

STAFF PAPER

14-15 May 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 when a borrowing covenant is breached.
2. The purpose of this paper is to set out the proposed wording for the tentative agenda decision taken by the Interpretations Committee at its March meeting.

Paper structure

3. The paper is organised as follows:
 - (a) background;
 - (b) summary of the March 2013 analysis;

- (c) summary of the March 2013 discussions of the Interpretations Committee; and
- (d) draft agenda notice.

Background

4. The example discussed in March concerned an operating entity that had obtained a loan from a bank under an arrangement that contained 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.
5. The entity breaches a covenant. Who now controls the investee—the original investor or the bank?
6. The Standard is effective for annual periods beginning on or after 1 January 2013, so we were unable to conduct outreach to obtain evidence of diversity in practice. The submitter, however, referred 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.

Summary of the March analysis

7. The analysis presented to the Interpretations Committee in March in Agenda Paper 11 *IFRS 10 Consolidated Financial Statements: Effect of protective rights*

on an assessment of control recommended that the Interpretations Committee should not take this topic onto its agenda for four reasons:

- (a) *Need for reassessment*—paragraph 8 of the Standard requires that control must be reassessed if facts and circumstances change. 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 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
- (b) *Nature of protective rights*—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.
- (c) *IASB intention*—the application guidance to the Standard 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. However, IASB *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. 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.

- (d) *Assessment against agenda setting criteria*—because the Standard is effective from 1 January 2013 we were unable to conduct sufficient outreach to obtain evidence of diversity in practice. We spoke informally with a number of accounting firms to establish whether this topic had arisen when planning future audit work with their clients. All but one of these firms thought that the Standard is clear and say that they did not expect diversity in practice to arise when IFRS 10 is applied.

Summary of the March 2013 discussions of the Interpretations Committee

8. After discussing this topic at its March 2013 meeting, the Interpretations Committee tentatively decided that the agenda criteria were not met for this submission. In their 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 change;
 - (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.
9. They thought 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. They thought that View A is the only view that is consistent with the Standard.
10. In addition, they did not expect that there would be significant future diversity in practice once the Standard is applied.

Draft agenda notice

11. We propose the following wording for the tentative agenda decision:

IFRS 10 Consolidated Financial Statements—Effect of protective rights on an assessment of control

The Interpretations Committee received a request for clarification about IFRS 10. The query relates to protective rights and the effect of those rights on the power over the investee. More specifically, the submitter asked whether the control assessment should be reassessed if protective rights become exercisable, for example on the breach of a covenant in a borrowing arrangement that causes the lender to be in default of the arrangement, or whether, instead, protective rights can never affect an assessment of control.

The Interpretations Committee observed that paragraph 8 of IFRS 10 requires an investor to reassess whether it controls an investee if facts and circumstances change and further observed that if the breach resulted in the protective rights becoming exercisable, that did constitute such a change. It noted that the Standard does not include an exemption for protective rights from this need for reassessment. The Interpretations Committee also discussed the IASB's redeliberations of this topic during the development of IFRS 10 and concluded that the IASB's intention was that protective rights should be included in a reassessment of control when facts and circumstances change. Accordingly, the Interpretations Committee noted that the conclusion about who controlled the investee would need to be reassessed after the breach occurred and after the rights in question became exercisable.

The Interpretations Committee also concluded that it did not expect significant diversity in practice to develop following the implementation of the Standard.

Consequently, the Interpretations Committee [decided] not to add this issue to its agenda.

Question for the Interpretations Committee

Does the IFRS Interpretations Committee have any comments on the drafting of the tentative agenda decision?