NEW CONTROL MODEL UNDER IFRS 10*

Teorik İnceleme
(Theoretical Research)

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ABSTRACT

Consolidated financial statements are the financial statements of a group of entities that are presented as being a single economic entity. IFRS 10 Consolidated Financial Statement (revised by IASB in 2011) provides methodology for preparing and presenting consolidated financial statements. Beside the consolidation methodology, IFRS 10 includes guidance on how to determine the level of control over the investee. The aim of this study is to examine the new control model and its process under IFRS 10.

Keywords: Consolidated financial statements, control, IFRS 10, power

JEL Codes: M41

TFRS 10'A GÖRE YENİ KONTROL MODELİ

ÖZ

Konsolide finansal tablolar bir topluluk içinde yer alan işletmelerin finansal tablolarını tek bir ekonomik işletme gibi sunan finansal tablolardır. TFRS 10 Konsolide Finansal Tablolar (2011 ylından UMSK tarafindan revise edilen) konsolide finansal tabloların hazırlanması ve sunumuna yönelik metodolojileri içermektedir. Konsolidasyon methodalojisinin yanısıra, TFRS 10, yatirım yapılan işletme üzerinde sahip olunan kontrolün derecesinin belirlenmesi konusunda bilgiler içermektedir. Bu çalışmanın amacı TFRS 10'da yer alan yeni control modelini ve süreçlerini incelemektir.

Anahtar Sözcükler: Konsolide finansal tablolar, control, TFRS 10, güç

JEL Kodları: M41

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1. INTRODUCTION

In May 2011, IASB issued a package of five standards (three new and two amended) which set out new requirements for group accounting: consolidation, accounting for joint agreements and associates. These were the results of the IASB's project on consolidation which IASB added to its agenda in June 2003. These new standards have been mandatory for annual periods beginning on or after January, 1, 2013. Early applications surely encouraged.

The new consolidation package replaced the following standards: (Mackenzie et al 2013,206)

New IFRS	Replaced IFRS
IFRS 10 Consolidated Financial Statements	IAS 27 Consolidated and Separate Financial Statements and SIC 12 Consolidation Special Purpose Entities
IFRS 11 Joint Ventures	IAS 31 Interests in Joint Ventures and SIC 13 Jointly Controlled Entities- Non monetary Contributions by Venturers
IFRS 12 Disclosure of Interest in Other Entities	None. Previously the disclosure requirements relating to interests in other entities were contained in each separate standard.
IAS 27 Separate Financial Statements	IAS 27 Consolidated and Separate Financial Statements
IAS 28 Investments in Associates and Joint Ventures	IAS 28 Investments in Associates and IAS 31 31 Interests in Joint Ventures

After the revision, the previous IAS 27(2008) has been restructured into three different standards: IFRS 10 Consolidated Financial Statements, IAS 27(2011) Separate Financial Statements and IFRS 12 Disclosure of Interests in Other Entities. The revised IAS 27(2011) now only includes guidance for separate financial statements.

The logic behind the revision was declared by IASB as *"the divergence in practice when applying IAS 27 Consolidated and Separate Financial Statements and SIC-12 Consolidation—Special Purpose Entities"* (IASB 2011). The IASB defined the basic consolidation model and principles stated in IAS 27 and SIC-12 as *"**sound**"*, and therefore they were not always applied consistently. The new consolidation package standard IFRS 10 clarifies requirements that were either implicitly embedded or only briefly addressed in IAS 27 and SIC-12 and provides additional application guidance. By the consolidation package also the guidance for non-consolidated entities were established for the first time.

2. THE NEW CONTROL MODEL

The consolidation model in IFRS 10 is based on control. A reporting entity is required to consolidate an investee when that entity controls the investee (Pricewaterhousecoopers 2011,3). However IFRS 10 includes a new definition of control and increases the requirements to consider while deciding whether an entity (investor) has control on an investee.

IFRS 10 defines control as "*An investor controls an investee when the investor 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*".

IAS 27(2008)'s and IFRS 10's control definitions seem similar, however the two standards use different terminology. The basic implications of revised control definition by the analysis of the revision of IAS 27(2008) and its supplement SIC 12 are as follows: (Grand Thornton 2012,11)

- IAS 27(2008) refers to power but IFRS 10 refers to rights and ability
- IAS 27(2008) refers to governing the financial and operating policies but IFRS 10 refers to the ability to affect returns
- IAS 27 (2008) refers to obtaining benefits while IFRS 10 requires exposure or rights to variable returns
- SIC 12 includes specific control indicators for special purpose entities (SPEs) while IFRS 10 does not

According to IFRS 10.7, control exists when an investor has all three of the following elements: (Also the linkage between three elements is shown on Figure 1)

(a) power over the investee

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

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

IFRS 10 uses the term "*investor*" to refer a reporting entity that potentially controls one or more other entities (parent company), and "*investee*" to refer to a subsidiary of a reporting entity.

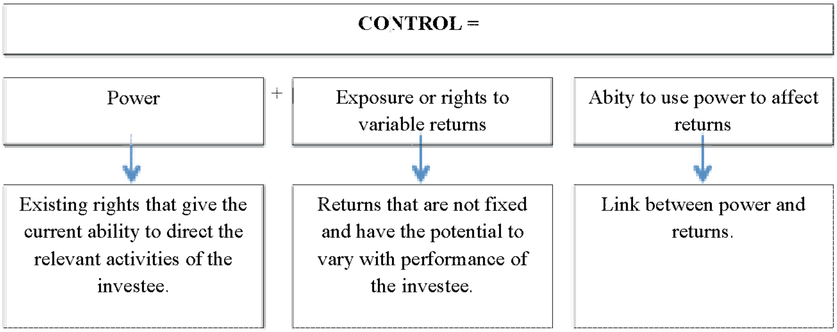

Figure 1: The Elements of Control

Reference: Deloitte.2013. Clearly IFRS: A Practical Guide to Implementing IFRS 10 Consolidated Financial Statements,p.4

IFRS 10 intensively focus on control and assessment of control and tried to figure out a sole control model that could be applied for all types of entities. The control principle is the base for consolidation. The investor will decide whether it is a parent company or not via the control principle. An investor shall consider all facts and circumstances when assessing whether it controls an investee. The investor shall reassess whether it controls an investee if facts and circumstances indicate that there are changes to one or more of the three elements of control. (IFRS 10.8)

In IAS 27(2008) control was addressed through voting rights while exposure to variable returns was an important consideration within the SIC 12 framework. However, the relationship between these two approaches to control was not always clear. IFRS 10 links power and returns by introducing an additional requirement that the investor is capable of wielding that power to influence its returns. (Pricewaterhousecoopers 2011,4)

The application guidance in IFRS 10 Appendix B detailed information on assessment of control. This assessment framework is shown on Figure 2.

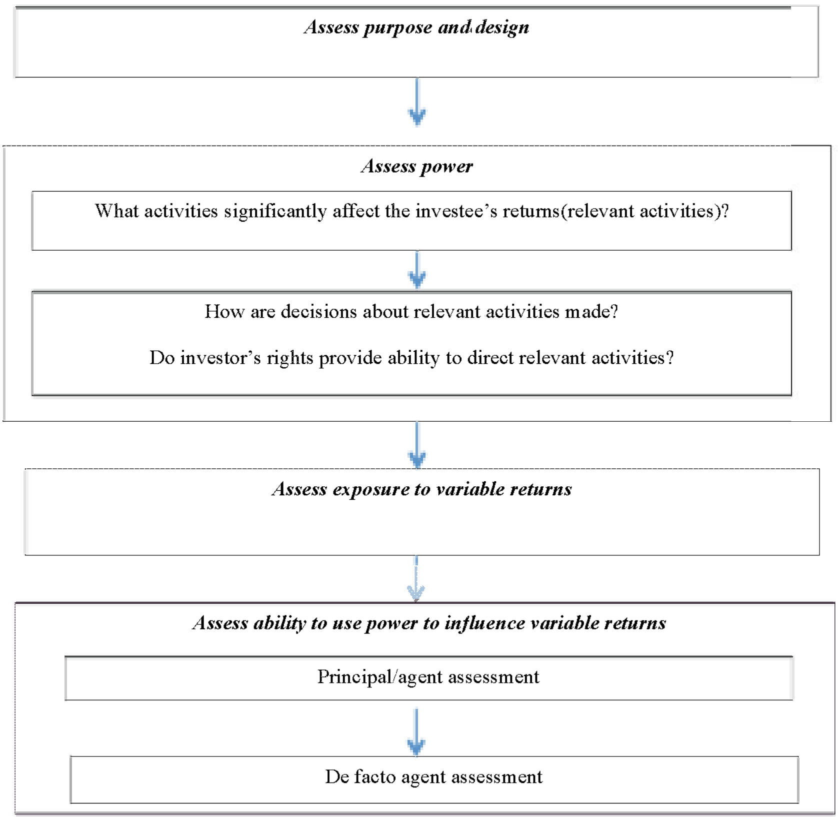

Figure 2: Framework for Assessment for Control

Reference: Pricewaterhousecoopers.2011. Practical Guide to IFRS: Consolidated Financial Statements, Redefining Control p.4

As shown on Figure 2, the process for assessment of control begins with the purpose and design of the investee.

2.1. Understanding the Purpose and Design of the Investee

When assessing control of an investee, an investor shall consider the purpose and design of the investee in order to identify the relevant activities, how decisions about the relevant activities are made, who has the current ability to direct those activities and who receives returns from those activities.(IFRS 10.B5) It is critical to understand the purpose and design of the investee in order to decide whether the investor has control or not. The consideration of purpose and design make it clear that the entity is controlled by voting or potential voting rights. Control is generally determined by voting rights. But in the cases where majority voting rights do not exist, a more complex process determines control (IFRG of Ernst&Young 2013,378).

Understanding the purpose and design of the investee helps to determine the following: (Ernst&Young 2013,10)

- What risks the investee was designed to be exposed to, and what risks it was designed to pass on to the parties with which it is involved
- What the relevant activities are
- How decisions about the relevant activities are made
- Who has the current ability to direct the relevant activities
- Which parties have exposure to variable returns from the investee
- How the relevant activities affect returns
- Whether the parties that have power and have exposure to variable returns have the ability to use that power to affect returns.
- Who receives returns from these activities

Understanding the purpose and design of the entity will provide to clearly determine whether the investee has been controlling by the investor via voting or potential voting rights. The investor which has the majority of voting right would have control of the investee unless otherwise specified. In more complex cases, where the control could not be determined by the voting or potential voting rights, the assessment of power should be the next step.

2.2. Power

The first criterion to have control relates with power. An investor has power when it has existing rights that give it the current ability to direct the relevant activities. In IFRS 10 power is defined as *"existing rights that give the current ability to direct the relevant activities."* There are two concepts when assessing power: *relevant activities and existing rights.*

An investor can easily determine whether it has power or not if it has the majority of voting rights. In the case of not clearly determination of control by voting rights, relevant activities of the investee should be identified.

Relevant activities are activities of the investee that significantly affect the investee's returns. For many investees, a range of operating and financing activities significantly affect their returns. Examples of relevant activities are given as the following in IFRS10.B12 :

(a) selling and purchasing of goods or services;

(b) managing financial assets during their life (including upon default);

(c) selecting, acquiring or disposing of assets;

(d) researching and developing new products or processes; and

(e) determining a funding structure or obtaining funding.

After identifying relevant activities, the second phase in assessment of power is to determine whether the investor has the ability to direct these relevant activities.

2.3. Rights (Rights that give an investor power over an investee)

Power arises from rights. Power could arise whether the investor may have a majority of voting rights or an investor may have less than 50% of the voting rights or other arrangements. This hierarchy comes more complex in lower steps. ((Mackenzie et al 2013,263)

Examples of rights that, either individually or in combination, can give an investor power include but are not limited to: (IFRS 10.B15)

(a) rights in the form of voting rights (or potential voting rights) of an investee

(b) rights to appoint, reassign or remove members of an investee's key management personnel who have the ability to direct the relevant activities;

(c) rights to appoint or remove another entity that directs the relevant activities;

(d) rights to direct the investee to enter into, or veto any changes to, transactions for the benefit of the investor; and

(e) other rights (such as decision-making rights specified in a management contract) that give the holder the ability to direct the relevant activities.

Rights are categorized into two groups in IFRS 10: *(1) substantive rights (2) protective rights*

Substantive rights give current ability to direct the relevant activities to the holder. Protective rights are rights designed to protect the interest of the party holding those rights without giving that party power over the entity to which those rights relate.

2.3.1. Substantive Rights

An investor, in assessing whether it has power, considers only substantive rights relating to an investee (held by the investor and others). For a right to be substantive, the holder must have the practical ability to exercise that right (IFRS 10.B22). Therefore while assessing power, only substantive rights are considered, protective rights are being disregarded. Also, if an investor has substantive rights on an investee, but did not choose to use them, the investor still has power on the investee. (BDO 2013,17)

Determining whether rights are substantive requires judgment, taking into account all facts and circumstances. The distinction between substantive rights and protective right are explained in IFRS 10.B23)

Judgment about whether these rights are practical ability to exercise is required in order to determine whether the rights are substantive or not. If the rights have practical ability to exercise, then they are substantive. There are three main judgments in this process: ((Pricewaterhousecoopers 2011,12)

i. Are there barriers to exercise of those rights by holder? [IFRS 10.B23(a)]

- financial penalties and incentives that would prevent (or deter) the holder from exercising its rights.

- an exercise or conversion price that creates a financial barrier that would prevent (or deter) the holder from exercising its rights.

- terms and conditions that make it unlikely that the rights would be exercised, for example, conditions that narrowly limit the timing of their exercise.

- the absence of an explicit, reasonable mechanism in the founding documents of an investee or in applicable laws or regulations that would allow the holder to exercise its rights.

- the inability of the holder of the rights to obtain the information necessary to exercise its rights.

- operational barriers or incentives that would prevent (or deter) the holder from exercising its rights (eg the absence of other managers willing or able to provide specialized services or provide the services and take on other interests held by the incumbent manager).

- legal or regulatory requirements that prevent the holder from exercising its rights (eg where a foreign investor is prohibited from exercising its rights).

ii. Do practical mechanisms exist for collective exercise of rights? [IFRS 10.B23(b)]

When the exercise of rights requires the agreement of more than one party, or when the rights are held by more than one party, whether a mechanism is in place that provides those parties with the practical ability to exercise their rights collectively if they choose to do so. The lack of such a mechanism is an indicator that the rights may not be substantive.

The more parties that are required to agree to exercise the rights, the less likely it is that those rights are substantive.

iii. Will the holder benefit from the exercise of those rights? [IFRS 10.B23(c)]

For example, the holder of potential voting rights in an investee shall consider the exercise or conversion price of the instrument. The terms and conditions of potential voting rights are more likely to be substantive when the instrument is in the money or the investor would benefit for other reasons (eg by realizing synergies between the investor and the investee) from the exercise or conversion of the instrument.

To be substantive, rights also need to be exercisable when decisions about the direction of the relevant activities need to be made. Usually, to be substantive, the rights need to be currently exercisable. However, sometimes rights can be substantive, even though the rights are not currently exercisable.

2.3.2. Protective Rights

Protective rights relate to fundamental changes to the activities of an investee or apply in exceptional circumstances. However, not all rights that apply in exceptional circumstances or are contingent on events are protective. [IFRS 10(B26)]. Examples of protective rights include but are not limited to: [IFRS 10(B28)]

(a) a lender's right to restrict a borrower from undertaking activities that could significantly change the credit risk of the borrower to the detriment of the lender.

(b) the right of a party holding a non-controlling interest in an investee to approve capital expenditure greater than that required in the ordinary course of business, or to approve the issue of equity or debt instruments.

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

As explained earlier, when assessing whether the investor has control over the investee, only substantive rights should be considered. The most important substantive rights that an investor can hold are voting rights.

2.4. Voting Rights

An investor that holds more than half of the voting rights of an investee has power . the power that come arise by the majority of the voting rights could be in two situations: (IFRS 10:B35)

(a) the relevant activities are directed by a vote of the holder of the majority of the voting rights, or

(b) a majority of the members of the governing body that directs the relevant activities are appointed by a vote of the holder of the majority of the voting rights.

For an investor that holds more than half of the voting rights of an investee, to have power over an investee, *"the investor's voting rights must be substantive and must provide the investor with the current ability to direct the relevant activities",* which often will be through determining operating and financing policies. If another entity has existing rights that provide that entity with the right to direct the relevant activities and that entity is not an agent of the investor, the investor does not have power over the investee. (IFRS 10:B36)

In some cases, voting rights do not give the investor to direct the relevant activities of the investee. These could be the examples: (Ernst&Young 2013,17)

- Relevant activities are directed by contract
- Relevant activities are directed by government, judiciary, administrator, receiver, liquidator or regulator
- Voting rights are not substantive
- Voting rights have been delegated to a decision maker, which holds the voting rights as an agent
- Voting right are held as a de facto agent of another investor

2.5. Power Without a Majority of the Voting Rights(de facto control)

IFRS 10 provides guidance on when an investor with less than 50% of the voting rights has rights that are sufficient to give it power. IFRS 10 includes the term de facto in order to refer this type of control.

An investor can have power even if it holds less than a majority of the voting rights of an investee. An investor can have power with less than a majority of the voting rights of an investee, for example, through:

(a) a contractual arrangement between the investor and other vote holders: A contractual arrangement between an investor and other vote holders can give the investor the right to exercise voting rights sufficient to give the investor power, even if the investor does not have voting rights sufficient to give it power without the contractual arrangement.

(b) rights arising from other contractual arrangements : For example, the rights specified in a contractual arrangement in combination with voting rights may be sufficient to give an investor the current ability to direct the manufacturing processes of an investee or to direct other operating or financing activities of an investee that significantly affect the investee's returns.

(c) the investor's voting rights : An investor with less than a majority of the voting rights has rights that are sufficient to give it power when the investor has the practical ability to direct the relevant activities unilaterally.(de facto control)

(d) potential voting rights : Potential voting rights are rights to obtain voting rights of an investee, such as those arising from convertible instruments or options, including forward contracts. Those potential voting rights are considered only if the rights are substantive

(e) a combination of (a)–(d): For example an investor could have power over investee by 40%voting rights and 20% potential voting rights.

Diagram 1 summarizes the process for assessment of power over an investee.

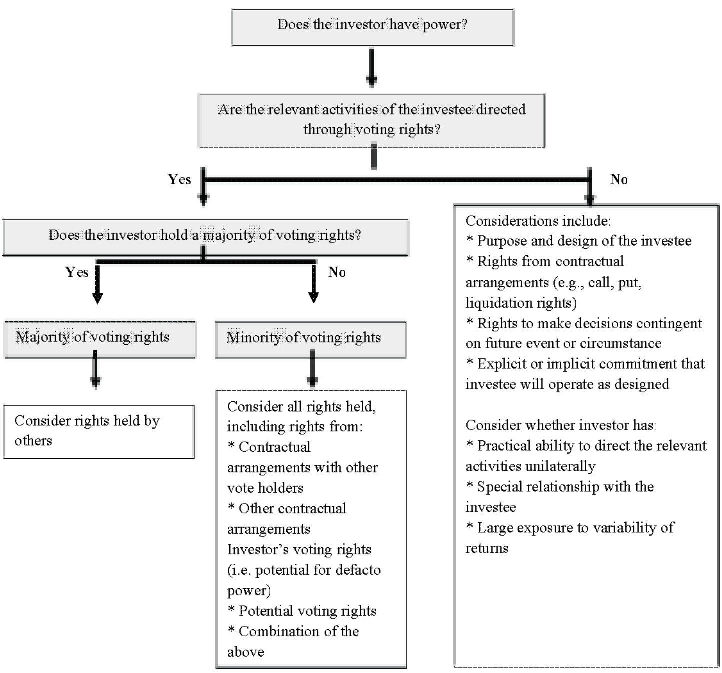

Diagram 1: Assessment Process

Reference: Deloitte.2013. Clearly IFRS: A Practical Guide to Implementing IFRS 10 Consolidated Financial Statements,p.4

2.6. Link Between Power and Variable Returns

The last step for assessment of control requires an investor to have ability to use its power to affect the investor's variable returns. IFRS 10 includes this process through principal-agent relationships.

An investor controls an investee if the investor not only has power over the investee and exposure or rights to variable returns from its involvement with the investee, but also has the ability to use its power to affect the investor's returns from its involvement with the investee. Thus, an investor with decision-making rights shall determine whether it is a principal or an agent. (IFRS 10.17&18) An investor can be considered a principal if the investor is able to use its rights to influence returns. Figure 3 shows the principal/agent classification.

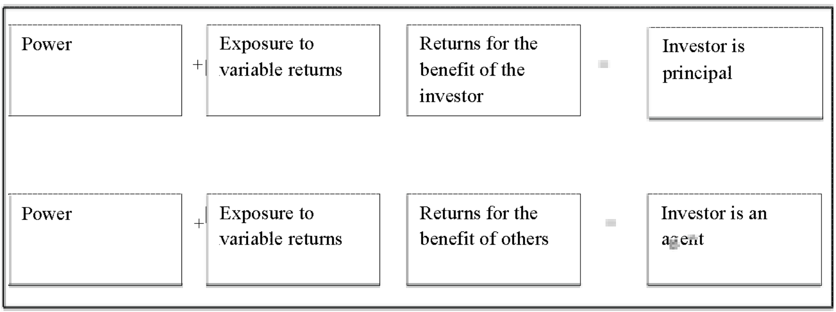

Figure 3: Link between power and returns (principal-agent classification)

Reference: BDO.2013. Need to Know: IFRS 10 Consolidated Financial Statements, p.31

3. CONSLUSION

IFRS 10 provides a single model for assessing control and more extensive guidance on applying this model. Also identifies this single model as *"the basis of consolidation"* for all types of entities.

According to the IFRS 10's control paradigm, majority of voting rights is still a significant criteria, but on the other hand a process of assessment of control is largely explained in the Standard. These explanations addressed to many complicated situations that have not been took place in IAS 27 (2008).

IFRS 10's new control definition retains a "power and returns" concept, but also focuses on the ability to direct the relevant activities that mostly affect the investee's returns.

Adopting the new consolidation package standards of IASB will require time, effort and and cost. The package, especially the control model stated in IFRS 10 largely based on the exercise of considerable judgments while there is no a majority of voting rights. These judgments would be based on a comprehensive understanding of the business, operations, and legal rights and obligations. This will lead a complex structure of control model. The accounting personnel that is obligated to adopt these consolidation standards should be aware of the requirements of IAS/IFRSs and willing to adopt fairly presented financial statements procedures.

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