IFRS

STAFF PAPER

December 2021

IASB® Meeting

Project	**Second Comprehensive Review of the *IFRS for SMEs*® Standard**
Paper topic	Towards an Exposure Draft—IFRS 10 *Consolidated Financial Statements*

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Introduction

1. This paper discusses whether and, if so, how to propose amendments to Section 9 *Consolidated and Separate Financial Statements* of the *IFRS for SMEs* Standard to align with IFRS 10 *Consolidated Financial Statements*.

2. In this paper, the term SMEs refers to small and medium-sized entities that are eligible to apply the *IFRS for SMEs* Standard.

Purpose of the paper

3. The purpose of this paper is to ask the International Accounting Standards Board (IASB) to:
   (a) consider feedback on the Request for Information *Comprehensive Review of the* IFRS for SMEs *Standard*, published in January 2020, and the recommendations of the SME Implementation Group (SMEIG) on possible amendments to Section 9 (Question S2 of the Request for Information); and
   (b) decide whether and, if so, how Section 9 should align with IFRS 10.

Summary of staff recommendations

4. The staff recommend the IASB propose partially aligning Section 9 with IFRS 10 on the basis that was set out in the Request for Information, in particular:

    (a) aligning the definition of control in Section 9 with IFRS 10;

    (b) retaining and updating paragraph 9.5 of the *IFRS for SMEs* Standard; and

    (c) not introducing the requirement that an investment entity measures its investments in subsidiaries at fair value through profit or loss.

Structure of the paper

5. This paper is structured as follows:

    (a) background (paragraphs 6–11);

    (b) question in the Request for Information (paragraph 12);

    (c) feedback and SMEIG recommendations (paragraphs 13–26);

    (d) Post-implementation Review of IFRS 10 (paragraphs 27–29);

    (e) staff analysis:

        (i) aligning the definition of control with IFRS 10 (paragraphs 30–52); and

        (ii) investment entities (paragraphs 53–59);

    (f) question for the IASB; and

    (g) Appendix—Extract from the Request for Information

Background

6. Section 9 of the *IFRS for SMEs* Standard prescribes the circumstances in which an SME presents consolidated financial statements.

7. The Glossary of terms of the *IFRS for SMEs* Standard defines 'control (of an entity)' as:

> 'the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities'

The definition is aligned with the definition of control in IAS 27 *Consolidated and Separate Financial Statements*.

8. Section 9 also addresses:

(a) special purpose entities (SPEs)—requiring consolidated financial statements that include the entity and any SPEs controlled by that entity (generally aligning with SIC-12 *Consolidation—Special Purpose Entities*); and

(b) potential voting rights—requiring potential voting rights to be considered in the assessment of control when they are currently exercisable by the investor.

9. Paragraph 9.5 of the *IFRS for SMEs* Standard provides a rebuttable presumption relating to the assessment of control:

> Control is presumed to exist when the parent owns, directly or indirectly through subsidiaries, more than half of the voting power of an entity. That presumption may be overcome in exceptional circumstances if it can be clearly demonstrated that such ownership does not constitute control. Control also exists when the parent owns half or less of the voting power of an entity but it has:
>
> (a) power over more than half of the voting rights by virtue of an agreement with other investors;
>
> (b) power to govern the financial and operating policies of the entity under a statute or an agreement;
>
> (c) power to appoint or remove the majority of the members of the IASB of directors or equivalent governing body and control of the entity is by that board or body; or
>
> (d) power to cast the majority of votes at meetings of the IASB of directors or equivalent governing body and control of the entity is by that board or body.

10. IFRS 10 replaced the requirements in IAS 27 and SIC-12 with a single basis for consolidation—control over an investee. Applying IFRS 10, an investor has control over an investee and therefore must consolidate it if it:

    (a) has power over the investee;

    (b) is exposed, or has rights, to variable returns from its involvement with the investee; and

    (c) has the ability to use its power over the investee to affect the amount of the investor's returns.

11. As an exception to this, IFRS 10 requires an entity that qualifies as an investment entity to measure its investments in subsidiaries at fair value through profit or loss instead of consolidating them.

Question in the Request for Information

12. Question S2A and S2B of the Request for Information asked for views on alignment of Section 9 of the *IFRS for SMEs* Standard:

    (a) aligning the definition of control in Section 9 with IFRS 10;

    (b) retaining and updating the simplification in paragraph 9.5 of the *IFRS for SMEs* Standard; and

    (c) not introducing the requirement that an investment entity measures its investments in subsidiaries at fair value through profit and loss.

Feedback on the Request for Information and SMEIG recommendations

Overall feedback

13. Overall feedback on the Request for Information supported aligning Section 9 with IFRS 10 in respect of the definition of control and retaining and updating the rebuttable presumption in paragraph 9.5 of the *IFRS for SMEs* Standard.

14. Respondents' views were mixed on whether to introduce the requirement that an investment entity measures its investments in subsidiaries at fair value through profit and loss.

Feedback from comment letters

15. Many respondents agreed with aligning the definition of control in Section 9 with IFRS 10 and retaining and updating paragraph 9.5 of the *IFRS for SMEs* Standard. They were of the view that alignment would:

    (a) provide greater consistency and clarity among SMEs; and

    (b) improve the quality of information provided to users because the definition of control is an important definition.

16. Some respondents that agreed with the alignment of the definition of control nonetheless raised concerns on challenges that an SME might encounter in applying the new definition, for example, Singapore Accounting Standards Council commented:

> …we recognise that the control model in IFRS 10 is intended to be used in a broad range of fact patterns and governance structures, and therefore, requires an entity to assess all relevant facts and circumstances in its application. Accordingly, there may be difficulty and significant judgment involved in applying the definition of control and the related guidance in IFRS 10, especially to more complex fact patterns…

17. Many respondents agreed with the IASB's position to retain and update paragraph 9.5 of the *IFRS for SMEs* Standard because the rebuttable presumption simplifies the requirements and retaining the presumption would not contradict the new control definition.

18. A few respondents disagreed with the IASB's position to retain the rebuttable presumption because they thought it would introduce a departure from the general principle of control.

19. Some respondents agreed with the IASB's view not to introduce the requirement that an investment entity measures its investments in subsidiaries at fair value through profit or loss. These respondents said:

    (a) few SMEs are likely to qualify as investment entities; and

    (b) the requirements to determine fair value may be too complex for SMEs.

20. In contrast, a small number of respondents were of the view that the requirement should be introduced into the *IFRS for SMEs* Standard as it adds to faithful representation and will be relevant to some SMEs.

Feedback from online survey and outreach events

21. Most of respondents to the online survey agree with aligning the definition of control in Section 9 with IFRS 10 and retaining and updating paragraph 9.5 of the *IFRS for SMEs* Standard.

22. Some respondents to the online survey said the requirement for an investment entity to measure its investments in subsidiaries at fair value through profit or loss should be introduced to Section 9 to achieve alignment with IFRS 10.

23. Most participants in outreach agreed with aligning the definition of control and not introducing a requirement that an investment entity measures its investments in subsidiaries at fair value through profit or loss.

SMEIG recommendations[1]

24. SMEIG members generally agreed that the feedback to the Request for Information provides evidence for the IASB to align the definition of control in Section 9 with IFRS 10 and retain and update paragraph 9.5 of the *IFRS for SMEs* Standard.

25. SMEIG members had mixed views on not introducing the requirement that an investment entity measures its investments in subsidiaries at fair value through profit or loss.

26. A small number of SMEIG members said that the IASB should consider the feedback from the Post-implementation Review of IFRS 10, IFRS 11 *Joint Arrangements* and IFRS 12 *Disclosure of Interests in Other Entities* before deciding whether and if so how to align Section 9 with IFRS 10.

Post-implementation Review of IFRS 10, IFRS 11 and IFRS 12

27. The IASB is nearing completion of the Post-implementation Review of IFRS 10, IFRS 11 and IFRS 12. The IASB, at its October meeting, concluded that IFRS 10, IFRS 11 and IFRS 12 are working as intended based on the feedback.

28. The topics relevant to this paper on which the IASB is considering whether to take further action include:
    (a) investment entities—definition of an investment entity (paragraph 57(a) of this agenda paper);
    (b) investment entities—subsidiaries that are investment entities (paragraph 57(b) of this agenda paper); and
    (c) assisting the application of IFRS 10 and IFRS 11 (paragraph 29 of this agenda paper).

[1] The Report on the SMEIG meeting, held via remote participation, on 4–5 February 2021 can be accessed here.

29. The feedback to the Request for Information of the Post-implementation Review generally indicated that stakeholders support the single control model introduced by IFRS 10. Stakeholders said challenges arise when applying some particular areas of IFRS 10 and requested additional guidance on these areas. The IASB is considering whether and, if so, how to respond to these requests.

Staff analysis

Aligning the definition of control with IFRS 10

30. The staff think the Board should, consistent with its thinking when developing the Request for Information, align the definition of control with IFRS 10 whilst retaining and updating the rebuttable presumption in paragraph 9.5 of the *IFRS for SMEs* Standard.

Relevance to SMEs

31. When the IASB developed the *IFRS for SMEs* Standard it concluded that consolidated financial statements are essential for users of SMEs' financial statements when two or more entities operate as a single economic entity.[2]

32. Section 9 of the *IFRS for SMEs* Standard requires an SME to assess whether it controls an investee by assessing whether the SME has the power to govern the financial and operating policies of the investee so as to obtain benefits from its activities.

33. Section 9 also requires an SME to assess whether it controls a special purpose entity and if so, whether the special purpose entity is required to be consolidated. Paragraph 9.11 of the *IFRS for SMEs* Standard is similar to paragraph 10 of SIC-12 which required an entity to consider some circumstances that may indicate the entity controls a special purpose entity.

[2] Basis for Conclusions on the *IFRS for SMEs* Standard paragraph BC147.

34. The changes in the definition of control introduced by IFRS 10 provide a single basis for consolidation, meaning that an entity does not need to apply different criteria to assess whether it controls a special purpose entity in accordance with SIC-12 or other entities in accordance with IAS 27.

35. Applying Section 9 of the *IFRS for SMEs* Standard, an SME's conclusion on whether it controls an investee might depend on its assessment of whether its investee is a special purpose entity. Thus, introducing a single control model to the *IFRS for SMEs* Standard might have impact on whether an SME controls an investee.

36. Thus, the staff think aligning the definition of control with IFRS 10 could in some circumstances change the boundary of an SME group and would therefore make a difference to the decision of users of financial statements; hence the definition of control is relevant to SMEs.

Simplicity

37. Requiring a single control model that applies to all types of entities is itself a simplification. An SME does not need to distinguish whether an entity is a special purpose entity and consequently, an SME does not need to make separate assessments based either on power to govern financial and operating policies or on exposure to most of the risks and rewards.

38. Aligning the definition of control with IFRS 10 would require SMEs to reassess whether they control their investees and the reassessments require SMEs to exercise judgement.

39. According to the feedback received in the Post-implementation Review of IFRS 10, applying the definition of control in IFRS 10 requires judgement, which can sometimes be significant. The amount of judgement required depends on the complexity of transactions or facts and circumstances. The staff believe that the concerns about the application of judgement when assessing control could be relevant to SMEs in certain circumstances.

40. Some respondents to the Request for Information said SMEs do not usually use complex structures, for example Deloitte Touche Tohmatsu Limited commented:

> In our experience, it is not common for entities that apply the IFRS for SMEs Standard to utilise complex group structures. We have not noted any instances where the conclusion reached using the principles in the *IFRS for SMEs* Standard differs from the conclusion that would have been reached using the principles in full IFRS Standards and therefore this has not been an area of concern in the past.

41. In the staff's view, retaining and updating the rebuttable presumption in paragraph 9.5 of the *IFRS for SMEs* Standard would assist an SME applying the definition of control because in the circumstances an SME controls an investee directly through voting rights, the SME would not need to review other elements of the definition of control. SMEs with simple structures are likely to continue to use the rebuttable presumption in paragraph 9.5 and SMEs with unusually complex structures in their investments in subsidiaries may need to apply judgement when applying the newly aligned definition of control to determine whether they control these investees.

42. Therefore aligning the definition of control with IFRS 10 and retaining and updating the rebuttable presumption would be a simplification.

Faithful representation

43. The IASB concluded, at its October 2021 meeting, that IFRS 10 is working as intended, in particular the single control model enables entities to determine whether they control an investee. Aligning the definition of control with IFRS 10—introducing a single control model would improve faithful representation.

44. The staff acknowledge that retaining the rebuttable presumption might lead to a departure from the definition of control in particular circumstances. However, the concern can be mitigated by providing illustrations when the presumption can be rebutted, that is updating the current illustrations in paragraph 9.5 of the *IFRS for SMEs* Standard.

45. The staff think the illustrations of when the presumption needs to be rebutted should address two aspects:

    (a) an SME that owns more than half of the voting power of an investee and does not control the investee; and

    (b) an SME that owns half or less than half of the voting power of an investee and controls the investee.

46. Retaining and updating paragraph 9.5 of the *IFRS for SMEs* Standard would not have significant impact on faithful representation for SMEs with simpler structures that hold investments in subsidiaries though holding a majority of the voting rights. For SMEs with more complex structures where judgement would be needed in applying the newly aligned control definition, paragraph 9.5 is unlikely to be applicable.

47. Providing these illustrations of when the presumption needs to be rebutted, it becomes less probable that an SME would draw an inappropriate conclusion on control using the presumption.

48. The staff think aligning the definition of control with IFRS 10 and retaining and updating the rebuttable presumption in paragraph 9.5 of the *IFRS for SMEs* Standard would result in similar outcome as IFRS 10 and therefore it would meet the faithful representation principle.

Assessment of costs and benefits

49. Some SMEs applying the new definition of control might need to change the boundaries of their groups. However, the staff do not think the impact for most SMEs would be significant. The Effects Analysis for IFRS 10 states:

> At a very basic level, however, most consolidation decisions should be unaffected by the new consolidation model in IFRS 10. Change is most likely to occur around the margins, in the cases of the more complex structures.

50. With alignment of the definition of control with IFRS 10, SMEs would need to reassess whether they control an investee applying the new definition of control. However, as discussed in paragraph 41 of this agenda paper, the rebuttable presumption would ease the application of the new control definition for many SMEs.

51. The feedback received from the Post-implementation Review of IFRS 10 indicated that challenges may arise in applying the definition of control in IFRS 10. Stakeholders who took part in the outreach in the Post-implementation Review of IFRS 10 also observed that the application guidance and illustrative examples in IFRS 10 are useful for entities to understand and apply the requirements of IFRS 10. The staff think, if the IASB agrees with the staff recommendation to align the definition of control with IFRS 10, it should also bring in application guidance and illustrative examples in IFRS 10 to assist SMEs to exercise judgement in the control assessments. The application guidance and illustrative examples in IFRS 10 can be brought into the *IFRS for SMEs* Standard or its educational modules.

52. Having considered the analysis on faithful representation, the staff think the benefit of aligning the definition of control with IFRS 10 exceeds the cost of applying the new control definition.

Investment entities

53. The staff think the Board should, consistent with its thinking when developing the Request for Information, not align Section 9 with the requirements for an investment entity to measure its investments in subsidiaries at fair value through profit or loss as part of the Second Comprehensive Review of the *IFRS for SMEs* Standard.

Relevance to SMEs

54. Applying the relevance principle, relevance to SMEs is determined by assessing whether requiring an investment entity to measure its investments in subsidiaries at fair value

through profit or loss would make a difference in the decisions of users of financial statements prepared applying the *IFRS for SMEs* Standard.

55. A small number of respondents (paragraph 20 of this agenda paper) are of the view the *IFRS for SMEs* Standard should be aligned with the requirement that an investment entity measures its investments in subsidiaries at fair value through profit or loss. This view was supported by some SMEIG members—they noted that high wealth individuals often have investment entities.

56. As stated in paragraph 28 of this agenda paper, two topics arising from the Post-implementation Review of IFRS 10 on which the IASB is considering taking further action relate to investment entities.

57. During the Post-implementation Review of IFRS 10, respondents said:

    (a) assessing whether an entity qualifies as an investment entity can be challenging. For example respondents asked what evidence is required to decide whether an entity has an exit strategy and what extent of involvement in the activities of an investee would prevent an entity from qualifying as an investment entity.

    (b) information is lost when an investment entity measures at fair value its subsidiary that is itself an investment entity. The information includes investments held by the subsidiary, other assets and liabilities of the subsidiary and investment-related services provided by the subsidiary.

    The staff think these concerns are equally applicable to SMEs, were the IASB to require an investment entity to measure its investments in subsidiaries at fair value through profit or loss.

58. Although the SMEIG consider the topic of investment entities is relevant to some SMEs, the staff think the feedback to the Post-implementation Review of IFRS 10 provides evidence the IASB should wait to align until the completion of further action, if any, on these two topics. Therefore the staff do not recommend that the IASB propose amendments to the *IFRS for SMEs* Standard with the requirements for investment entities as part of the Second Comprehensive Review.

59. If the Board agrees that the topic of investment entities does not meet the relevance principle, analysis of the other two alignment principles ‘simplicity’ and ‘faithful representation’ is not necessary.

Question for the IASB

Do you agree with the staff’s recommendations to propose partially aligning Section 9 with IFRS 10 on the basis that was set out in the Request for Information, in particular:

(a) aligning the definition of control in Section 9 with IFRS 10;

(b) retaining and updating paragraph 9.5 of the *IFRS for SMEs* Standard; and

(c) not introducing the requirement that an investment entity measures its investments in subsidiaries at fair value through profit and loss?

Appendix—Extract from the Request for Information

How the Board developed this Request for Information—Aligning Section 9 *Consolidated and Separate Financial Statements* of the *IFRS for SMEs* Standard with IFRS 10 *Consolidated Financial Statements*

B15 Questions S2A and S2B discuss aligning Section 9 *Consolidated and Separate Financial Statements* of the *IFRS for SMEs* Standard with IFRS 10 *Consolidated Financial Statements*. IFRS 10 was already issued at the time of the first comprehensive review but not incorporated in the *IFRS for SMEs* Standard due to the lack of implementation experience.

B16 In deciding whether to ask about aligning Section 9 with IFRS 10, the Board applied its 'alignment principles' of relevance, simplicity and faithful representation to determine whether and how to align the *IFRS for SMEs* Standard with IFRS Standards.

B17 In considering whether and how to ask about aligning Section 9 with IFRS 10, the Board decided that it had already judged consolidated financial statements to be relevant for entities applying the *IFRS for SMEs* Standard and that the question was whether alignment would improve the quality of information provided to users of financial statements applying the *IFRS for SMEs* Standard.

Definition of control

B18 The definition of control in Section 9 is based on the definition of control from the superseded version of IAS 27 *Consolidated and Separate Financial Statements* and includes some guidance from SIC-12 *Consolidation—Special Purpose Entities*; it is a principle with supplementary requirements. IFRS 10 builds on the concepts in IAS 27 and SIC-12 and combines them into a single principle of control.

B19 The requirements of IFRS 10 state that an investor controls an investee if, and only if, the investor has all the following:

(a) power over the investee (power);

(b) exposure, or rights, to variable returns from its involvement with the investee (returns); and

(c) the ability to use its power over the investee to affect the amount of the investor's returns (link between power and returns).

B20 The Board discussed if a single principle of control, which can be applied whenever an entity is assessing control, would result in greater consistency between the financial statements of reporting entities than the current position, where the model applied depends on the type of entity being assessed.

B21 A single principle of control that applies to all entities would remove uncertainty about which guidance to apply to different entities. The control model in IFRS 10 clarifies requirements that were implicitly included in IAS 27 and SIC-12 and provides additional application guidance.

B22 The Board noted that aligning the definition of control in Section 9 with IFRS 10 would not introduce significantly new concepts with which entities applying the *IFRS for SMEs* Standard are unfamiliar. For example, Section 9 already requires that voting rights be considered if they are currently exercisable and IFRS 10 requires that substantive potential voting rights be considered. Consequently, the Board is seeking views on aligning the definition of control in Section 9 with the definition of control in IFRS 10.

B23 In considering aligning Section 9 with IFRS 10, the Board noted that introducing a single principle of control is, in itself, a simplification. Section 9 includes a further simplification—a rebuttable presumption that the parent has control when it directly or indirectly owns more than half of the voting rights. This simplification assists entities applying the *IFRS for SMEs* Standard that control another entity directly through voting rights, as such entities do not need to perform a complex review of other elements of the definition of control.

B24 The Board noted that the rebuttable presumption in Section 9 simplifies the requirements in IFRS Standards and that the arguments for including this simplification had not changed. Thus, the Board is seeking views on retaining this simplification even if the Board aligns the definition of control in Section 9 with IFRS 10.

Investment entities

B25 IFRS 10 requires an investment entity to measure an investment in a subsidiary at fair value through profit or loss. The *IFRS for SMEs* Standard has no equivalent requirement. Based on the definition of an 'investment entity' in IFRS 10 the Board considered that few entities eligible to apply the *IFRS for SMEs* Standard will also be investment entities. Consequently, the Board is seeking views on not introducing the requirements in IFRS 10 for investment entities into the *IFRS for SMEs* Standard.

B26 The Board also took into consideration the feedback from the SME Implementation Group (SMEIG) members who were divided on whether Section 9 should include requirements for investment entities. Some SMEIG members considered investment entities applying the *IFRS for SMEs* Standard may not have their investment strategies sufficiently documented to demonstrate that they meet all the requirements for classification as an investment entity.