as outlined in a simple example.

Example submitted

2. The shares of an operating entity are all owned by one entity, the investor.
3. The operating entity enters into a loan arrangement with a bank that contains several covenants. If a covenant is breached, the bank has the right to veto major business decisions (considered to be the relevant activities of the operating entity) and to call in the loan. The bank’s rights are considered to be protective. The investor continues to consolidate the operating entity.

4. The entity breaches a covenant. What are the consolidation implications for the investor entity and for the bank? Who now controls the investee—the original investor or the bank?
5. The Standard is effective for annual periods beginning on or after 1 January 2013, so as yet there is no evidence of diversity in practice. The submitter, however, refers to two possible interpretations that they think could arise in the future:
 - (a) **View A:** when protective rights become exercisable, there is a change in facts and circumstances and the control assessment should be reassessed in accordance with paragraph 8 of the Standard. In the staff's view this is the interpretation that the IASB intended.
 - (b) **View B:** the Standard states that (i) protective rights are designed to protect the interests of the holder without giving power and (ii) protective rights are defined in the Standard as not conferring power. Consequently, in the submitter's alternative view, protective rights can *never* affect an assessment of control.
6. This paper will discuss the question raised by the submitter—whether protective rights should be reassessed from a control perspective when facts and circumstances change. In this paper we do not intend to answer the question of who would control the investee in this example if that reassessment were made, although we do include some factors that would be considered in that reassessment.
7. The submitter's original query is included as Appendix A to this paper.

Paper structure

8. The paper is organised as follows:
 - (a) requirements of the Standard;
 - (b) submitter's alternative view;
 - (c) the requirement for continuous assessment;

- (d) discussion of control and power in the Standard;
- (e) IASB intention;
- (f) outreach activities;
- (g) assessment against the IASB's agenda criteria;
- (h) staff summary and recommendation; and
- (i) consolidation conclusion in the submitted example.

Requirements of the Standard

9. IFRS 10 requires an entity that is a parent to present consolidated financial statements. The Standard also sets out the accounting requirements for the preparation of consolidated financial statements.
10. There is a single principle as the basis of preparing consolidated financial statements, which is that of a parent's control over the investee. This principle is stated in the Standard:

5 An investor, regardless of the nature of its involvement with an entity (the investee), shall determine whether it is a parent by assessing whether it controls the investee.

6 An investor controls an investee when it 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.

7 Thus, an investor controls an investee if and only if the investor has all the following:

- (a) power over the investee (see paragraphs 10–14);
 - (b) exposure, or rights, to variable returns from its involvement with the investee (see paragraphs 15 and 16)
- and

(c) the ability to use its power over the investee to affect the amount of the investor's returns (see paragraphs 17 and 18).

Power

11. The submitter's query arises from one aspect of control-power.

12. Paragraph 10 of the Standard defines power:

An investor has power over an investee when the investor has existing rights that give it the current ability to direct the *relevant activities*, ie the activities that significantly affect the investee's returns.

13. The Standard goes on to explain that power arises from rights (paragraph 11); that an entity can have power even if it chooses not to exercise its power to direct (paragraph 12); and that a power assessment needs to consider the existing rights that may exist for more than one investor (paragraphs 13 and 14). It is in part of this discussion that the Standard refers to protective rights:

14 An investor can have power over an investee even if other entities have existing rights that give them the current ability to participate in the direction of the relevant activities, for example when another entity has *significant influence*. However, an investor that holds only protective rights does not have power over an investee (see paragraphs B26–B28), and consequently does not control the investee.

14. There is detailed guidance about protective rights in the application guidance.

The submitter's query arises from the guidance in paragraph B27 of the Standard:

B27 Because protective rights are designed to protect the interests of their holder without giving that party power over the investee to which those rights relate, an investor that holds only protective rights cannot have power or

prevent another party from having power over an investee
(see paragraph 14).

Submitter's alternative view

15. The submitter argues, in its alternative view, that protective rights should never be assessed as part of the control assessment for two reasons:
- (a) the immutability of design; and
 - (b) the definition of protective rights.

Immutability of design

16. Paragraph B27 of the Standard states that protective rights are designed to protect the interests of the holder without giving power, and in the Standard we use intention and design as a factor in the assessment of control (B3, B5-B8). The submitter contends that because the design and intention behind protective rights does not change over time, this means that the facts and circumstances relating to protective rights, which are relevant to an assessment of power, also cannot change over time.
17. The submitter thinks that 'protective' is a design-based status and is therefore historical and fixed at the point of design. Because the intention has not changed, the 'protective' nature does not change and these rights should be left out of any subsequent control assessment.

Definition of protective rights

18. Protective rights are defined in the Standard as rights that do not confer power upon the holder, and so, in the submitter's view, protective rights do not need to be reassessed as facts and circumstances change, because they can never confer power on the holder.

19. The submitter thinks that including any discussion of protective rights in IFRS 10 presupposes that they are excluded from any assessment of power. In their alternative view, the submitter contends that:
- (a) Protective rights are ‘dormant’ before default and so they could not affect the control conclusion *before* default occurs.
 - (b) In their view, therefore, a discussion of protective rights must have been included by the IASB only because it is relevant to an assessment of power *after* default occurs. That discussion states that protective rights do not confer power.
 - (c) In the submitter’s view, therefore, protective rights can *never* be relevant to an assessment of power because the rights are dormant before breach and are defined as not conferring power after breach.
20. The staff do not think that the alternative view proposed by the submitter reflects the IASB’s intention in IFRS 10 and that the alternative view submitted contradicts the key principles on which the Standard is based. We argue against the alternative view on three grounds:
- (a) the requirement for continuous assessment;
 - (b) the Standard’s discussion of control and power; and
 - (c) the IASB’s intention.

The requirement for continuous assessment

21. The Standard requires that control must be reassessed if facts and circumstances change:

8 An investor shall consider all facts and circumstances when assessing whether it controls an investee. The investor shall reassess whether it controls an investee if facts and circumstances indicate that there are changes to one or more of the three elements of control listed in paragraph 7 (see paragraphs B80–B85).

22. The submitted issue relates to the element of control that is power. If something changes that would affect the investor's power to direct the investee, the power element of the control decision should be reassessed:

B81 If there is a change in how power over an investee can be exercised, that change must be reflected in how an investor assesses its power over an investee. For example, changes to decision-making rights can mean that the relevant activities are no longer directed through voting rights, but instead other agreements, such as contracts, give another party or parties the current ability to direct the relevant activities.

23. The Standard is clear that the elements of control should be reassessed in accordance with paragraph 8 of the Standard when facts and circumstances change. The Basis for Conclusions (BC149-153) also makes it clear that this reassessment should be continuous. This need for continuous reassessment arose because the IASB thought that it would not be possible to develop reassessment criteria that would apply in every situation in which the control decision could change.
24. In addition to the key principle in paragraph 8 of the Standard, which requires continual reassessment, the application guidance provides several examples of when and how reassessments of the elements of control should be made. For example, B13 is relevant to the submitted example because it considers reassessment when two or more entities have different decision-making rights, which are exercisable at different times. Furthermore, examples in B53 consider the effect on the power assessment when particular circumstances arise or events occur and this guidance states that the if the rights are contingent, that does not, in itself, make those rights protective.
25. As well as providing evidence of the need to reassess the elements of control, these examples also refute the submitter's analysis at paragraph 19 of this paper that protective rights are 'dormant' before breach. B53, and the examples in that

section, states clearly that rights that are exercisable only in the future can still be a substantive right:

B53 ...The circumstances or events need not have occurred for an investor with the ability to make those decisions to have power....

Reassessment of design

26. The submitter contends that the purpose and design of a protective right does not change over time and that a design-based element of control should not be reassessed when facts and circumstances change. In the application guidance, however, purpose and design is quoted only as one of five possible factors that may assist in determining control (B3). In our view, the IASB did not intend that an interpretation of one factor, noted in application guidance, should contradict a principle, such as reassessment, laid out in the Standard itself.

Summary—reassessment

27. There is no exception for protective rights from the requirement for reassessment in the Standard, and nor is there any provision to choose which changes to the three elements of control are reassessed and which are not. The Standard is clear that all aspects of power—and in our view this includes an assessment of rights that were originally assessed as protective—must be reassessed if facts change. The breach of the covenants in the loan agreement in the submitted example is a significant change in the facts and circumstances relating to power, and so the rights and obligations conferred by the loan agreement should be reassessed at the time of breach to decide who controls the investee.

Discussion of control and power in the Standard

28. The Standard requires that an entity must decide whether it is a parent by deciding whether it controls the investee. An investor controls the investee, in accordance with paragraph 7 of the Standard if all three elements of control are met:

- (a) power over the investee;
- (b) rights to variable returns; and
- (c) an ability to affect the amount of the investor’s returns.

29. Power is defined in paragraph 10 of the Standard:

An investor has power over an investee when the investor has existing rights that give it the current ability to direct the relevant activities, ie the activities that significantly affect the investee’s returns.

30. Paragraph 11 of the Standard states that power arises from rights and that these rights can include contractual rights. On this basis, contractual terms, such as those contained in the loan agreement in the submitted example, could affect an assessment of power. Consequently, any change in the terms of the loan agreement, for example at breach, could potentially affect an assessment of control.

31. In an assessment of control it is the “Current ability to direct relevant activities” that we are trying to assess—and application guidance is provided to clarify that:

B9 To have power over an investee, an investor must have existing rights that give it the current ability to direct the relevant activities. For the purpose of assessing power, **only substantive rights and rights that are not protective** shall be considered (see paragraphs B22–B28). (Emphasis added.)

Substantive rights

32. Substantive rights are not defined in the Standard, but the application guidance discusses substantive rights in B22-B25. For a right to be substantive, the holder of the rights must have the practical ability to exercise that right and the guidance discusses these practicalities and the potential barriers to exercising these rights.

33. Only substantive rights and rights that are not protective are considered in an assessment of power in accordance with the guidance in B9 and part of the

confusion arises from there being no direct correlation between substantive rights and protective rights. The situation is further complicated because of the history of the term ‘substantive rights’. The Exposure Draft of the proposals that preceded IFRS 10 used the term ‘participating rights’ to refer to rights that confer power on the investor. In developing these proposals, however, the IASB subsequently replaced ‘participating rights’ with ‘substantive rights’, which led many to conclude, incorrectly, that substantive rights were exactly the same as participating rights.

34. This confusion was compounded by the reliance that some constituents formerly placed on EITF Abstract 96-16 *Investor’s Accounting for an Investee When the Investor Has a Majority of the Voting Interest but the Noncontrolling Shareholder or Shareholders Have Certain Approval or Veto Rights* for additional guidance in this area.
35. EITF 96-16 provides guidance in situations in which the powers of an investor to control an investee are restricted by approval or veto rights granted to others. These rights are called ‘noncontrolling rights’. The guidance in EITF 96-16 is that these rights overcome the consolidation presumption of the investor if they permit the holder “to effectively participate in significant decisions that would be expected to be made in the ordinary course of business”. This reinforces the notion of ‘participating rights’, as those rights that confer control. As a result, many still prefer to use ‘participative’ to describe rights that give the holder power over the investee. This term is in common usage as shorthand for the ‘substantive and non-protective rights’ that confer power in the Standard.
36. Following this change in term from ‘participating’ to ‘substantive’, many are confused about whether there is now any relationship between ‘substantive’ and ‘protective’ rights. The Standard is explicit that they are not mutually exclusive:

B25 Substantive rights exercisable by other parties can prevent an investor from controlling the investee to which those rights relate. Such substantive rights do not require the holders to have the ability to initiate decisions. As long as the rights are not merely protective (see paragraphs

B26–B28), substantive rights held by other parties may prevent the investor from controlling the investee even if the rights give the holders only the current ability to approve or block decisions that relate to the relevant activities.

37. B25 of the Standard makes it clear that protective rights are not the opposite of substantive rights, so if power arises from substantive rights, what is the relationship of protective rights to power?

Protective rights

38. Protective rights are discussed in IFRS 10 in the application guidance relating to power. The Standard says :

B26 In evaluating whether rights give an investor power over an investee, the investor shall assess whether its rights, and rights held by others, are protective rights. Protective rights relate to fundamental changes to the activities of an investee or apply in exceptional circumstances. However, not all rights that apply in exceptional circumstances or are contingent on events are protective (see paragraphs B13 and B53).

39. Protective rights apply in exceptional circumstances or are contingent on future fundamental changes and this accords with most people’s understanding of protective rights at law.

40. The Standard goes on to give a common example of a protective right:

B28

(c) the right of a lender to seize the assets of a borrower if the borrower fails to meet specified loan repayment conditions.

41. In example (c), the right, prior to breach, is the future ability to seize goods if the (exceptional and contingent) future event of non-payment occurs. That protective right does not give the lender a right over the asset, or over the entity, at inception.

After the breach occurs, however, the lender has the present right to seize the asset. Breach triggers a substantive right. Most would conclude that after breach the lender has the legal right to the asset and, therefore, controls the asset.

(Whether control of that asset means that the lender also controls the investee, in terms of IFRS 10, would depend on how significant that asset was to the relevant activities of the investee.)

42. Many would conclude that this right was protective before breach, but that after breach control of the asset passes to the lender and, therefore, the right can no longer be protective as defined by IFRS 10. Most would conclude that the present right to seize is a substantive, non-protective right. We think, therefore, that most people's understanding about a protective right is that the nature of these rights can change, particularly on breach. If a protective right *did not* change on breach, what protection could it possibly confer upon the holder?

Current ability

43. The Standard defines power in terms of the investor's 'current ability'. Many think that current ability rests on a right being currently exercisable.
44. Protective rights that will be triggered upon the occurrence of a future event, which is uncertain of occurrence, are not currently exercisable, but become exercisable upon the occurrence of the defined events. In our view, the occurrence of an event that makes a protective right exercisable would be caught by the requirement in paragraph 8 of the Standard relating to a change in facts and circumstance and would require a reassessment of control.
45. In support of the IASB's intention that rights should be reassessed and that only currently exercisable rights should normally be considered, we note that B24 states:

B24 To be substantive, rights also need to be exercisable when decisions about the direction of the relevant activities need to be made. Usually, to be substantive, the rights need to be currently exercisable. However, sometimes

rights can be substantive, even though the rights are not currently exercisable.

Summary—control and power in the Standard

46. In our view, there is nothing in the Standard that says that if a right is assessed as protective at inception, it must always be considered to be protective. On the contrary, the Standard requires that the control assessment is based on continual reassessment of the elements of control and that assessment with regard to power is based on a *current* ability to direct.

IASB intention

47. The application guidance does not provide an explicit discussion about the reassessment of protective rights or under what circumstances a protective right would be reassessed and redesignated as one that can affect the control decision. In the absence of such a discussion, we have looked at the IASB's redeliberations of the Standard.
48. *Update* October 2009 reaffirms the section in the Exposure Draft on protective rights. The paper discussed by the IASB at this meeting (Agenda Paper 3C Consolidation Project *Power to direct: Protective and Participating Rights*) included two examples. The second example included a reassessment of a protective right on breach and, in that example, the original investor loses control of the investee. In those redeliberations, the IASB concluded that this protective right did give control to the holder once breach had occurred. Putting this another way—a right that was only protective at contract inception became a substantive right, which changed the control assessment, after breach. The submitter's alternative view, that protective rights should not be reassessed, clearly contradicts the IASB's decision.
49. This decision demonstrates a clear intention that the IASB did not consider protective rights, as discussed in the application guidance, to be exempt from continuous assessment. That reassessment could conclude, as it does in the

example deliberated by the IASB, that the right was no longer a protective right but that the right, at the time of reassessment, could give rise to a change in the control assessment.

Summary—IASB intention

50. In our view, this shows a clear intention by the IASB that the Standard should be read in accordance with View A, ie when protective rights become exercisable, there is a change in facts and circumstances and the control assessment should be reassessed in accordance with paragraph 8 of the Standard.

Outreach activities

51. The Standard is effective for annual periods beginning on or after 1 January 2013. Consequently, we have been unable to conduct our normal outreach on this issue because few entities currently apply this Standard.
52. We have spoken informally with a number of accounting firms to establish whether this topic has arisen when planning future audit work with their clients. All but one of these firms think that View A is the approach required by the Standard and say that they do not expect diversity in practice to arise when IFRS 10 is applied.

Assessment against the IASB’s agenda criteria

53. We have assessed this issue against the agenda criteria of the current *Due Process Handbook*:

We should address issues(5.16):	Our assessment
that have widespread effect and have, or are expected to have, a material effect on those affected;	Yes. The consolidation decision has a material effect on those affected.

<p>where financial reporting would be improved through the elimination, or reduction, of diverse reporting methods; and</p>	<p>No. We do not expect that there will be diversity in practice.</p>
<p>that can be resolved efficiently within the confines of existing IFRSs and the <i>Conceptual Framework for Financial Reporting</i>.</p>	<p>No. Reassessment of the control elements is fundamental to IFRS 10. Excluding protective rights from this requirement would contradict the control principle in the Standard.</p>
<p>In addition:</p>	
<p>Can the Interpretations Committee address this issue in an efficient manner (5.17)?</p>	<p>No. Any revision to the reassessment requirement of paragraph 8 of IFRS 10 would be a fundamental change of principle, outside the scope of the Interpretations Committee.</p>

54. We do not think that this issue satisfies the agenda criteria of the IASB’s *Due Process Handbook*.

Staff summary and recommendation

55. We do not recommend adding this issue to the Interpretation’s Committee’s agenda. In our view:

- (a) the breach of the loan covenants results in a significant change in those rights that might be considered in an assessment of power;

- (b) the Standard is clear that a reassessment of control must be carried out when facts and circumstances relating to any one of the three elements of control changes;
- (c) the Standard is clear that an assessment of power is based on current, substantive rights; and
- (d) the IASB's clear intention was that protective rights should be included in a reassessment of control when facts and circumstances change.

56. We think that the submitter's alternative view contradicts decisions made by the IASB and could, in some cases, contradict the control principle on which the Standard is based. We think that View A is the only view that is consistent with the Standard.

57. In addition, we do not expect that there will be significant future diversity in practice once the Standard is applied.

Question 1 for the Interpretations Committee

Do you agree with the staff recommendation not to add this topic to the Interpretation Committee's agenda?

Consolidation conclusion in the submitted example

58. The submitter specifically asks about the consolidation conclusion in the example given.
59. We do not think that we have sufficient information about the rights of the investor, bank or other parties to come to a conclusion about control in this example. We would, however, note the following in that regard:
- (a) Power is the current ability to direct the relevant activities of the investee and that power is conferred by holding substantive and non-protective rights.

- (b) Protective rights, in common with all factors that may influence the control assessment, should be reassessed when facts and circumstances change, in accordance with IFRS 10, paragraph 8.
- (c) Depending on the facts and circumstances, the right(s) held by the bank after default may or may not be substantive and non-protective and may or may not prevent another entity from having power over the investee.
- (d) All three criteria of control required by paragraph 7 of IFRS 10 must be satisfied for one entity to control another.

Question 2 for the Interpretations Committee

Do you agree:

- (a) that we do not have enough information to come to a conclusion about the control assessment in the submitted example; and
- (b) do you have any comments on the notes made with regard to making a control assessment?

Appendix A Original agenda request

A1. On 21 August 2012 the IFRS Interpretations Committee received a request for clarification on the effect of protective rights on an assessment of control. The request, below, has been rendered anonymous in respect of the submitter.

Dear Mr Stewart

IFRIC potential agenda item request

This letter describes an issue that we believe should be added to the IFRIC's agenda. We have included a summary of the issue, a range of possible views and an assessment of the issue against IFRIC's agenda criteria.

The issue: protective rights and continuous assessment of control under IFRS 10

IFRS 10 *Consolidated Financial Statements* explicitly introduces the concept of protective rights. However, we believe that the application of the concept is unclear when rights that are otherwise protective are 'activated' - i.e. become exercisable. As explained in the rest of this letter, the fundamental issue is whether or not a change in the control conclusion is appropriate as a result of such rights becoming exercisable.

The following example is used to illustrate the issue:

An operating company has all of its shares owned by another entity (the investor), which has held them for many years. The operating company enters into a loan arrangement with a bank, which contains several covenants. If a covenant is breached, then the bank has rights to veto major business decisions (considered to be the relevant activities of that company) and to call the loan. At the outset of the loan, the investor concludes that the bank's rights are protective, because they are designed to protect the interests of the bank without giving the bank power over the company. The investor continues to consolidate the company.

After a period of time, due to its deteriorating financial position, the company breaches a covenant. The bank does not call the loan, although it retains the right to do so, and now also has the right to veto any major business decisions - i.e. it has veto rights over

the relevant activities of the company. In some cases such a situation may be resolved in the short-term (covenants renegotiated), and in others it may not.

At the point in time at which the bank's right to call the loan and to veto any major business decisions becomes exercisable, what are the consolidation implications for the investor and the bank?

- The consolidation conclusion is or may be changed because there has been a change as to how decisions about relevant activities are made.
- The consolidation conclusion is not changed, because once rights are assessed as being protective they continue to be classified as protective throughout their lives, and protective rights are not taken into account in the control assessment.¹

These outcomes are explored further below.

Current practice

There is currently no established practice because IFRS 10 is not yet in effect. However, we believe that this issue is likely to establish itself as a practice issue once entities begin to apply the standard. We believe that IFRIC should consider the issue because the potential outcomes (consolidate vs do not consolidate) could have a significant effect on the statement of financial position of entities, particularly lenders, and that consistency in this area is desirable.

Here we outline what we believe are the different approaches that an entity could take.

View 1: Consolidation conclusion is reassessed and may change

View 1 proceeds from the premise that IFRS 10 is based on the concept of 'continuous assessment'. When protective rights become exercisable, there is a change in facts and circumstances, which warrants a reassessment of the control conclusion. In the example above this will, or may, lead the majority investor to conclude that it no longer controls the company and for the bank to conclude that it controls it. This is based on IFRS 10.8 and BC149-BC153.

Supporters of View 1 argue the following based on IFRS 10:

- Paragraph 8 takes precedence in assessing (reassessing) control, because it establishes the overall principle underlying the consolidation model. Therefore, even if the guidance in Appendix B can be read (explicitly or implicitly) to support View 2, this was not the Board's intent.

The issues set out in the two bullet points would also be relevant to the bank even if there was no investor that owned all of the shares of the borrower company - e.g. if the borrower company was listed.

- While BC152 refers to changes in market conditions not leading to a change in control, the text refers to market conditions *alone*. However, in accordance with BC153, if a change in market conditions triggers a consequential change in one of the three elements of control, then control should be reassessed.

Paragraph BC85 of IFRS 12 *Disclosure of Interests in Other Entities* states that traditional operating entities whose financing was restricted following a downturn in activities were not meant to be structured entities - i.e. entities that are controlled by rights other than voting rights. Supporters of View 1 believe that this statement is made solely in the context of disclosure, and was not intended to indicate that no reassessment of control is required in such circumstances.

View 2: Consolidation conclusion would not change even if reassessed

View 2 is based on the premise that protective rights are excluded from the control assessment and that rights that were originally determined to be protective do not stop being protective solely because the rights become exercisable due to the occurrence of the exceptional circumstances to which they relate. Accordingly, a reassessment of control at this point would lead to the same control conclusion as arrived at initially.

This view is supported by the following analysis of IFRS 10:

- Paragraph B26 has a direct definition of protective rights. Paragraph B27 states the consequence of meeting this definition, being that such rights do not lead to power.
- There is nothing in IFRS 10 to specify the fact that rights cease to be protective on the occurrence of the exceptional circumstances to which they relate. In fact, B27 refers to protective rights as being so by design, supporting that it is the initial set-up and purpose of rights that is the focus of application of the definition and not any later activation.
- Accordingly, if rights meet the definition of protective when they are initially set up, then they do not lose their protective character if they subsequently become exercisable.

Supporters of View 2 argue that there would be no purpose to having categorised rights as protective when they are dormant at the outset, only to reverse that once they become exercisable:

- At the outset it would be uncontentious that dormant protective rights could not affect the consolidation assessment, and this would be so without needing a special designation of those rights as 'protective'.
- The protective designation would then be withdrawn on the occurrence of the exceptional circumstances for which they are designed.

So, if View 2 does not apply, then at no time would the concept of protective rights have had any practical consequences.

Supporters of View 2 would also note the following points:

View 2 is not denying the principle of continuous assessment. It is not trying to prevent a re-performance of the assessment in order to avoid a consequent change in the consolidation conclusion. Rather, it is saying that even if the assessment were re-performed, it would not result in a different conclusion because the rights are still protective.

It may be important to consider the relationship between substantive and protective rights. For example, if substantive and protective rights were mutually exclusive categories, then that might

support View 1 - on activation the rights become substantive and therefore can no longer be protective. However, supporters of View 2 would argue that B22, B25 and B26 of IFRS 10 appear clear that protective rights are also substantive - i.e. they are a subset of substantive rights. In effect, they would argue that the steps of analysis required by IFRS 10 are: (1) disregard any rights that are not substantive (B22); (2) some of the remaining substantive rights may be protective (B25); (3) so identify those substantive rights that are protective as defined (B26) and disregard them (B27).

Reasons for the IFRIC to address the issue

- a) *Is the issue widespread and practical?*** Yes. Protective rights are common in contractual arrangements, especially loans, and given the ongoing economic environment, we expect this issue to be very widespread.
- b) *Does the issue involve significantly divergent interpretations?*** Yes. Depending on the interpretation applied, the decision to consolidate vs not consolidate by a majority investor and a lender could have a significant effect on an entity's statement of financial position.
- c) *Would financial reporting be improved through elimination of the diversity?*** Yes. The comparability of financial statements will be improved if entities apply the concept of substantive vs protective rights on the same basis.
- d) *Is the issue sufficiently narrow...?*** Yes. We believe that the issue is capable of interpretation within the confines of IFRS 10. It is concerned with specific concepts in IFRS 10.
- e) *If the issue relates to a current or planned IASB project is there a pressing need for guidance sooner than would be expected from the IASB project?*** ***The issue does not relate to a current or planned IASB project.***

Please contact XXX if you wish to discuss any of the issues raised in this letter.