REGAINING CONTROL

In response to the global financial crisis, the International Accounting Standards Board (IASB) committed to address as a matter of urgency perceived inadequacies with the consolidation model, most notably the consolidation of so-called special purpose entities. Almost three years later, the IASB has finally delivered on that commitment by issuing the 'package of five' standards to deal with consolidation and related matters. **Glenn Gillard** and **Goind Ram Khatri** ask whether the new standards really change the game or just create new rules for bending.

Back in 2008, amidst the sense of impending financial doom, we were all cheered up by the lay man explanations of the financial crisis. Even today many a lecturer can't resist logging on to YouTube to play the Bird and Fortune sketch for an eager set of business students to liven up their class. However, a fundamental question lay beneath many of these analyses of the subprime crisis – how did the banks manage to get the loans off their balance sheet? The same fundamental question was asked of the IASB and the Financial Accounting Standards Board (FASB) by the G20 leaders and the Financial Stability Board. One of the commitments in 2008 of the IASB, as part of the one hundred day response, was to address the question of consolidation.

It has taken much more than 100 days (you can actually add on a zero), but in reaction to these calls for answers, the IASB in May 2011 issued the 'package of five standards' on consolidation. Each of the standards in the 'package of five' has an effective date for annual periods beginning on or after 1 January 2013, with earlier application permitted, subject to EU endorsement, so long as each of the standards in the package is adopted early.

PRINCIPLE OF CONTROL

IFRS 10: *Consolidated Financial Statements* (the standard), one of the five standards, establishes a single consolidation model, based on control, for all entities, regardless of the nature of the investee, unlike the current standards which establish two different models: 'risks and rewards' for special purposes entities and the 'power to govern the financial and operating policies' for other entities. The concept of control as used in the standard is based on the relationship between the investor and the investee. 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. Thus the principle of control sets out the following three elements of control:

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.

These three elements together significantly broaden the definition of control and, therefore, are intended to result in more instances of consolidation, including instances of *de facto* control.

Power over the investee
Power exists when the investor has rights that give it the ability to direct the relevant activities of the investee which significantly affect the returns of the investee. Power not only arises through the voting rights but can also arise through other contractual rights. Other decision-making rights, in combination with voting rights, can give an investor the current ability to direct the relevant activities. 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. Therefore, an investor can have power even if it holds less than a majority of the voting rights of an investee.

A key area of debate in respect of control has been where a party holds protective rights. IFRS 10 distinguishes between protective rights and substantive rights. Protective rights are the rights designed to protect the interest of the holder and, as such, cannot provide power over an investee. An example of protective rights includes 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. Therefore protective rights do not result in an entity having control.

Exposure to variable returns
In order to control an investee, an investor must have exposure, or right, to variable returns of the investee in addition to power. Variable returns are the returns which are not fixed and have the potential to vary as a result of the performance of an investee. Variable returns can be only positive, only negative or both positive and negative. A fixed performance fee for managing the investee's assets is a variable return because it exposes investors to the performance risk of the investee. The amount of variability depends on the investor's ability to generate sufficient income to pay the fee. Examples of returns include dividends, residual interests in the investee's assets and liabilities on liquidation, interest, management or service fee arrangements, interest and returns that are not available to other interest holders.

Ability to use power
Lastly, one of the fundamental components of the control model, is the ability of the investor to use its power to affect the investor's returns. In order to have control over an investee, an investor must not only have power over the investee and exposure or rights to variable return from its involvement, but must also have the ability to use its power to affect the return from its involvement with the investee.

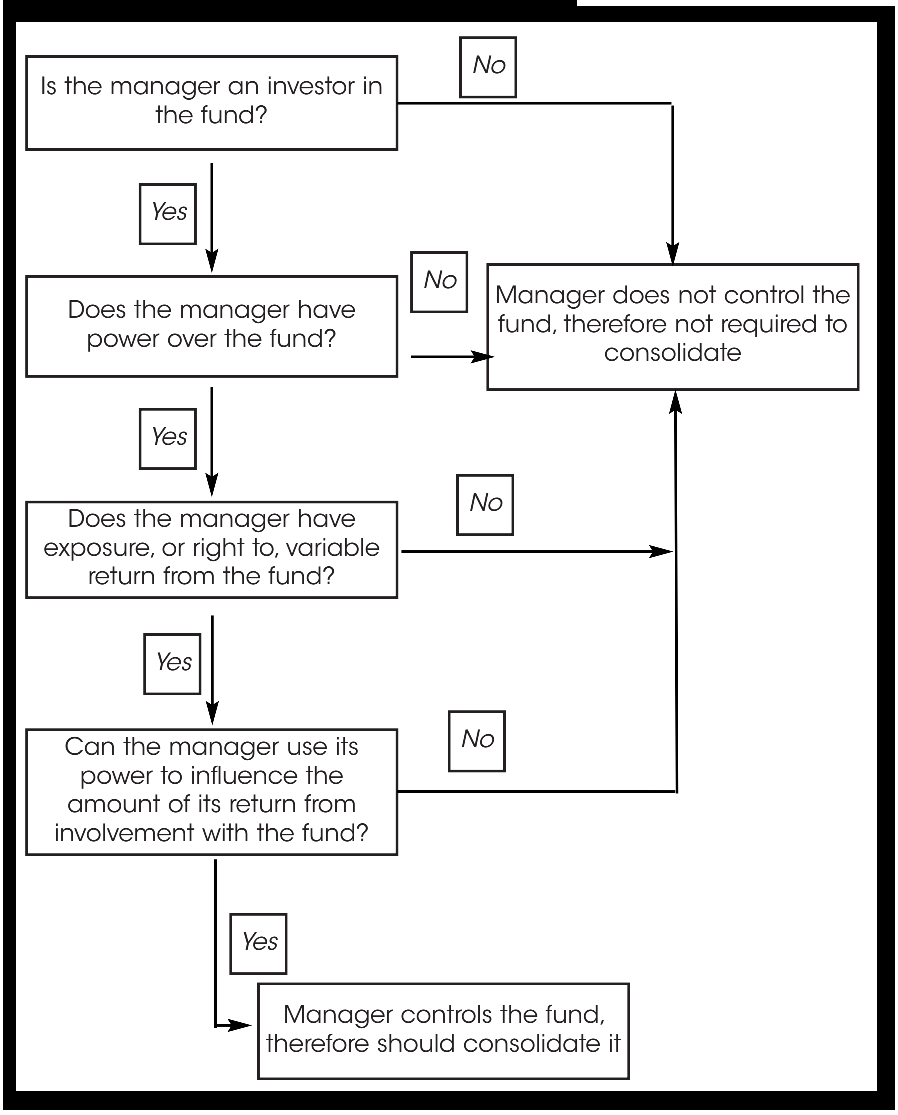
As a further consideration, IFRS 10 introduces guidance on assessing whether an entity is a principal or an agent. An investor with decision-making rights shall determine whether it acts as a principal or an agent. An agent is a party primarily engaged to act on behalf of and for the benefit of another party or parties (the principal(s)) and therefore does not control the investee when it exercises its decision-making authority. The standard provides a list of factors which should be considered to determine whether the decision maker acts as an agent or a principal.

APPLICATION IN PRACTICE
In line with the approach adopted for most of its recent standards, the IASB has recognised the need for application guidance. In fact, IFRS 10 runs to only twelve pages with nearly another forty pages dedicated to application guidance. While the application guidance is extremely useful, many of the examples provided illustrate that a significant level of subjectivity remains within the consideration of whether to consolidate.

A good illustration of this point is the application guidance around determining whether an investor has the current ability to direct the relevant activities of the investee. The example provided in the standard relates to a securitisation or special purpose vehicle structure (the type of entity that the standard is meant to be directly targeting). While the example provides a good analysis of the key considerations, it provides little by way of bright lines in assessing the consolidation question which is likely to lead to uncertainty until consensus emerges from practitioners around these key areas of judgment.

> "THE CONCEPT OF CONTROL AS USED IN IFRS 10 IS BASED ON THE RELATIONSHIP BETWEEN THE INVESTOR AND THE INVESTEE. 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."

Chart A
Control model
Impact for an Investment Manager (the manager)



Another example of this uncertainty is in respect of entities that receive fees and also have an interest in an entity (common in the investment management industry). In certain scenarios, investment managers would be required to consolidate the funds they manage. However, assessing whether the manager acts as an agent or a principal can be very subjective.

Chart A summarises the impact of the control model for an investment manager.

Let us take an example of a manager that manages a regulated fund. The fund prospectus outlines the investment objectives of the fund but the manager has sole discretion in executing that objective by investing in particular assets. The manager is entitled to receive a management fee and an incentive fee of 1% and 20% respectively. The investment manager also takes 20% strategic investment in the fund.

Although the manager acts within the parameters of the prospectus, it is considered to have power over the fund because of its sole discretion in investing in particular assets. Such discretion enables the manager to direct the relevant activities of the fund. The manager's 20% ownership stake as well as its 1% and 20% fee arrangements exposes the manager to variability of returns from the activities of the fund. Furthermore, a 20% stake along with remuneration received could create exposure to variability of returns from the activities of the fund that is of such significance as to indicate the manager is acting in the role of principal rather than an agent.

As can be seen from the above example, the analysis still requires a final subjective consideration of all the factors together and will result in a lack of consistency at least until practice emerges.

CONCLUSION

It has been a long process for the IASB (if you don't believe us check out the evolution of the project on www.iasplus.com) and in many ways has illustrated just how difficult it is to create a standard that provides enough bright lines to ensure consolidation happens without creating scenarios where entities must consolidate other entities for little benefit to the user of the financial statements. It's interesting to see that the key elements of control finally agreed upon are not that different from the three criteria set out by IASB staff in September 2003.

So while we have had much debate and finally have a new standard, the fundamental issues remain the same with plenty of grey areas. Uncertainty remains a key element of the question of whether you consolidate or not. However, one thing is for sure, we'll still have people turning to YouTube to help teach the accountants of the future the lessons of the financial crisis.

Glenn Gillard, ACA is a partner with Deloitte and Goind Ram Khatri, ACA, FCCA is a manager in the same firm.