

MAZARS INSIGHT



**Key points of IFRS 10  
“Consolidated Financial  
Statements” in 40 questions and  
answers**



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## Summary

<b>Introduction</b> .....	6
1. When was IFRS 10 published and what is the mandatory effective date? .....	7
2. Does IFRS 10 replace other standards or interpretations? .....	7
3. What was the IASB's main objective? .....	8
4. Will IFRS 10 help to bring about convergence with US GAAP? .....	9
5. What is the new definition of control? .....	10
6. What new concepts are introduced in IFRS 10? .....	11
7. Must the purpose and design of the entity be taken into account, and if so, how? .....	11
8. What are the definitions of substantive rights and protective rights? .....	12
9. In practice, what elements should be considered when assessing whether or not rights are substantive? .....	13
10. In practice, what types of rights should be deemed protective rights? .....	14
11. What is the difference between an agent and a principal (the concept of delegated power)? .....	15
12. Are there any situations in which it is not necessary to take all these indicators into account when assessing whether an investor is an agent or a principal? .....	17
13. How do you identify a "de facto agent"? .....	18
14. How should franchises be dealt with? .....	18
15. What are "relevant activities"? .....	19
16. How should an investor assess shared authority over relevant activities? .....	20
17. What is the definition of a "silo"? .....	20
18. What is the definition of "power"? .....	21
19. What elements should be taken into consideration when assessing the level of power over the entity's relevant activities? .....	22
20. What should an investor do in practice when voting rights are conclusive in determining power? .....	22
21. What is the definition of de facto control? .....	23
22. How should an investor assess whether de facto control exists? .....	24
23. How should call options and other "potential voting rights" be taken into account? .....	25

## Key points of IFRS 10 “Consolidated Financial Statements” in 40 questions and answers

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24. What elements should be taken into account when assessing power if voting rights are not substantive?.....	25
25. What are the main indicators for assessing the investor’s practical ability to direct the entity’s relevant activities? .....	26
26. If the above are not conclusive, what are the additional indicators? .....	26
27. What does IFRS 10 mean by “special relationship”? .....	27
28. In what situations should a large exposure to the variability of the entity’s returns be taken into account? .....	27
29. What is the definition of “returns”?.....	28
30. Is the concept of “returns” linked to a specific threshold? .....	29
31. But is there a “de minimis” threshold, below which the returns criterion probably not be met?.....	29
32. How should an investor assess whether it has the ability to use its power to affect its rights/exposure to variable returns (i.e. whether there is a link between power and returns)? .....	29
33. What are the steps to be followed when applying IFRS 10? .....	30
34. Generally speaking, what elements should be examined in order to determine whether the investor has the ability to direct the entity’s relevant activities? .....	31
35. What are the rules on initial application of IFRS 10? .....	32
36. What are the requirements under IFRS 10 if there is no change in the level of control? .....	34
37. What is the procedure for first-time consolidation linked to initial application of IFRS 10? .....	34
38. What is the procedure when the group no longer controls an entity under IFRS 10? .....	35
39. Which sectors are likely to be the most affected? .....	35
40. What are the key points to remember about IFRS 10? .....	36
Notes.....	38

## Introduction

IFRS 10, which was published in May 2011, introduces a single definition of control and replaces the portion of IAS 27 which related to consolidated financial statements, as well as the SIC 12 interpretation on special purpose entities.

According to the IASB's schedule, the new standard is effective from 2013 for entities with a reporting date at the end of the calendar year.

It may change the scope of consolidation (i.e. which entities should be consolidated) but the consolidation techniques remain the same (i.e. how to carry out consolidation).

In addition to the new definition of control, IFRS 10 includes clarifications on various issues which were not previously addressed by the IFRS framework, including:

- the difference between protective rights and substantive rights;
- de facto control;
- the difference between an agent and a principal;
- the concept of "silos".

IFRS leaves a large amount open to professional judgement, particularly as regards potential voting rights (e.g. call options).

Given the potential difficulties in applying this standard, it is essential that all stakeholders familiarise themselves with it quickly – particularly preparers of financial statements, auditors and regulators.

To help with this, we have prepared the following series of 40 questions and answers.

## 1. WHEN WAS IFRS 10 PUBLISHED AND WHAT IS THE MANDATORY EFFECTIVE DATE?

IFRS 10 “Consolidated Financial Statements” was published on 13 May 2011. Application is mandatory for financial periods commencing on or after 1 January 2013 (for European entities, this is subject to adoption by the European Union), and early application is permitted as long as the whole consolidation package is applied simultaneously.

For a discussion on identifying the date of initial application for IFRS 10, cf. question 35.

The other standards in the consolidation package, which were also published on 13 May 2011, are as follows:

- IFRS 11 “Joint Arrangements”;
- IFRS 12 “Disclosure of Interests in Other Entities”;
- IAS 27 “Separate Financial Statements”;
- IAS 28 “Investments in Associates and Joint Ventures”.

However, if an entity voluntarily opts for early disclosure of some of the information required under IFRS 12, it is not obliged to apply IFRS 12 in its entirety, or the other standards relating to consolidation.

## 2. DOES IFRS 10 REPLACE OTHER STANDARDS OR INTERPRETATIONS?

IFRS 10 introduces a single definition of control and replaces the portion of IAS 27 which related to consolidated financial statements, as well as the SIC 12 interpretation on special purpose entities.

IAS 27 “Separate Financial Statements” now deals solely with recognition of interests in subsidiaries, joint ventures and associates for entities preparing separate financial statements under IFRS.

IFRS 10, which follows the ED10 exposure draft published in December 2008, changes the scope of consolidation (i.e. which entities should be consolidated) but the consolidation techniques remain the same (i.e. how to carry out consolidation).

The standard is quite short (the main body of the standard is only five pages long, supplemented by a useful 38-page application guide) and leaves a large amount open to professional judgement. As a result, there is likely to be plenty of discussion between entities, their auditors and the regulators.

### 3. WHAT WAS THE IASB'S MAIN OBJECTIVE?

By introducing a single definition of control, the IASB wanted to make it easier to assess control without needing to know whether the entity fell within the scope of SIC 12.

Readers will remember that the current definition of control under IAS 27 (“the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities”) primarily focuses on the ability to take strategic decisions relating to the entity’s operations or financing. In contrast, SIC 12 is based upon an evaluation of risks and rewards

ED10 proposed a single definition of control but, as it attempted to bring IAS 27 and SIC 12 together into a single standard, it dealt with special purpose entities (referred to as “structured entities”) separately. This was felt to be inconsistent with the goal of introducing a single definition of control.

In response to the criticisms, the IASB has introduced a single definition of control in IFRS 10 which is applicable in all cases, for both “traditional” subsidiaries and special purpose entities, with no distinction between the different types of entity.



#### 4. WILL IFRS 10 HELP TO BRING ABOUT CONVERGENCE WITH US GAAP?

The project was begun in 2008 by the IASB and became a joint project in October 2009.

However, in January 2011 the FASB decided not to develop a single consolidation model which would apply to both voting interest entities and variable interest entities (structured entities).

On withdrawing from the project, the FASB highlighted the following areas where differences existed:

- control in situations where the investor owns less than the majority of the voting rights, and specifically the new guidance introduced by IFRS 10 on the concept of de facto control;
- the accounting treatment of potential voting rights, as the FASB did not wish to take these into account when assessing control.

However, the IASB and FASB also have a joint project relating to investment entities. The IASB published an exposure draft entitled Investment Entities on 25 August 2011 and the comment period closed on 5 January 2012.

According to this project, entities which meet certain strict criteria must measure their interests in subsidiaries, associates and joint ventures at fair value through profit and loss.

## 5. WHAT IS THE NEW DEFINITION OF CONTROL?

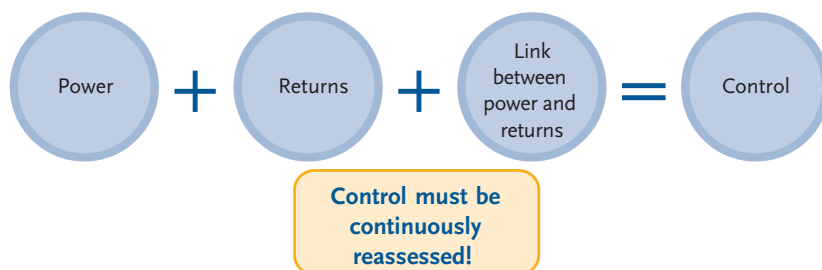
Under IFRS 10, an investor controls an entity when it is exposed, or has rights, to variable returns from its involvement with the entity, and has the ability to affect those returns through its power over the entity. (IFRS 10.6)

*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.*

In practice, an investor **controls** an entity if all the following conditions are met:

- the investor has **power** over the entity (cf. question 18);
- the investor is exposed or has **rights to variable returns** from its involvement with the entity (cf. question 29);
- the investor has the ability to use its power over the entity to affect the amount of these returns (i.e. there is a **link between power and variable returns**, cf. question 32).

The standard also requires the investor to reassess its level of control over an entity if facts or circumstances indicate that there may be changes to any of the three conditions specified above.



## 6. WHAT NEW CONCEPTS ARE INTRODUCED IN IFRS 10?

In addition to the new definition of control, and the changes to the scope of consolidation, IFRS 10 includes additional clarifications on various specific issues.

The new concepts introduced in IFRS 10 include:

- substantive rights and protective rights (cf. question 8);
- power exercised on behalf of a third party, which may distinguish an agent from a principal (cf. question 11) or identify a “de facto agent” (cf. question 13);
- relevant activities (cf. question 15);
- silos (cf. question 17);
- returns (cf. question 29).

## 7. MUST THE PURPOSE AND DESIGN OF THE ENTITY BE TAKEN INTO ACCOUNT, AND IF SO, HOW?

As a starting point, the standard recommends that preparers of financial statements should consider the purpose and design of the entity in order to assess how decisions relating to relevant activities are made, who currently has the ability to direct these activities, and who has rights to returns from these activities.

In a situation where voting rights (or similar rights) do not have a significant effect on an entity’s returns (as is generally the case for special purpose entities, in the broad sense), it is all the more important to assess whether the investor was involved when the entity was created.

If the investor was involved in creating the entity, this may indicate that the investor had the opportunity to obtain sufficient rights to gain control of the entity (even if this element is not sufficient in itself for the investor to be deemed to have control of the entity).

The same applies in the case of instruments which include potential voting rights, as taking these into consideration will help to shed light on the interests and objectives of the various parties.

## 8. WHAT ARE THE DEFINITIONS OF SUBSTANTIVE RIGHTS AND PROTECTIVE RIGHTS?

IFRS 10 introduces the concept of “substantive rights”, which is to say rights that are currently exercisable, and “protective” rights, which are solely designed to protect the investor in specific situations.

The investor must assess both its own rights and those held by other parties.

### ■ SUBSTANTIVE RIGHTS (CF. QUESTION 9)

To be considered substantive, rights must be exercisable when decisions on relevant activities are made.

In practice, this generally means that the rights need to be currently exercisable in order to be substantive (but there are exceptions to this).

Substantive rights which are not merely protective may also prevent the investor from controlling the entity (e.g. if other parties have the right to approve or block decisions relating to relevant activities).

### ■ PROTECTIVE RIGHTS (CF. QUESTION 10)

Rights are considered to be protective if they relate to fundamental changes in the entity’s activities or only apply in exceptional circumstances.

The purpose of protective rights is solely to protect the interests of their holder, rather than to transfer power to that party.

**9. IN PRACTICE, WHAT ELEMENTS SHOULD BE CONSIDERED WHEN ASSESSING WHETHER OR NOT RIGHTS ARE SUBSTANTIVE?**

Professional judgement is required in order to determine whether or not rights are substantive. Various factors should be considered, including the three points below.

1. The existence of barriers (economic, legal, etc.) which would prevent the holder(s) from exercising the rights, such as:
  - financial penalties and incentives for exercising or not exercising rights;
  - an exercise price that would create a financial barrier to exercising rights;
  - a very short exercise period for the rights;
  - the inability of the rights holder to obtain the information necessary to exercise the rights;
  - operational barriers (such as the lack of another manager willing or able to provide the same services as the current manager);
  - legal or regulatory constraints (e.g. in the case of a foreign investor).

2. Whether or not the exercise of the rights in question requires agreements from other parties (and if so, whether there is a mechanism in place to allow these parties to exercise their rights).

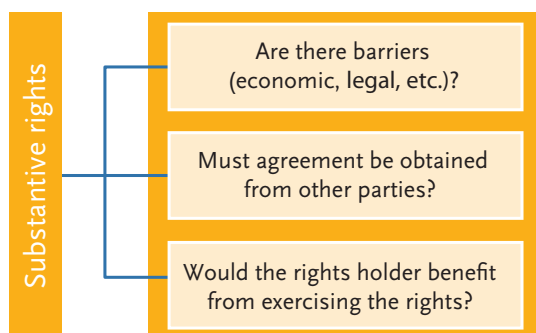
In practice, the likelihood that the rights are substantive is inversely proportional to the number of parties involved (i.e. the more parties involved, the more difficult it will be to obtain agreement from all the various parties).

3. Whether or not the rights holder would benefit from exercising the rights.

For example, in the case of potential voting rights, the exercise price (or conversion price) of the instrument should be taken into consideration.

Whether or not the rights holder would benefit may also depend on whether significant synergies would be possible (if the rights were exercised), as the concept of “returns” is broader than the concept of benefits as in IAS 27 (cf. question 29).

**To be considered substantive, rights must be exercisable when decisions on relevant activities are made.**



## 10. IN PRACTICE, WHAT TYPES OF RIGHTS SHOULD BE DEEMED PROTECTIVE RIGHTS?

Examples of protective rights include:

- a lender’s right to restrict a borrower’s activities (that is, activities which could result in a significant deterioration of the borrower’s credit risk);
- a right of veto held by a minority shareholder over significant capital expenditure (greater than that required in the normal course of business) or over the issue of equity or debt instruments;
- a lender’s right to seize a borrower’s assets in the case of default on a loan.

## 11. WHAT IS THE DIFFERENCE BETWEEN AN AGENT AND A PRINCIPAL (THE CONCEPT OF DELEGATED POWER)?

IFRS 10 makes explicit the concept of the agent and the principal, where the power over an entity is delegated.

Thus, in practice, when a party has the ability to direct the relevant activities of the entity (i.e. the power criterion is met), the following four indicators should be considered in order to assess whether the decision-maker is acting as the principal (i.e. on its own account and in its own interests) or as an agent (i.e. for a third party).

### 1. The scope of the decision-maker’s authority

The scope of its decision-making authority depends on both the activities that are permitted under the decision-making agreement, and the discretion that the decision-maker has over those activities.

### 2. Rights held by other parties

In a situation where the decision-maker may be removed without cause by a single other party, the decision-maker is considered to be an agent.

If the removal right must be exercised jointly by several other parties, it is necessary to assess whether or not the right is substantive.

If there are only a small number of other parties involved, the decision-maker is generally considered to be an agent (if the removal right is substantive).

Liquidation rights may also deprive the decision-maker of its decision-making power, and thus potentially have the same implications as removal rights.

### 3. The type of remuneration

The greater the magnitude and variability of the remuneration, the more likely the decision-maker is acting on its own account (as the decision-maker is then assumed to have acted in its own best interests).

In order for the decision-maker to be considered an agent, the following two conditions must be met:

- the remuneration must be commensurate with the services provided (i.e. market conditions);

- the terms of the agreement must be in line with those usually stipulated in agreements for provision of this type of service.

However, receiving “normal” remuneration is not sufficient in itself for a decision-maker to be considered an agent.

4. Exposure to variability of returns (from the decision-maker’s interests in the entity, other than those directly relating to its remuneration for services)

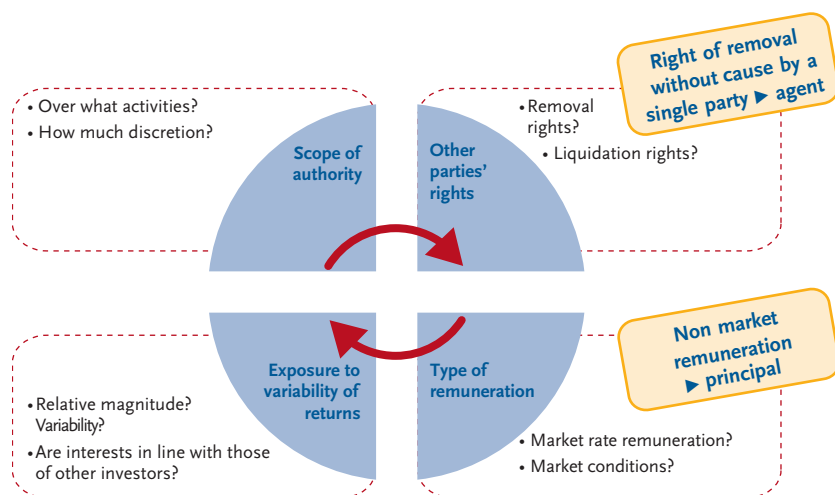
When a party with decision-making power has an interest in an entity (e.g. an investment in the entity, provision of guarantees, etc.), it is necessary to consider whether it is an agent or a principal.

It is particularly important to consider the following elements:

- the relative magnitude and variability of the interest;
- the decision-maker’s exposure to variability of returns, compared with that of other investors (i.e. if the decision-maker’s interests differ from those of other investors, this could influence its behaviour).

As well as introducing the concept of the agent-principal relationship, IFRS 10 also makes reference to the concept of the de facto agent (cf. question 13).

### Distinguishing between an agent and a principal





**12. ARE THERE ANY SITUATIONS IN WHICH IT IS NOT NECESSARY TO TAKE ALL THESE INDICATORS INTO ACCOUNT WHEN ASSESSING WHETHER AN INVESTOR IS AN AGENT OR A PRINCIPAL?**

Generally speaking, all the indicators listed in question 11 must be taken into consideration when assessing whether an entity is an agent or a principal.

However, if the decision-maker can be removed without cause by a single other party, it is not necessary to continue with the analysis: this in itself is sufficient to determine that the decision-maker is an agent.

Similarly, if the decision-maker’s remuneration is not market-based, the decision-maker is deemed to be acting on its own account (i.e. it is the principal, except in the unlikely event that it can be removed without cause by a single other party).

IFRS 10 includes several examples pertaining to a fund manager, which are intended to aid understanding of the principles set out in the standard in a particular practical situation.

Notwithstanding the fact that each situation must be examined with regard to its specific facts and circumstances, the fact that the fund manager owns around 20% of the shares in the fund in question means that consolidation is likely to be required (unless the other investors hold substantive removal rights).

Thus, while these examples are for illustrative purposes only, the example threshold of around 20% is significantly lower than that generally used previously (i.e. the majority of risks and rewards under SIC 12).

### 13. HOW DO YOU IDENTIFY A “DE FACTO AGENT”?

IFRS 10 also introduces the concept of the “de facto agent”, i.e. a party acting on the investor’s behalf.

For example, the parties described below could be considered to be “de facto agents” for the investor, due to the nature of their relationship with said investor:

- the investor’s related parties;
- a party that received its interest in the entity as a contribution (or as a loan) from the investor;
- a party that has agreed not to sell its interest in the entity without the investor’s prior agreement;
- a party that cannot finance its operations without subordinated financial support from the investor;
- an entity for which more than half the members of its governing body (or its key management personnel) are the same as those of the investor;
- a party that has a close business relationship with the investor (e.g. a service provider and one of its major clients).

Given the highly subjective nature of the concept of the “de facto agent”, it is currently difficult to say what impact this new guidance will have in practice in the future.

### 14. HOW SHOULD FRANCHISES BE DEALT WITH?

IFRS 10 also discusses franchises, stipulating that the existence of a franchise agreement does not usually give the franchisor power over the franchisee.

This is because franchisors’ rights normally exist in order to protect the brand and the franchisee directs its activities in its own interests, even though this must be done in accordance with the terms of the franchise agreement.

## 15. WHAT ARE “RELEVANT ACTIVITIES”?

The definition on power also makes reference to the concept of relevant activities, i.e. the activities that significantly affect the entity’s returns. (IFRS 10 Appendix A)

*Relevant activities – (...) activities of the investee that significantly affect the investee’s returns.*

Many entities will have various activities which significantly affect their returns, such as:

- the sale and purchase of goods and services;
- selecting, purchasing and disposing of assets;
- obtaining funding (and determining a funding structure);
- researching and developing new products;
- managing financial assets throughout their lifetime (including upon default);
- ...

Examples of decisions relating to relevant activities include preparing budgets, or appointing and devising a remuneration policy for key management personnel.

Thus, for many entities, “relevant activities” correspond to the operating and financial activities used for assessing control under IAS 27 (cf. question 3).

In some cases, relevant activities are directly linked to the occurrence of a specific event (for example, the ability to manage the entity’s assets upon default).

## 16. HOW SHOULD AN INVESTOR ASSESS SHARED AUTHORITY OVER RELEVANT ACTIVITIES?

The authority to direct relevant activities may be shared, either because the entity has various relevant activities, or because the direction of relevant activities changes over time.

When the power is shared by several entities (i.e. several investors have the ability to direct different relevant activities), the investor with the greatest ability to affect the entity's returns is deemed to have control (assuming that these activities have a significant impact on the entity's results).

If several investors have the ability to direct relevant activities at different times, it is necessary to assess which investor has the greatest impact on the entity's returns.

Example:

Investor A is in charge of developing a medical product (and obtaining the necessary regulatory approval), while investor B is responsible for producing and marketing the product (after the development stage).

In order to determine which of A or B has the greatest impact on the entity's returns, all the facts and circumstances must be taken into account, particularly the uncertainty involved in obtaining regulatory approval.

This example, which is taken from the application guidance for IFRS 10, lists the elements to be taken into consideration but does not provide an answer.

## 17. WHAT IS THE DEFINITION OF A “SILO”?

In practice, when a structure can be divided into different portions (e.g. in the case of portfolios of receivables sold to an entity), it can sometimes be difficult to identify the entity to be consolidated (if consolidation is indeed required).

IFRS 10 clarifies the concept of a separate entity within a larger structure (sometimes called a “silo”) and stipulates that only the “silo” controlled by the investor should be consolidated (i.e. not the larger structure).

In the event that all the assets, liabilities and equity of the “silo” are totally separate from the larger structure (i.e. the investee), the silo is deemed to be “ring-fenced” and control needs to be assessed at the level of the separate entity.

## 18. WHAT IS THE DEFINITION OF “POWER”?

Under IFRS 10, power is defined as the current ability to direct the activities that significantly affect the investee’s returns. (IFRS 10.10)

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

Readers will remember that IAS 27 defines control as “the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities”.

Although directing an entity’s financial and operating policies often equates to having control, the Board justified its decision to change the definition by pointing out that power can also be obtained in other ways.

Thus, according to the definition of control given in IFRS 10, power arises from rights and it is not necessary to have actually directed activities in order to have control (the ability to direct activities is sufficient).

The exercise of power thus involves identifying relevant activities (cf. question 15), how decisions are made about these relevant activities, and what are the rights over the entity held by the investor and by other parties.

However, only substantive rights (cf. question 9) are taken into account in the analysis, not protective rights (cf. question 10).

## 19. WHAT ELEMENTS SHOULD BE TAKEN INTO CONSIDERATION WHEN ASSESSING THE LEVEL OF POWER OVER THE ENTITY’S RELEVANT ACTIVITIES?

Key rights to be taken into consideration include:

- voting rights (current and potential);
- contractual arrangements with other investors (especially those relating to the obtaining of proxies from other holders of voting rights);
- the right to appoint or remove an entity’s key management personnel (i.e. the individuals with the ability to direct the relevant activities);
- the right to appoint or remove another entity that directs the relevant activities;
- the contractual right to direct the relevant activities (e.g. as specified in a management contract).

The standard also addresses situations where the entity’s relevant activities are actually directed by the government, a court, a regulator or a liquidator, in which case the investor which holds the majority of the voting rights does not have power over the entity.

In some sectors, such as defense, a foreign majority shareholder may be required to transfer its voting rights to “independent” citizens of the country in which the entity is based. These citizens must exercise their rights in order to “protect” the entity from any external influence.

In practice, it will usually be a question of assessing whether voting rights are conclusive (cf. question 20), or not (cf. question 24), in determining power over the entity.

## **20. WHAT SHOULD AN INVESTOR DO IN PRACTICE WHEN VOTING RIGHTS ARE CONCLUSIVE IN DETERMINING POWER?**

The process of assessing rights may be quite simple when power results from the exercise of voting rights (and when there are no other elements to complicate the situation, such as additional contracts or potential voting rights). However, in more complex situations it may be necessary to examine all the facts and circumstances before drawing conclusions.

Generally speaking, when an entity has various activities that affect returns, and substantive decision-making is required continuously, power is determined by voting rights and other similar rights, either in isolation or together with other contractual arrangements.

When voting rights do not have a significant effect on the entity’s returns (as when voting rights relate to administrative decisions only), the investor must assess all the contractual arrangements.

Going beyond the most simple cases (where holding the majority of the voting rights determines control), IFRS 10 makes the following additional provisions:

- it clarifies the fact that de facto control exists under IFRS (cf. question 21);
- it changes the way in which potential voting rights should be taken into consideration when assessing control (cf. question 23).

Assessing power in traditional entities	
Majority of voting rights held	Majority of voting rights not held
<ul style="list-style-type: none"> <li>- Assess potential voting rights</li> <li>- What rights are held by third parties?</li> </ul>	<ul style="list-style-type: none"> <li>- Are there arrangements with other shareholders?</li> <li>- Assess potential voting rights</li> <li>- Contractual rights (to appoint or remove key management personnel, etc.)?</li> <li>- De facto control (based on the percentage of voting rights held, the dispersal of voting rights among other shareholders, other shareholders' voting patterns at general meetings, etc.)</li> </ul>

## 21. WHAT IS THE DEFINITION OF DE FACTO CONTROL?

De facto control, i.e. when an investor has power even without holding the majority of the voting rights, is now explicitly recognised under IFRS.

Readers may remember that the IASB made a statement on this subject in the October 2005 IASB Update, explaining that de facto control was included under IAS 27, but acknowledging that the lack of guidance in the standard could result in inconsistent application.

IFRS 10 now clarifies that the power criterion may be met if the investor has the practical ability to direct the relevant activities unilaterally, even if it does not hold the majority of the voting rights.

## 22. HOW SHOULD AN INVESTOR ASSESS WHETHER DE FACTO CONTROL EXISTS?

In order to assess whether it has the practical ability to direct the entity's activities, an investor should consider the following:

- the relative size of its holding, taking into account the dispersal of holdings owned by other investors. The larger the investor's holding, and the greater the number of other shareholders that would be needed to outvote the investor, the more likely it is that the investor has the ability to direct the entity's activities;
- the potential voting rights held by the investor (and by other parties);
- rights resulting from other contractual arrangements;
- all the facts and circumstances which indicate that the investor has, or does not have, the current ability to direct the entity's activities at the time when decisions are made (including voting patterns at previous shareholders' meetings).

Example:

If the percentage of voting rights exercised at previous shareholders' meetings was between 70% and 75%, the shareholders have not arranged to make collective decisions, and no other shareholder owns more than 5% of the voting rights, then a 40% holding of voting rights may be sufficient to give the investor control of the entity.

If an assessment of the first three indicators is not conclusive, then all the facts and circumstances must be taken into consideration.

In this case, the investor must assess (a) the indicators which shed light on the investor's practical ability to direct the entity's relevant activities (cf. question 25) and, if necessary, (b) additional indicators (cf. question 26).

Although these various indicators are more generally used in the case of structured entities, it may sometimes be necessary to use them in the case of “traditional” entities.



### 23. HOW SHOULD CALL OPTIONS AND OTHER “POTENTIAL VOTING RIGHTS” BE TAKEN INTO ACCOUNT?

Readers will remember that the current IAS 27 requires potential voting rights to be taken into account (i.e. call options and other currently exercisable instruments) when assessing the percentage of control (this is a standardised calculation, and the group’s intentions and financial capacity are not taken into account).

Under IFRS 10, only substantive potential voting rights are taken into account. When assessing control, an entity shall consider whether the ability to obtain voting rights arising from options (and other convertible instruments) gives it the ability to direct the activities of another entity when coupled with other relevant facts and circumstances.

The following shall be taken into consideration in this assessment:

- the purpose and design of these instruments (and especially the investor’s original motives) (cf. question 7);
- the terms and conditions of the instruments (exercise price, exercise periods, etc.);
- the benefits which the investor could derive from exercising these instruments (economies of scale, synergies, etc.).

The Board states that, given that a range of elements must be taken into consideration, changes in market conditions (such as changes in the market value of the securities) should not normally change the conclusions reached on whether or not the investor has control over the entity.

The practical application of this complex issue is likely to result in a great deal of discussion, given the large part played by professional judgement in reaching a decision.

### 24. WHAT ELEMENTS SHOULD BE TAKEN INTO ACCOUNT WHEN ASSESSING POWER IF VOTING RIGHTS ARE NOT SUBSTANTIVE?

IFRS 12 uses the term “structured entity” to refer to entities in which voting rights (or similar rights) are not the dominant factor in determining who controls the entity in question (for example, when voting rights relate to administrative tasks and activities are directed through contractual arrangements).

Readers will remember that the concept of a “structured entity” was introduced in the exposure draft (ED10) published in December 2008.

Many commentators criticised the fact that ED10 proposed a differentiated approach to control, noting that this was not consistent with the Board's objective of introducing a single definition of control which would apply to both “traditional” and special purpose entities.

The elements to be taken into consideration comprise a series of indicators for assessing the investor's practical ability to direct the entity's relevant activities (cf. question 25) plus two additional indicators of lesser importance (cf. question 26).

### **25. WHAT ARE THE MAIN INDICATORS FOR ASSESSING THE INVESTOR'S PRACTICAL ABILITY TO DIRECT THE ENTITY'S RELEVANT ACTIVITIES?**

In order to determine whether the investor has the practical ability to direct the entity's relevant activities unilaterally, the following indicators should be assessed initially:

- the investor can (without having the contractual right to do so) appoint the key management personnel who have the ability to direct activities;
- the investor can (without having the contractual right to do so) direct the entity to carry out significant transactions for the benefit of the investor;
- the investor can dominate the process for nominating members of the entity's governing body (or can obtain proxies from other shareholders);
- the entity's key management personnel are related parties of the investor;
- more than half of the members of the entity's governing body are related parties of the investor.

### **26. IF THE ABOVE ARE NOT CONCLUSIVE, WHAT ARE THE ADDITIONAL INDICATORS?**

If the assessment of the first series of indicators is inconclusive, additional indicators must be taken into consideration.

The additional indicators, which are considered less important, include the existence of a special relationship (cf. question 27) and a large exposure to the variability of the entity's returns (cf. question 28).

## 27. WHAT DOES IFRS 10 MEAN BY “SPECIAL RELATIONSHIP”?

If the investor has a special relationship with the entity, suggesting that the investor has more than a passive interest in the entity, other indicators must be examined (although they are deemed to be less important than the first series of indicators):

- the entity’s key management personnel (who have the ability to direct activities) are current or former employees of the investor;
- the entity’s operations are dependent on the investor:
  - because the entity depends on the investor for a significant portion of its funding, technology, raw materials, etc.;
  - because the investor guarantees a significant portion of the entity’s obligations;
  - because the investor controls assets (such as licences or trademarks) that are critical to the entity’s activities;
  - because the entity depends on the investor for its key management personnel;
- a significant portion of the entity’s activities involve or are conducted on behalf of the investor;
- the investor’s exposure, related to its involvement with the entity, is disproportionately greater than its voting rights (or other rights).

The use of this second series of indicators to assess control is likely to prove particularly complex in practice, given that the standard states that the existence of a special relationship does not necessarily indicate control over the entity.

## 28. IN WHAT SITUATIONS SHOULD A LARGE EXPOSURE TO THE VARIABILITY OF THE ENTITY’S RETURNS BE TAKEN INTO ACCOUNT?

IFRS 10 states that power and exposure to returns are usually closely linked. As a result, if the investor has a large exposure to the variability of the entity’s returns, this is likely to indicate that the investor has power (although this indicator is less important than the first series of indicators).

However, consolidation must nonetheless be based on control (even in the event that the parent company does not have the majority of the risks and rewards from the entity in question).

Structured entities will be particularly challenged by the requirement to regularly reassess the level of control, given the greater reliance on individual judgement (in comparison with “traditional” entities) and the difficulty of carrying out the analysis.

### 29. WHAT IS THE DEFINITION OF “RETURNS”?

Returns vary in line with the entity’s activities and may be positive or negative (or both positive and negative). The legal form of the returns is not significant.

IFRS 10 uses a very broad definition of returns, including but not limited to:

- dividends (and other economic distributions from a subsidiary) and changes in the value of the subsidiary;
- remuneration for services provided, access to liquidity, tax benefits, etc.;
- returns that are not available to other shareholders (economies of scale, synergies, access to scarce products, etc.).

Thus, in practice, a bond with fixed interest payments is deemed to give the investor rights/exposure to variable returns as the interest payments expose the investor to the entity’s credit risk.

Similarly, fixed performance fees for managing an asset are also deemed to be variable returns.

The concept of “benefits” used in IAS 27 was not specifically defined, but was generally interpreted narrowly and limited to benefits directly linked to the ownership of securities.

**30. IS THE CONCEPT OF “RETURNS” LINKED TO A SPECIFIC THRESHOLD?**

The concept of exposure to variable returns is not dependent on crossing a specific threshold.

In contrast to interpretation SIC 12, which referred to the majority of risks and rewards, IFRS 10 does not stipulate a threshold above which consolidation is necessary.

As stated above, control generally implies exposure (whether positive or negative) to variable returns, but the Board did not wish to introduce a specific threshold (no “bright line”).

**31. BUT IS THERE A “DE MINIMIS” THRESHOLD, BELOW WHICH THE RETURNS CRITERION WOULD PROBABLY NOT BE MET?**

Although there is no “official” threshold, the examples provided in the standard do nonetheless give some indication of the level above which the issue needs to be seriously considered.

In practice, in the examples provided for fund managers (cf. question 12 on delegated power), the IASB seems to implicitly suggest that 20% ownership of an entity is sufficient for the “exposure to variable returns” condition to be met.

**32. HOW SHOULD AN INVESTOR ASSESS WHETHER IT HAS THE ABILITY TO USE ITS POWER TO AFFECT ITS RIGHTS/EXPOSURE TO VARIABLE RETURNS (I.E. WHETHER THERE IS A LINK BETWEEN POWER AND RETURNS)?**

In practice, an investor with power over an entity must determine whether it is acting as an agent (i.e. on behalf of another organisation) or as a principal (i.e. on its own account) (cf. question 11).

The link between power and returns does not mean that the proportion of the entity’s returns due to the investor must be perfectly in line with the amount of power it holds; it simply means that the parent company must have the ability to influence the entity’s returns on its own behalf.

### 33. WHAT ARE THE STEPS TO BE FOLLOWED WHEN APPLYING IFRS 10?

The first thing to note is that the standard does not incorporate a decision tree or propose a structured analysis approach.

As there is a single definition of control for both “traditional” and structured entities, this means that some of the provisions are more or less applicable depending on the type of entity.

Given the lack of a decision tree, we suggest that in the majority of cases encountered in practice, preparers of financial statements should consider the questions below in order to reach a conclusion on the level of control over an entity.

**The following questions should be considered:**

1. At what level should the analysis of control be carried out?  
Cf. question 17 – the “silo” concept.
2. What are the activities that significantly affect the entity’s returns (i.e. the relevant activities)?  
Cf. question 15 – the concept of “relevant activities”.
3. How are decisions made about the entity’s relevant activities?
4. Does the investor have the ability to direct the entity’s relevant activities?  
At this stage, in practice, it will usually be useful to identify whether or not voting rights are a significant factor in determining control, and to select an approach accordingly (cf. question 34 for a practical approach which differentiates between “traditional” and structured entities).
5. Does the investor have rights/exposure to variable returns?  
Cf. question 29 – the concept of (positive or negative) exposure to variable returns.
6. Does the investor have the ability to use its power over the entity to affect the amount of these returns, in its own interest?  
Cf. question 11 – the distinction between an agent and a principal.

**34. GENERALLY SPEAKING, WHAT ELEMENTS SHOULD BE EXAMINED IN ORDER TO DETERMINE WHETHER THE INVESTOR HAS THE ABILITY TO DIRECT THE ENTITY’S RELEVANT ACTIVITIES?**

There are many elements which may need to be considered, depending on the situation. The table below is intended only to show the most common scenarios in a simplified form (with reference to the relevant sections).

	“Traditional” entities	Structured entities
	Voting rights are important for determining control	Voting rights are less important for determining control, in contrast to contractual arrangements
<b>Substantive rights only</b>  <b>Q.9</b>	Voting rights held	Purpose and design of the entity Q.7
	The concept of “power” and the rights held by the entity (and by third parties) Q.20	Practical ability to exercise power Q.25
	Potential voting rights Q.23	Special relationship Q.27
	De facto control Q.22	Level of exposure to variability of returns Q.28

Assessing power in the case of structured entities (a visual summary)	
Practical ability to exercise power	Special relationship
<ul style="list-style-type: none"> <li>- Can appoint key management personnel (who have the ability to direct activities)</li> <li>- Can direct the entity to carry out significant transactions for the benefit of the investor</li> <li>- Can dominate the process for nominating members of the governing body</li> <li>- The entity's key management personnel are related parties of the investor</li> <li>- The majority of the members of the entity's governing body are related parties of the investor</li> </ul> <p><b>Do not forget (a) the purpose and design of the entity and (b) the exposure to variability of returns</b></p>	<ul style="list-style-type: none"> <li>- The entity's key management personnel are current or former employees of the investor</li> <li>- The entity's operations are dependent on the investor               <ul style="list-style-type: none"> <li>• for funding, technology, raw materials, etc.;</li> </ul> </li> <li>- because the investor controls assets that are critical to the entity's activities (licences, trademarks, etc.);</li> <li>- because the investor acts as a guarantor for the entity;</li> <li>- for its key management personnel.</li> <li>- A significant portion of the entity's activities involve or are conducted on behalf of the investor</li> <li>- The investor's exposure, related to its involvement with the entity, is disproportionately greater than its voting rights (or other rights)</li> </ul>

### 35. WHAT ARE THE RULES ON INITIAL APPLICATION OF IFRS 10?

As stated above (cf. question 1), application of the standard is mandatory for financial periods commencing on or after 1 January 2013 (for European entities, this is subject to adoption by the European Union), and early application is permitted as long as the whole consolidation package is applied simultaneously.

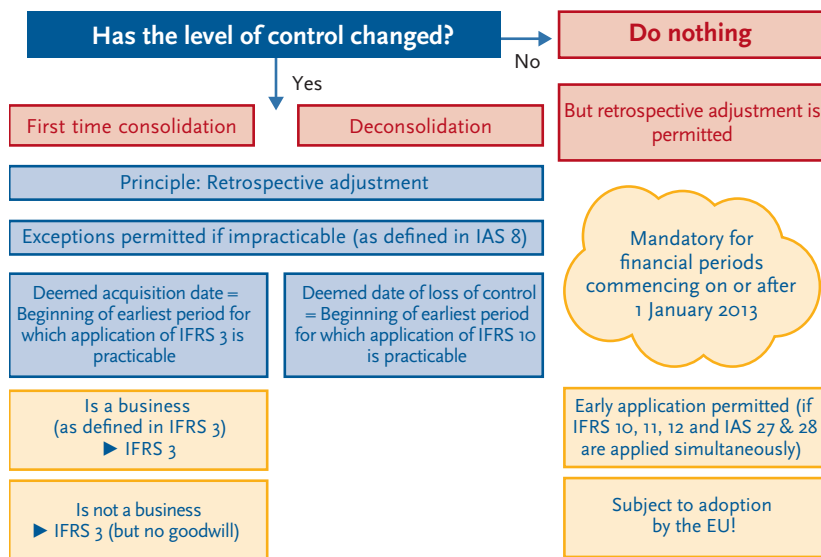
The accounting treatment stipulated by IFRS 10 is **retrospective, in principle**.

**The following three situations are possible:**

- no change in the level of control (cf. question 36);
- consolidation required for the first time (cf. question 37);
- deconsolidation required (cf. question 38).



## Key points of IFRS 10 “Consolidated Financial Statements” in 40 questions and answers



The IASB published an amendment to IFRS 10 on 28 June 2012, which aimed to clarify the Board’s original intentions regarding the date of initial application.

Remember that the date of initial application is the date on which the investor should determine whether it controls the entity on the basis of the requirements of IFRS 10.

According to this document, the date of initial application should be understood as the start of the period in which IFRS 10 is applied for the first time (i.e. 1 January 2013 in the example above).

### 36. WHAT ARE THE REQUIREMENTS UNDER IFRS 10 IF THERE IS NO CHANGE IN THE LEVEL OF CONTROL?

If the level of control is deemed to be unchanged when it is assessed at the date of initial application, there is no need to adjust the accounts.

However, the wording used in IFRS 10 seems to permit the option of genuinely retrospective application.

Thus, for example, the date on which the investor obtained control may differ depending on whether the analysis was based on IAS 27 / SIC 12 or on IFRS 10 (e.g. due to the differing treatment of potential voting rights).

The amendment published in June 2012 clarifies that it is not necessary to restate retrospectively the comparative periods presented if an entity which was unconsolidated under IAS 27 / SIC 12 but which would have been consolidated under IFRS 10 (or vice versa) has been disposed of before 1 January 2013.

### 37. WHAT IS THE PROCEDURE FOR FIRST-TIME CONSOLIDATION LINKED TO INITIAL APPLICATION OF IFRS 10?

When retrospective application is impracticable (as defined in IAS 8, that is: when the entity cannot apply it after making every reasonable effort to do so), the following specific rules apply.

Where an investor is consolidating an entity for the first time, IFRS 10 permits the use of a deemed acquisition date, which is the beginning of the earliest period for which application of IFRS 3 is practicable (which may be the period of initial application of the revised standard).

In practice, application of IFRS 3 could take place on 1 January 2013 for an entity which has a reporting date at the end of the calendar year and which has not opted for early application.

IFRS 3 shall therefore be applied at the deemed acquisition date. However, if the entity is not a business (as defined in IFRS 3), no goodwill can be recognised.

As the standard is generally to be applied retrospectively, this raises questions over which version of IFRS 3 should be used. This is a significant issue, due to changes in the definition of a “business”.

## Key points of IFRS 10 “Consolidated Financial Statements” in 40 questions and answers

Readers will remember that the revised IFRS 3 (published in 2008) was prospectively applicable (i.e. for business combinations taking place in financial periods starting on or after 1 July 2009).

The amendment published on 28 June 2012 clarifies that IFRS 3 (2008) must be used if control was obtained later than the effective date of IFRS 3 (2008). If control was obtained before that date, an entity can apply either IFRS 3 (2004) or IFRS 3 (2008).

### **38. WHAT IS THE PROCEDURE WHEN THE GROUP NO LONGER CONTROLS AN ENTITY UNDER IFRS 10?**

When retrospective application is impracticable (as defined in IAS 8, that is: when the entity cannot apply it after making every reasonable effort to do so), the following specific rules apply.

When an investor is “deconsolidating” an entity, IFRS 10 shall be applied at the date on which control is deemed to have been lost, which is the beginning of the earliest period for which application of IFRS 10 is practicable (which may be the period of initial application of the revised standard).

### **39. WHICH SECTORS ARE LIKELY TO BE THE MOST AFFECTED?**

In practice, the sectors which are the most likely to be affected by the new standard are as follows:

- the funds and fund management sector, irrespective of whether the funds in question are invested in financial instruments or real estate assets. Fund managers often have to invest in the fund themselves at the outset (referred to as “seed money”), even if the ultimate goal is to open the fund to external investors. Cf. question 12 on the illustrative examples included in the standard;
- the infrastructure concessions sector (when the infrastructure is located in a special purpose entity).

In both cases, this is due to the lack of any reference to a specific threshold for exposure to risks and rewards (whereas SIC 12 referred to a majority of risks and rewards).

#### 40. WHAT ARE THE KEY POINTS TO REMEMBER ABOUT IFRS 10?

The key points to remember about IFRS 10 are as follows:

1. A single definition of control, which applies to both “traditional” entities (subsidiaries of industrial and commercial groups) and structured entities (special purpose entities and similar entities).
2. Control implies (a) power over the relevant activities, (b) exposure (positive or negative) to variable returns, and (c) the ability to use this power to affect the amount of these returns.
3. The concept of “benefits” is replaced by the much broader concept of “returns”, which includes returns that are specific to that investor (such as synergies, economies of scale or access to scarce products).
4. Several additional clarifications on (a) substantive and protective rights, (b) the distinction between an agent and a principal, (c) de facto control, and (d) silos.
5. The accounting treatment for call options and other potential voting rights is potentially very different (and is largely left open to professional judgement).
6. The level of control must be reassessed regularly, especially if facts and circumstances indicate that there may be changes to any of the three criteria mentioned in point 2 above.
7. There is no “official” threshold above which consolidation is required (when assessing the criterion which relates to exposure to variable returns). However, the examples suggest an implied threshold of around 20% (above which the exposure to variable returns criterion is deemed to be met).

## Key points of IFRS 10 “Consolidated Financial Statements” in 40 questions and answers

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8. A large amount is left open to professional judgement and there is no decision tree in the standard.
9. No change to consolidation techniques (i.e. the question of how to carry out consolidation).
10. Date of initial application: financial periods beginning on or after 1 January 2013 (usually retrospective, but with scope for exceptions).



Notes

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