

INTERNATIONAL FINANCIAL REPORTING BULLETIN 2011/06

ACCOUNTING FOR SUBSIDIARIES, JOINT ARRANGEMENTS AND ASSOCIATES, AND DISCLOSURES OF INTERESTS IN OTHER ENTITIES



Background

The International Accounting Standards Board (IASB) has published a package of five new standards which set out new requirements for consolidation, joint arrangements and disclosure of interests in other entities.

The new standards are:

IFRS 10: *Consolidated Financial Statements*

IFRS 11: *Joint Arrangements*

IFRS 12: *Disclosure of Interests in Other Entities*

In addition, the following standards have been amended:

IAS 27: *Separate Financial Statements*

IAS 28: *Investments in Associates and Joint Ventures*

This IFRB sets out a brief summary of each of the new and amended standards, including how each of them changes existing accounting requirements, together with transitional arrangements.

STATUS

Final

EFFECTIVE DATE

Annual periods beginning on/after 1 January 2013, with earlier application permitted

ACCOUNTING IMPACT

May be significant.

IFRS 10: Consolidated Financial Statements**Background**

IFRS 10 replaces IAS 27 *Consolidated and Separate Financial Statements* and SIC-12 *Consolidation – Special Purposes Entities*. The project to replace the existing guidance was undertaken for the following main reasons:

- Diversity arose in practice from IAS 27 using control as the basis for consolidation and SIC-12, which applies to Special Purpose Entities (SPEs), using risks and rewards. It was not always clear whether an entity met the definition of an SPE and, in consequence, whether IAS 27 or SIC-12 should be applied; and
- The need to enhance disclosure requirements, in particular as a consequence of the global financial crisis.

Requirements

IFRS 10 is based on a single control model for all entities. There are three key elements to the definition of control that is used in the standard:

- Power over an investee (whether or not that power is used in practice);
- Exposure, or rights, to variable returns from an investee; and
- The ability to use the power over an investee to affect the reporting entity's returns from that investee.

IFRS 10 includes guidance to be applied in circumstances where the assessment of control may be difficult, including where an entity has potential voting rights (such as share options) over another, agency relationships and cases where voting rights are not the principal indicator of control.

The accounting requirements and consolidation procedures in the existing IAS 27 are carried forward unchanged.

Changes from existing IFRSs

The requirements of IFRS 10 may result in changes in those entities that are regarded as being controlled by a reporting entity and, in consequence, are consolidated in its financial statements. In particular:

IAS 27 and SIC-12	IFRS 10
Basis for consolidation	
IAS 27 uses control as the basis for consolidation with SIC-12, which applies to Special Purpose Entities (SPEs), using risks and rewards.	IFRS 10 uses control as the sole basis for consolidation, with control being defined widely. Exposure to risks and rewards (variable returns) from an investee is not in itself sufficient to determine whether control exists.
'De facto' control	
IAS 27 does not include the concept of 'de facto' control, which is where an investor can control an investee while holding less than 50% of the investee's voting rights.	IFRS 10 includes the concept of 'de facto' control.
Potential voting rights	
Only potential voting rights (such as share options) that are currently exercisable at a reporting date are considered when assessing whether control exists. Certain aspects, including management intent and the availability of necessary funding, are ignored.	Potential voting rights are considered when they are substantive, which is when the holder has the practical ability to exercise them (that is, there are no barriers, financial or otherwise, to their exercise) and the rights are currently exercisable. In addition, potential voting rights may need to be considered when they are not currently exercisable. Determining whether potential voting rights are substantive requires consideration of a variety of factors.
Agency relationships	
IAS 27 contains no guidance for agency relationships.	IFRS 10 includes guidance which notes that when decision making authority over an entity has been delegated by a principal to an agent, the principal and not the agent controls the entity. An agency relationship may be evidenced by the principal having a substantive removal right over the agent; in the absence of this factor, an assessment is required of the overall facts and circumstances in each case.

IFRS 11: Joint Arrangements**Background**

IFRS 11 replaces IAS 31 *Interests in Joint Ventures*. The project to replace existing requirements was undertaken for the following main reasons:

- Under IAS 31, the structure of an arrangement is the principal factor in determining the accounting approach, meaning that the accounting might not reflect the rights and obligations of each of the parties involved in an arrangement; and
- IAS 31 contains an option to account for jointly controlled entities (JCEs) using either proportionate consolidation or equity accounting. This option means parties to similar arrangements could account for them differently, and arrangements that give rise to different rights and obligations for each of the parties could be accounted for in a similar way.

Requirements

IFRS 11 is based on the principle that each party to a joint arrangement accounts for its rights and obligations that arise from that arrangement. In consequence:

- Where an entity has rights to the assets and obligations for the liabilities relating to a joint arrangement, it is regarded as being a joint operator. Joint operators account for the assets and liabilities, and associated revenues and expenses, that arise from the joint arrangement.
- Where an entity has rights to the net assets relating to a joint arrangement, it is regarded as having an interest in a joint venture. Joint venturers account for the net assets arising from the joint arrangement by applying equity accounting.

Changes from existing IFRSs

The requirements of IFRS 11 may result in changes in the way in which parties to joint arrangements reflect them in their financial statements. The following table sets out a comparison of IAS 31 and IFRS 11 in the context of whether a joint arrangement is structured through a separate vehicle (which is a separately identifiable financial structure, including separate legal entities or entities recognised by statute) or is not structured through a separate vehicle:

IAS 31	IFRS 11
Structured through a separate vehicle	
The arrangement gives rise to a jointly controlled entity. Each party to the joint arrangement has the choice of accounting using either proportionate consolidation or the equity method.	It is necessary to analyse the legal form of the joint arrangements, the contractual terms and any other relevant facts and circumstances in order to determine whether the arrangement gives rise to a joint operation or a joint venture. A joint operation is where the parties that have joint control over the joint arrangement have rights to the assets and obligations for the liabilities relating to the arrangement. They will account for their respective interests in the assets, liabilities, revenue and expenses in accordance with the contractual arrangements. A joint venture is where the parties that have joint control over the joint arrangement have rights to the net assets of the arrangement. They account for their respective interests in the net assets of the joint arrangement using the equity method.
Not structured through a separate vehicle	
Depending on the terms of the arrangement, it is regarded as giving rise to either jointly controlled assets or jointly controlled operations. Each party to the joint arrangement accounts for its assets, liabilities, revenue and expenses in accordance with the contractual arrangements.	The arrangement is regarded as a joint operation. Each of the parties that has joint control over the joint arrangement accounts for its assets, liabilities, revenue and expenses in accordance with the contractual arrangements.

IFRS 12: Disclosure of Interests in Other Entities

The objective of IFRS 12 is to require a reporting entity to disclose information that helps users of its financial statements understand:

- the nature of, and risks associated with, its interests in other entities (whether these are subsidiaries, joint operations, joint ventures, associates or interests in structured entities that are not consolidated); and
- the effects of those interests on the reporting entity's financial position, financial performance and cash flows.

IFRS 12 combines, and makes consistent, certain existing disclosures that were previously included, in some cases with overlapping requirements, in IAS 27 *Consolidated and Separate Financial Statements*, IAS 28 *Investments in Associates* and IAS 31 *Interests in Joint Ventures*. In addition, it introduces certain new disclosure requirements, including those related to unconsolidated structured entities where a lack of transparency about entities' exposures to related risks was highlighted by the global financial crisis.

A structured entity is one which has been designed such that voting or similar rights are not the dominant factor in deciding who controls the entity. Examples of structured entities are securitisation vehicles, asset-backed financing arrangements and some investment funds, with these entities normally having some or all of the following features:

- restricted activities;
- a narrow and well defined objective (such as to effect a tax efficient structure);
- insufficient equity to finance the entity's activities, meaning that subordinated financial support is required; and
- financing in the form of tranches of contractually linked instruments issued to investors that create concentrations of credit or other risk.

New disclosures that are introduced by IFRS 12 include:

Subsidiaries

- how it has been determined that the reporting entity has control over its subsidiary;
- interests that non-controlling interests have in the group's activities and cash flows;
- the nature and extent of significant restrictions on the reporting entity's ability to access or use assets, and settle liabilities of the group; and
- the nature of, and changes in, the risks associated with its interests in consolidated structured entities, including any contractual requirement to provide financial support to the structured entity, events or circumstances that could expose the reporting entity to a loss, and circumstances in which non contractual financial support has, or could be, provided to the structured entity.

Unconsolidated structured entities

Disclosures are required to set out the nature and extent of a reporting entity's interests in unconsolidated structured entities, and the risks associated with those interests. The wider term 'interests' has been used in order to include a reporting entity's involvement with another, whether contractual or non-contractual, which expose the reporting entity to variability of returns from the performance of the other entity. These disclosures include:

- how a reporting entity has determined which structured entities it has sponsored (1);
- income received from those entities during the period;
- details of assets and liabilities recognised in the reporting entity's financial statements that relate to its interests in unconsolidated structured entities, together with information about its maximum exposure to loss;
- circumstances in which non contractual financial support has, or could be, provided to structured entities.

The first bullet point above refers to structured entities that have been 'sponsored' by a reporting entity. This is where the reporting entity has been involved in the formation of a structured entity; for example, a bank might set up a structured entity for the purposes of securitising part of its originated mortgage receivables. This is relevant as, even where a sponsor of a structured entity does not retain any (or any significant) interest in that structured entity, in the event that the structured entity encounters difficulties the sponsor might be challenged on its advice or actions, or might choose to act to protect its reputation even though there is no contractual obligation to do so.

Interests in joint arrangements and associates

New disclosures include the following:

- how the activities of the joint arrangement or associate relate to those of the reporting entity, including whether they are strategic to the reporting entity's activities; and
- although a requirement to disclose summarised financial information for individually material joint venture and associate has been carried forward from IAS 28 and IAS 31, IFRS 12 expands the information that is to be disclosed.

IAS 27: Separate Financial Statements

Most of the requirements of IAS 27 *Consolidated and Separate Financial Statements* relating to separate financial statement have been carried forward unchanged, although the disclosure requirements of that standard have now been incorporated into IFRS 12. In order to locate all related guidance together, the requirements for separate financial statements previously included in IAS 28 *Investments in Associates* and IAS 31 *Interests in Joint Ventures* have been incorporated into the amended IAS 27.

In addition, the previous requirement in IAS 27 to disclose the country of incorporation or residence of subsidiaries, joint ventures and associates (and, if applicable, the parent entity that prepares consolidated financial statements in accordance with IFRS) has been expanded to include disclosure of the principal place of business.

IAS 28: Investments and Associates and Joint Ventures

Most of the requirements of IAS 28 *Investments in Associates* have been carried forward unchanged, with the exception of the incorporation of accounting for joint ventures.

In addition:

- In some cases, an entity may have an investment in an associate, part of which is held indirectly by a venture capital or other organisation that qualifies, and elects, to measure that part at fair value through profit or loss. It has been clarified that the entity may elect to measure that part at fair value through profit or loss in its consolidated or individual financial statements, with the other part being accounted for in accordance with the equity method. It should be noted that individual financial statements are required to be prepared by an entity which does not have any subsidiaries, but does have interests in associates and/or joint arrangements. Individual financial statements are different from separate financial statements which are not mandatory and in which investments are accounted for on the basis of the direct equity interest (either at cost, subject to any impairment, or in accordance with IAS 39 or IFRS 9) rather than on the basis of the reported results and net assets of the investees.
- IFRS 5 Non-current Assets held for Sale and Discontinued Operations applies to an investment, or a portion of an investment, in an associate that meets the criteria to be classified as held for sale. Any portion to be retained continues to be accounted for on the basis of the combined holdings, with a reassessment of the applicable accounting guidance being carried out at the point at which the portion to be sold is disposed of. If, after a partial disposal, a reassessment shows that the retained interest falls within the scope of IFRS 9 *Financial Instruments* (or IAS 39 *Financial Instruments: Recognition and Measurement* if IFRS 9 has not yet been adopted), the retained interest is then accounted for in accordance with that standard. This includes initial recognition at fair value.
- It has been clarified that a change in the status of an investment from an interest in a joint venture (joint control) to an interest in an associate (significant influence) is not viewed as changing the nature of the investment. Consequently, equity accounting is maintained. This is because the composition of the group (being a parent and its subsidiaries) has not changed, with the loss of joint control and retention of significant influence not being regarded as being sufficient to warrant remeasurement of the retained interest at fair value. This is in contrast to the approach required on loss of control of a subsidiary, where a partial interest is to be retained; that retained interest is remeasured to fair value with any adjustment to the carrying amount being recorded in profit or loss.

Effective date and transition

The new standards are effective for annual periods beginning on or after 1 January 2013, with earlier application being permitted provided that all five of the new standards are applied at the same time.

There are detailed transitional provisions in IFRS 10 and IFRS 11. A summary of key aspects is set out below.

IFRS 10

The new requirements are to be applied on a fully retrospective basis, in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*, with the following guidance also being applicable:

- An entity that is a business that was not previously consolidated in accordance with IAS 27 and SIC-12 may be required to be consolidated by IFRS 10. In such cases, the assets, liabilities and non-controlling interests in that entity are required to be accounted for as if IFRS 3 had been applied from the date on which control was obtained on the basis of the requirements of IFRS 10.
- An entity that is not a business that was not previously consolidated in accordance with IAS 27 and SIC-12 may be required to be consolidated by IFRS 10. In such cases, the assets, liabilities and non-controlling interests in that entity are required to be accounted for as if IFRS 3 had been applied from the date on which control was obtained on the basis of the requirements of IFRS 10, but without recognising any goodwill. Any difference, as at the date of initial application of IFRS 10, between the net amount of assets, liabilities and non-controlling interest recognised and the previous carrying amount is recognised as an adjustment to equity.
- If it is impracticable (as defined in IAS 8) to apply the requirements summarised above on a fully retrospective basis, then the application of IFRS 3 is carried out at the beginning of the earliest period for which this is practicable. The guidance notes that this may be the current period. In such cases, the investor recognises any differences between the assets, liabilities and non-controlling interest and the previous carrying amount as at the deemed acquisition date as an adjustment to equity for that period.
- Similarly, if the application of IFRS 10 results in an investee no longer being consolidated, the retained interest is measured on the basis of the fully retrospective application of the new requirements. If measurement on this basis is impracticable (as defined in IAS 8), then the loss of control is accounted for at the start of the earliest period for which this is practicable. Again, the guidance notes that this may be the current period. In such cases, the investor recognises any difference between the previous carrying amounts of assets, liabilities and non-controlling interest and the carrying amount of the retained interest as at the deemed acquisition date as an adjustment to equity for that period.

IFRS 11

Change from proportionate consolidation to the equity method

Where an entity changes from proportionate consolidation to the equity method, that change is recognised at the start of the earliest period presented in the financial statements. The initial carrying amount of the investment is the net asset value of the assets and liabilities that were previously proportionately consolidated. That carrying amount is assessed for impairment at that point before the subsequent application of equity accounting.

When the proportionately consolidated assets and liabilities are 'collapsed' into a single amount for the purposes of equity accounting, the initial recognition exemption in IAS 12 does not apply. Consequently, it is possible that there will be a related deferred tax adjustment if there is a difference between the carrying amount of the investment and its tax base.

Where the aggregation of proportionately consolidated amounts results in a negative (liability) amount, an assessment is carried out of whether the reporting entity has legal or constructive obligations in respect of that negative amount. If so, the liability is recognised. If a liability is not recognised, disclosures are required of the unrecognised share of losses.

Joint operations – change from the equity method to accounting for assets and liabilities

Where an entity changes from the equity method to accounting for assets and liabilities, that change is recognised at the start of the earliest period presented in the financial statements. The entity recognises its share of each of the assets and liabilities in respect of its interest in the joint operation, including any goodwill.

The adjustment for any difference between the previously recognised amounts under equity accounting and the share of assets and liabilities depends on whether the net amount of the assets and liabilities is higher or lower than the previously recognised amount. If it is higher, the difference is first applied against any goodwill balance recognised with the excess, if any, being recorded in equity. If it is lower, the difference is recorded in equity. The requirement to adjust goodwill is linked to the IAS 28 requirement that, when accounting using the equity method, an impairment loss is not allocated to any underlying asset, including goodwill. Consequently, for a previously impaired interest that had been accounted for in this way, the net amount of the underlying assets and liabilities could be higher than the (previously) impaired carrying amount of the investment.

IFRS 12, IAS 27 and IAS 28

There are no specific transitional provisions, with each of the standards being required to be applied on a retrospective basis.

However, entities are encouraged to provide some or all of the information required by IFRS 12 earlier than the effective date of periods beginning on or after 1 January 2013. If these disclosures are provided, this does not result in the entity being required to early adopt the requirements of the other four new standards.

This publication has been carefully prepared, but it has been written in general terms and should be seen as broad guidance only. The publication cannot be relied upon to cover specific situations and you should not act, or refrain from acting, upon the information contained therein without obtaining specific professional advice. Please contact your respective BDO member firm to discuss these matters in the context of your particular circumstances. Neither BDO IFR Advisory Limited, Brussels Worldwide Services BVBA, BDO International Limited and/or BDO member firms, nor their respective partners, employees and/or agents accept or assume any liability or duty of care for any loss arising from any action taken or not taken by anyone in reliance on the information in this publication or for any decision based on it.

Service provision within the international BDO network of independent member firms ('the BDO network') in connection with IFRS (comprising International Financial Reporting Standards, International Accounting Standards, and Interpretations developed by the IFRS Interpretations Committee and the former Standing Interpretations Committee), and other documents, as issued by the International Accounting Standards Board, is provided by BDO IFR Advisory Limited, a UK registered company limited by guarantee. Service provision within the BDO network is coordinated by Brussels Worldwide Services BVBA, a limited liability company incorporated in Belgium with its statutory seat in Brussels.

Each of BDO International Limited (the governing entity of the BDO network), Brussels Worldwide Services BVBA, BDO IFR Advisory Limited and the member firms is a separate legal entity and has no liability for another such entity's acts or omissions. Nothing in the arrangements or rules of the BDO network shall constitute or imply an agency relationship or a partnership between BDO International Limited, Brussels Worldwide Services BVBA, BDO IFR Advisory Limited and/or the member firms of the BDO network.

BDO is the brand name for the BDO network and for each of the BDO member firms.

© 2011 BDO IFR Advisory Limited, a UK registered company limited by guarantee. All rights reserved.

www.bdointernational.com