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Investor Perspectives

Patrick Finnegan: At long last—a single model for consolidation

Following several years of detailed analysis and discussion, last week the IASB issued two new standards dealing with consolidation accounting and disclosures about relationships with other entities, including disclosures related to consolidated and unconsolidated entities—IFRS 10 *Consolidated Financial Statements* and IFRS 12 *Disclosure of Interests in Other Entities*. We think that investors will benefit from these new standards because they make the approach to consolidation accounting more understandable, comparable and consistent, and, we hope, the new standards will ensure that what you see on the balance sheet is a complete picture of what is under the control of a parent company and its management. Please let us know your views.

Some History

In 2003, the IASB added to its agenda a project to examine consolidation accounting with the aim of developing a single set of principles that would apply to investees that are either voting-interest or non-voting interest entities (sometimes referred to as 'structured entities' or 'special purpose entities' (SPEs)). The plan was to clarify the conditions for assessing the existence of control of an entity irrespective of its business purpose or means of ownership. This was considered critical because of the divergence in practice in the application of the control concept, particularly for less than majority-owned voting interest entities and for structured entities. In addition, the Board planned to improve the disclosure about investees that are consolidated and those that are unconsolidated.

While the project was well under way, the global financial crisis emerged.

This led many observers to encourage the IASB and FASB to accelerate their examination of consolidation accounting and, in particular, for structured entities. The reason for such urgency was to deal swiftly with concerns about perceived inconsistencies in IFRS that permitted a broad range of off-balance sheet financing structures. In addition, the global financial crisis highlighted the need for new disclosure requirements to provide investors with better information. We believe that our new model deals effectively with those concerns and significantly improves the package of information, which will help investors make better analytical and investment decisions.

Current guidance

IAS 27 *Consolidated and Separate Financial Statements* requires the consolidation of entities that are controlled by a reporting entity, and it defines control as the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities. Standards Interpretation Committee Issue No. 12 (SIC 12) interprets the requirements of IAS 27 within the context of special purpose entities, and places greater emphasis on risks and rewards in the analysis of assessing control. This perceived conflict of emphasis has led to inconsistent application of the concept of control. This is exacerbated by a lack of clear guidance on how to determine which entities are within the scope of IAS 27 and which are within the scope of SIC 12. As a result, assessing control sometimes falls back upon an assessment of whether an investor has a majority of the risks and rewards. Such assessments that are based on 'bright line' distinctions can create structuring opportunities to achieve particular accounting outcomes.

Who is in control?

The basis for our single consolidation model rests on assessing whether a reporting entity has control of another entity regardless of its nature. However, we acknowledge that the way in which control is assessed will vary depending upon the nature of the investee being evaluated. We decided to change the definition of control because, even though power is often obtained by governing the strategic operating and financing policies of an investee, it is only one of the ways in which power to direct the activities of an investee can be achieved. For example, an investor can obtain power through decision-making rights that relate to the relevant activities of an investee and those rights can extend beyond merely voting rights.

The assessment of control may not be straightforward, but we believe that we have established a set of criteria and additional guidance that will enhance the understandability, consistency and completeness of consolidation practice. The criteria for assessing control are:

- power over an investee—that is, does the reporting entity have the current ability to direct activities that significantly affect an investee’s returns;
- exposure to, or rights to, variable returns from involvement with an investee; and
- linkage between power and returns—whether the investor has the ability to affect its returns through its power.

Let us examine each criterion briefly.

Power

In assessing whether an investor has power over another entity, we considered whether power should refer to having the *legal* or *contractual right* to direct the activities, or to the ability to direct the activities. We have chosen the latter, which is consistent with the Board’s view of current IFRS, particularly for voting interest entities.

One way in which to understand the concept of power is to view it as a package of rights. In other words, an investor should always evaluate its package of rights—whether they are voting rights or other contractual provisions that give it the ability to direct the relevant activities of an investee. Relevant activities are considered to be activities of the investee that significantly affect its returns. The implication of such a principle is that there will be situations in which an investor can control an investee even though it may own less than a majority of an investee’s voting rights and has no further rights in addition to the voting rights. We concluded that drawing a bright line at 50 per cent of the voting rights would perpetuate existing structuring opportunities. It is equally important to note that the new standard does not create a presumption that an investor with the largest holdings of voting rights, even though less than a majority, will always be required to consolidate such investees. On the contrary, the standard requires that sufficient evidence must be available to conclude that an investor has the current ability to direct the relevant activities.

Returns

The second element of control requires that an investor must have exposure to, or rights to, variable returns. We use the term ‘returns’ instead of benefits to convey the notion that returns can be either positive or negative. In addition, the concept of returns is meant to be broad and not to be construed only within the context of financial returns, such as dividends. In this sense, returns may encompass a broad range of benefits or detriments.

Link between power and returns

The link between power and returns was created to ensure that, in addition to having power over an investee and exposure to, or rights to, returns of an investee, an investor must be able to use its power to affect its returns. This third criterion was introduced to address agency relationships, ie, when assessing control, an investor should consider whether it has the current ability to direct the relevant activities of an investee that it manages to affect the returns it receives, or whether it uses its decision-making authority for the benefit of others.

A couple of examples

A couple of examples will help to illustrate the proposed standards. The first deals with voting interest entities and the second with a structured entity.

Example 1

ABC Company is a marketer, producer and distributor of consumer products. As of 31 December, 2010, the company owned 45 per cent of the outstanding common shares of XYZ Company. The remaining common shares are held by numerous other institutional and retail investors, none of which own more than 3 per cent of XYZ individually. In addition, none of the remaining shareholders have an arrangement to consult or make decisions collectively as a group.

Decisions about the relevant activities of XYZ require the approval of a majority of votes cast at relevant shareholders’ meetings. Less than a majority of the other shareholders are active, as is shown by voting patterns at previous shareholders' meetings. In addition, there are no signs of shareholder activism and the shareholder composition has been relatively stable over the recent years. Most recently, 60 per cent of the voting rights of XYZ have been cast at the last shareholders' meeting.

In addition to owning 45 per cent of the outstanding common shares of XYZ, ABC provides XYZ with essential management personnel and specialised industry knowledge. Furthermore, ABC is the sole customer of XYZ's products and ABC controls XYZ's licences and trademarks, which are critical to XYZ's operations.

Even though ABC owns less than a majority of the outstanding common shares, ABC controls XYZ. This is because ABC is exposed to variable returns from the investee through its equity investment and has the ability to affect its returns through its power. ABC has power because it has the practical ability to direct unilaterally the relevant activities of XYZ as evidenced by holding the majority of votes required at the most recent shareholders' meeting; in addition, ABC provides XYZ with essential management personnel and specialised industry knowledge.

Example 2

SPE is a securitisation vehicle that was created to allocate risks (mainly credit risk) and benefits (cash flows received) of a portfolio of consumer credit card receivables to the parties involved with it. The only activity of SPE that can be directed, and that can significantly affect the returns to its investors, is managing the receivables when they default. Managing the receivables before default is not a relevant activity because it does not require substantive decisions to be made that could significantly affect the investee's returns.

Sponsor Co. is an investor that has the current ability to direct those activities that significantly affect the returns of SPE by, for example, writing a put option on the receivables that is triggered when the receivables default. By virtue of the design of SPE, Sponsor Co. has decision-making authority over the activities that significantly affect the returns at the only time that such decision-making authority is required.

As a consequence, the terms of the put agreement are integral to the overall transaction and to the establishment of the investee. Moreover, the put agreement would be considered together with the founding documents of the investee to assess whether Sponsor Co. has the current ability to direct the activities of SPE that significantly affect the returns of the transaction (even before the default of the receivables). In this example, because Sponsor Co. has such ability, it has power over the SPE.

More detail in the disclosures

One of the most important lessons from the global financial crisis was that investors were exposed to significant risks from their involvement with structured entities, even though they believed such risks had been transferred to other parties. This was especially true for institutions that had established or sponsored structured entities.

During our deliberations of the responses to the disclosure proposals, we chose to combine the disclosure requirements for interests in subsidiaries, joint arrangements, associates and unconsolidated structured entities into a single comprehensive standard, IFRS 12 *Disclosure of Interests in Other Entities*.

In response to the concerns of investors who wanted us to make the risks associated with both consolidated and unconsolidated investees more clear and comprehensive, the standard establishes disclosure objectives to help investors:

- understand the significant judgements and assumptions (and changes to those judgements and assumptions) about whether a reporting entity controls, or does not control, another entity;
- understand the claims that non-controlling interests have on a consolidated group's activities and cash flows;
- evaluate the nature and effect of significant restrictions on a parent's ability to access and use assets of a group, and on its obligation to settle liabilities of the group;
- evaluate the nature of, and changes in, the risks associated with a parent's interests in consolidated structured entities;
- evaluate the nature and extent of a reporting entity's interests in, and risks associated with, unconsolidated structured entities; and
- evaluate the accounting consequences of changes in a parent's ownership interest in a subsidiary that do not result in a loss of control.

The risk disclosures required for interests in unconsolidated structured entities ask for information about an entity's expected and maximum exposure to loss. They also ask sponsors of structured entities to disclose information about risks from, and income that it has derived from, sponsoring those structured entities.

Patrick Finnegan is a Board member of the IASB. The views expressed in this article are those of the author as an individual and do not necessarily reflect the views of the International Accounting Standards Board (Board) or the IFRS Foundation (Foundation). The Board and the Foundation encourage members and staff to express their individual views. This article has not undergone the Foundation's due process. The Board takes official positions only after extensive review, in accordance with the Foundation's due process.