ISCTE Business School
Instituto Universitário de Lisboa

EFFECT ANALYSIS ON THE APPLICATION OF IFRS 10 COMPARED WITH THE IAS 27

Maria Salomé de Jesus Martins Morgado

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Orientadora:

Professora Doutora Isabel Lourenço

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Abstract

This study investigates the changes caused on the application of IFRS 10 *Consolidated Financial Statements* compared with the previous guidance IAS 27 *Consolidated and Separated Financial Statements* on the Consolidated Financial Statements.

IFRS 10 replaces the IAS 27 and is effective application started, for the annuals periods beginning on or after 1 January 2013.

With the objective of understanding it's possible effects, this work started to compare the standard currently applied (IAS 27) with the IFRS 10, and it is identified a number of differences, some of them that could be only complements or effective instructions of implicit references already on IAS 27 and with no practice consequences, but there are also existent differences.

To demonstrate the identified differences, some illustrative examples are used in this study, some of them adapted from the IFRS 10.

An exhaustive search was also done, through the universe of European Firms, with the intention of finding entities already applying the IFRS 10, to be able to analyze the impact of IFRS 10 on the scope of consolidation. Although in this early stage it was not so easy to find a case study, BASF Group and is participation on an investee, is presented in this study as a real example of a change in the consolidation method caused by the revised definition of control.

The result of this work gives support to real differences on the scope of consolidation with the application of IFRS 10. Some investors will control investees that they did not consolidate under IAS 27, and other investors will not consolidate investees that were consolidated under IAS 27. And also significant judgment will be needed on the applying of the new definition of control, and also the application guidance of the IFRS 10.

JEL Classification:

M41 (Accounting)

Palavras-chave: IFRS 10 *Consolidated Financial Statements;* IAS 27 *Consolidated and Separated Financial Statements;* Effect Analysis; Definition of Control

Resumo

Este estudo pretende analisar as diferenças de aplicação da IFRS 10 *Consolidated Financial Statements* comparado com o normativo anterior IAS 27 *Consolidated and Separated Financial Statements* nas Demonstrações Financeiras Consolidadas.

A IFRS 10 substitui a IAS 27, tendo como inicio para aplicação efectiva, para o período contabilístico iniciado a 1 de Janeiro de 2013 e posteriores.

Com o objectivo de compreender estes possíveis efeitos, este trabalho começa por comparar o normativo actualmente aplicado (IAS 27) com a IFRS 10, onde são identificadas algumas diferenças, sendo que algumas podem ser apenas complementos ou instruções de algumas referências já implícitas na IAS 27 que podem não ter consequências praticas, no entanto existem também diferenças efectivas.

Para demonstrar as diferenças identificadas, são usados neste trabalho alguns exemplos ilustrativos dessas diferenças, alguns deles adaptados da própria norma IFRS 10.

Foi também efectuado uma procura exaustiva, pelo universo dos Grupos Empresarias Europeus, com o objectivo de encontrar entidades já a aplicarem a IFRS 10, para se poder analisar qual a alteração da nova norma no perímetro da consolidação. Embora a procura nesta fase ainda tão embrionária não fosse assim tão fácil, o Grupo BASF e a sua aplicação numa empresa investida, é apresentada neste trabalho como um exemplo real de alteração do método de consolidação devido á aplicação da definição de controlo apresentada na IFRS 10.

O resultado deste trabalho dá apoio a diferenças efectivas, que vão ocorrer no perímetro de consolidação com a aplicação da IFRS 10. Alguns investidores vão controlar investidas que não consolidavam com a IAS 27 e outros não vão consolidar investidas que eram consolidadas com a IAS 27. Vai também ser necessário uma muito maior análise aquando da aplicação da nova definição de controlo, bem como todas as orientações adicionais relativas á existência de controlo que a norma oferece.

JEL Classification: M41 (Accounting)

Palavras-chave:

IFRS 10 *Consolidated Financial Statements;* IAS 27 *Consolidated and Separated Financial Statements;* Effect Analysis; Definition of Control

Executive brief

This study is focused on the new approach of control and also on the control decisions introduced by the IFRS 10 and that are expected to have an adjustment or not on the consolidated financial statements.

The work started to compare the standard currently applied (IAS 27) with the IFRS 10, issued by the IASB on the 12th of May 2011 as part of its new suite of consolidation and related standards, a number of differences are identified, some of them that could be only complements or effective instructions of implicit references already on IAS 27 and with no practice consequences, but there are main differences, that with the adoption of IFRS 10 may lead to significant changes in an entity's reported financial position and performance.

To demonstrate the probable changes identified, some illustrative examples are used in this study, some of them adapted from the IFRS 10.

A case study of a European Group is also presented, which illustrates the effect on the Consolidated Financial Statement, with the application of the revised definition of control, introduced by the IFRS 10.

The revised definition of control will probably guide to many changes on the consolidation of some entities: probably there will be entities previously not included on the consolidation, which this new definition will included them on the consolidation. This change probably represents more assets and liabilities on the books. Although, there may also be entities previously consolidated, that would not be considered on the consolidation, even though this is expected to be rare. In this case the change probably will take off those entities from the balance sheet.

Also the great adjustment introduced by IFRS 10 compared with the existing consolidation standard is a greater focus on which investor has the control over an investee`s activities instead of who has the majority of the voting rights. Much more judgment may be required to determine whether an entity has control. While the consolidation assessment may change for many entities, the effect will depend on the specific terms of each structure (purpose and the design of the investee).

On the contrary that it may seem, IFRS 10 does not introduce new concepts and consolidation requirements, instead it is built on the control guidance that existed in IAS 27 and SIC-12, but

also included additional context, explanations and application guidance that are constant with the definition of control.

At a very basic level, the consolidation decisions probably should be unaffected with the new consolidation model, stated by IFRS 10. The most significant changes will likely occur, in the cases of the more complex structures.

I think that the most important is not if whether the application of IFRS 10 will result in more consolidation or less, but whether the changes will result in consolidation that will better reflect the relationship between a reporting entity and an investee.

The present study wishes to demonstrate that IFRS 10 will result in more appropriate consolidation, because investors will consolidate investees only when they control them and at the same time they only will consolidate all investees that they truly control.

List of abbreviations

APB - Accounting Principles Board

ARB - Accounting Research Bulletin

ASB - Accounting Standards Board

ASC - Accounting Standards Committee

CAP - Committee on Accounting Procedures

CDS - Credit Default Swap

CFS – Consolidation Financial Statements

DM - Discussion Memorandum

ED - Exposure Draft

EU – European Union

FASB - Financial Accounting Standards Board

FRS - Financial Reporting Standards

GAAP - Generally Accepted Accounting Principles

IAS – International Accounting Standard

IASB – International Accounting Standards Board

IASC - International Accounting Standards Committee

IFRC - International Financial Reporting Interpretation Committee

IFRS – International Financial Reporting Standards

IOSCO - International Organization of Securities Commissions

SEC - Securities and Exchange Commission

SFAS - Statements of Financial Accounting Standard

SIC – Standing Interpretations Committee

SPEs – Special Purpose Entities

SSAP - Statement of Standard Accounting Practice

UK - United Kingdom

USA – United States of America

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1 – Introduction

This chapter will begin by presenting this study topics and the justification of their relevance as academic study and study value creator for great knowledge on the new approach of control and also on the control decisions introduced by the IFRS 10 and that are expected to have an impact or not on the consolidated financial statements.

Then will be defined general and specific objectives that the study proposes achieve defined and explained the focus of research and made a brief summary of each one of the sections of the thesis.

1.1Relevance of the theme and research focus

The IASB recently issued IFRS 10, which is effective for annual periods beginning on or after January 1, 2013. Early application is permitted.

IFRS 10, which supersedes the requirements relating to consolidated financial statements in both IAS 27, and SIC – 12, introduces a new, principles-based definition of control that applies to all types of investees, also including the special-purpose entities, to determine the scope of consolidation on the parent´s consolidated financial statements.

The principle key presented by the new standard is that control exists, and consolidation is required only if the investor owns power over the investee has exposure to variable returns from its involvement with the investee and also has the ability to use power over the investee to affect its returns.

Also the great adjustment introduced by IFRS 10 compared with the existing consolidation standard is a greater focus on which the investor has the control over an investee’s activities, instead of the entity who has the majority of the voting rights. Much more judgment may be required to determine whether an entity has control. While the consolidation assessment may change for many entities, the effect will depend on the specific terms of each structure (purpose and the design of the investee).

The relevance of this study is to investigate the changes caused on the application of IFRS 10 *Consolidated Financial Statements* compared with the previous guidance IAS 27 *Consolidated and Separated Financial Statements* on the Consolidated Financial Statements.

It is also very important to understand the possible changes that the application of IFRS 10 could impact on the universe of consolidated financial statements that will apply or already are applying the new standard.

The hopping of IASB with the recently issue of new standards to revise the existing guidance on consolidation is that the single model founded on a principles-based definition of control, will reduce structuring incentives, promote consistency, and improve transparency.

On the contrary that it may seem, IFRS 10 does not introduce new concepts and consolidation requirements, instead it is built on the control guidance that existed in IAS 27 and SIC-12, but also included additional context, explanations and application guidance that are constant with the definition of control.

At a very basic level, the consolidation decisions probably should be unaffected with the new consolidation model, stated by IFRS 10. The most significant changes will likely occur, in the cases of the more complex structures.

The result of this work gives support to real changes on the scope of consolidation with the application of IFRS 10. Some investors will control investees that they did not consolidate under IAS 27, and other investors will not consolidate investees that were consolidated under IAS 27. And also significant judgment will be needed on the applying of the new definition of control, and also the application guidance of the IFRS 10.

I think that the most important is not if whether the application of IFRS 10 will result in more consolidation or less, but whether the changes will result in consolidation that will better reflect the relationship between a reporting entity and an investee.

1.2 Objectives of the Study

The general objective of this work is to identify and to analysis the differences caused by the application of IFRS 10 *Consolidated Financial Statements* compared with the previous guidance IAS 27 *Consolidated and Separated Financial Statements* on the Consolidated Financial Statements.

1.3 Methodology Used

With the objective of understands the possible changes caused by the application of IFRS 10 *Consolidated Financial Statements*, this work started to compare the standard currently

applied (IAS 27) with the IFRS 10, and it is identified a number of differences, some of them that could be only complements or effective instructions of implicit references already on IAS 27 and with no practice consequences, but there are also existent differences.

To demonstrate the probable changes identified, some illustrative examples are used in this study, some of them adapted from the IFRS 10. Were also made and presented analysis under the IFRS 10 and also under the previous guidance (IAS 27). This analysis were carried out by identifying typical scenarios to focus those areas where is expect the most significant effects from applying IFRS 10 as compared to IAS 27, some of them already identified by the examples presented on the IFRS 10.

An exhaustive search was also done, through the universe of European Firms, with the intention of finding entities already applying the IFRS 10, to be able to analyze the impact of IFRS 10 on the scope of consolidation. Although in this early stage it was not so easy to find a case study, BASF Group and is participation on an investee, is presented in this study as a real example of a change in the consolidation method caused by the revised definition of control.

1.4 Work Structure

The organization of this thesis is based on four chapters.

In this first chapter is intended to frame the subject and explain its importance as a scientific study, define its focus, investigated and objectives to be achieved.

The second chapter is a revision of the historical literature of consolidated financial statements and its evolution.

The third chapter includes the main presentation of all identified situations; a number of differences with the application of IFRS 10, some of them that could be only complements or effective instructions of implicit references already on IAS 27 and with no practice consequence.

On the fourth and final chapter is also presented a case study of a European Group, which illustrates a real change on the Consolidated Financial Statement, with the application of the revised definition of control, introduced by the IFRS 10.

2 – Historic Introduction

To understand the practice of Consolidation and the Consolidated Financial Statements it is necessary to know the evolution of the practice and the rules on the elaboration of this information.

The production and the presentation of the Consolidated Financial Statements started in the USA in the beginning of the twentieth century.

In the beginning these presentations were prepared voluntarily, because there were no rules that could establish an obligation to the societies to publish this kind of information.

The necessity began on the USA with the emergence of the holding societies, mainly because in these societies the individual financial information has no economic meaning (these societies do not develop any activity directly, for this reason their assets summarize only a group of financial investments), as well as the positive social surrounding to renovation and also because some authors present a positive opinion of the Consolidated Financial Statements production.

As it lives a situation that was characterized by the nonexistence of the legal barriers to the appearance of new accounting techniques, this with the necessity sight near the holding societies make easier the emergence of the first consolidated financial statements.

Indeed, Mumford (1982), Rodríguez Figueroa (1986) e Chatfield e Vangermeersch (1996), mentioned the developed work by Arthur Dickinson, partner of Price Waterhouse in the USA and to point out financial statements of 1902, published in 1903, of the United States Steel Corporation audited by Price Waterhouse, has the first step on the divulgation of the DFC in the USA.

As referred to by some authors as Walker (1978), Mumford (1982), Nobes (1993) e Taylor (1996) the production and presentation of the DFC on the USA became a generally accepted practice in the 1920´s, although they were not required by law.

Because of the Stock Exchange crash of 1929, investors trust and credibility in the financial market was affected, it was concluded that one of the motives for it happening was the missed reliable and compared financial information not accessible to the investors as refers

Meek (1997). Therefore two federal laws were issued, through that it search to regulate the process associated to the transactions carried out at stock exchanges: the *Securities Act* 1933 and the *Securities Exchange Act* 1934.

The first one regulated, among other aspects, the information published at the time of the admission to the stock exchange of a society. The second one, besides imposing the publishing of the periodic financial information of the entities admitted, allows for the creation of the *Securities and Exchange Commission* (SEC), an organization that should guarantee the application of those laws and who's the main function it was to assure that the investors had access to all the information needed to make decisions.

Although it has the legal power to issue the elaborating financial statement rules demand by itself, the SEC only assumes the supervision mission, allowing and encouraging the private sector to take on the work of issuing the rules known today as *Accepted Accounting Principles* (GAAP).

The first entity to issue GAAP was the *Committee on Accounting Procedures* (CAP). CAP issued between 1939 and 1959, fifty-one, *Accounting Research Bulletins (ARB).*

ARB 51, issued in 1959, *"Consolidated Financial Statements"* was the last announcement of the CAP.

This ARB was primarily descriptive rather than prescriptive; it described what was considered acceptable practice at the time, expressing some preferences and setting few hard and fast rules. ARB 51 states a strong position in favor of consolidated financial statements.

In ARB 51 there is a presumption that consolidated statements are more meaningful than separate statements and they are usually necessary for a fair presentation when one of the companies in the group directly or indirectly has a controlling financial interest in the other companies.

This controlling financial interest has the usual condition the ownership of a majority voting interest, and, therefore, as a general rule ownership by one company, directly or indirectly, of over fifty per cent of the outstanding voting shares of another company.

However there were exceptions to the general rule if the control was likely to be temporary or if the control did not rest with the majority owner.

On the other hand, the ARB 51 described what has commonly been referred to as the “nonhomogeneity” exception, where separate statements or combined statements would be preferable for a subsidiary or a group of subsidiaries if the presentation of financial information concerning the particular activities of such subsidiaries would be more informative to shareholders and creditors of the parent company than would the inclusion of such subsidiaries in the consolidation.

The nonhomogeneity exception was permissive, not mandatory.

Subsequently, the CAP was replaced by the Accounting Principles Board (APB) that issued, between 1959 and 1973, thirty-one APB Opinions and four APB Statements.

In 1973, the APB was replaced by the Financial Accounting Standards Board (FASB), independent organization that issued a set of Statements of Financial Accounting Standard (SFAS), between then the remark the SFAS 94 (1987): “Consolidation of All Majority-Owned Subsidiaries”, that change some of predicted on the ARB 51, particularly on the exceptional exclusions the subsidiaries of the consolidated statements, and the SFAS 141 (2001): “Business Combinations” and 142 (2001): “Goodwill and Other Intangible Assets”, that respectively changed the APB Opinion 16 and 17.

As part of the Board Consolidations Project, the Board issued Statement 94 in October 1987, amending ARB 51 to eliminate the nonhomegeneity exception. It requires consolidation of all majority-owned subsidiaries unless control is likely to be temporary or does not rest with the majority owner. The Board establishes that consolidation of all majority-owned subsidiaries whose control is not in question is consistent with all the reporting entity concepts and consolidation policies.

However neither the FASB concepts Statements nor authoritative accounting standards expressly define e concept of the reporting entity or describe concepts of consolidated financial statements.

The rules issued since the late 1970s do not provide much more guidance on those concepts, particularly on the notion of financial control.

Finally, in 1982, the SEC urged the Board to undertake a major project on consolidation and related matters.

From that FASB started to issue the Discussion Memorandum (DM) 27 (1991): "Consolidation Policy and Procedures", which result on the "Preliminary View (1994): "Consolidation Policy" and the "Exposure Draft" (ED) 133 (1995): "Consolidated Financial Statements: Policy and Procedures".

It was FASB that wished to devote them first of all to the resolution of issues related to consolidation policy, more especially to the identification of the entities that should be included on the Consolidated Financial Statements. For this reason the ED 149 (1999): "Consolidated Financial Statement: Purpose and Policy" was issued.

On the other hand, FASB decided to assign to other projects some questions related with the consolidated procedures, namely:

- For the first stage of the project about business combinations, the first option for the accounting method to use, and the recognition option and the valorization of the acquired goodwill and the acquired negative goodwill. The FASB on the continuity of this work issued in 1999, the *ED* 154 (1999): *"Business Combinations and Intangible Assets"* and in 2001 also issued the definitive rules *SFAS* 141: *"Business Combinations"* and 142: *"Goodwill and Other Intangible Assets";*
- For the second stage of the project called of "Business Combinations: Procedures and New Basis Issues" FASB has the intention of take some decisions related to some procedures associated with the Acquisition Method.
- For the project about liability and equity and the option of the minority interest classification. The FASB added this program of work to his agenda in 1986 as an integral part of the global project of financial instruments, issuing in 1990, the *DM* 24: *"Distinguishing between Liability and Equity Instruments and Accounting for Instruments with the Characteristics of Both*" and the ED 158 (2000): *"Accounting for Financial Instruments with Characteristics of Liabilities, Equity or Both"*.

In December 2007 the FASB issued FAS No. 160 *"Noncontrolling Interest in Consolidated Financial Statements"* as an amendment of ARB No. 51. This statement establishes accounting and reporting standards for the noncontrolling interest in a subsidiary and for the deconsolidation of a subsidiary.

The Consolidated Financial Statements in Europe have a later development than in the USA, and it started in the United Kingdom, mostly because of an also later development of the holding societies as well as a more conservative accounting class.

The first entity to publish this kind of financial information on the UK was the *Peason and Knowles Coal and Iron Co. Ltd.,* but at this time this was not a habitual practice.

Eduard e Webb (1984) and Nobes and Parker (1995) have distinguished the developed work by Gilbert Garney, partner of the Price Waterhouse from the UK, that publication is the first literary work about consolidation procedures with the title of *Holding Companies and Their Published Accounts.*

The same authors also mention, the *Dunlop Rubber Co.*, consolidated financial statements, published has an integral part of the individual financial statements, in 1933, which have an important step to the development of the CFS.

But it is only after 1947, that the elaboration and publishing of this kind of information is generalized, only as a complement and not as a substitute of the Individual Financial Statements of the mother society. These occur because of the issuing of the *Companies Act,* which establishes the publishing obligation of the CFS for the companies that accomplished the established requisites.

In 1970, the *Accounting Standards Committee (ASC)* was created*,* with the main objective of defining accounting definitions, to decrease the differences on the production of the financial information and to codify the generally accepted practices.

Until 1990, this organization issued 25 Statements of Standard Accounting Practice (SSAP).

Although the obligation of the vertical group to produce the Consolidated Financial Statements existed, it only started after the transposition of the VII communitarian guideline to the national legislation, in 1983, and this transposition happens through the change on the *Companies Act 1985,* in 1989.

It is in the sequence of this event that the rules to apply become compulsory by law.

Finally, in 1990, the *Accounting Standards Board (ASB)* was created, which was the substitute of the *ASC* on the production of the accounting rules. This Organization issued the *Financial Reporting Standards (FRS).*

The IASB:

The IASB is an organization formed in 1973, first with the name of *International Accounting Standards Committee (IASC)*, with the objective of formulating and publishing rules that normalize the production of the Individual and Consolidated Financial Statements, and promote it's acceptance and application at an international level, with the main purpose of the international harmonization of the practice on the elaboration of the financial information.

The work created by this organization could be divided into four stages, with distinctive characteristics, the first one happens between 1973 and 1989, the second one has is beginning in 1989 and it ends in 1994, the third one started in 1995 and it ends in 2002, the fourth and the last one includes the year of 2002 and the subsequent ones.

In the first step the IASB issued 29 rules, characterized by a descriptive approach, and once its content was based on the practice most used on the countries with more tradition in accounting matters. In the issued rules by the organization to emphasize the *IAS* 3 (1976): *"Consolidated Financial Statements"* and the *IAS 27* (1989): *"Consolidated Financial Statements and Accounting for Investments in Subsidiaries*".

The *IAS 27* was approved for issuance in 1988 and is effective for periods beginning on or after January 1, 1990. *IAS 27* replaces IAS 3, *Consolidated Financial Statements. IAS 27 recognizes* that control can exist other than through ownership of voting rights and requires consolidation of all controlled companies.

The second phase, which is the publication period for the document named *"Framework for the Preparation and Presentation of Financial Statements"* in 1989, and the *"Statement of Intent on Comparability of Financial Statements"* in 1990.

To fill the gap in the theory basis, the conceptual structure emerged that would become the support and the justification for the rules issued and to the rules that needed examination, and at the same time it was the guarantee of the internal consistency of those rules. As a result of the conceptual structure, at the end of 1993, ten *IAS* were revised and also issued, to give emphasis to the *IAS 22,* a set of reformulations to the remaining regulations that were still used, particularly the *IAS 27,* were also issued.

In the situations marked by the IASB with two alternative accounting treatments, the first one is the practice more acceptable and also the way more attached with the conceptual structure,

and the second alternative is the less consensual way, but it is also supported by the conceptual structure contained issued in 1989.

The third stage began on 1995 with the celebration of the agreement with the *International Organization of Securities Commissions (IOSCO),* with the objective of developing a work plan, with the intention to create a body of rules.

In that context some accounting questions were analyzed and some were not foreseen in the existing rules, as a result a set of new rules were published and some of the ones already existent were revised.

At the same time a *Standing Interpretations Committee (SIC)* was created, with the main objective of giving some guidance to the divergences on the treatment of some accounting issues. On the various documents produced by the committee to distinguish the *SIC 12* (1998):*"Consolidation – Special Purpose Entities"*. The *SIC 12* clarifies some aspects related with the application of the *IAS 27*.

In 2001 the IASB changed is designation from the old *(International Accounting Standards Committee – IASC)* to be current designation (*IASB*). The *SIC* also had a new designation, *IFRC (International Financial Reporting Interpretation Committee)*. On that date the IASB also took the decision of changing the designation of is rules to *(IFRS – International Financial Reporting Standards)*.

The fourth stage is highlighted by the application of the IASB rules by the UE, in the sequence of the approval of the regulation 1606/2002 of the UE.

In the development of that decision taken in Europe the IASB advance a project to improve the already existing rules, and it is issued in 2003, 13 changed *IAS*, between them to mark the *IAS 27.* This version requires Non Control Interest to be presented within equity, instead of a hybrid element presented separately from liabilities and from equity.

Besides that, the IASB had already issued new rules, named by *IFRS;* between them was the IFRS 3, *Business combinations,* 2004.

In 2008 the IAS 27 and the IFRS 3 had another version. This new version of the IAS 27 requires that changes in a parent's ownership interest in a subsidiary that does not result in a loss of control should be accounted for as equity transactions.

Although emanate IFRS, has as main objective the full international comparability, it is not yet arrived, “as long as accounting standards contains options and require use of judgment, some variation in accounting practice is inevitable” as refers Kvaal and Nobes (2010:173).

On May 12th, 2011, IASB issued the IFRS 10 – *Consolidated Financial Statements,* which replaces IAS 27 and SIC 12.

Under IFRS 10, control is the single basis for consolidation, irrespective of the nature of the investee.

3 – Effect analysis IFRS 10 / IAS 27

IFRS 10 replaces the IAS 27 and also the SIC -12 and its effective application started, for the annual periods beginning on or after 1 January 2013.

The constant divergence between IAS 27 and SIC-12, in order to determine which one was the more significant, had lead to different conclusions on the application of the concept of control. These divergences where mainly because the definition of control under IAS 27 is explained as “the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities” and the interpretation of control standard on the SIC-12, but only in the context of special purpose entities, give large importance to the risks and rewards.

There are also many constituents that requested some guidance on the following aspects of IAS 27, for example: “whether a reporting entity can control another entity even though it holds less than the majority of voting rights in that entity”; “how potential voting rights affect the control assessment in IAS 27”; ”when approval or veto rights of other parties prevent a reporting entity from having control of an entity”; ”how to identify agents that act for a reporting entity”; and “how to assess control when a reporting entity acts simultaneously in the role of a principal and agent”.

As a result there was the necessity to clarify the definition of control and to provide additional application guidance.

IFRS 10 changes the further view of consolidation, because there were two different consolidation models: one for special purpose entities and another for all the other investees. In IFRS 10 the initial objective achieved was to develop a single consolidation model applicable to all the investees.

On the whole, the application of the new standard will need significant judgment in many aspects.

3.1 Definition of Subsidiary

IFRS 10	IAS 27
A subsidiary is an entity that is controlled by another entity.	A subsidiary is an entity, including an unincorporated entity such as a partnership, that is controlled by another entity (known as the parent)

At first impression there is no difference in this definition, although the new definition seems much simpler. This is because the importance is all positioned on control and its definition.

There is no practical difference on assessing whether an investor includes the accounts of an investee on their consolidated financial statements, analyzing only the subsidiary definition.

3.2 Applying the definition of control

IFRS 10	IAS 27 and SIC-12
An investor controls an investee when is exposed, or has rights, to variable returns from its involvement with the investee and has the ability to affect those returns though its power over the investee.	Control is the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities (IAS 27). And the focus on the risks and rewards in the assessment of the control (SIC-12 *Consolidation-Special Purpose Entities*).

IFRS 10 introduces a consolidation model that builds upon the requirements and the concepts of the IAS 27 and SIC-12, although the consolidation model established by IFRS 10 applies to all investees (a single control model).

The new standard does not introduce new concepts and consolidation requirements when compared to IAS 27 and SIC-12. On the other hand, instead of introducing new concepts, it was built on the control guidance already existing in IAS 27 and SIC-12, but it is completed with additional context, explanation and application guidance that is coherent with the definition of control.

Similar to IAS 27 and the SIC-12, the consolidation model in IFRS 10 is also based on control, given that the investor is required to consolidate an investee, when it has control over that investee.

However, IFRS 10 more clearly articulates the principle of control, in order to be more basically applied to all investees. It defines control as consisting of three elements: power, exposure to variable returns, and an investor's ability to use power to affect its amount of variable returns.

Additionally the principle of control and its three elements are exposed in detail all over IFRS 10 and application guidance is also provided, as well as application examples.

Otherwise IAS 27 and SIC-12 did not enclose a detailed explanation of the control definition, as they did not provide application guidance.

IFRS 10 also includes application guidance regarding situations in which control is difficult to assess.

The two different approaches on the requirements for assessing control established on the previous standards: IAS 27 focused on the power to govern financial and operating policies, and SIC-12 focused on exposure to a majority of risks and rewards had led to several inconsistencies on the application of IAS 27 and SIC-12 that have resulted in diversity in practices. Also because some reporting entities found it difficult to determine which investees were within the scope of IAS 27 or SIC-12.

IAS 27 and SIC-12 also led to a focus on “bright lines” and structuring opportunities, because of the risks and rewards approach in the assessment of control. This “bright lines” and structuring opportunities allow reporting entities wishing to achieve particular accounting outcomes.

This new control model is built on principles rather than bright lines, so probably will result in accounting that better reflects the economic substance of the fundamental relationships between the entities.

The previous standard had two different consolidation models, one for all investees (IAS 27) and other for special purpose entities (SIC-12). The first one is based especially on the voting power of the dominant entity, because on IAS 27 control is presumed, when the parent owns more than half but although it has power “to govern policies; to appoint the majority of the

Board of Directors; or to cast the majority of the votes of the Board of Directors". The second one (SIC-12) is based on the risks and rewards.

On this new consolidation standard (IFRS 10), the objective of the IASB was to develop one consolidation model with a definition of control applied to all investees.

As a result IFRS 10 identifies control as the single basis for consolidation, regardless of the type of the entity to consolidate. Now control determines which the entities that should be consolidated are. This standard therefore eliminates the risks-and-rewards advance in SIC-12.

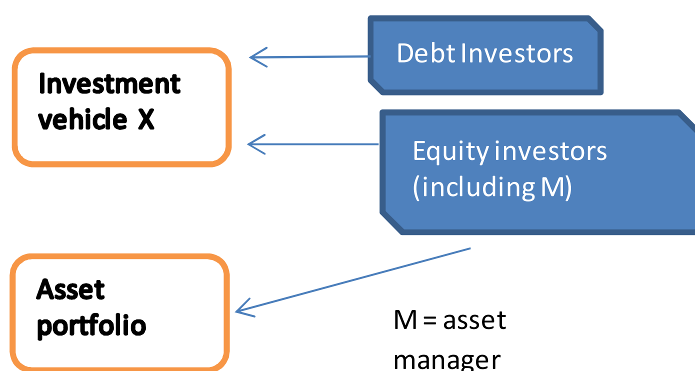
The single control model applied to all the investees could impact on the control conclusion because it could change for SPEs currently in the scope of SIC-12, given that the changing from a risk and rewards model is expected to change the consolidation conclusion in some cases.

There will probably be investees, currently not in the scope of SIC-12, for which rights other than voting rights are relevant in assessing control.

This could be demonstrated on this example:

3.2.1 Example 1

Figure 1 - Example applying the definition of control



Investment vehicle X was created to buy a portfolio of financial assets, funded by debt and equity instruments issued to a number of investors.

Investor A holds 30 percent of the equity and it was also the managing of the asset portfolio guidelines. This management includes decisions about the selection, acquisition and disposal

of the assets inside those portfolio guidelines. And the management is responsible for any asset in the portfolio.

3.2.1.1Analysis under IFRS 10

A as the ability to direct the relevant activities and has rights to the variable returns from the performance of the vehicle and also has the ability to use that power to affect his owns returns, so under the IFRS 10, A controls X.

3.2.1.2 Analysis under IAS 27

Because IAS 27 does not provide enough guidance regarding control with less than a majority of voting rights, this illustration could be an example of inconsistency in the application of the definition of control. Some would focus on the 30 percent voting interest to say that Investor A does not control Investee X because it does not have the majority of the voting rights. So A does not consolidate X, because it has less than half of the voting power of entity X, and it has no power to govern the financial and operating policies of X, under a statute or an agreement.

On the other hand, others could probably focus on the investor A´s rights to direct the activities of investee X and conclude that investor A controls Investee X and should consolidate that entity.

3.2.1.3 Considering SIC-12

If it is assumed in the analysis that X is an SPE in the scope of SIC-12. There probably also be a different interpretation of SIC-12 in this model, that would depend on the risks and rewards indicators rather than the purpose for which Investee X was created. So the analysis provided under SIC-12 is that some would conclude that A does not consolidate the investment vehicle, based on the fact that M does not have the majority of risks and rewards.

3.3 Definition of control

IFRS 10	IAS 27
An investor controls an investee when is exposed, or has rights, to variable returns from its involvement with the investee and has the ability to affect those returns though its power over the investee.	Control is the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities.

3.4Elements from the definition of control

3.4.1Power

	IFRS 10	IAS 27
Power	"To have power over an investee, an investor must have existing rights that give the current ability to direct the relevant activities. For the purpose of assessing power, only substantive rights and rights that are not protective shall be considered."	Under IAS 27 power is a part of the definition of control: "power to govern the financial and operating policies of an entity so as to obtain benefits from its activities."

One of the factors that most contributes to a more appropriate consolidation is a clearer definition of power, one of the three elements of control. Because, in this model the power, depends on the assessment of all existing rights that an entity and other investors have in relation to the activities of an investee.

"Power" as defined under IFRS 10, exists when an investor has existing rights that give it the current ability to direct the activities that significantly affect the returns of an investee. The activities that significantly affect the returns of an investee are the "relevant activities". Power arises generally through voting rights by equity instruments, although it is not the only to acquire them, but can also arise through other contractual arrangements.

As a result of this definition of power, there are two significant concepts that are critical when the investor makes the assessment to evaluate if it has power over the investee: “relevant activities” and “existing rights”.

If there are different relevant activities on an investee and two or more investors have rights to direct diverse of that activities, it is necessary to analyze and decide which of that relevant activities most significantly affect the returns of the investee.

Paragraphs B3 e B4 of IFRS 10 state that an investor should consider the following factors in determining whether it has power over an investee:

- The “purpose and design of the investee”.
- The relevant activities of the investee and “how decisions about those activities are made”.
- Whether the investor`s rights “give it the current ability to direct the relevant activities”.
- “Whether the investor is exposed, or has rights, to variable returns from its involvement with the investee”.
- “Whether the investor has the ability to use its power over the investee to affect the amount of the investor`s returns”.
- The investor`s “relationship with other parties.”

Power could came through the owning of rights to direct the relevant activities, and those rights do not need to be exercised to give an investor with power, because this definition of power is based on ability.

In IAS 27, power to govern the financial and operating policies is one means to obtain power to direct the activities of the investee, but it is not the only means. Because power could be achieved through many ways, and that is the one of the main changes, by having voting rights, by having options or convertible instruments, by means of contractual arrangements, or a combination of these, or by having an agent with the ability to direct the activities for the benefit of the dominant entity.

At first glance it could conclude that the definition of control and the definition of power seem repetitive, because both definitions refer to returns. Power is defined as the current

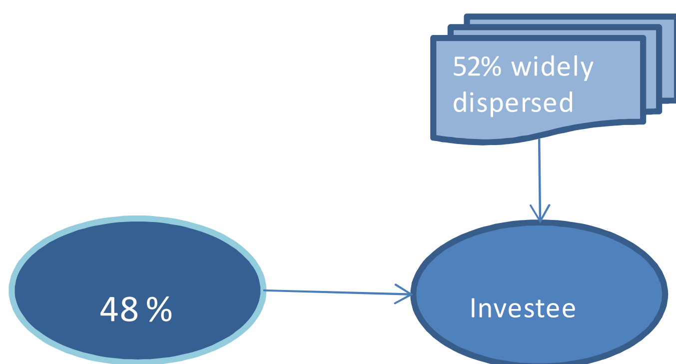
ability of the investor to direct the activities that affect significantly the returns of the investee. However the possibilities owned by the investor of managing the activities that are returns generating (power definition) is different from the ability possessed by the investor of through its power generate it owns returns (definition of control).

By articulating a clear principle of power and control, the chances that an entity to avoid consolidation by, for example, only focusing on risks and rewards, is very reduced for the reason that the consolidation's decision now depends on a full analysis of a reporting entity's relationship with an investee.

IFRS 10 on the paragraph B43 gives this example that could illustrate the changing that this new sight of power can take place:

3.4.1.1 Example 2 (IFRS 10 B43)

Figure 2 - Example power element from definition of control



An investor acquires 48 per cent of the voting rights of an investee. The remaining voting rights are held by thousands of shareholders, none individually holding more than 1 per cent of the voting rights. None of the shareholders has any arrangements to consult any of the others or make collective decisions. When assessing the proportion of voting rights to acquire, on the basis of the relative size of the other shareholdings, the investor determined that a 48 per cent interest would be sufficient to give it control.

3.4.1.1.1 Analysis under IFRS 10

In this case, the investor controls the investee on the basis of the absolute size of its holding and the relative size of the other shareholdings, the investor concludes that it has a

sufficiently dominant voting interest to meet the power criterion without the need to consider any other evidence of power.

3.4.1.1.2 Analysis under IAS 27

Under the IAS 27 the conclusion could be different because there the investor does not have the more than half of the voting power and it is not obvious that it has the power to govern the financial and operating policies, as defined in IAS 27.

So, because IAS 27 provided limited guidance, regarding control without a majority of voting rights, there probably will be inconsistent consolidation conclusions in this case. There could be drawn different "bright lines" by different investors regarding this concern. In some jurisdictions, the investor could be considered to control the investee with only 48 percent of the voting rights, though in others, the investors would not be deemed to control.

And also because in IAS 27 the assessment made to evaluate the ability to control based on de facto circumstance does not necessarily take into account the active or passive nature of the other shareholder, but rather considerers how many other shareholders are expected to vote in the same way as the investor.

3.4.2. Exposure, or rights, to variable returns

	IFRS 10	**IAS 27**
Exposure, or Rights, to Variable Returns	"When assessing whether an investor has control of an investee, the investor determines whether it is exposed, or has rights, to variable returns from its involvement with the investee."	This criterion was not considered on the IAS 27, as matter of fact, it does not make part of the definition of control.

The second element of the new definition of control is that the investor must be exposed or has the rights to the variable returns of the investee; this second criterion was not considered on the definition of control stated on IAS 27.

IAS 27 use the term "benefits", but IFRS 10 uses the term "returns" rather than "benefits", because of the misinterpretation that could be made. "Benefits" could imply only positive returns. So the use of the term "returns" is clearer on the explanation that a reporting entity

may obtain positive or negative returns. In this case IFRS 10 uses the term "returns" rather than "benefits" to make clear that the economic exposure that an investor has to an investee may be positive, negative or both.

IFRS 10 also enumerates several examples of returns from the involvement with the investee: "changes in the amount value of the investment, residual interest in cash flows of structured entities, dividends, interest, management or service fee arrangements, guarantees, tax benefits, or any other returns that may not be available to other interest holders". But while only the dominant investor can control the investee, many investors may share the returns of the investee.

The simple application of the second criterion of the definition of control does not mean that the investor has control. For the investor to have control it is necessary also to have power over the investee and also the ability to use the power to significantly affect the returns of the investee.

Although when the exposure, or rights to the variable returns of the investee, by the involvement of the investor, is excessively greater than its rights over the investee, this could be an indicator of control. However, it is not mandatory; the assessment of control should be completed by the investor, in the same, to determine if the control it is real.

IFRS 10 gives the example of an investor that holds a bond with fixed interest payment to clarify that certain fixed economic interest may still result in variable returns because they expose the investor to variability, because those returns are variable as they depend on the credit risk of the bond.

The new standard includes the ability to benefit of the investee's returns as an element of the definition of control, rather than simply defining the control as a synonym of power, just to exclude the situations where an entity might have power over another entity but only as a trustee or an agent.

As IAS 27 defines control as "the power to govern the financial and operating policies of an entity, as to obtain benefits its activities" and SIC-12 indicates a circumstance that might show that an entity controls an SPE, that is the entity must have the decision-making power to obtain the majority of the benefits of the activities of the SPE. The main change is that

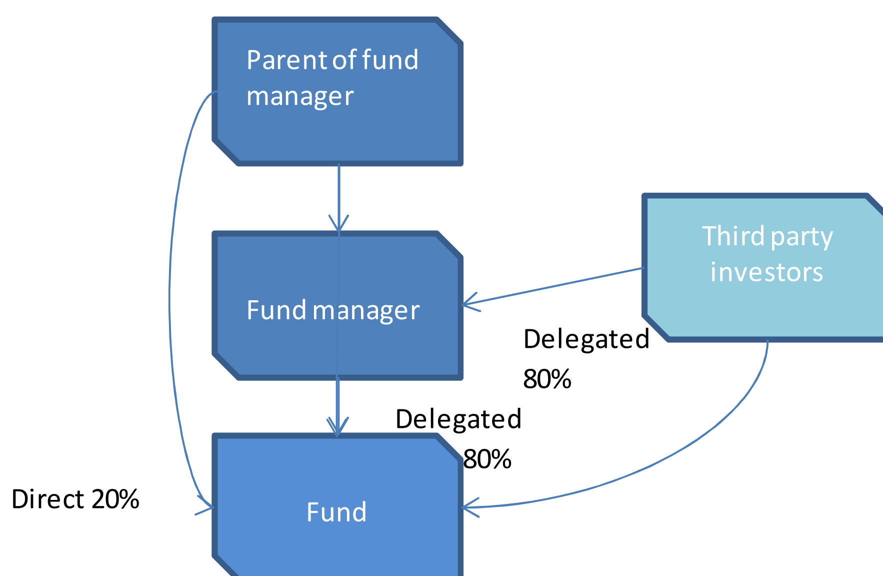
IFRS 10 requires that the investor must be exposed, or have rights, to the variable returns, as a result of its involvement with the investee, to control them.

It is also probably that an investor will more easily meet the new measure of being exposed or having rights to the variable returns of an investee than the criterion stand on SIC-12 of obtaining the majority of the benefits of the investee´s activities.

A potential impact of this change is that the variable returns, is a much more comprehensive concept than the ownership-type benefits and the solely risk and reward analysis, so as a result it may have impact on the control conclusion, mainly when the benefits stated on IAS 27 and SIC-12 were considered as ownership-type benefits and those benefits were dispersed.

3.4.2.1 Example 3

Figure 3 - Example exposure, or rights, to variable returns element from definition of control



A parent of a fund manager has a 20% direct interest in a fund. The other 80% of the fund is held by third party investors, who have delegated their rights to the fund manager. When assessing whether the parent controls the fund, it is necessary to know if the fund manager (parent) effectively use the power that has been delegated to it by the third parties that hold 80% of the interest.

Assuming that in this case the parent does not use that power of the indirect interest in the fund and could not benefit from that interest and it is not exposed to the variability of returns.

3.4.2.1.1 Analysis under IFRS 10

Under IFRS 10 and considering the exposure to variability of returns the parent does not control the fund, because it does not benefit of the power that has been delegated to it by the third parties.

3.4.2.1.2 Analysis under IAS 27

The analysis made by IAS 27 could not be the same because the parent has the majority of the voting rights 20% of them by direct owning and the other 80% of interest is by contractual arrangement.

Some investor would focus on the percentage of voting interest to say that investor controls the fund. And in addition some also argued the contrary based on the fact that the control was historically not exercised.

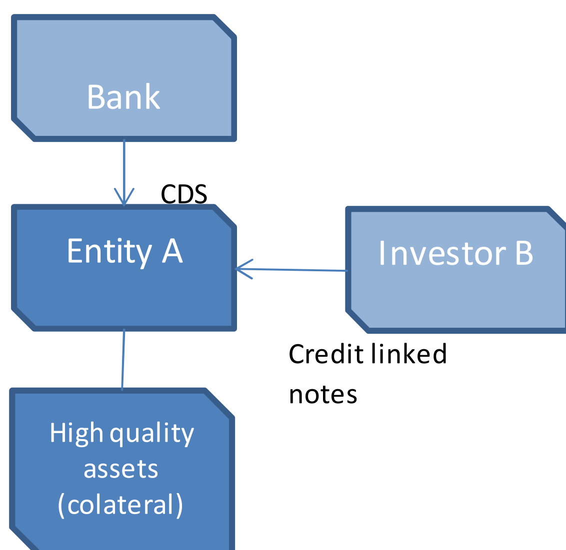
3.4.3 Ability to use power to affect returns

	IFRS 10	**IAS 27**
Ability to Use Power to Affect Returns	IFRS 10 states that to have control over an investee, an investor must have the ability to use its power over the investee to affect its returns from its involvement with the investee.	This criterion was not considered on the IAS 27, as matter of fact, it does not make part of the definition of control.

The third consideration in the assessment of control is that the investor must have the ability to use its power over the investee to significantly affect the returns of the investor. The interaction between the first two control components is essential on the assessment of whether an investor has control over an investee. An investor that has power through an investee, however it cannot benefit from that power, it does not control the investee, in the same way as an investor that has an exposure or as rights to the variable return of the investee, but it does not use it power to direct the activities that significantly affect the returns, does not control that investee.

3.4.3.1 Example 4 (Basis for conclusions to IFRS 10 BC66)

Figure 4 - Example ability to use power to affect returns element from definition of control



Vehicle A is established by B to provide them with investment opportunities that expose B to Entity C´s credit risk. C is not related and has no participation on A and B.

A issues notes that are linked to C´s credit risk to B and invests in a portfolio of high quality financial assets. A obtains exposure to C´s credit risk by entering into a credit default swap agreement (CDS) with a bank in return for a fee, with the portfolio of assets as collateral.

B does not have the ability to direct activities that significantly affect A´s returns.

3.4.3.1.1 Analysis under IFRS 10

Under IFRS 10 B does not consolidate A. Although B receives substantially all of returns, and is exposed to considerably all of the risks of A. B has no possibility of managing the activities that significantly affect the returns of A. B does not have power over A so it does not control A.

3.4.3.1.2 Analysis under IAS 27

B control A, because it has more than half of the voting rights of A.

Presume that A is an SPE in the scope of SIC-12. The analysis provided under SIC-12 is that B consolidates A, because A was created for the benefit of B and B is exposed to all of the risks and rewards of A and it also receives all of the returns of A.

On the example 4 and in addition, The Project *Summary and Feedback Statement* states that although an investor may conclude under IFRS 10 that it does not consolidate an investee that it used to consolidate under SIC-12, the effect of deconsolidation will be alleviate by the derecognition requirements for financial instruments in an number of cases. In effect, if the investor has transferred assets to a vehicle for which it bears the majority of risks and rewards, even if it does not control the vehicle under IFRS 10, then typically it will not derecognise the assets transferred to that investee according to the derecognition requirements in IFRS 9.

3.5. Relevant activities

	IFRS 10	**IAS 27**
Relevant activities	Relevant activities are defined in IFRS 10 as “the activities of the investee that significantly affect the investee`s returns”.	This definition was not considered on the IAS 27, as matter of fact, it does not make part of the definition of control.

IFRS 10 introduces the reference to activities that significantly affect the returns of the investee and provides explicit guidance for the investor to consider which activities should be analyzed when assessing control over an investee. This is very important in particularly for entities with prearranged activities and when activities for a specific event are only administrative with no effect or a minimum effect on the returns of the investee. How much more are the activities of an entity predetermined, more important is the design of the investee and is activities on the evaluating of the possession of power over the relevant activities.

IFRS 10 on the paragraph B11 and B12 gives this example: an entity that its operations are managed through voting rights the relevant activities will probably be its operating and financing activities. Examples for relevant activities of that type of entity could be: product development, purchases and sales of goods or services, managing financial assets, acquiring and disposing of assets, or obtaining financing and examples of decisions about relevant activities could include the establishing of operating and capital decisions in the investee and the appointment and the decision about remuneration of a key management of the investee or service providers and terminating their employment.

In the cases that are clear that the investor controls the investee, because it holds voting rights that really gives control, there is no need to identify the relevant activities.

However, when it is not clear that control is held through voting rights, a crucial step on the application of this new model of consolidation is the inevitability for the investor to identify the relevant activities of the investee, and is also required that the investor considerers whether it controls that relevant activities or not. Is also necessary the classification of how the decision are made, decisions concerning the relevant activities.

The procedure of determine the activities that significantly affect the returns of the investee could be extremely judgmental part in some cases.

The application of this model and the introduction of this procedure on the assessing of control by the investor could potential change the control conclusion; mostly in respect of investees in which several investors each have the ability to manage different activities.

Paragraph B13 of IFRS 10 gives the following example of two or more investors that have rights to direct different relevant activities of an entity:

3.5.1 Example 5

Two investors A and B form an investee to develop and market a medical product. They established a new entity (C). Entity A holds 40 percent of the voting rights of Company C and entity B holds 60 percent of Company C. Investor A is responsible for developing and obtaining regulatory approval of the medical product — that responsibility includes having the unilateral ability to make all decisions relating to the development of the product and to obtaining regulatory approval. Once the regulator has approved the product, the investor B will manufacture and market it — this investor has the unilateral ability to make all decisions

about the manufacture and marketing of the project. If all the activities — developing and obtaining regulatory approval as well as manufacturing and marketing of the medical product — are relevant activities, each investor needs to determine whether it is able to direct the activities that most significantly affect the investee's returns. Accordingly, each investor needs to consider whether developing and obtaining regulatory approval or the manufacturing and marketing of the medical product is the activity that most significantly affects the investee's returns and whether it is able to direct that activity. In determining which investor has power, the investors would consider:

A - The purpose and design of the investee;

B - The factors that determine the profit margin, revenue and value of the investee as well as the value of the medical product;

C - The effect on the investee's returns resulting from each investor's decision-making authority with respect to the factors in (b); and

D - The investors' exposure to variability of returns.

In this particular example, the investors would also consider:

A - The uncertainty of, and effort required in, obtaining regulatory approval (considering the investor's record of successfully developing and obtaining regulatory approval of medical products); and

B - Which investor controls the medical product once the development phase is successful.

The conclusion on this particularly case is that the activities that most significantly affects the investee's returns are on the developing and obtaining regulatory approval of the medical product, this is with the investor A.

3.5.1.1 Analysis under IFRS 10

Investor A controls Company C, because in this case both investor direct relevant activities, but there was the need of understand of whom where the investor that it is able to direct the activities that most significantly affect the investee's returns.

3.5.1.2 Analysis under IAS27

The conclusion reached under current standards would be that B controls C and is not entity A, because it is the entity that holds more than half of the voting rights.

3.6. Substantive rights versus protective rights

	IFRS 10	**IAS 27**
Substantive rights	"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."	IAS 27 does not provide guidance to identify when the rights of other parties prevent the reporting entity of controlling another entity.
Protective rights	"In evaluating whether rights give an investor power over an investee, the investor shall assess whether its rights, and rights held by others, are protective rights. Protective rights relate to fundamental changes to the activities of an investee or apply in exceptional circumstances. However, not all rights that in exceptional circumstances or are contingent on events are protective."	Guidance on the rights of other parties does not exist in IAS 27 (2008).

The Board decided to give guidance on when an investor controls the investee although others investors have rights in that investee. These rights of others parties that does not give them the control are referred as the protective rights.

Protective rights were designed to protect the interest of the party holding those rights without giving to the owner, power over the entity to which those rights are relate.

So IFRS 10 distinguishes between substantive rights and protective rights. The investor that holds only the designed protective rights, does not have power over the investee, and also cannot prevent other investors from having power over the investee. Protective rights relate to “fundamental changes to the activities of an investee or apply in exceptional circumstances”. Examples of protective rights may include the right to approve new debt financing, the right of a party holding a noncontrolling interest in an investee to approve the investee`s issuance of additional equity instruments, or the right of a lender to seize assets in the event of default.

The rights to be substantive need to be currently exercisable, although in some cases the rights could be substantive even though the rights are not currently exercisable, because those rights prevent the others invertors to control the investee.
The substantive rights only need to give the current ability to direct decisions that changes the relevant activities of the controlled entity, and it is not necessary that these rights provide the ability to initiate decisions to the owner of that substantive right.

This guidance does not exist in IAS 27, so the preparers of IFRS financial statements normally use the guidance stated by the US GAAP (participating rights and protective rights) that is different from the definition stated on IFRS 10. As a result, the analysis practice could probably be different from the existing practice.

3.6.1. Example 6

An investor determined that the approving annual operating budget of an investee is the relevant activity, so is the activity that most significantly affects the investee´s returns. And in this case the investor has the right to veto this annual operating budget of the investee.

3.6.1.1 Analysis under IFRS 10

Because approving the annual operating budget is the relevant activity, then a veto right over the annual operating budget would be substantive, and not a protective right.

The investor controls the investee, because in this case this right takes to other parties the control of the investee.

Although the evaluation of whether approving an annual operating budget is the most relevant activity will depend on facts and circumstances, and requires judgment.

3.6.1.2 Analysis under IAS 27

The analysis under IAS 27 could be must more different because the definition of substantive and protective rights it is not considered on this standard. So what are considered are the voting rights and not a veto right over the relevant activity.

3.7. Voting rights

	IFRS 10	**IAS 27**
Voting rights	"Often an investor has the current ability, through voting or similar rights, to direct the relevant activities"	IAS 27 presumes control, "when the parent owns, more than half of the voting power of an entity".
Rights other than voting rights	"when assessing whether an investor´s voting rights are sufficient to give it power, an investor considers all facts and circumstances, including: - The size of the investor´s holding of voting rights relative to the size and dispersion of holdings of the other vote holders; - Potential voting rights held by the investor; - Rights arising from other contractual arrangements; - Any additional facts that indicate the investor have, or do not have, the current ability to direct the relevant activities at the time that decisions need to be made."	Rights were not considered at the same way as IFRS 10 considerer. IAS 27 states that "Control also exist when the parent owns half or less of the voting power, when there is power: - More than half of the voting rights; - To govern the policies; - To appoint the majority of the Board of Directors; - Or, to cast the majority of the votes of the Board of Directors."

In this new model of consolidation there is gating question, which determine whether the voting rights or rights other than voting rights are relevant, when the investor assesses whether it has power over the investee.

So there are situations where the voting rights and there´s holder by themself do not have the ability to significantly affect the returns of the investee, and in those cases it is necessary that the investor considers the purpose and the design of the investee as well as the following factors:

- The evidence that the investor has the ability to manage the all relevant activities depending only on him;
- The investor can have a special relationship with the investee; and
- The investor can have a large exposure to the returns variability of the Investee.

The ability to manage the relevant activities is the factor with the most importance in the analysis.

In some cases, and it could in many cases, the assessing of whether an investor has power can be straightforward. And this is often when, after understanding de design and the purpose of the entity investee, it is concluded that the power over the investee is acquired directly and solely by the voting rights detained by the investors.

The next points presented are the guidance standard in the IFRS 10 to deal with these cases:

3.7.1. Power with a majority of the voting rights

In many cases, the structure of the investee or the legal environment, establishes that the relevant activities are directed by owner or group of owners of more than half of the voting rights of the investee.

An investor holding more than half of the voting rights has the power on the following situations (paragraph B35 of IFRS 10):

- The relevant activities are directed by a vote of the holder of the majority of the voting rights, or
- 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.

In both cases, when the dominant investor has more than half of the voting rights, it has power over the investee, considering that there are no others relevant facts and circumstances.

These cases are very common, and in such situations, the adoption of IFRS 10, probably it would not impact, or the impact would by minimum, on whether or not an entity is consolidated.

3.7.2. Majority of the voting rights but no power

In some cases, although it has the majority of the voting rights, that voting rights do not give the holder the power to direct the investee.

The IFRS 10 gives guidance on these situations, and the investor even though it has the majority of the voting rights, it does not have power over the investee:

- when those voting rights are not substantive;
- when those voting rights do not provide the investor, with the current ability to direct the relevant activities;
- when another party has existing rights to direct the relevant activities of the investee and that party is not an agent of the investor.

For example, an investor can have more than half of the voting rights of an investee, but it cannot have power over the relevant activities of that investee, if the relevant activities are subject to management of a government, court, administrator, receiver, liquidator or regulator.

3.7.3. Control with less than a majority of voting rights

Although the concept of control with less than a majority of voting rights was implicit in IAS 27, the standard did not provide explicit guidance or illustrative examples about the concept. As a result of this lack of guidance, inconsistent interpretations of this concept exist in practice. The new standard clarifies that control can definitely exist without a majority of voting rights and also provides elements and facts to consider in the control assessment and examples of such circumstances.

In some cases, an investor can have control over an investee, even when it holds less than the majority of the voting rights of the investee.

IFRS 10 also gives guidance on the matter, and states that an investor can have power over the investee with less of the majority of the voting rights, and give some examples:

- Contractual arrangement;
- Holding voting rights;
- Holding potential voting rights; or
- A combination of the above.

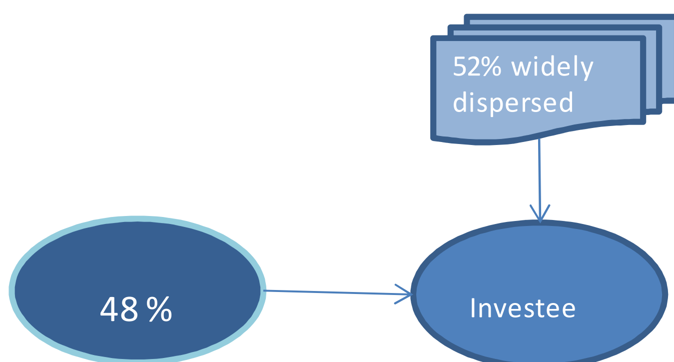
Paragraph B42 of IFRS 10 also gives guidance to when an investor that holds less than the majority of the voting rights, to the investor to consider the "size of the investor´s holding of voting rights relative to the size and dispersion of holdings of the other vote holders" and also the relevant facts and circumstances, must be considered (voting patterns at previous shareholders meetings).

IAS 27 (2008) also contains in this matter similar guidance at this time; however there are situations where the more specified guidance gave by the IFRS 10 and the application of the concept of the facto control will probably impact on whether or not an entity is consolidated

IFRS 10 also includes several examples illustrating how to assess whether an investor has power when it has less than a majority of voting rights. I also analyzed the differences of treatment under the IAS 27.

3.7.4. Example 7 (IFRS 10 B43)

Figure 5 - Example less than a majority of voting rights number 1



An investor acquires 48 per cent of the voting rights of an investee. The remaining voting rights are held by thousands of shareholders, none individually holding more than 1 per cent of the voting rights. None of the shareholders has any arrangements to consult any of the

others or make collective decisions. When assessing the proportion of voting rights to acquire, on the basis of the relative size of the other shareholdings, the investor determined that a 48 per cent interest would be sufficient to give it control.

3.7.4.1 Analysis under IFRS 10

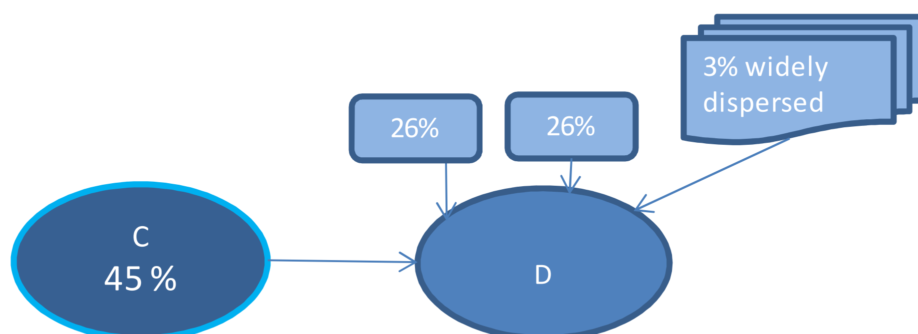
In this case, based on the absolute size of its holding and the relative size of the other shareholdings, the investor concludes that it has a sufficiently dominant voting interest to meet the power criterion without the need to consider any other evidence of power.

3.7.4.2 Analysis under IAS 27

Under the IAS 27 the investor does not control the investee, because it does not have the majority of the voting rights, and it has no legal or contractual arrangement that give them power over the investee.

3.7.5. Example 8 (IFRS 10 B44)

Figure 6 - Example less than a majority of voting rights number 2



C holds 45% of the voting rights of D. The other 55% of D is held by two shareholders (each holds 26%), with the remaining 3% held by three other shareholders, each holding 1%.

3.7.5.1 Analysis under IFRS 10

C does not have power over D, because the two other significant shareholders (relatively small number) could easily cooperate to outvote C. The size of C´s holding, and size of that holding relative to other shareholders, would not give it power.

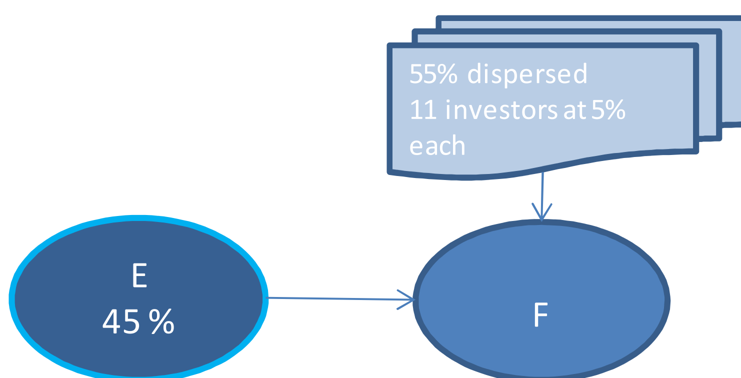
3.7.5.2 Analysis under IAS 27

Under IAS 27 the conclusion would be the same but for different reasons, the possibility that the two other significant shareholders, could cooperate to vote and change the decision over relevant activities are not considered.

So as the example 7 the investor C does not control the investee D because it does not detain the majority of the voting rights neither any contractual arrangement that could give them power of the investee.

3.7.6 Example 9 (IFRS 10 B45)

Figure 7 - Example less than a majority of voting rights number 3



E holds 45% of the voting rights of F. The other 55% of F is dispersed among 11 shareholders, who each hold 5%.

3.7.6.1 Analysis under IFRS 10

In this case IFRS 10 explains that the size of E´s holding and the dispersion of the other shareholders are not conclusive in determining whether E has power over F. Other relevant facts and circumstances would be considered to determine whether E has power over F.

3.7.6.2 Analysis under IAS 27

Under IAS 27 the conclusion would only be that E does not control F, regardless of other relevant facts and circumstances that could be considered, because it does not detain the majority of the voting rights neither any contractual arrangement that could give them power of the investee.

Analyzing the two examples (8 and 9) and the conclusion illustrate by the IFRS 10, where is applied the analysis made with the respect to the facto control. It is considered that it is must

easier for two other shareholders to act together (Example 8), than would be for 11 other shareholders to act together to outvote an investor (Example 9). So there is a question that it is not very well explain on the IFRS 10, and it will require must more judgment, that is: where is the line between these two examples.

The application of the concept of the facto control could be a significant change for the investors with significant voting interests in the investees. Because applying this concept there is no room for bright lines and is requested significant judgment to all relevant facts and circumstances. For example and following the examples there is important to analyze the subsequent facts:

- The size of the investor´s interest concerning the size of the others investor;
- The extensibility of the dispersion of the other investors;
- The possibility of the past voting patterns to be repeated in the future voting patterns;
- The possible agreements stand between shareholders.

In general, when the percentage held by the dominant investor is lower (example 7), less is the probability of the investor to have the facto control.

An investor could come to conclusion that it controls an investee, simply because of the relevant facts and circumstances that exist at a point in time, rather than because of an intentional action. Additionally, although it may seems easy to use the retrospection to assess whether an investor had or has control, on other hand it might be difficult to apply this principle on a real time basis. Mostly because the information need to be collected and also analyzed, and also a new systems and new processes might be needed so that the administration can achieve to an opportune conclusion.

3.8. Potential voting rights

	IFRS 10	**IAS 27**
Potential voting rights	"Potential voting rights are considered in assessing control only when substantive (when the holder has the practical ability to exercise that right)".	They were considered in assessing control only when currently exercisable.

Potential voting rights also should be considered by the investor, when it assesses whether it has power over an investee. The investor should consider not only the potential rights held by it, but also the potential voting rights held by other parties.

Paragraph B50 of IFRS 10 gives guidance to this subject considering that the potential voting rights are only measured when they are substantive and "alone, or in combination with other rights, can give an investor the current ability to direct the relevant activities".

The main change in this subject is that all potential rights that are substantive, although is not currently exercisable, is always considered on the assessing of control, while under IAS 27 only the potential voting rights currently exercisable where taken into account.

This modification will require to the management a must more effort, because will be needed the monitor the potential voting rights in order to determine whether they are substantive. To determine if potentials voting rights are substantive is very important analyze the practical ability of the investor to exercise those rights, for example. This probably will change the control conclusion in some cases, because currently exercisable potential voting rights could not be considered substantive (if for example exercise price is deeply out of the money), and otherwise, not currently exercisable potential voting rights might be considered substantive (if for example the rights are exercisable when the decision about the direction of the activities that significantly affect the returns need to be made – Example 10).

3.8.1. Example 10 (Adapted IFRS 10 B24)

Investee S, whose activities are controlled thought voting rights, has annual shareholders meetings at which decisions to direct the relevant activities are made. The next shareholder meeting is scheduled for eight months' time. However, shareholders can call a special meeting to change the existing policies over relevant activities, but a requirement to give notice to the shareholders means that such a meeting cannot be held for at least 30 days.

Investor N holds an option to acquire the majority of the shares in S that is exercisable in 25 days and that is deeply in the money. N has rights that are essentially equivalent to the majority, because N as the holder of the option can make decisions about the direction of the relevant activities when they need to be made because the rights are exercisable before a special meeting would be held.

It takes longer for N to call a special meeting than for an ordinary shareholder: it takes N 55 days (25+30) instead of 30 days. However, as it takes 30 days for the meeting to be held, if any other shareholder calls a special meeting, the potential voting rights held by N can become current voting rights by the time the meeting is held as the option is exercisable in 25 days.

3.8.1.1 Analysis under IFRS 10

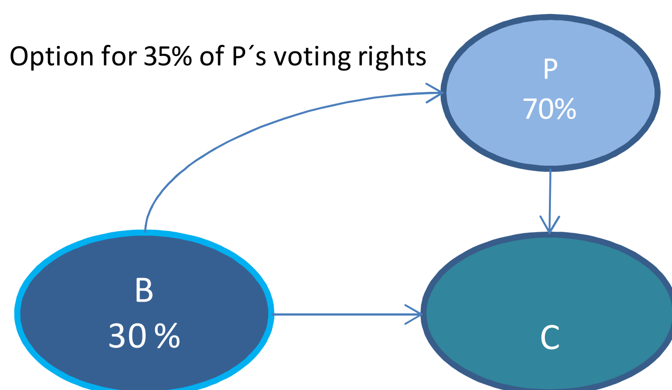
Investor N controls investee S because the potential voting rights owned by N are considered currently substantive, because this potential voting rights can became current voting rights by the time the meetings is held, because the option is exercisable in 25 days and also the fact that the option is deeply in the money.

3.8.1.2 Analysis under IAS 27

The potential voting rights held by N are not currently exercisable and therefore are not considered when assessing whether investor N currently controls Investee S, under IAS 27.

3.8.2. Example 11 – (Adapted IFRS 10 B50) Potential voting rights out of the money

Figure 8 - Example potential voting rights out of the money



Company B holds 30 percent of the voting rights of Company C as well as an option to acquire half of P´s voting rights. Company P holds 70 percent of the voting rights of C.

The option is exercisable at any time during the next two years at a fixed price that is deeply out of the money and is expected to remain so for that two-year period. P has been exercising its votes and is actively directing the activities of C.

3.8.2.1 Analysis under IFRS 10

P controls the company C because it meets the power criterion as it seems to have the current ability to direct the relevant activities.

The potential voting rights held by B are not considered substantive because the option is out of the money, so it is not exercisable, as even thou it is exercisable at any time the possibility of B exercise this option is very remote because of the price condition.

However, if a significant change in the conversion price of the options happens and it became in-the-money, during the two years it could lead to a conclusion that the options are substantive, which would result in a loss of control by P and a gained of control by B. And this combined with the exercisable option at any time during the next two years.

3.8.2.2 Analysis under IAS 27

In this case and because the option is exercisable at any time investor B is likely to controls investee C. Under IAS 27 the potential voting rights are considered in assessing control only when currently exercisable.

3.8.3. Example 12 – (Adapted IFRS 10 B24) Potential voting rights in the money

Company X holds an option to acquire the majority of voting shares in Company Z that is exercisable in 25 days and that is deeply in the money. Z has annual shareholder meeting at which decisions to direct the relevant activities are made. The next shareholder meeting is scheduled for 8 months' time. However, shareholders can call a special meeting to change the existing policies over relevant activities, but a requirement to give notice to the other shareholders means that such a meeting cannot be held for at least 30 days.

3.8.3.1 Analysis under IFRS 10

Under IFRS 10 X controls Z, because the potential voting rights are substantive and must be considered on assessing whether X controls Z.

As the option is in the money and is exercisable in 25 days, and the other shareholders can call a special meeting to change policies related with relevant activities in 30 days. (The option is exercisable in time of the meeting)

3.8.3.2 Analysis under IAS 27

The potential voting rights held by X are not currently exercisable and therefore are not considered when assessing whether investor X currently controls Investee Z, under IAS 27.

3.8.4. Factors to be considered on the evaluation of an option

On these three examples to the option (potential voting rights) to be substantive it depends on relevant facts and circumstances. These are the common factors that must be considered when evaluating whether an option is substantive or not:

- Exercise price or conversion price, relative to market terms;
- Ability to obtain financing;
- Timing and length of exercise period.

3.8.4.1. Exercise price or conversion price

With the necessity of analyzing whether a potential voting right is substantive, it is essential to make the evaluating the exercise price (or conversion price) of an option, because this factor can represent a difficulty to the exercise of the potential voting right. These are the judgments that should be considered:

- **Deeply-out-of-the-money** – Commonly, these would be considered non-substantive;
- **Out-of-the money (but not deeply)** – in this case judgment will be needed to assess whether the cost is worth the potential benefits of exercise the option;
- **In-the-money –** Generally, these options would be considered substantive.

However, the analysis is not only based on the option´s nature, at the beginning and at the end, of the reporting period. It is also important the evaluation inside of the period. For example, if an option was deeply-out-of-the money at the reporting date, but expected to become in-the-money before the relevant activities of the investee need to be controlled, then the option may be substantive.

3.8.4.2. Financial ability

It also must be considered on the assessment of whether a potential voting rights is substantive, the financial ability of the owner of the potential voting rights to pay the exercise price, because it could be an economic barrier the financial impossibility to exercise the potential voting rights, as contemplated by IFRS 10. For example, if an investor cannot obtain financing to exercise an in-the money option, it could be determinant to conclude that this option it is not substantive. On other hand, it is also probably and also more common, that the holder of the option has the financial ability to exercise them, even though it is out-of-the-money (but not so deeply), and to benefit from some synergies consider the possibility of using that potential voting rights

3.8.4.3. Exercise period

The third factor is also very important in the assessment of substantive potential voting rights, because under IFRS 10, an option could give to an investor the current ability the relevant activities of the investee, even though it is not currently exercisable. This situation it was not considered on the IAS 27. Under IFRS 10 the term “current” is not used as, under IAS 27, to “currently exercisable”, but is generally used when it refers to the ability to decide about relevant activities of the investee, when that decision need to be made.(Example 10)

3.9. Control Assessment made on a continuous basis

IFRS 10	**IAS 27**
“An investor shall reassess whether it control an investee if facts and circumstances indicate that there are changes to one or more of the three elements of control”	In IAS 27 it was also required a reporting entity to asses control continuously even thought this is not stated explicitly.

IAS 27 implicitly required the continuous assessment of control, now IFRS 10 explicitly includes the requirement of continuous assessment of control and also provides application guidance and descriptions of situations in which a reporting entity will gain or lose control.

The difference is that IFRS 10 explicitly requires a continuous reassessment if the dominant investor still controls the investee. This reassessment takes into account the changing over the

investor´s power through the investee and also the exposure or rights to the variable returns of the investee.

The analysis, to determine how decisions about the relevant activities are made is also needed to be happening in a continuous basis.

IFRS 10 gives guidance on where should fall the reassessment:

- “If there is a change in how power over an investee can be exercised”
- “If an event can cause an investor to gain or lose power over an investee without the investor being involved in that event”
- “If an investor also considers changes affecting its exposure, or rights, to variable returns from its involvement with the investee”
- “An investor shall also consider whether its assessment that it acts as an agent or a principal has changed”.

This reassessment should be performed if there is a change in the relevant facts and circumstances and also at the end of each reporting period.

IFRS 10 considered the assessment of control in a continuous basis, with the objective to avoid inappropriate consolidation and the malfunction to consolidation. That would probably be what it happens if the reassessment of control would not be considered continuous assessment.

However a clean criticize analysis of control is not indispensable in every reporting period. The entity may continue with its earlier analysis until relevant facts and circumstances could advance that there are changes on one or more of the elements that make the definition of control.

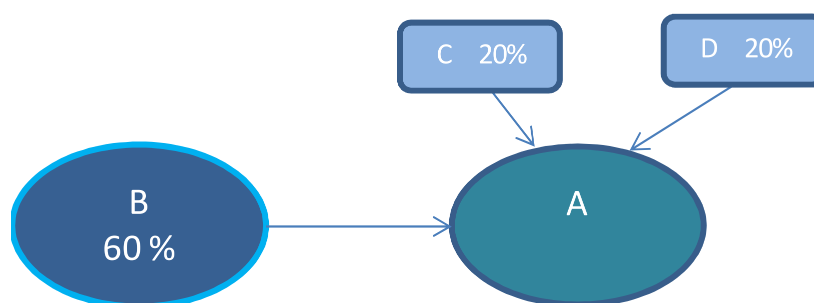
In practice, issues may happen when an investor is assessing whether it controls de investee. For example, it could be challenging to determine the date on which the investor obtains de facto control over the investee, when the investor holds less than a majority of the voting rights. In the same way that could also be challenging and probably not well concluded, the assessment of control made by an investor at the date that it acquires less than a majority of the voting rights in an investee, because the investor does not know how other shareholders behave. With the passes of time, the information of others shareholders probably it becomes

more accessible, and the experience gains from the meetings with the shareholders, could eventually determine that the investor has control over the investee. In this case the continuous assessment of control it is determinant. But it is also very challenging and requires significant judgment to determine the point in time at which the control is achieved.

Changes in the decision-making rights can for example mean that the relevant activities are no longer controlled by means of equity instruments but by means of contractual rights:

3.9.1. Example 13 – Change in relevance of voting rights

Figure 9 - Example change in relevance of voting rights



Company A set up as an entity controlled by means of equity instruments. Company B holds 60 percent of the voting rights in A, and Companies C and D each hold 20%. There are no arrangements that alter decision making in A, and it is concluded that B controls A.

During its first years of activity, A incurs significant unexpected losses so that its net assets become negative. C agrees to provide significant financing to A to continue development of its activities and in return obtains the right to appoint some of the key management personnel who direct the relevant activities of A as well as the right to approve budgets in the ordinary course of business.

3.9.1.1 Analysis under IFRS 10

In this example A was controlled by the company B, because of the majority of the voting rights held by B, that it has permitted the power over the relevant activities of A.

But significant changes on the key management personnel as transform the relevance of the voting rights, on the assessment of control on company A, so and with that changing B is no

longer the dominant shareholder but instead is investee C, because although is as not the majority of the voting rights it as the power over the relevant activities.

3.9.1.2 Analysis under IAS 27

Under IAS the conclusion in the first assessment would be the same as assessed under IFRS 10, because B as the majority of the voting rights of A. On the second assessment the company B would still remain the dominant shareholders.

In this case the different it is not direct of the control assessment made in a continuous basis because in IAS 27 it was also required to the reporting entity to asses control continuously even thought this was implicit.

3.10. Relations with Other Parties

IFRS 10	IAS 27
"When assessing control, an investor shall consider the nature of its relationship with other parties and whether those other parties are acting on the investor´s behalf (i.e. they are de facto agents)".	In IAS 27 and SIC-12 this issue was considered, although not in an explicit way, require that only one party controls another party.

IFRS 10 also requires and provides guidance for an investor to consider whether there are other parties that act on the investor´s behalf, by virtue of their relationship with the investor. These situations are referred in IFRS 10, to as a "de facto agent".

Paragraph B75 list the following examples of the facto agents:

- Related parties as defined in IAS 24.
- An investor that received its interest in the investee as a result of a loan or contribution from the investor.
- An investor that "has agreed not to sell, transfer, or encumber its interest in the investee" without the prior approval of another investor.
- A "party that cannot finance its operations without subordinated financial support from the investor."

- An investee that shares a majority of its board or key management personnel with an investor.

- A "party that has a close business relationship with the investor" (e.g., a service provider and a significant client).

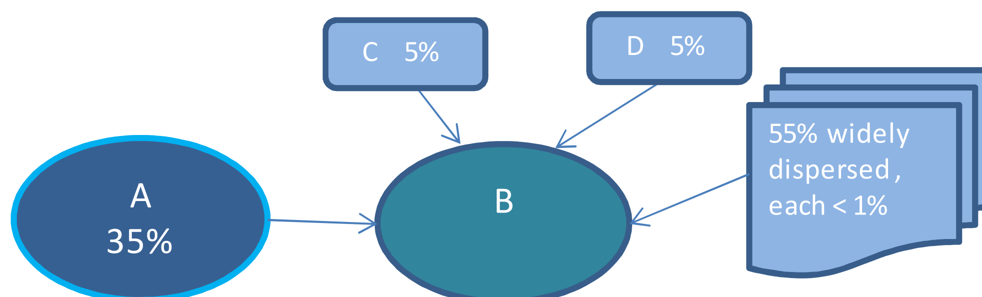
This guidance regarding the relationship of the investor with the other parties in the group it is necessary because of the relationship that a group could have with the investee. The investor and its probable "de facto agents" could have power, that considerer in isolation, might not result in a control conclusion to any party involved, but that considered together probably should result in a control conclusion.

Paragraph BC58 and BC59 of the Basis for Conclusion of IFRS 10 conclude that the control is not shared with others. "The Board refined its view and concluded that the parent need not have absolute power. Other parties can have rights relating to the activities of an entity. For example, there are often limits on power that are imposed by law or regulations. Similarly, other entities such as non-controlling interests may hold protective rights that limit the power of the reporting entity. However, only one party can have power that is sufficient to direct the activities of that entity to generate returns and, thus, only one party controls an entity. However, when other parties have rights that restrict the power of the reporting entity to an extent that it does not have the ability to direct the activities of an entity to generate returns for itself, the reporting entity does not have power sufficient to control that entity"

However IFRS 10 does not provide much description on how the evaluating of whether there are other parties who are acting on behalf of the investor. But there are probably numerous parties that need to be analyzed to determine if they are "the facto agents", and this will require a careful evaluating of all the relevant facts and circumstances, including also the purpose and the design of the investee.

3.10.1. Example 14 – De facto agents

Figure 10 - Example de facto agents



Investor A holds 35% of the voting rights of Investee B. Two other shareholders each hold 5% (company C and D) of the voting rights of B. Numerous other shareholders hold the remaining 55% of the voting rights, although none individually holds more than 1% voting interest in B. There is no contractual arrangement between A, C and D on how to vote on the relevant activities of B. However, C and D have always voted in the same way as A in the past. C and D both have significant business relations with A.

Considering that C and D are acting as the facto agents of P as far as the investment in B is concerned and the voting rights are relevant when assessing which investor has power over B.

3.10.1.1 Analysis under IFRS 10

In this case and considering that C and D are acting as the facto agents of P as far as the investment in B is concerned, then it would be as if A held a 45% voting interest in B (the sum of A, C and D percentage), and A should considerer whether it has the facto control over B. Also considering that investor A has power over the relevant activities of B and has the facto control, so A controls B based on C and D percentage.

3.10.1.2 Analysis under IAS 27

Under IAS 27 the analysis does not take into account the C and D voting rights, because the policy of assessing control is based on a legal or contractual basis. So in this case A does not control B.

3.11. Principal-Versus-Agent Relationships

IFRS 10	IAS 27
"When an investor with decision-making rights (a decision maker) assesses whether it controls an investee, it shall determine whether it is a principal or an agent. An investor shall also determine whether another entity with decision-making rights is acting as an agent for the investor."	There is no specific guidance.

IFRS 10 also provide us with the concept of delegated power. It is very important that the decision maker assesses whether it is acting as a principal or as an agent, when the dominant investor direct the relevant activities of the investee on behalf of other investors, because it is necessary to assess whether the investor is the decision-maker and then it is a principal, or instead it is an agent; to determine whether it has control.

It is very important to assess if the decision-maker has delegated rights, that given power for its own benefit, or instead it only have power for the benefit of others. Because as an agent the investor cannot have control over the investee, so it does not consolidate the investee, but as a principal the investor may have control over the investee, so it would consolidate the investee.

IFRS 10 gives us guidance to determine whether an entity with decision-making rights is a principal or an agent. Paragraph B58 describes an agent as a party that has been "engaged to act on behalf and for the benefit of another party". However, this paragraph clarifies that an investor "is not an agent simply because other parties can benefit from" the investor´s decision making.

On paragraph BC90 of Basis to conclusion of IFRS 10 the Board also conclude that the power held by an agent is limited only for the benefits the principal entity, for which the agent entity is working, so the capacity to affect those returns on it owns benefit is controlled by the agreement establish with the principal entity.

In some cases the line between principal and the agent is not very clear, because an agent also have it owns responsibilities so they can mixed. “For example, a fund manager may act in a fiduciary capacity and have a direct investment in the fund it is managing”.

To determine whether an investor with decision-making rights is an agent or id a principal, the investor should considerer the following factors, and also with the other relevant elements of the relationship between the dominant investor and the investee: (IFRS 10 Paragraph B60)

- “The scope of the decision maker´s authority over the investee.
- Rights held by other parties.
- The remuneration that the decision maker is entitled to (including whether this remuneration is commensurate with the services provided and whether any nonstandard terms are included).
- The decision maker´s exposure to variability of returns from other interest that it holds in the investee.
- The rights of a single party to remove the decision maker.”

On other hand the IAS 27 does not contain guidance or requirements to guide the treatment of the interest held by another entity when acting as an agent. This guidance introduced with the IFRS 10 was in order to reduce the diversity on the practice of consolidation in this matter.

While all facts and circumstances need to be considered, it could be very difficult for some entities to assess whether their remuneration is proportionate with the service provider, or if the removal rights owned by other parties are substantive or not.

3.12. Control of specified assets

IFRS 10	IAS 27
“An investor shall consider whether it treats a portion of an investee as a deemed separate entity and, if so, whether it controls the deemed separate entity.”	IAS 27 (2008) and SIC-12 do not include specific guidance for situations in which an investor has power over only specified assets and liabilities of an investee.

IFRS 10 also considerer and give some guidance to situations where the investor may have interest in a particular set of assets and liabilities (“a portion of an investee as a deemed

separate entity"), and if so, whether it controls the deemed separate entity. This deemed separate entity is in some cases a separate part of a legal division, of an entire entity, and often called a "silo". In addition, IFRS 10 clarifies that an investor can control a specified asset of an investee.

This concept was not explained and it was not included on the IAS 27, although it was also considered in practice.

Because of the arising questions about whether it is possible, for the investor to consider only a part of the entire legal entity, as a separate entity. And also in which circumstances, that could happen, the consideration of only a part of the entity, when the investor assesses the control to consider in the consolidation.

So under IFRS 10, the determination of whether a silo exist "in substance, when none of the returns from the specified assets can be used by the remaining investee and none of the liabilities of the deemed separate entity are payable from the assets of the remaining investee. Thus, in substance, all the assets, liabilities and equity of that deemed separate entity is ring-fenced from the overall investee".

Although, IFRS 10 on the paragraph B79 states that the silos that assemble the conditions specified on the standard are excluded from consolidation if another investor controls and consolidates the entity that contains the silos.

The adoption of IFRS 10 it may change the arrived conclusions under IAS 27, because in some cases, the investor, may have not considered the possibility or the concept of whether a silo existed. As in IAS 27 there is no explicit requirement. Now, under IFRS 10 the necessity of identify and consolidate any silos, that the investor controls, it is clear.

To identify the existence and to determine the control of an investor under a silo could require a robust analysis and it can be complex, because this evaluating also needs de identification of the purpose and design of the investee.

4 – Case Study

4.1. Introduction

Wintershall is Germany's largest crude oil and natural gas producer. It explores and produces oil and gas in Europe, North Africa, South America, Russia, the Caspian Sea region, and the Middle East. Also have been active for over 80 years and have a workforce in excess of 2,000 employees from more than 40 nationalities.

This company is detained in 51% by the BASF Group, and the remained 49% of the shares are held by the Gazprom Group.

Gazprom is a global energy company. Its major business lines are geological exploration, production, transportation, storage, processing and sales of gas, gas condensate and oil, as well as generation and marketing of heat and electric power. The Company is among Russia's five largest oil producers and it is the largest owner of power generating assets in the country. These assets account for 17 per cent of the total installed capacity of the national energy system.

BASF is the world's leading chemical company. BASF Group is a chemical company, which has subsidiaries in more than eight countries and supplies products to a large number of business partners in nearly every part of the world. Is broad arranged into six segments: Chemicals, Plastics, Performance Products, Functional Solutions, Agricultural Solutions and Oil & Gas.

With more than 110,000 employees, six Verbund sites and approximately 380 additional production sites worldwide this company serve customers and partners in almost all countries of the world.

4.2. Scenario

BASF Group is a chemical company, which has subsidiaries in more than eight countries and supplies products to a large number of business partners in nearly every part of the world

One of the subsidiaries of the chemical group BASF is Wintershall AG which is the largest European subsidiary of BASF. For the parent company, Wintershall represents an important supplier of raw materials and a key component of its resource security strategy. Wintershall´s activities focus on oil and gas.

BASF Group has an investment on is subsidiary Wintershall of 51%, and exercise the operational management on the investee, which produces oil and gas in Libya. However, contractual obligations with the Libyan government, strictly limit influence on variable returns after income taxes.

The other investor with an investment on Wintershall of 49% is Gazprom Group. This partnership also represents to Wintershall the banner of thinking, acting, and working together. This associated of more than 20 years has always produced successful results, and it made them the world's largest natural gas company has over 70 percent of Russia's gas reserves and guarantees Europe's gas supplies.

4.3. Previous guidance - Analysis under IAS 27

On previous guidance (IAS 27) control is defined as "the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities", so BASF in 2012 on the Consolidated Financial Statement considered Wintershall on the scope of consolidation and was consolidated using fully consolidated method.

On other hand on 2012 Consolidated Financial Statement of Gazprom Group, Wintershall AG is considered as an associate company, because Gazprom has less than half of the voting power of Wintershall, and in this case as a consequence the investor has no power to govern the financial and operating policies the investee.

4.4. Analysis under IFRS 10

According to both IAS 27 and IFRS 10, a group consists of a parent entity and its subsidiaries. Consolidated financial statements must present all assets, liabilities, equity, income and expenses and cash flows of the parent company and its subsidiaries together as a single economic entity.

In contrast to IAS 27, IFRS 10 is geared more strongly toward the economic situation as opposed to the legal conditions.

According to IFRS 10 there is a new definition of control, which is to be applied in determining the companies to be consolidated. With this new guidance control now requires three elements:

- Decision-making power of the parent company over the relevant activities of the subsidiary.

- Variable returns from the subsidiary to the parent company, and
- The ability of the parent company to use decision-making power to affect the variable returns.

This new definition of control leads to a change in the consolidation method for this participation held by BASF.

Also the application of the IFRS 11 *Joint Arrangements,* that regulates the accounting of joint arrangements. This standard differentiates between joint ventures and joint operations. While shares in joint venture are accounted for using the equity method, for joint operations the proportional share of assets, liabilities, income and expenses are reported.

The application of both standards IFRS 10 and IFRS 11, applied on BASF Consolidated Financial Statements, Wintershall ceases to be classified as a subsidiary by the IFRS 10 and becomes in a joint venture with the application of the IFRS 11.

The basis for this conclusion is the long term and very important contract between Gazprom and Wintershall: the cooperation between Wintershall, Germany’s largest producer of crude oil and natural gas, and Gazprom, the world’s largest producer of natural gas extends from the exploration and production of natural gas in West Siberia to transportation through the Nord Stream pipeline and the sale of the natural gas in Germany and Europe by the jointly owned natural gas trading company WINGAS.

On the Consolidated Financial Statement of Gazprom Group the impact of the application of IFRS 10 will not change the assumed of Wintershall Company as an associated, because Gazprom with the application of the new definition of control, does not fulfill the first element from the control definition stated (power) “To have power over an investee, an investor must have existing rights that give the current ability to direct the relevant activities.”

So in this case the equity method will remain to represent the investment made by Gazprom on Wintershall AG.

On analyze made in the Notes to the IFRS Consolidated Financial Statements from 2012, Gazprom assume that the application of IFRS 10 is not expected to materially affect the Group´s consolidated financial statements.

This inconsistency on the classification of the investee Wintershall on the scope of the investors (Gazprom and BASF) forced BASF to change their justifications in the Consolidated Financial Statements for the first quarter of 2013.

Upon application of the new standard as of January 1, 2013, the company Wintershall has been switched from full consolidation to the equity method. Because, although the investor hold 51 per cent of the voting rights, and the operational management will continue to be exercised at Wintershall company, contractual obligations with the Libyan government strictly limit influence on variable returns after income taxes, so that the company is not controlled according to IFRS 10.

The requirement of a careful evaluating of all the relevant facts and circumstances, including also the purpose and the design of the investee, that is necessary with the adoption of the IFRS 10 was made by BASF Company. And this careful evaluating and analyzing in this case result in a clear assessment: one of the elements of the definition of control it is not verified – exposure, or rights to variable returns. Contractual obligations with the Libyan government limit the influence of BASF on the variable returns of the investee (Wintershall) in such a way that made them conclude that they not control the investee. So without control Wintershall, in the scope of BASF, ceases to be classified as a subsidiary, as concluded on the previous guidance.

4.5. Quantitative impact

To BASF overall, the application of IFRS 10 will lead to lower reported sales and income from operations, especially in the Oil & Gas segment. Because besides Wintershall AG, there´s also more tree subsidiaries in the scope of consolidation, that from January 1, 2013 will be accounted for using the equity method rather than fully consolidated, with the application of the new guidance. For this tree companies, no control exists according to IFRS 10, because the BASF Group´s partners in these subsidiaries retain significant rights for determining and carrying out relevant activities through supervisory bodies. Net income will not significantly influenced by the change in accounting standards. But the Group also will adjust the 2012 figures for future reporting periods.

4.5.1. IFRS 10 application impact on BASF Group reporting

Statement of income:

- Reduced sales, EBIT and financial result but no impact on net income;
- Equity results as separate income statement line item in EBIT;
- Reclassification of the equity results of associated companies previously in financial result into EBIT.

Balance sheet:

- Decrease in all asset line items, except financial assets;
- Higher financial assets due to increased investments accounted for using the equity method;
- Decrease of liabilities line items and reduction of equity as a result of lower minority interests.

Statement of cash flows

- Cash flow provided by operating activities slightly lower as only the dividend payments out of joint ventures are recognized;
- Cash used in investing activities and financing activities decreases slightly as a result of the elimination of investing and financing outflows of so far fully or pro-rata consolidated companies.

4.5.2. BASF Group reporting of 2012 and restated with the IFRS 10 application

Figure 11 - Income Statement: (from BASF Group Press Briefing on March 22, 2013, in Ludwigshafen)

Million €	2012 restated	2012	Δ million €	Δ %
Sales to third parties	72,129	78,729	-6,600	-8.4
EBITDA	10,009	12,516	-2,507	-20.0
EBIT before special items	6,647	8,881	-2,234	-25.2
EBIT	6,742	8,976	-2,234	-24.9
– thereof equity income	361		361	
Financial result	-765	-540	-225	-41.7
Income before taxes and minority interests	5,977	8,436	-2,459	-29.1
Income taxes	910	3,214	-2,304	-71.7
– thereof Libyan oil taxes		2,243	-2,243	
Income before minority interests	5,067	5,222	-155	-3.0
Net Income	4,819	4,879	-60	-1.2
EBIT after cost of capital	1,164	1,534	-370	-24.1
EPS in €	5.25	5.31	-0.06	-1.13

Sales
- Decrease mainly due to Wintershall AG: -€2,748 million and BASF-YPC: -€1,337 million

EBITDA
- Reduction mainly due to Wintershall AG

EBIT
- IFRS 10/11 reclassification leads to reduction in EBIT
- Partially offsetting effect due to inclusion of equity income of associated companies in EBIT

Financial result
- Reduction due to reclassi-fication of associated com-panies and IAS 19 (rev.)

Figure 12 - Balance Sheet: (from BASF Group Press Briefing on March 22, 2013, in Ludwigshafen)

Million €	2012 restated	2012	Δ million €	Δ %
Long-term assets	35,259	35,538	-279	-0.8
– thereof property, plant and equipment	16,610	18,177	-1,567	-8.6
– thereof financial assets	4,331	2,925	1,406	48.1
Short-term assets	27,467	28,789	-1,322	-4.6
Equity	25,621	25,804	-183	-0.7
Liabilities	37,105	38,523	-1,418	-3.7
– thereof financial indebtedness	12,798	13,355	-557	-4.2
Total	62,726	64,327	-1,601	-2.5

Property, plant and equipment
- Decrease mainly due to BASF-YPC, Wintershall AG

Financial assets
- Increase of investments accounted for using the equity method

Short-term assets
- Decrease mainly due to reduction of trade receivables and inventories

Liabilities
- Decrease mainly due to BASF-YPC, Wintershall AG

Financial indebtedness
- Decrease mainly due to BASF-YPC

Conclusion

The result of this work gives support to real changes on the scope of consolidation with the application of IFRS 10. Some investors will control investees that they did not consolidate under IAS 27, and other investors will not consolidate investees that were consolidated under IAS 27.

Whether an investor will consolidate more or fewer investees under IFRS 10, compared with IAS 27, will depend on the nature of the interest in its investees. And the method of assessing whether an investee is in the scope of consolidation under IFRS 10 is almost the same, regardless of whether the relevant activities of the investee are directed by voting rights, or not.

Investors that enter into complex arrangements that give rights to direct the activities of the investees, also need to consider whether they have control or not, and consolidate or not consequently.

To determine whether the investor have or not control over the investee, significant judgment will be needed applying the new definition of control, and also the application guidance of the IFRS 10.

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