

HKFRS 10
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Hong Kong Financial Reporting Standard 10

Consolidated Financial Statements



Hong Kong Institute of
Certified Public Accountants
香港會計師公會

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Hong Kong Financial Reporting Standard 10 *Consolidated Financial Statements* (HKFRS 10) is set out in paragraphs 1–33 and Appendices A–D. All the paragraphs have equal authority. Paragraphs in **bold type** state the main principles. Terms defined in Appendix A are in *italics* the first time they appear in the Standard. Definitions of other terms are given in the Glossary for Hong Kong Financial Reporting Standards. HKFRS 10 should be read in the context of its objective and the Basis for Conclusions, the *Preface to Hong Kong Financial Reporting Standards* and the *Conceptual Framework for Financial Reporting*. HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* provides a basis for selecting and applying accounting policies in the absence of explicit guidance.

Introduction

- IN1 HKFRS 10 *Consolidated Financial Statements* establishes principles for the presentation and preparation of consolidated financial statements when an entity controls one or more other entities.
- IN2 The HKFRS supersedes HKAS 27 (Revised) *Consolidated and Separate Financial Statements* and HK(SIC)-Int 12 *Consolidation—Special Purpose Entities* and is effective for annual periods beginning on or after 1 January 2013. Earlier application is permitted.

Reasons for issuing the HKFRS

- IN3 The International Accounting Standards Board added a project on consolidation to its agenda to deal with divergence in practice in applying IAS 27 and SIC-12 (that is, the international equivalent of HKAS 27 and HK(SIC)-Int 12). For example, entities varied in their application of the control concept in circumstances in which a reporting entity controls another entity but holds less than a majority of the voting rights of the entity, and in circumstances involving agency relationships.
- IN4 In addition, a perceived conflict of emphasis between IAS 27 and SIC-12 had led to inconsistent application of the concept of control. IAS 27 required the consolidation of entities that are controlled by a reporting entity, and it defined control as the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities. SIC-12, which interpreted the requirements of IAS 27 in the context of special purpose entities, placed greater emphasis on risks and rewards.
- IN5 The global financial crisis that started in 2007 highlighted the lack of transparency about the risks to which investors were exposed from their involvement with ‘off balance sheet vehicles’ (such as securitisation vehicles), including those that they had set up or sponsored. As a result, the G20 leaders, the Financial Stability Board and others asked the IASB to review the accounting and disclosure requirements for such ‘off balance sheet vehicles’.

Main features of the HKFRS

- IN6 The HKFRS requires an entity that is a parent to present consolidated financial statements. A limited exemption is available to some entities.

General requirements

- IN7 The HKFRS defines the principle of control and establishes control as the basis for determining which entities are consolidated in the consolidated financial statements. The HKFRS also sets out the accounting requirements for the preparation of consolidated financial statements.
- IN7A *Investment Entities* (Amendments to HKFRS 10, HKFRS 12 and HKAS 27), issued in December 2012, introduced an exception to the principle that all subsidiaries shall be consolidated. The amendments define an investment entity and require a parent that is an investment entity to measure its investments in particular subsidiaries at fair value through profit or loss in accordance with HKFRS 9 *Financial Instruments** instead of consolidating those subsidiaries in its consolidated and separate financial statements. In addition, the amendments introduce new disclosure requirements related to investment entities in HKFRS 12 *Disclosure of Interests in Other Entities* and HKAS 27 *Separate Financial Statements*.

* Paragraph C7 of HKFRS 10 *Consolidated Financial Statements* states “If an entity applies this HKFRS but does not yet apply HKFRS 9, any reference in this HKFRS to HKFRS 9 shall be read as a reference to HKAS 39 *Financial Instruments: Recognition and Measurement*.”

- IN8 An investor controls an investee when it is exposed, or has rights, to variable returns from its involvement with the investee and has the ability to affect those returns through its power over the investee. Thus, the principle of control sets out the following three elements of control:
- (a) power over the investee;
 - (b) exposure, or rights, to variable returns from involvement with the investee; and
 - (c) the ability to use power over the investee to affect the amount of the investor's returns.
- IN9 The HKFRS sets out requirements on how to apply the control principle:
- (a) in circumstances when voting rights or similar rights give an investor power, including situations where the investor holds less than a majority of voting rights and in circumstances involving potential voting rights.
 - (b) in circumstances when an investee is designed so that voting rights are not the dominant factor in deciding who controls the investee, such as when any voting rights relate to administrative tasks only and the relevant activities are directed by means of contractual arrangements.
 - (c) in circumstances involving agency relationships.
 - (d) in circumstances when the investor has control over specified assets of an investee.
- IN10 The HKFRS requires an investor to reassess whether it controls an investee if facts and circumstances indicate that there are changes to one or more of the three elements of control.
- IN11 When preparing consolidated financial statements, an entity must use uniform accounting policies for reporting like transactions and other events in similar circumstances. Intragroup balances and transactions must be eliminated. Non-controlling interests in subsidiaries must be presented in the consolidated statement of financial position within equity, separately from the equity of the owners of the parent.
- IN12 The disclosure requirements for interests in subsidiaries are specified in HKFRS 12.

Hong Kong Financial Reporting Standard 10

Consolidated Financial Statements

Objective

- 1 The objective of this HKFRS is to establish principles for the presentation and preparation of consolidated financial statements when an entity controls one or more other entities.

Meeting the objective

- 2 To meet the objective in paragraph 1, this HKFRS:
- (a) requires an entity (the *parent*) that controls one or more other entities (*subsidiaries*) to present consolidated financial statements;
 - (b) defines the principle of *control*, and establishes control as the basis for consolidation;
 - (c) sets out how to apply the principle of control to identify whether an investor controls an investee and therefore must consolidate the investee;
 - (d) sets out the accounting requirements for the preparation of consolidated financial statements; and
 - (e) defines an investment entity and sets out an exception to consolidating particular subsidiaries of an investment entity.
- 3 This HKFRS does not deal with the accounting requirements for business combinations and their effect on consolidation, including goodwill arising on a business combination (see HKFRS 3 *Business Combinations*).

Scope

- 4 An entity that is a parent shall present consolidated financial statements. This HKFRS applies to all entities, except as follows:
- (a) a parent need not present consolidated financial statements if it meets all the following conditions:
 - (i) it is a wholly-owned subsidiary or is a partially-owned subsidiary of another entity and all its other owners, including those not otherwise entitled to vote, have been informed about, and do not object to, the parent not presenting consolidated financial statements;
 - (ii) its debt or equity instruments are not traded in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local and regional markets);
 - (iii) it did not file, nor is it in the process of filing, its financial statements with a securities commission or other regulatory organisation for the purpose of issuing any class of instruments in a public market; and
 - (iv) its ultimate or any intermediate parent produces financial statements that are available for public use and comply with HKFRSs or International Financial Reporting Standards, in which subsidiaries are consolidated or are measured at fair value through profit or loss in accordance with this HKFRS or IFRS 10.
 - (b) [deleted]
 - (c) [deleted]

- 4A This HKFRS does not apply to post-employment benefit plans or other long-term employee benefit plans to which HKAS 19 *Employee Benefits* applies.
- 4B A parent that is an investment entity shall not present consolidated financial statements if it is required, in accordance with paragraph 31 of this HKFRS, to measure all of its subsidiaries at fair value through profit or loss.

Control

- 5 **An investor, regardless of the nature of its involvement with an entity (the investee), shall determine whether it is a parent by assessing whether it controls the investee.**
- 6 **An investor controls an investee when it is exposed, or has rights, to variable returns from its involvement with the investee and has the ability to affect those returns through its power over the investee.**
- 7 **Thus, an investor controls an investee if and only if the investor has all the following:**
- (a) **power over the investee (see paragraphs 10–14);**
 - (b) **exposure, or rights, to variable returns from its involvement with the investee (see paragraphs 15 and 16); and**
 - (c) **the ability to use its power over the investee to affect the amount of the investor’s returns (see paragraphs 17 and 18).**
- 8 An investor shall consider all facts and circumstances when assessing whether it controls an investee. The investor shall reassess whether it controls an investee if facts and circumstances indicate that there are changes to one or more of the three elements of control listed in paragraph 7 (see paragraphs B80–B85).
- 9 Two or more investors collectively control an investee when they must act together to direct the relevant activities. In such cases, because no investor can direct the activities without the co-operation of the others, no investor individually controls the investee. Each investor would account for its interest in the investee in accordance with the relevant HKFRSs, such as HKFRS 11 *Joint Arrangements*, HKAS 28 *Investments in Associates and Joint Ventures* or HKFRS 9 *Financial Instruments*.

Power

- 10 An investor has power over an investee when the investor has existing rights that give it the current ability to direct the *relevant activities*, ie the activities that significantly affect the investee’s returns.
- 11 Power arises from rights. Sometimes assessing power is straightforward, such as when power over an investee is obtained directly and solely from the voting rights granted by equity instruments such as shares, and can be assessed by considering the voting rights from those shareholdings. In other cases, the assessment will be more complex and require more than one factor to be considered, for example when power results from one or more contractual arrangements.
- 12 An investor with the current ability to direct the relevant activities has power even if its rights to direct have yet to be exercised. Evidence that the investor has been directing relevant activities can help determine whether the investor has power, but such evidence is not, in itself, conclusive in determining whether the investor has power over an investee.

- 13 If two or more investors each have existing rights that give them the unilateral ability to direct different relevant activities, the investor that has the current ability to direct the activities that most significantly affect the returns of the investee has power over the investee.
- 14 An investor can have power over an investee even if other entities have existing rights that give them the current ability to participate in the direction of the relevant activities, for example when another entity has *significant influence*. However, an investor that holds only protective rights does not have power over an investee (see paragraphs B26–B28), and consequently does not control the investee.

Returns

- 15 An investor is exposed, or has rights, to variable returns from its involvement with the investee when the investor's returns from its involvement have the potential to vary as a result of the investee's performance. The investor's returns can be only positive, only negative or both positive and negative.
- 16 Although only one investor can control an investee, more than one party can share in the returns of an investee. For example, holders of non-controlling interests can share in the profits or distributions of an investee.

Link between power and returns

- 17 An investor controls an investee if the investor not only has power over the investee and exposure or rights to variable returns from its involvement with the investee, but also has the ability to use its power to affect the investor's returns from its involvement with the investee.
- 18 Thus, an investor with decision-making rights shall determine whether it is a principal or an agent. An investor that is an agent in accordance with paragraphs B58–B72 does not control an investee when it exercises decision-making rights delegated to it.

Accounting requirements

- 19 **A parent shall prepare consolidated financial statements using uniform accounting policies for like transactions and other events in similar circumstances.**
- 20 Consolidation of an investee shall begin from the date the investor obtains control of the investee and cease when the investor loses control of the investee.
- 21 Paragraphs B86–B93 set out guidance for the preparation of consolidated financial statements.

Non-controlling interests

- 22 A parent shall present non-controlling interests in the consolidated statement of financial position within equity, separately from the equity of the owners of the parent.
- 23 Changes in a parent's ownership interest in a subsidiary that do not result in the parent losing control of the subsidiary are equity transactions (ie transactions with owners in their capacity as owners).
- 24 Paragraphs B94–B96 set out guidance for the accounting for non-controlling interests in consolidated financial statements.

Loss of control

- 25 If a parent loses control of a subsidiary, the parent:
- (a) derecognises the assets and liabilities of the former subsidiary from the consolidated statement of financial position.
 - (b) recognises any investment retained in the former subsidiary at its fair value when control is lost and subsequently accounts for it and for any amounts owed by or to the former subsidiary in accordance with relevant HKFRSs. That fair value shall be regarded as the fair value on initial recognition of a financial asset in accordance with HKFRS 9 or, when appropriate, the cost on initial recognition of an investment in an associate or joint venture.
 - (c) recognises the gain or loss associated with the loss of control attributable to the former controlling interest.
- 26 Paragraphs B97–B99 set out guidance for the accounting for the loss of control.

Determining whether an entity is an investment entity

- 27 **A parent shall determine whether it is an investment entity. An investment entity is an entity that:**
- (a) **obtains funds from one or more investors for the purpose of providing those investor(s) with investment management services;**
 - (b) **commits to its investor(s) that its business purpose is to invest funds solely for returns from capital appreciation, investment income, or both; and**
 - (c) **measures and evaluates the performance of substantially all of its investments on a fair value basis.**

Paragraphs B85A–B85M provide related application guidance.

- 28 In assessing whether it meets the definition described in paragraph 27, an entity shall consider whether it has the following typical characteristics of an investment entity:
- (a) it has more than one investment (see paragraphs B85O–B85P);
 - (b) it has more than one investor (see paragraphs B85Q–B85S);
 - (c) it has investors that are not related parties of the entity (see paragraphs B85T–B85U); and
 - (d) it has ownership interests in the form of equity or similar interests (see paragraphs B85V–B85W).

The absence of any of these typical characteristics does not necessarily disqualify an entity from being classified as an investment entity. An investment entity that does not have all of these typical characteristics provides additional disclosure required by paragraph 9A of HKFRS 12 *Disclosure of Interests in Other Entities*.

- 29 If facts and circumstances indicate that there are changes to one or more of the three elements that make up the definition of an investment entity, as described in paragraph 27, or the typical characteristics of an investment entity, as described in paragraph 28, a parent shall reassess whether it is an investment entity.
- 30 A parent that either ceases to be an investment entity or becomes an investment entity shall account for the change in its status prospectively from the date at which the change in status occurred (see paragraphs B100–B101).

Investment entities: exception to consolidation

- 31 **Except as described in paragraph 32, an investment entity shall not consolidate its subsidiaries or apply HKFRS 3 when it obtains control of another entity. Instead, an investment entity shall measure an investment in a subsidiary at fair value through profit or loss in accordance with HKFRS 9.¹**
- 32 Notwithstanding the requirement in paragraph 31, if an investment entity has a subsidiary that is not itself an investment entity and whose main purpose and activities are providing services that relate to the investment entity's investment activities (see paragraphs B85C–B85E), it shall consolidate that subsidiary in accordance with paragraphs 19–26 of this HKFRS and apply the requirements of HKFRS 3 to the acquisition of any such subsidiary.
- 33 A parent of an investment entity shall consolidate all entities that it controls, including those controlled through an investment entity subsidiary, unless the parent itself is an investment entity.

¹ Paragraph C7 of HKFRS 10 *Consolidated Financial Statements* states "If an entity applies this HKFRS but does not yet apply HKFRS 9, any reference in this HKFRS to HKFRS 9 shall be read as a reference to HKAS 39 *Financial Instruments: Recognition and Measurement*."

Appendix A

Defined terms

This appendix is an integral part of the HKFRS.

consolidated financial statements	The financial statements of a group in which the assets, liabilities, equity, income, expenses and cash flows of the parent and its subsidiaries are presented as those of a single economic entity.
control of an investee	An investor controls an investee when the investor is exposed, or has rights, to variable returns from its involvement with the investee and has the ability to affect those returns through its power over the investee.
decision maker	An entity with decision-making rights that is either a principal or an agent for other parties.
group	A parent and its subsidiaries .
investment entity	An entity that: <ul style="list-style-type: none"> (a) obtains funds from one or more investors for the purpose of providing those investor(s) with investment management services; (b) commits to its investor(s) that its business purpose is to invest funds solely for returns from capital appreciation, investment income, or both; and (c) measures and evaluates the performance of substantially all of its investments on a fair value basis.
non-controlling interest	Equity in a subsidiary not attributable, directly or indirectly, to a parent .
parent	An entity that controls one or more entities.
power	Existing rights that give the current ability to direct the relevant activities .
protective rights	Rights designed to protect the interest of the party holding those rights without giving that party power over the entity to which those rights relate.
relevant activities	For the purpose of this HKFRS, relevant activities are activities of the investee that significantly affect the investee's returns.
removal rights	Rights to deprive the decision maker of its decision-making authority.
subsidiary	An entity that is controlled by another entity.

The following terms are defined in HKFRS 11, HKFRS 12 *Disclosure of Interests in Other Entities*, HKAS 28 (as amended in 2011) or HKAS 24 *Related Party Disclosures* and are used in this HKFRS with the meanings specified in those HKFRSs:

- associate
- interest in another entity
- joint venture
- key management personnel
- related party
- significant influence.

Appendix B

Application guidance

This appendix is an integral part of the HKFRS. It describes the application of paragraphs 1–33 and has the same authority as the other parts of the HKFRS.

- B1 The examples in this appendix portray hypothetical situations. Although some aspects of the examples may be present in actual fact patterns, all facts and circumstances of a particular fact pattern would need to be evaluated when applying HKFRS 10.

Assessing control

- B2 To determine whether it controls an investee an investor shall assess whether it has all the following:
- (a) power over the investee;
 - (b) exposure, or rights, to variable returns from its involvement with the investee; and
 - (c) the ability to use its power over the investee to affect the amount of the investor's returns.
- B3 Consideration of the following factors may assist in making that determination:
- (a) the purpose and design of the investee (see paragraphs B5–B8);
 - (b) what the relevant activities are and how decisions about those activities are made (see paragraphs B11–B13);
 - (c) whether the rights of the investor give it the current ability to direct the relevant activities (see paragraphs B14–B54);
 - (d) whether the investor is exposed, or has rights, to variable returns from its involvement with the investee (see paragraphs B55–B57); and
 - (e) whether the investor has the ability to use its power over the investee to affect the amount of the investor's returns (see paragraphs B58–B72).
- B4 When assessing control of an investee, an investor shall consider the nature of its relationship with other parties (see paragraphs B73–B75).

Purpose and design of an investee

- B5 When assessing control of an investee, an investor shall consider the purpose and design of the investee in order to identify the relevant activities, how decisions about the relevant activities are made, who has the current ability to direct those activities and who receives returns from those activities.
- B6 When an investee's purpose and design are considered, it may be clear that an investee is controlled by means of equity instruments that give the holder proportionate voting rights, such as ordinary shares in the investee. In this case, in the absence of any additional arrangements that alter decision-making, the assessment of control focuses on which party, if any, is able to exercise voting rights sufficient to determine the investee's operating and financing policies (see paragraphs B34–B50). In the most straightforward case, the investor that holds a majority of those voting rights, in the absence of any other factors, controls the investee.

- B7 To determine whether an investor controls an investee in more complex cases, it may be necessary to consider some or all of the other factors in paragraph B3.
- B8 An investee may be designed so that voting rights are not the dominant factor in deciding who controls the investee, such as when any voting rights relate to administrative tasks only and the relevant activities are directed by means of contractual arrangements. In such cases, an investor's consideration of the purpose and design of the investee shall also include consideration of the risks to which the investee was designed to be exposed, the risks it was designed to pass on to the parties involved with the investee and whether the investor is exposed to some or all of those risks. Consideration of the risks includes not only the downside risk, but also the potential for upside.

Power

- B9 To have power over an investee, an investor must have existing rights that give it 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 (see paragraphs B22–B28).
- B10 The determination about whether an investor has power depends on the relevant activities, the way decisions about the relevant activities are made and the rights the investor and other parties have in relation to the investee.

Relevant activities and direction of relevant activities

- B11 For many investees, a range of operating and financing activities significantly affect their returns. Examples of activities that, depending on the circumstances, can be relevant activities include, but are not limited to:
- (a) selling and purchasing of goods or services;
 - (b) managing financial assets during their life (including upon default);
 - (c) selecting, acquiring or disposing of assets;
 - (d) researching and developing new products or processes; and
 - (e) determining a funding structure or obtaining funding.
- B12 Examples of decisions about relevant activities include but are not limited to:
- (a) establishing operating and capital decisions of the investee, including budgets; and
 - (b) appointing and remunerating an investee's key management personnel or service providers and terminating their services or employment.
- B13 In some situations, activities both before and after a particular set of circumstances arises or event occurs may be relevant activities. When two or more investors have the current ability to direct relevant activities and those activities occur at different times, the investors shall determine which investor is able to direct the activities that most significantly affect those returns consistently with the treatment of concurrent decision-making rights (see paragraph 13). The investors shall reconsider this assessment over time if relevant facts or circumstances change.

Application examples

Example 1

Two investors form an investee to develop and market a medical product. One investor 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 other investor 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:

- (e) 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
- (f) which investor controls the medical product once the development phase is successful.

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Application examples

Example 2

An investment vehicle (the investee) is created and financed with a debt instrument held by an investor (the debt investor) and equity instruments held by a number of other investors. The equity tranche is designed to absorb the first losses and to receive any residual return from the investee. One of the equity investors who holds 30 per cent of the equity is also the asset manager. The investee uses its proceeds to purchase a portfolio of financial assets, exposing the investee to the credit risk associated with the possible default of principal and interest payments of the assets. The transaction is marketed to the debt investor as an investment with minimal exposure to the credit risk associated with the possible default of the assets in the portfolio because of the nature of these assets and because the equity tranche is designed to absorb the first losses of the investee. The returns of the investee are significantly affected by the management of the investee's asset portfolio, which includes decisions about the selection, acquisition and disposal of the assets within portfolio guidelines and the management upon default of any portfolio assets. All those activities are managed by the asset manager until defaults reach a specified proportion of the portfolio value (ie when the value of the portfolio is such that the equity tranche of the investee has been consumed). From that time, a third-party trustee manages the assets according to the instructions of the debt investor. Managing the investee's asset portfolio is the relevant activity of the investee. The asset manager has the ability to direct the relevant activities until defaulted assets reach the specified proportion of the portfolio value; the debt investor has the ability to direct the relevant activities when the value of defaulted assets surpasses that specified proportion of the portfolio value. The asset manager and the debt investor each need to determine whether they are able to direct the activities that *most* significantly affect the investee's returns, including considering the purpose and design of the investee as well as each party's exposure to variability of returns.

Rights that give an investor power over an investee

- B14 Power arises from rights. To have power over an investee, an investor must have existing rights that give the investor the current ability to direct the relevant activities. The rights that may give an investor power can differ between investees.
- B15 Examples of rights that, either individually or in combination, can give an investor power include but are not limited to:
- (a) rights in the form of voting rights (or potential voting rights) of an investee (see paragraphs B34–B50);
 - (b) rights to appoint, reassign or remove members of an investee's key management personnel who have the ability to direct the relevant activities;
 - (c) rights to appoint or remove another entity that directs the relevant activities;

- (d) rights to direct the investee to enter into, or veto any changes to, transactions for the benefit of the investor; and
 - (e) other rights (such as decision-making rights specified in a management contract) that give the holder the ability to direct the relevant activities.
- B16 Generally, when an investee has a range of operating and financing activities that significantly affect the investee's returns and when substantive decision-making with respect to these activities is required continuously, it will be voting or similar rights that give an investor power, either individually or in combination with other arrangements.
- B17 When voting rights cannot have a significant effect on an investee's returns, such as when voting rights relate to administrative tasks only and contractual arrangements determine the direction of the relevant activities, the investor needs to assess those contractual arrangements in order to determine whether it has rights sufficient to give it power over the investee. To determine whether an investor has rights sufficient to give it power, the investor shall consider the purpose and design of the investee (see paragraphs B5–B8) and the requirements in paragraphs B51–B54 together with paragraphs B18–B20.
- B18 In some circumstances it may be difficult to determine whether an investor's rights are sufficient to give it power over an investee. In such cases, to enable the assessment of power to be made, the investor shall consider evidence of whether it has the practical ability to direct the relevant activities unilaterally. Consideration is given, but is not limited, to the following, which, when considered together with its rights and the indicators in paragraphs B19 and B20, may provide evidence that the investor's rights are sufficient to give it power over the investee:
- (a) The investor can, without having the contractual right to do so, appoint or approve the investee's key management personnel who have the ability to direct the relevant activities.
 - (b) The investor can, without having the contractual right to do so, direct the investee to enter into, or can veto any changes to, significant transactions for the benefit of the investor.
 - (c) The investor can dominate either the nominations process for electing members of the investee's governing body or the obtaining of proxies from other holders of voting rights.
 - (d) The investee's key management personnel are related parties of the investor (for example, the chief executive officer of the investee and the chief executive officer of the investor are the same person).
 - (e) The majority of the members of the investee's governing body are related parties of the investor.
- B19 Sometimes there will be indications that the investor has a special relationship with the investee, which suggests that the investor has more than a passive interest in the investee. The existence of any individual indicator, or a particular combination of indicators, does not necessarily mean that the power criterion is met. However, having more than a passive interest in the investee may indicate that the investor has other related rights sufficient to give it power or provide evidence of existing power over an investee. For example, the following suggests that the investor has more than a passive interest in the investee and, in combination with other rights, may indicate power:

- (a) The investee's key management personnel who have the ability to direct the relevant activities are current or previous employees of the investor.
 - (b) The investee's operations are dependent on the investor, such as in the following situations:
 - (i) The investee depends on the investor to fund a significant portion of its operations.
 - (ii) The investor guarantees a significant portion of the investee's obligations.
 - (iii) The investee depends on the investor for critical services, technology, supplies or raw materials.
 - (iv) The investor controls assets such as licences or trademarks that are critical to the investee's operations.
 - (v) The investee depends on the investor for key management personnel, such as when the investor's personnel have specialised knowledge of the investee's operations.
 - (c) A significant portion of the investee's activities either involve or are conducted on behalf of the investor.
 - (d) The investor's exposure, or rights, to returns from its involvement with the investee is disproportionately greater than its voting or other similar rights. For example, there may be a situation in which an investor is entitled, or exposed, to more than half of the returns of the investee but holds less than half of the voting rights of the investee.
- B20 The greater an investor's exposure, or rights, to variability of returns from its involvement with an investee, the greater is the incentive for the investor to obtain rights sufficient to give it power. Therefore, having a large exposure to variability of returns is an indicator that the investor may have power. However, the extent of the investor's exposure does not, in itself, determine whether an investor has power over the investee.
- B21 When the factors set out in paragraph B18 and the indicators set out in paragraphs B19 and B20 are considered together with an investor's rights, greater weight shall be given to the evidence of power described in paragraph B18.

Substantive rights

- B22 An investor, in assessing whether it has power, considers only substantive rights relating to an investee (held by the investor and others). For a right to be substantive, the holder must have the practical ability to exercise that right.
- B23 Determining whether rights are substantive requires judgement, taking into account all facts and circumstances. Factors to consider in making that determination include but are not limited to:
- (a) Whether there are any barriers (economic or otherwise) that prevent the holder (or holders) from exercising the rights. Examples of such barriers include but are not limited to:

- (i) financial penalties and incentives that would prevent (or deter) the holder from exercising its rights.
 - (ii) an exercise or conversion price that creates a financial barrier that would prevent (or deter) the holder from exercising its rights.
 - (iii) terms and conditions that make it unlikely that the rights would be exercised, for example, conditions that narrowly limit the timing of their exercise.
 - (iv) the absence of an explicit, reasonable mechanism in the founding documents of an investee or in applicable laws or regulations that would allow the holder to exercise its rights.
 - (v) the inability of the holder of the rights to obtain the information necessary to exercise its rights.
 - (vi) operational barriers or incentives that would prevent (or deter) the holder from exercising its rights (eg the absence of other managers willing or able to provide specialised services or provide the services and take on other interests held by the incumbent manager).
 - (vii) legal or regulatory requirements that prevent the holder from exercising its rights (eg where a foreign investor is prohibited from exercising its rights).
- (b) When the exercise of rights requires the agreement of more than one party, or when the rights are held by more than one party, whether a mechanism is in place that provides those parties with the practical ability to exercise their rights collectively if they choose to do so. The lack of such a mechanism is an indicator that the rights may not be substantive. The more parties that are required to agree to exercise the rights, the less likely it is that those rights are substantive. However, a board of directors whose members are independent of the decision maker may serve as a mechanism for numerous investors to act collectively in exercising their rights. Therefore, removal rights exercisable by an independent board of directors are more likely to be substantive than if the same rights were exercisable individually by a large number of investors.
- (c) Whether the party or parties that hold the rights would benefit from the exercise of those rights. For example, the holder of potential voting rights in an investee (see paragraphs B47–B50) shall consider the exercise or conversion price of the instrument. The terms and conditions of potential voting rights are more likely to be substantive when the instrument is in the money or the investor would benefit for other reasons (eg by realising synergies between the investor and the investee) from the exercise or conversion of the instrument.
- B24** 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.

Application examples**Example 3**

The investee has annual shareholder meetings at which decisions to direct the relevant activities are made. The next scheduled shareholders' meeting is in eight months. However, shareholders that individually or collectively hold at least 5 per cent of the voting rights can call a special meeting to change the existing policies over the 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. Policies over the relevant activities can be changed only at special or scheduled shareholders' meetings. This includes the approval of material sales of assets as well as the making or disposing of significant investments.

The above fact pattern applies to examples 3A–3D described below. Each example is considered in isolation.

Example 3A

An investor holds a majority of the voting rights in the investee. The investor's voting rights are substantive because the investor is able to make decisions about the direction of the relevant activities when they need to be made. The fact that it takes 30 days before the investor can exercise its voting rights does not stop the investor from having the current ability to direct the relevant activities from the moment the investor acquires the shareholding.

Example 3B

An investor is party to a forward contract to acquire the majority of shares in the investee. The forward contract's settlement date is in 25 days. The existing shareholders are unable to change the existing policies over the relevant activities because a special meeting cannot be held for at least 30 days, at which point the forward contract will have been settled. Thus, the investor has rights that are essentially equivalent to the majority shareholder in example 3A above (ie the investor holding the forward contract can make decisions about the direction of the relevant activities when they need to be made). The investor's forward contract is a substantive right that gives the investor the current ability to direct the relevant activities even before the forward contract is settled.

Example 3C

An investor holds a substantive option to acquire the majority of shares in the investee that is exercisable in 25 days and is deeply in the money. The same conclusion would be reached as in example 3B.

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Application examples

Example 3D

An investor is party to a forward contract to acquire the majority of shares in the investee, with no other related rights over the investee. The forward contract's settlement date is in six months. In contrast to the examples above, the investor does not have the current ability to direct the relevant activities. The existing shareholders have the current ability to direct the relevant activities because they can change the existing policies over the relevant activities before the forward contract is settled.

- B25 Substantive rights exercisable by other parties can prevent an investor from controlling the investee to which those rights relate. Such substantive rights do not require the holders to have the ability to initiate decisions. As long as the rights are not merely protective (see paragraphs B26–B28), substantive rights held by other parties may prevent the investor from controlling the investee even if the rights give the holders only the current ability to approve or block decisions that relate to the relevant activities.

Protective rights

- B26 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 apply in exceptional circumstances or are contingent on events are protective (see paragraphs B13 and B53).
- B27 Because protective rights are designed to protect the interests of their holder without giving that party power over the investee to which those rights relate, an investor that holds only protective rights cannot have power or prevent another party from having power over an investee (see paragraph 14).
- B28 Examples of protective rights include but are not limited to:
- (a) a lender's right to restrict a borrower from undertaking activities that could significantly change the credit risk of the borrower to the detriment of the lender.
 - (b) the right of a party holding a non-controlling interest in an investee to approve capital expenditure greater than that required in the ordinary course of business, or to approve the issue of equity or debt instruments.
 - (c) the right of a lender to seize the assets of a borrower if the borrower fails to meet specified loan repayment conditions.

Franchises

- B29 A franchise agreement for which the investee is the franchisee often gives the franchisor rights that are designed to protect the franchise brand. Franchise agreements typically give franchisors some decision-making rights with respect to the operations of the franchisee.
- B30 Generally, franchisors' rights do not restrict the ability of parties other than the franchisor to make decisions that have a significant effect on the franchisee's returns. Nor do the rights of the franchisor in franchise agreements necessarily give the franchisor the current ability to direct the activities that significantly affect the franchisee's returns.
- B31 It is necessary to distinguish between having the current ability to make decisions that significantly affect the franchisee's returns and having the ability to make decisions that protect the franchise brand. The franchisor does not have power over the franchisee if other parties have existing rights that give them the current ability to direct the relevant activities of the franchisee.
- B32 By entering into the franchise agreement the franchisee has made a unilateral decision to operate its business in accordance with the terms of the franchise agreement, but for its own account.
- B33 Control over such fundamental decisions as the legal form of the franchisee and its funding structure may be determined by parties other than the franchisor and may significantly affect the returns of the franchisee. The lower the level of financial support provided by the franchisor and the lower the franchisor's exposure to variability of returns from the franchisee the more likely it is that the franchisor has only protective rights.

Voting rights

- B34 Often an investor has the current ability, through voting or similar rights, to direct the relevant activities. An investor considers the requirements in this section (paragraphs B35–B50) if the relevant activities of an investee are directed through voting rights.

Power with a majority of the voting rights

- B35 An investor that holds more than half of the voting rights of an investee has power in the following situations, unless paragraph B36 or paragraph B37 applies:
- (a) the relevant activities are directed by a vote of the holder of the majority of the voting rights, or
 - (b) a majority of the members of the governing body that directs the relevant activities are appointed by a vote of the holder of the majority of the voting rights.

Majority of the voting rights but no power

- B36 For an investor that holds more than half of the voting rights of an investee, to have power over an investee, the investor's voting rights must be substantive, in accordance with paragraphs B22–B25, and must provide the investor with the current ability to direct the relevant activities, which often will be through determining operating and financing policies. If another entity has existing rights that provide that entity with the right to direct the relevant activities and that entity is not an agent of the investor, the investor does not have power over the investee.

- B37 An investor does not have power over an investee, even though the investor holds the majority of the voting rights in the investee, when those voting rights are not substantive. For example, an investor that has more than half of the voting rights in an investee cannot have power if the relevant activities are subject to direction by a government, court, administrator, receiver, liquidator or regulator.

Power without a majority of the voting rights

- B38 An investor can have power even if it holds less than a majority of the voting rights of an investee. An investor can have power with less than a majority of the voting rights of an investee, for example, through:
- (a) a contractual arrangement between the investor and other vote holders (see paragraph B39);
 - (b) rights arising from other contractual arrangements (see paragraph B40);
 - (c) the investor's voting rights (see paragraphs B41–B45);
 - (d) potential voting rights (see paragraphs B47–B50); or
 - (e) a combination of (a)–(d).

Contractual arrangement with other vote holders

- B39 A contractual arrangement between an investor and other vote holders can give the investor the right to exercise voting rights sufficient to give the investor power, even if the investor does not have voting rights sufficient to give it power without the contractual arrangement. However, a contractual arrangement might ensure that the investor can direct enough other vote holders on how to vote to enable the investor to make decisions about the relevant activities.

Rights from other contractual arrangements

- B40 Other decision-making rights, in combination with voting rights, can give an investor the current ability to direct the relevant activities. For example, the rights specified in a contractual arrangement in combination with voting rights may be sufficient to give an investor the current ability to direct the manufacturing processes of an investee or to direct other operating or financing activities of an investee that significantly affect the investee's returns. However, in the absence of any other rights, economic dependence of an investee on the investor (such as relations of a supplier with its main customer) does not lead to the investor having power over the investee.

The investor's voting rights

- B41 An investor with less than a majority of the voting rights has rights that are sufficient to give it power when the investor has the practical ability to direct the relevant activities unilaterally.
- B42 When assessing whether an investor's voting rights are sufficient to give it power, an investor considers all facts and circumstances, including:
- (a) the size of the investor's holding of voting rights relative to the size and dispersion of holdings of the other vote holders, noting that:
 - (i) the more voting rights an investor holds, the more likely the investor is to have existing rights that give it the current ability to direct the relevant activities;
 - (ii) the more voting rights an investor holds relative to other vote holders, the more likely the investor is to have existing rights that give it the current ability to direct the relevant activities;

- (iii) the more parties that would need to act together to outvote the investor, the more likely the investor is to have existing rights that give it the current ability to direct the relevant activities;
 - (b) potential voting rights held by the investor, other vote holders or other parties (see paragraphs B47–B50);
 - (c) rights arising from other contractual arrangements (see paragraph B40); and
 - (d) any additional facts and circumstances that indicate the investor has, or does not have, the current ability to direct the relevant activities at the time that decisions need to be made, including voting patterns at previous shareholders’ meetings.
- B43 When the direction of relevant activities is determined by majority vote and an investor holds significantly more voting rights than any other vote holder or organised group of vote holders, and the other shareholdings are widely dispersed, it may be clear, after considering the factors listed in paragraph B42(a)–(c) alone, that the investor has power over the investee.

Application examples

Example 4

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. In this case, 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.

Example 5

Investor A holds 40 per cent of the voting rights of an investee and twelve other investors each hold 5 per cent of the voting rights of the investee. A shareholder agreement grants investor A the right to appoint, remove and set the remuneration of management responsible for directing the relevant activities. To change the agreement, a two-thirds majority vote of the shareholders is required. In this case, investor A concludes that the absolute size of the investor’s holding and the relative size of the other shareholdings alone are not conclusive in determining whether the investor has rights sufficient to give it power. However, investor A determines that its contractual right to appoint, remove and set the remuneration of management is sufficient to conclude that it has power over the investee. The fact that investor A might not have exercised this right or the likelihood of investor A exercising its right to select, appoint or remove management shall not be considered when assessing whether investor A has power.

- B44 In other situations, it may be clear after considering the factors listed in paragraph B42(a)–(c) alone that an investor does not have power.

Application example

Example 6

Investor A holds 45 per cent of the voting rights of an investee. Two other investors each hold 26 per cent of the voting rights of the investee. The remaining voting rights are held by three other shareholders, each holding 1 per cent. There are no other arrangements that affect decision-making. In this case, the size of investor A's voting interest and its size relative to the other shareholdings are sufficient to conclude that investor A does not have power. Only two other investors would need to co-operate to be able to prevent investor A from directing the relevant activities of the investee.

- B45 However, the factors listed in paragraph B42(a)–(c) alone may not be conclusive. If an investor, having considered those factors, is unclear whether it has power, it shall consider additional facts and circumstances, such as whether other shareholders are passive in nature as demonstrated by voting patterns at previous shareholders' meetings. This includes the assessment of the factors set out in paragraph B18 and the indicators in paragraphs B19 and B20. The fewer voting rights the investor holds, and the fewer parties that would need to act together to outvote the investor, the more reliance would be placed on the additional facts and circumstances to assess whether the investor's rights are sufficient to give it power. When the facts and circumstances in paragraphs B18–B20 are considered together with the investor's rights, greater weight shall be given to the evidence of power in paragraph B18 than to the indicators of power in paragraphs B19 and B20.

Application examples

Example 7

An investor holds 45 per cent of the voting rights of an investee. Eleven other shareholders each hold 5 per cent of the voting rights of the investee. None of the shareholders has contractual arrangements to consult any of the others or make collective decisions. In this case, the absolute size of the investor's holding and the relative size of the other shareholdings alone are not conclusive in determining whether the investor has rights sufficient to give it power over the investee. Additional facts and circumstances that may provide evidence that the investor has, or does not have, power shall be considered.

Example 8

An investor holds 35 per cent of the voting rights of an investee. Three other shareholders each hold 5 per cent of the voting rights of the investee. The remaining voting rights are held by numerous other shareholders, none individually holding more than 1 per cent of the voting rights. None of the shareholders has arrangements to consult any of the others or make collective decisions. Decisions about the relevant activities of the investee require the approval of a majority of votes cast at relevant shareholders' meetings—75 per cent of the voting rights of the investee have been cast at recent relevant shareholders' meetings. In this case, the active participation of the other shareholders at recent shareholders' meetings indicates that the investor would not have the practical ability to direct the relevant activities unilaterally, regardless of whether the investor has directed the relevant activities because a sufficient number of other shareholders voted in the same way as the investor.

- B46 If it is not clear, having considered the factors listed in paragraph B42(a)–(d), that the investor has power, the investor does not control the investee.

Potential voting rights

- B47 When assessing control, an investor considers its potential voting rights as well as potential voting rights held by other parties, to determine whether it has power. Potential voting rights are rights to obtain voting rights of an investee, such as those arising from convertible instruments or options, including forward contracts. Those potential voting rights are considered only if the rights are substantive (see paragraphs B22–B25).
- B48 When considering potential voting rights, an investor shall consider the purpose and design of the instrument, as well as the purpose and design of any other involvement the investor has with the investee. This includes an assessment of the various terms and conditions of the instrument as well as the investor's apparent expectations, motives and reasons for agreeing to those terms and conditions.
- B49 If the investor also has voting or other decision-making rights relating to the investee's activities, the investor assesses whether those rights, in combination with potential voting rights, give the investor power.

- B50 Substantive potential voting rights alone, or in combination with other rights, can give an investor the current ability to direct the relevant activities. For example, this is likely to be the case when an investor holds 40 per cent of the voting rights of an investee and, in accordance with paragraph B23, holds substantive rights arising from options to acquire a further 20 per cent of the voting rights.

Application examples

Example 9

Investor A holds 70 per cent of the voting rights of an investee. Investor B has 30 per cent of the voting rights of the investee as well as an option to acquire half of investor A's voting rights. The option is exercisable for 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). Investor A has been exercising its votes and is actively directing the relevant activities of the investee. In such a case, investor A is likely to meet the power criterion because it appears to have the current ability to direct the relevant activities. Although investor B has currently exercisable options to purchase additional voting rights (that, if exercised, would give it a majority of the voting rights in the investee), the terms and conditions associated with those options are such that the options are not considered substantive.

Example 10

Investor A and two other investors each hold a third of the voting rights of an investee. The investee's business activity is closely related to investor A. In addition to its equity instruments, investor A also holds debt instruments that are convertible into ordinary shares of the investee at any time for a fixed price that is out of the money (but not deeply out of the money). If the debt were converted, investor A would hold 60 per cent of the voting rights of the investee. Investor A would benefit from realising synergies if the debt instruments were converted into ordinary shares. Investor A has power over the investee because it holds voting rights of the investee together with substantive potential voting rights that give it the current ability to direct the relevant activities.

Power when voting or similar rights do not have a significant effect on the investee's returns

- B51 In assessing the purpose and design of an investee (see paragraphs B5–B8), an investor shall consider the involvement and decisions made at the investee's inception as part of its design and evaluate whether the transaction terms and features of the involvement provide the investor with rights that are sufficient to give it power. Being involved in the design of an investee alone is not sufficient to give an investor control. However, involvement in the design may indicate that the investor had the opportunity to obtain rights that are sufficient to give it power over the investee.

- B52 In addition, an investor shall consider contractual arrangements such as call rights, put rights and liquidation rights established at the investee’s inception. When these contractual arrangements involve activities that are closely related to the investee, then these activities are, in substance, an integral part of the investee’s overall activities, even though they may occur outside the legal boundaries of the investee. Therefore, explicit or implicit decision-making rights embedded in contractual arrangements that are closely related to the investee need to be considered as relevant activities when determining power over the investee.
- B53 For some investees, relevant activities occur only when particular circumstances arise or events occur. The investee may be designed so that the direction of its activities and its returns are predetermined unless and until those particular circumstances arise or events occur. In this case, only the decisions about the investee’s activities when those circumstances or events occur can significantly affect its returns and thus be relevant activities. The circumstances or events need not have occurred for an investor with the ability to make those decisions to have power. The fact that the right to make decisions is contingent on circumstances arising or an event occurring does not, in itself, make those rights protective.

<p>Application examples</p>
<p>Example 11</p> <p>An investee’s only business activity, as specified in its founding documents, is to purchase receivables and service them on a day-to-day basis for its investors. The servicing on a day-to-day basis includes the collection and passing on of principal and interest payments as they fall due. Upon default of a receivable the investee automatically puts the receivable to an investor as agreed separately in a put agreement between the investor and the investee. The only relevant activity is managing the receivables upon default because it is the only activity that can significantly affect the investee’s returns. Managing the receivables before default is not a relevant activity because it does not require substantive decisions to be made that could significantly affect the investee’s returns—the activities before default are predetermined and amount only to collecting cash flows as they fall due and passing them on to investors. Therefore, only the investor’s right to manage the assets upon default should be considered when assessing the overall activities of the investee that significantly affect the investee’s returns.</p> <p>In this example, the design of the investee ensures that the investor has decision-making authority over the activities that significantly affect the returns at the only time that such decision-making authority is required. The terms of the put agreement are integral to the overall transaction and the establishment of the investee. Therefore, the terms of the put agreement together with the founding documents of the investee lead to the conclusion that the investor has power over the investee even though the investor takes ownership of the receivables only upon default and manages the defaulted receivables outside the legal boundaries of the investee.</p> <p style="text-align: right;"><i>continued...</i></p>

...continued

Application examples

Example 12

The only assets of an investee are receivables. When the purpose and design of the investee are considered, it is determined that the only relevant activity is managing the receivables upon default. The party that has the ability to manage the defaulting receivables has power over the investee, irrespective of whether any of the borrowers have defaulted.

- B54 An investor may have an explicit or implicit commitment to ensure that an investee continues to operate as designed. Such a commitment may increase the investor's exposure to variability of returns and thus increase the incentive for the investor to obtain rights sufficient to give it power. Therefore a commitment to ensure that an investee operates as designed may be an indicator that the investor has power, but does not, by itself, give an investor power, nor does it prevent another party from having power.

Exposure, or rights, to variable returns from an investee

- B55 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.
- B56 Variable returns are returns that are not fixed and have the potential to vary as a result of the performance of an investee. Variable returns can be only positive, only negative or both positive and negative (see paragraph 15). An investor assesses whether returns from an investee are variable and how variable those returns are on the basis of the substance of the arrangement and regardless of the legal form of the returns. For example, an investor can hold a bond with fixed interest payments. The fixed interest payments are variable returns for the purpose of this HKFRS because they are subject to default risk and they expose the investor to the credit risk of the issuer of the bond. The amount of variability (ie how variable those returns are) depends on the credit risk of the bond. Similarly, fixed performance fees for managing an investee's assets are variable returns because they expose the investor to the performance risk of the investee. The amount of variability depends on the investee's ability to generate sufficient income to pay the fee.
- B57 Examples of returns include:
- (a) dividends, other distributions of economic benefits from an investee (eg interest from debt securities issued by the investee) and changes in the value of the investor's investment in that investee.
 - (b) remuneration for servicing an investee's assets or liabilities, fees and exposure to loss from providing credit or liquidity support, residual interests in the investee's assets and liabilities on liquidation of that investee, tax benefits, and access to future liquidity that an investor has from its involvement with an investee.

- (c) returns that are not available to other interest holders. For example, an investor might use its assets in combination with the assets of the investee, such as combining operating functions to achieve economies of scale, cost savings, sourcing scarce products, gaining access to proprietary knowledge or limiting some operations or assets, to enhance the value of the investor's other assets.

Link between power and returns

Delegated power

- B58 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. An agent is a party primarily engaged to act on behalf and for the benefit of another party or parties (the principal(s)) and therefore does not control the investee when it exercises its decision-making authority (see paragraphs 17 and 18). Thus, sometimes a principal's power may be held and exercisable by an agent, but on behalf of the principal. A decision maker is not an agent simply because other parties can benefit from the decisions that it makes.
- B59 An investor may delegate its decision-making authority to an agent on some specific issues or on all relevant activities. When assessing whether it controls an investee, the investor shall treat the decision-making rights delegated to its agent as held by the investor directly. In situations where there is more than one principal, each of the principals shall assess whether it has power over the investee by considering the requirements in paragraphs B5–B54. Paragraphs B60–B72 provide guidance on determining whether a decision maker is an agent or a principal.
- B60 A decision maker shall consider the overall relationship between itself, the investee being managed and other parties involved with the investee, in particular all the factors below, in determining whether it is an agent:
- (a) the scope of its decision-making authority over the investee (paragraphs B62 and B63).
 - (b) the rights held by other parties (paragraphs B64–B67).
 - (c) the remuneration to which it is entitled in accordance with the remuneration agreement(s) (paragraphs B68–B70).
 - (d) the decision maker's exposure to variability of returns from other interests that it holds in the investee (paragraphs B71 and B72).
- Different weightings shall be applied to each of the factors on the basis of particular facts and circumstances.
- B61 Determining whether a decision maker is an agent requires an evaluation of all the factors listed in paragraph B60 unless a single party holds substantive rights to remove the decision maker (removal rights) and can remove the decision maker without cause (see paragraph B65).

The scope of the decision-making authority

- B62 The scope of a decision maker's decision-making authority is evaluated by considering:
- (a) the activities that are permitted according to the decision-making agreement(s) and specified by law, and
 - (b) the discretion that the decision maker has when making decisions about those activities.
- B63 A decision maker shall consider the purpose and design of the investee, the risks to which the investee was designed to be exposed, the risks it was designed to pass on to the parties involved and the level of involvement the decision maker had in the design of an investee. For example, if a decision maker is significantly involved in the design of the investee (including in determining the scope of decision-making authority), that involvement may indicate that the decision maker had the opportunity and incentive to obtain rights that result in the decision maker having the ability to direct the relevant activities.

Rights held by other parties

- B64 Substantive rights held by other parties may affect the decision maker's ability to direct the relevant activities of an investee. Substantive removal or other rights may indicate that the decision maker is an agent.
- B65 When a single party holds substantive removal rights and can remove the decision maker without cause, this, in isolation, is sufficient to conclude that the decision maker is an agent. If more than one party holds such rights (and no individual party can remove the decision maker without the agreement of other parties) those rights are not, in isolation, conclusive in determining that a decision maker acts primarily on behalf and for the benefit of others. In addition, the greater the number of parties required to act together to exercise rights to remove a decision maker and the greater the magnitude of, and variability associated with, the decision maker's other economic interests (ie remuneration and other interests), the less the weighting that shall be placed on this factor.
- B66 Substantive rights held by other parties that restrict a decision maker's discretion shall be considered in a similar manner to removal rights when evaluating whether the decision maker is an agent. For example, a decision maker that is required to obtain approval from a small number of other parties for its actions is generally an agent. (See paragraphs B22–B25 for additional guidance on rights and whether they are substantive.)
- B67 Consideration of the rights held by other parties shall include an assessment of any rights exercisable by an investee's board of directors (or other governing body) and their effect on the decision-making authority (see paragraph B23(b)).

Remuneration

- B68 The greater the magnitude of, and variability associated with, the decision maker's remuneration relative to the returns expected from the activities of the investee, the more likely the decision maker is a principal.

B69 In determining whether it is a principal or an agent the decision maker shall also consider whether the following conditions exist:

- (a) The remuneration of the decision maker is commensurate with the services provided.
- (b) The remuneration agreement includes only terms, conditions or amounts that are customarily present in arrangements for similar services and level of skills negotiated on an arm's length basis.

B70 A decision maker cannot be an agent unless the conditions set out in paragraph B69(a) and (b) are present. However, meeting those conditions in isolation is not sufficient to conclude that a decision maker is an agent.

Exposure to variability of returns from other interests

B71 A decision maker that holds other interests in an investee (eg investments in the investee or provides guarantees with respect to the performance of the investee), shall consider its exposure to variability of returns from those interests in assessing whether it is an agent. Holding other interests in an investee indicates that the decision maker may be a principal.

B72 In evaluating its exposure to variability of returns from other interests in the investee a decision maker shall consider the following:

- (a) the greater the magnitude of, and variability associated with, its economic interests, considering its remuneration and other interests in aggregate, the more likely the decision maker is a principal.
- (b) whether its exposure to variability of returns is different from that of the other investors and, if so, whether this might influence its actions. For example, this might be the case when a decision maker holds subordinated interests in, or provides other forms of credit enhancement to, an investee.

The decision maker shall evaluate its exposure relative to the total variability of returns of the investee. This evaluation is made primarily on the basis of returns expected from the activities of the investee but shall not ignore the decision maker's maximum exposure to variability of returns of the investee through other interests that the decision maker holds.

Application examples

Example 13

A decision maker (fund manager) establishes, markets and manages a publicly traded, regulated fund according to narrowly defined parameters set out in the investment mandate as required by its local laws and regulations. The fund was marketed to investors as an investment in a diversified portfolio of equity securities of publicly traded entities. Within the defined parameters, the fund manager has discretion about the assets in which to invest. The fund manager has made a 10 per cent pro rata investment in the fund and receives a market-based fee for its services equal to 1 per cent of the net asset value of the fund. The fees are commensurate with the services provided. The fund manager does not have any obligation to fund losses beyond its 10 per cent investment. The fund is not required to establish, and has not established, an independent board of directors. The investors do not hold any substantive rights that would affect the decision-making authority of the fund manager, but can redeem their interests within particular limits set by the fund.

Although operating within the parameters set out in the investment mandate and in accordance with the regulatory requirements, the fund manager has decision-making rights that give it the current ability to direct the relevant activities of the fund—the investors do not hold substantive rights that could affect the fund manager’s decision-making authority. The fund manager receives a market-based fee for its services that is commensurate with the services provided and has also made a pro rata investment in the fund. The remuneration and its investment expose the fund manager to variability of returns from the activities of the fund without creating exposure that is of such significance that it indicates that the fund manager is a principal.

In this example, consideration of the fund manager’s exposure to variability of returns from the fund together with its decision-making authority within restricted parameters indicates that the fund manager is an agent. Thus, the fund manager concludes that it does not control the fund.

Example 14

A decision maker establishes, markets and manages a fund that provides investment opportunities to a number of investors. The decision maker (fund manager) must make decisions in the best interests of all investors and in accordance with the fund’s governing agreements. Nonetheless, the fund manager has wide decision-making discretion. The fund manager receives a market-based fee for its services equal to 1 per cent of assets under management and 20 per cent of all the fund’s profits if a specified profit level is achieved. The fees are commensurate with the services provided.

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Application examples

Although it must make decisions in the best interests of all investors, the fund manager has extensive decision-making authority to direct the relevant activities of the fund. The fund manager is paid fixed and performance-related fees that are commensurate with the services provided. In addition, the remuneration aligns the interests of the fund manager with those of the other investors to increase the value of the fund, without creating exposure to variability of returns from the activities of the fund that is of such significance that the remuneration, when considered in isolation, indicates that the fund manager is a principal.

The above fact pattern and analysis applies to examples 14A–14C described below. Each example is considered in isolation.

Example 14A

The fund manager also has a 2 per cent investment in the fund that aligns its interests with those of the other investors. The fund manager does not have any obligation to fund losses beyond its 2 per cent investment. The investors can remove the fund manager by a simple majority vote, but only for breach of contract.

The fund manager's 2 per cent investment increases its exposure to variability of returns from the activities of the fund without creating exposure that is of such significance that it indicates that the fund manager is a principal. The other investors' rights to remove the fund manager are considered to be protective rights because they are exercisable only for breach of contract. In this example, although the fund manager has extensive decision-making authority and is exposed to variability of returns from its interest and remuneration, the fund manager's exposure indicates that the fund manager is an agent. Thus, the fund manager concludes that it does not control the fund.

Example 14B

The fund manager has a more substantial pro rata investment in the fund, but does not have any obligation to fund losses beyond that investment. The investors can remove the fund manager by a simple majority vote, but only for breach of contract.

In this example, the other investors' rights to remove the fund manager are considered to be protective rights because they are exercisable only for breach of contract. Although the fund manager is paid fixed and performance-related fees that are commensurate with the services provided, the combination of the fund manager's investment together with its remuneration could create exposure to variability of returns from the activities of the fund that is of such significance that it indicates that the fund manager is a principal. The greater the magnitude of, and variability associated with, the fund manager's economic interests (considering its remuneration and other interests in aggregate), the more emphasis the fund manager would place on those economic interests in the analysis, and the more likely the fund manager is a principal.

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Application examples

For example, having considered its remuneration and the other factors, the fund manager might consider a 20 per cent investment to be sufficient to conclude that it controls the fund. However, in different circumstances (ie if the remuneration or other factors are different), control may arise when the level of investment is different.

Example 14C

The fund manager has a 20 per cent pro rata investment in the fund, but does not have any obligation to fund losses beyond its 20 per cent investment. The fund has a board of directors, all of whose members are independent of the fund manager and are appointed by the other investors. The board appoints the fund manager annually. If the board decided not to renew the fund manager's contract, the services performed by the fund manager could be performed by other managers in the industry.

Although the fund manager is paid fixed and performance-related fees that are commensurate with the services provided, the combination of the fund manager's 20 per cent investment together with its remuneration creates exposure to variability of returns from the activities of the fund that is of such significance that it indicates that the fund manager is a principal. However, the investors have substantive rights to remove the fund manager—the board of directors provides a mechanism to ensure that the investors can remove the fund manager if they decide to do so.

In this example, the fund manager places greater emphasis on the substantive removal rights in the analysis. Thus, although the fund manager has extensive decision-making authority and is exposed to variability of returns of the fund from its remuneration and investment, the substantive rights held by the other investors indicate that the fund manager is an agent. Thus, the fund manager concludes that it does not control the fund.

Example 15

An investee is created to purchase a portfolio of fixed rate asset-backed securities, funded by fixed rate debt instruments and equity instruments. The equity instruments are designed to provide first loss protection to the debt investors and receive any residual returns of the investee. The transaction was marketed to potential debt investors as an investment in a portfolio of asset-backed securities with exposure to the credit risk associated with the possible default of the issuers of the asset-backed securities in the portfolio and to the interest rate risk associated with the management of the portfolio. On formation, the equity instruments represent 10 per cent of the value of the assets purchased. A decision maker (the asset manager) manages the active asset portfolio by making investment decisions within the parameters set out in the investee's prospectus. For those services, the asset manager receives a market-based fixed fee (ie 1 per cent of assets under management) and performance-related fees (ie 10 per cent of profits) if the investee's profits exceed a specified level. The fees are commensurate with the services provided. The asset manager holds 35 per cent of the equity in the investee.

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Application examples

The remaining 65 per cent of the equity, and all the debt instruments, are held by a large number of widely dispersed unrelated third party investors. The asset manager can be removed, without cause, by a simple majority decision of the other investors.

The asset manager is paid fixed and performance-related fees that are commensurate with the services provided. The remuneration aligns the interests of the fund manager with those of the other investors to increase the value of the fund. The asset manager has exposure to variability of returns from the activities of the fund because it holds 35 per cent of the equity and from its remuneration.

Although operating within the parameters set out in the investee's prospectus, the asset manager has the current ability to make investment decisions that significantly affect the investee's returns—the removal rights held by the other investors receive little weighting in the analysis because those rights are held by a large number of widely dispersed investors. In this example, the asset manager places greater emphasis on its exposure to variability of returns of the fund from its equity interest, which is subordinate to the debt instruments. Holding 35 per cent of the equity creates subordinated exposure to losses and rights to returns of the investee, which are of such significance that it indicates that the asset manager is a principal. Thus, the asset manager concludes that it controls the investee.

Example 16

A decision maker (the sponsor) sponsors a multi-seller conduit, which issues short-term debt instruments to unrelated third party investors. The transaction was marketed to potential investors as an investment in a portfolio of highly rated medium-term assets with minimal exposure to the credit risk associated with the possible default by the issuers of the assets in the portfolio. Various transferors sell high quality medium-term asset portfolios to the conduit. Each transferor services the portfolio of assets that it sells to the conduit and manages receivables on default for a market-based servicing fee. Each transferor also provides first loss protection against credit losses from its asset portfolio through over-collateralisation of the assets transferred to the conduit. The sponsor establishes the terms of the conduit and manages the operations of the conduit for a market-based fee. The fee is commensurate with the services provided. The sponsor approves the sellers permitted to sell to the conduit, approves the assets to be purchased by the conduit and makes decisions about the funding of the conduit. The sponsor must act in the best interests of all investors.

The sponsor is entitled to any residual return of the conduit and also provides credit enhancement and liquidity facilities to the conduit. The credit enhancement provided by the sponsor absorbs losses of up to 5 per cent of all of the conduit's assets, after losses are absorbed by the transferors. The liquidity facilities are not advanced against defaulted assets. The investors do not hold substantive rights that could affect the decision-making authority of the sponsor.

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Application examples

Even though the sponsor is paid a market-based fee for its services that is commensurate with the services provided, the sponsor has exposure to variability of returns from the activities of the conduit because of its rights to any residual returns of the conduit and the provision of credit enhancement and liquidity facilities (ie the conduit is exposed to liquidity risk by using short-term debt instruments to fund medium-term assets). Even though each of the transferors has decision-making rights that affect the value of the assets of the conduit, the sponsor has extensive decision-making authority that gives it the current ability to direct the activities that *most* significantly affect the conduit's returns (ie the sponsor established the terms of the conduit, has the right to make decisions about the assets (approving the assets purchased and the transferors of those assets) and the funding of the conduit (for which new investment must be found on a regular basis)). The right to residual returns of the conduit and the provision of credit enhancement and liquidity facilities expose the sponsor to variability of returns from the activities of the conduit that is different from that of the other investors. Accordingly, that exposure indicates that the sponsor is a principal and thus the sponsor concludes that it controls the conduit. The sponsor's obligation to act in the best interest of all investors does not prevent the sponsor from being a principal.

Relationship with other parties

- B73 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 (ie they are 'de facto agents'). The determination of whether other parties are acting as de facto agents requires judgement, considering not only the nature of the relationship but also how those parties interact with each other and the investor.
- B74 Such a relationship need not involve a contractual arrangement. A party is a de facto agent when the investor has, or those that direct the activities of the investor have, the ability to direct that party to act on the investor's behalf. In these circumstances, the investor shall consider its de facto agent's decision-making rights and its indirect exposure, or rights, to variable returns through the de facto agent together with its own when assessing control of an investee.
- B75 The following are examples of such other parties that, by the nature of their relationship, might act as de facto agents for the investor:
- (a) the investor's related parties.
 - (b) a party that received its interest in the investee as a contribution or loan from the investor.
 - (c) a party that has agreed not to sell, transfer or encumber its interests in the investee without the investor's prior approval (except for situations in which the investor and the other party have the right of prior approval and the rights are based on mutually agreed terms by willing independent parties).

- (d) a party that cannot finance its operations without subordinated financial support from the investor.
- (e) an investee for which the majority of the members of its governing body or for which its key management personnel are the same as those of the investor.
- (f) a party that has a close business relationship with the investor, such as the relationship between a professional service provider and one of its significant clients.

Control of specified assets

B76 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.

B77 An investor shall treat a portion of an investee as a deemed separate entity if and only if the following condition is satisfied:

Specified assets of the investee (and related credit enhancements, if any) are the only source of payment for specified liabilities of, or specified other interests in, the investee. Parties other than those with the specified liability do not have rights or obligations related to the specified assets or to residual cash flows from those assets. In substance, 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 are ring-fenced from the overall investee. Such a deemed separate entity is often called a 'silo'.

B78 When the condition in paragraph B77 is satisfied, an investor shall identify the activities that significantly affect the returns of the deemed separate entity and how those activities are directed in order to assess whether it has power over that portion of the investee. When assessing control of the deemed separate entity, the investor shall also consider whether it has exposure or rights to variable returns from its involvement with that deemed separate entity and the ability to use its power over that portion of the investee to affect the amount of the investor's returns.

B79 If the investor controls the deemed separate entity, the investor shall consolidate that portion of the investee. In that case, other parties exclude that portion of the investee when assessing control of, and in consolidating, the investee.

Continuous assessment

B80 An investor shall reassess whether it controls an investee if facts and circumstances indicate that there are changes to one or more of the three elements of control listed in paragraph 7.

B81 If there is a change in how power over an investee can be exercised, that change must be reflected in how an investor assesses its power over an investee. For example, changes to decision-making rights can mean that the relevant activities are no longer directed through voting rights, but instead other agreements, such as contracts, give another party or parties the current ability to direct the relevant activities.

- B82 An event can cause an investor to gain or lose power over an investee without the investor being involved in that event. For example, an investor can gain power over an investee because decision-making rights held by another party or parties that previously prevented the investor from controlling an investee have lapsed.
- B83 An investor also considers changes affecting its exposure, or rights, to variable returns from its involvement with an investee. For example, an investor that has power over an investee can lose control of an investee if the investor ceases to be entitled to receive returns or to be exposed to obligations, because the investor would fail to satisfy paragraph 7(b) (eg if a contract to receive performance-related fees is terminated).
- B84 An investor shall consider whether its assessment that it acts as an agent or a principal has changed. Changes in the overall relationship between the investor and other parties can mean that an investor no longer acts as an agent, even though it has previously acted as an agent, and vice versa. For example, if changes to the rights of the investor, or of other parties, occur, the investor shall reconsider its status as a principal or an agent.
- B85 An investor's initial assessment of control or its status as a principal or an agent would not change simply because of a change in market conditions (eg a change in the investee's returns driven by market conditions), unless the change in market conditions changes one or more of the three elements of control listed in paragraph 7 or changes the overall relationship between a principal and an agent.

Determining whether an entity is an investment entity

- B85A An entity shall consider all facts and circumstances when assessing whether it is an investment entity, including its purpose and design. An entity that possesses the three elements of the definition of an investment entity set out in paragraph 27 is an investment entity. Paragraphs B85B–B85M describe the elements of the definition in more detail.

Business purpose

- B85B The definition of an investment entity requires that the purpose of the entity is to invest solely for capital appreciation, investment income (such as dividends, interest or rental income), or both. Documents that indicate what the entity's investment objectives are, such as the entity's offering memorandum, publications distributed by the entity and other corporate or partnership documents, will typically provide evidence of an investment entity's business purpose. Further evidence may include the manner in which the entity presents itself to other parties (such as potential investors or potential investees); for example, an entity may present its business as providing medium-term investment for capital appreciation. In contrast, an entity that presents itself as an investor whose objective is to jointly develop, produce or market products with its investees has a business purpose that is inconsistent with the business purpose of an investment entity, because the entity will earn returns from the development, production or marketing activity as well as from its investments (see paragraph B85I).
- B85C An investment entity may provide investment-related services (eg investment advisory services, investment management, investment support and administrative services), either directly or through a subsidiary, to third parties as well as to its investors, even if those activities are substantial to the entity, subject to the entity continuing to meet the definition of an investment entity.

- B85D An investment entity may also participate in the following investment-related activities, either directly or through a subsidiary, if these activities are undertaken to maximise the investment return (capital appreciation or investment income) from its investees and do not represent a separate substantial business activity or a separate substantial source of income to the investment entity:
- (a) providing management services and strategic advice to an investee; and
 - (b) providing financial support to an investee, such as a loan, capital commitment or guarantee.
- B85E If an investment entity has a subsidiary that is not itself an investment entity and whose main purpose and activities are providing investment-related services or activities that relate to the investment entity's investment activities, such as those described in paragraphs B85C–B85D, to the entity or other parties, it shall consolidate that subsidiary in accordance with paragraph 32. If the subsidiary that provides the investment-related services or activities is itself an investment entity, the investment entity parent shall measure that subsidiary at fair value through profit or loss in accordance with paragraph 31.

Exit strategies

- B85F An entity's investment plans also provide evidence of its business purpose. One feature that differentiates an investment entity from other entities is that an investment entity does not plan to hold its investments indefinitely; it holds them for a limited period. Because equity investments and non-financial asset investments have the potential to be held indefinitely, an investment entity shall have an exit strategy documenting how the entity plans to realise capital appreciation from substantially all of its equity investments and non-financial asset investments. An investment entity shall also have an exit strategy for any debt instruments that have the potential to be held indefinitely, for example perpetual debt investments. The entity need not document specific exit strategies for each individual investment but shall identify different potential strategies for different types or portfolios of investments, including a substantive time frame for exiting the investments. Exit mechanisms that are only put in place for default events, such as a breach of contract or non-performance, are not considered exit strategies for the purpose of this assessment.
- B85G Exit strategies can vary by type of investment. For investments in private equity securities, examples of exit strategies include an initial public offering, a private placement, a trade sale of a business, distributions (to investors) of ownership interests in investees and sales of assets (including the sale of an investee's assets followed by a liquidation of the investee). For equity investments that are traded in a public market, examples of exit strategies include selling the investment in a private placement or in a public market. For real estate investments, an example of an exit strategy includes the sale of the real estate through specialised property dealers or the open market.
- B85H An investment entity may have an investment in another investment entity that is formed in connection with the entity for legal, regulatory, tax or similar business reasons. In this case, the investment entity investor need not have an exit strategy for that investment, provided that the investment entity investee has appropriate exit strategies for its investments.

Earnings from investments

- B85I An entity is not investing solely for capital appreciation, investment income, or both, if the entity or another member of the group containing the entity (ie the group that is controlled by the investment entity's ultimate parent) obtains, or has the objective of obtaining, other benefits from the entity's investments that are not available to other parties that are not related to the investee. Such benefits include:

- (a) the acquisition, use, exchange or exploitation of the processes, assets or technology of an investee. This would include the entity or another group member having disproportionate, or exclusive, rights to acquire assets, technology, products or services of any investee; for example, by holding an option to purchase an asset from an investee if the asset's development is deemed successful;
- (b) joint arrangements (as defined in HKFRS 11) or other agreements between the entity or another group member and an investee to develop, produce, market or provide products or services;
- (c) financial guarantees or assets provided by an investee to serve as collateral for borrowing arrangements of the entity or another group member (however, an investment entity would still be able to use an investment in an investee as collateral for any of its borrowings);
- (d) an option held by a related party of the entity to purchase, from that entity or another group member, an ownership interest in an investee of the entity;
- (e) except as described in paragraph B85J, transactions between the entity or another group member and an investee that:
 - (i) are on terms that are unavailable to entities that are not related parties of either the entity, another group member or the investee;
 - (ii) are not at fair value; or
 - (iii) represent a substantial portion of the investee's or the entity's business activity, including business activities of other group entities.

B85J An investment entity may have a strategy to invest in more than one investee in the same industry, market or geographical area in order to benefit from synergies that increase the capital appreciation and investment income from those investees. Notwithstanding paragraph B85I(e), an entity is not disqualified from being classified as an investment entity merely because such investees trade with each other.

Fair value measurement

B85K An essential element of the definition of an investment entity is that it measures and evaluates the performance of substantially all of its investments on a fair value basis, because using fair value results in more relevant information than, for example, consolidating its subsidiaries or using the equity method for its interests in associates or joint ventures. In order to demonstrate that it meets this element of the definition, an investment entity:

- (a) provides investors with fair value information and measures substantially all of its investments at fair value in its financial statements whenever fair value is required or permitted in accordance with HKFRSs; and
- (b) reports fair value information internally to the entity's key management personnel (as defined in HKAS 24), who use fair value as the primary measurement attribute to evaluate the performance of substantially all of its investments and to make investment decisions.

- B85L In order to meet the requirement in B85K(a), an investment entity would:
- (a) elect to account for any investment property using the fair value model in HKAS 40 *Investment Property*;
 - (b) elect the exemption from applying the equity method in HKAS 28 for its investments in associates and joint ventures; and
 - (c) measure its financial assets at fair value using the requirements in HKFRS 9.

B85M An investment entity may have some non-investment assets, such as a head office property and related equipment, and may also have financial liabilities. The fair value measurement element of the definition of an investment entity in paragraph 27(c) applies to an investment entity's investments. Accordingly, an investment entity need not measure its non-investment assets or its liabilities at fair value.

Typical characteristics of an investment entity

B85N In determining whether it meets the definition of an investment entity, an entity shall consider whether it displays the typical characteristics of one (see paragraph 28). The absence of one or more of these typical characteristics does not necessarily disqualify an entity from being classified as an investment entity but indicates that additional judgement is required in determining whether the entity is an investment entity.

More than one investment

B85O An investment entity typically holds several investments to diversify its risk and maximise its returns. An entity may hold a portfolio of investments directly or indirectly, for example by holding a single investment in another investment entity that itself holds several investments.

- B85P There may be times when the entity holds a single investment. However, holding a single investment does not necessarily prevent an entity from meeting the definition of an investment entity. For example, an investment entity may hold only a single investment when the entity:
- (a) is in its start-up period and has not yet identified suitable investments and, therefore, has not yet executed its investment plan to acquire several investments;
 - (b) has not yet made other investments to replace those it has disposed of;
 - (c) is established to pool investors' funds to invest in a single investment when that investment is unobtainable by individual investors (eg when the required minimum investment is too high for an individual investor); or
 - (d) is in the process of liquidation.

More than one investor

- B85Q Typically, an investment entity would have several investors who pool their funds to gain access to investment management services and investment opportunities that they might not have had access to individually. Having several investors would make it less likely that the entity, or other members of the group containing the entity, would obtain benefits other than capital appreciation or investment income (see paragraph B85I).
- B85R Alternatively, an investment entity may be formed by, or for, a single investor that represents or supports the interests of a wider group of investors (eg a pension fund, government investment fund or family trust).
- B85S There may also be times when the entity temporarily has a single investor. For example, an investment entity may have only a single investor when the entity:
- (a) is within its initial offering period, which has not expired and the entity is actively identifying suitable investors;
 - (b) has not yet identified suitable investors to replace ownership interests that have been redeemed; or
 - (c) is in the process of liquidation.

Unrelated investors

- B85T Typically, an investment entity has several investors that are not related parties (as defined in HKAS 24) of the entity or other members of the group containing the entity. Having unrelated investors would make it less likely that the entity, or other members of the group containing the entity, would obtain benefits other than capital appreciation or investment income (see paragraph B85I).
- B85U However, an entity may still qualify as an investment entity even though its investors are related to the entity. For example, an investment entity may set up a separate 'parallel' fund for a group of its employees (such as key management personnel) or other related party investor(s), which mirrors the investments of the entity's main investment fund. This 'parallel' fund may qualify as an investment entity even though all of its investors are related parties.

Ownership interests

- B85V An investment entity is typically, but is not required to be, a separate legal entity. Ownership interests in an investment entity are typically in the form of equity or similar interests (eg partnership interests), to which proportionate shares of the net assets of the investment entity are attributed. However, having different classes of investors, some of which have rights only to a specific investment or groups of investments or which have different proportionate shares of the net assets, does not preclude an entity from being an investment entity.
- B85W In addition, an entity that has significant ownership interests in the form of debt that, in accordance with other applicable HKFRSs, does not meet the definition of equity, may still qualify as an investment entity, provided that the debt holders are exposed to variable returns from changes in the fair value of the entity's net assets.

Accounting requirements

Consolidation procedures

- B86 Consolidated financial statements:
- (a) combine like items of assets, liabilities, equity, income, expenses and cash flows of the parent with those of its subsidiaries.
 - (b) offset (eliminate) the carrying amount of the parent's investment in each subsidiary and the parent's portion of equity of each subsidiary (HKFRS 3 explains how to account for any related goodwill).
 - (c) eliminate in full intragroup assets and liabilities, equity, income, expenses and cash flows relating to transactions between entities of the group (profits or losses resulting from intragroup transactions that are recognised in assets, such as inventory and fixed assets, are eliminated in full). Intragroup losses may indicate an impairment that requires recognition in the consolidated financial statements. HKAS 12 *Income Taxes* applies to temporary differences that arise from the elimination of profits and losses resulting from intragroup transactions.

Uniform accounting policies

- B87 If a member of the group uses accounting policies other than those adopted in the consolidated financial statements for like transactions and events in similar circumstances, appropriate adjustments are made to that group member's financial statements in preparing the consolidated financial statements to ensure conformity with the group's accounting policies.

Measurement

- B88 An entity includes the income and expenses of a subsidiary in the consolidated financial statements from the date it gains control until the date when the entity ceases to control the subsidiary. Income and expenses of the subsidiary are based on the amounts of the assets and liabilities recognised in the consolidated financial statements at the acquisition date. For example, depreciation expense recognised in the consolidated statement of comprehensive income after the acquisition date is based on the fair values of the related depreciable assets recognised in the consolidated financial statements at the acquisition date.

Potential voting rights

- B89 When potential voting rights, or other derivatives containing potential voting rights, exist, the proportion of profit or loss and changes in equity allocated to the parent and non-controlling interests in preparing consolidated financial statements is determined solely on the basis of existing ownership interests and does not reflect the possible exercise or conversion of potential voting rights and other derivatives, unless paragraph B90 applies.
- B90 In some circumstances an entity has, in substance, an existing ownership interest as a result of a transaction that currently gives the entity access to the returns associated with an ownership interest. In such circumstances, the proportion allocated to the parent and non-controlling interests in preparing consolidated financial statements is determined by taking into account the eventual exercise of those potential voting rights and other derivatives that currently give the entity access to the returns.
- B91 HKFRS 9 does not apply to interests in subsidiaries that are consolidated. When instruments containing potential voting rights in substance currently give access to the returns associated with an ownership interest in a subsidiary, the instruments are not subject to the requirements of HKFRS 9. In all other cases, instruments containing potential voting rights in a subsidiary are accounted for in accordance with HKFRS 9.

Reporting date

- B92 The financial statements of the parent and its subsidiaries used in the preparation of the consolidated financial statements shall have the same reporting date. When the end of the reporting period of the parent is different from that of a subsidiary, the subsidiary prepares, for consolidation purposes, additional financial information as of the same date as the financial statements of the parent to enable the parent to consolidate the financial information of the subsidiary, unless it is impracticable to do so.
- B93 If it is impracticable to do so, the parent shall consolidate the financial information of the subsidiary using the most recent financial statements of the subsidiary adjusted for the effects of significant transactions or events that occur between the date of those financial statements and the date of the consolidated financial statements. In any case, the difference between the date of the subsidiary's financial statements and that of the consolidated financial statements shall be no more than three months, and the length of the reporting periods and any difference between the dates of the financial statements shall be the same from period to period.

Non-controlling interests

- B94 An entity shall attribute the profit or loss and each component of other comprehensive income to the owners of the parent and to the non-controlling interests. The entity shall also attribute total comprehensive income to the owners of the parent and to the non-controlling interests even if this results in the non-controlling interests having a deficit balance.
- B95 If a subsidiary has outstanding cumulative preference shares that are classified as equity and are held by non-controlling interests, the entity shall compute its share of profit or loss after adjusting for the dividends on such shares, whether or not such dividends have been declared.

Changes in the proportion held by non-controlling interests

- B96 When the proportion of the equity held by non-controlling interests changes, an entity shall adjust the carrying amounts of the controlling and non-controlling interests to reflect the changes in their relative interests in the subsidiary. The entity shall recognise directly in equity any difference between the amount by which the non-controlling interests are adjusted and the fair value of the consideration paid or received, and attribute it to the owners of the parent.

Loss of control

- B97 A parent might lose control of a subsidiary in two or more arrangements (transactions). However, sometimes circumstances indicate that the multiple arrangements should be accounted for as a single transaction. In determining whether to account for the arrangements as a single transaction, a parent shall consider all the terms and conditions of the arrangements and their economic effects. One or more of the following indicate that the parent should account for the multiple arrangements as a single transaction:
- (a) They are entered into at the same time or in contemplation of each other.
 - (b) They form a single transaction designed to achieve an overall commercial effect.
 - (c) The occurrence of one arrangement is dependent on the occurrence of at least one other arrangement.
 - (d) One arrangement considered on its own is not economically justified, but it is economically justified when considered together with other arrangements. An example is when a disposal of shares is priced below market and is compensated for by a subsequent disposal priced above market.

- B98 If a parent loses control of a subsidiary, it shall:
- (a) derecognise:
 - (i) the assets (including any goodwill) and liabilities of the subsidiary at their carrying amounts at the date when control is lost; and
 - (ii) the carrying amount of any non-controlling interests in the former subsidiary at the date when control is lost (including any components of other comprehensive income attributable to them).
 - (b) recognise:
 - (i) the fair value of the consideration received, if any, from the transaction, event or circumstances that resulted in the loss of control;
 - (ii) if the transaction, event or circumstances that resulted in the loss of control involves a distribution of shares of the subsidiary to owners in their capacity as owners, that distribution; and
 - (iii) any investment retained in the former subsidiary at its fair value at the date when control is lost.
 - (c) reclassify to profit or loss, or transfer directly to retained earnings if required by other HKFRSs, the amounts recognised in other comprehensive income in relation to the subsidiary on the basis described in paragraph B99.
 - (d) recognise any resulting difference as a gain or loss in profit or loss attributable to the parent.
- B99 If a parent loses control of a subsidiary, the parent shall account for all amounts previously recognised in other comprehensive income in relation to that subsidiary on the same basis as would be required if the parent had directly disposed of the related assets or liabilities. Therefore, if a gain or loss previously recognised in other comprehensive income would be reclassified to profit or loss on the disposal of the related assets or liabilities, the parent shall reclassify the gain or loss from equity to profit or loss (as a reclassification adjustment) when it loses control of the subsidiary. If a revaluation surplus previously recognised in other comprehensive income would be transferred directly to retained earnings on the disposal of the asset, the parent shall transfer the revaluation surplus directly to retained earnings when it loses control of the subsidiary.

Accounting for a change in investment entity status

- B100 When an entity ceases to be an investment entity, it shall apply HKFRS 3 to any subsidiary that was previously measured at fair value through profit or loss in accordance with paragraph 31. The date of the change of status shall be the deemed acquisition date. The fair value of the subsidiary at the deemed acquisition date shall represent the transferred deemed consideration when measuring any goodwill or gain from a bargain purchase that arises from the deemed acquisition. All subsidiaries shall be consolidated in accordance with paragraphs 19–24 of this HKFRS from the date of change of status.
- B101 When an entity becomes an investment entity, it shall cease to consolidate its subsidiaries at the date of the change in status, except for any subsidiary that shall continue to be consolidated in accordance with paragraph 32. The investment entity shall apply the requirements of paragraphs 25 and 26 to those subsidiaries that it ceases to consolidate as though the investment entity had lost control of those subsidiaries at that date.

Appendix C

Effective date and transition

This appendix is an integral part of the HKFRS and has the same authority as the other parts of the HKFRS.

Effective date

- C1 An entity shall apply this HKFRS for annual periods beginning on or after 1 January 2013. Earlier application is permitted. If an entity applies this HKFRS earlier, it shall disclose that fact and apply HKFRS 11, HKFRS 12, HKAS 27 *Separate Financial Statements* and HKAS 28 (as amended in 2011) at the same time.
- C1A *Consolidated Financial Statements, Joint Arrangements and Disclosure of Interests in Other Entities: Transition Guidance* (Amendments to HKFRS 10, HKFRS 11 and HKFRS 12), issued in July 2012, amended paragraphs C2–C6 and added paragraphs C2A–C2B, C4A–C4C, C5A and C6A–C6B. An entity shall apply those amendments for annual periods beginning on or after 1 January 2013. If an entity applies HKFRS 10 for an earlier period, it shall apply those amendments for that earlier period.
- C1B *Investment Entities* (Amendments to HKFRS 10, HKFRS 12 and HKAS 27), issued in December 2012, amended paragraphs 2, 4, C2A, C6A and Appendix A and added paragraphs 27–33, B85A–B85W, B100–B101 and C3A–C3F. An entity shall apply those amendments for annual periods beginning on or after 1 January 2014. Early application is permitted. If an entity applies those amendments earlier, it shall disclose that fact and apply all amendments included in *Investment Entities* at the same time.
- C1C *[This paragraph refers to amendments that are not yet effective, and is therefore not included in this edition.]*
- C1D *Investment Entities: Applying the Consolidation Exception* (Amendments to HKFRS 10, HKFRS 12 and HKAS 28), issued in January 2015, amended paragraphs 4, 32, B85C, B85E and C2A and added paragraphs 4A–4B. An entity shall apply those amendments for annual periods beginning on or after 1 January 2016. Earlier application is permitted. If an entity applies those amendments for an earlier period it shall disclose that fact.

Transition

- C2 An entity shall apply this HKFRS retrospectively, in accordance with HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*, except as specified in paragraphs C2A–C6.
- C2A Notwithstanding the requirements of paragraph 28 of HKAS 8, when this HKFRS is first applied, and, if later, when the *Investment Entities* and *Investment Entities: Applying the Consolidation Exception* amendments to this HKFRS are first applied, an entity need only present the quantitative information required by paragraph 28(f) of HKAS 8 for the annual period immediately preceding the date of initial application of this HKFRS (the ‘immediately preceding period’). An entity may also present this information for the current period or for earlier comparative periods, but is not required to do so.
- C2B For the purposes of this HKFRS, the date of initial application is the beginning of the annual reporting period for which this HKFRS is applied for the first time.
- C3 At the date of initial application, an entity is not required to make adjustments to the previous accounting for its involvement with either:

- (a) entities that would be consolidated at that date in accordance with HKAS 27 *Consolidated and Separate Financial Statements* and HK(SIC)-Int 12 *Consolidation—Special Purpose Entities* and are still consolidated in accordance with this HKFRS; or
 - (b) entities that would not be consolidated at that date in accordance with HKAS 27 and HK(SIC)-Int 12 and are not consolidated in accordance with this HKFRS.
- C3A At the date of initial application, an entity shall assess whether it is an investment entity on the basis of the facts and circumstances that exist at that date. If, at the date of initial application, an entity concludes that it is an investment entity, it shall apply the requirements of paragraphs C3B–C3F instead of paragraphs C5–C5A.
- C3B Except for any subsidiary that is consolidated in accordance with paragraph 32 (to which paragraphs C3 and C6 or paragraphs C4–C4C, whichever is relevant, apply), an investment entity shall measure its investment in each subsidiary at fair value through profit or loss as if the requirements of this HKFRS had always been effective. The investment entity shall retrospectively adjust both the annual period that immediately precedes the date of initial application and equity at the beginning of the immediately preceding period for any difference between:
- (a) the previous carrying amount of the subsidiary; and
 - (b) the fair value of the investment entity’s investment in the subsidiary.
- The cumulative amount of any fair value adjustments previously recognised in other comprehensive income shall be transferred to retained earnings at the beginning of the annual period immediately preceding the date of initial application.
- C3C Before the date that HKFRS 13 *Fair Value Measurement* is adopted, an investment entity shall use the fair value amounts that were previously reported to investors or to management, if those amounts represent the amount for which the investment could have been exchanged between knowledgeable, willing parties in an arm’s length transaction at the date of the valuation.
- C3D If measuring an investment in a subsidiary in accordance with paragraphs C3B–C3C is impracticable (as defined in HKAS 8), an investment entity shall apply the requirements of this HKFRS at the beginning of the earliest period for which application of paragraphs C3B–C3C is practicable, which may be the current period. The investor shall retrospectively adjust the annual period that immediately precedes the date of initial application, unless the beginning of the earliest period for which application of this paragraph is practicable is the current period. If this is the case, the adjustment to equity shall be recognised at the beginning of the current period.
- C3E If an investment entity has disposed of, or has lost control of, an investment in a subsidiary before the date of initial application of this HKFRS, the investment entity is not required to make adjustments to the previous accounting for that subsidiary.
- C3F If an entity applies the *Investment Entities* amendments for a period later than when it applies HKFRS 10 for the first time, references to ‘the date of initial application’ in paragraphs C3A–C3E shall be read as ‘the beginning of the annual reporting period for which the amendments in *Investment Entities* (Amendments to HKFRS 10, HKFRS 12 and HKAS 27), issued in December 2012, are applied for the first time.’
- C4 If, at the date of initial application, an investor concludes that it shall consolidate an investee that was not consolidated in accordance with HKAS 27 and (HK)SIC-Int 12, the investor shall:

- (a) if the investee is a business (as defined in HKFRS 3 *Business Combinations*), measure the assets, liabilities and non-controlling interests in that previously unconsolidated investee as if that investee had been consolidated (and thus had applied acquisition accounting in accordance with HKFRS 3) from the date when the investor obtained control of that investee on the basis of the requirements of this HKFRS. The investor shall adjust retrospectively the annual period immediately preceding the date of initial application. When the date that control was obtained is earlier than the beginning of the immediately preceding period, the investor shall recognise, as an adjustment to equity at the beginning of the immediately preceding period, any difference between:
 - (i) the amount of assets, liabilities and non-controlling interests recognised; and
 - (ii) the previous carrying amount of the investor's involvement with the investee.
- (b) if the investee is not a business (as defined in HKFRS 3), measure the assets, liabilities and non-controlling interests in that previously unconsolidated investee as if that investee had been consolidated (applying the acquisition method as described in HKFRS 3 but without recognising any goodwill for the investee) from the date when the investor obtained control of that investee on the basis of the requirements of this HKFRS. The investor shall adjust retrospectively the annual period immediately preceding the date of initial application. When the date that control was obtained is earlier than the beginning of the immediately preceding period, the investor shall recognise, as an adjustment to equity at the beginning of the immediately preceding period, any difference between:
 - (i) the amount of assets, liabilities and non-controlling interests recognised; and
 - (ii) the previous carrying amount of the investor's involvement with the investee.

C4A If measuring an investee's assets, liabilities and non-controlling interests in accordance with paragraph C4(a) or (b) is impracticable (as defined in HKAS 8), an investor shall:

- (a) if the investee is a business, apply the requirements of HKFRS 3 as of the deemed acquisition date. The deemed acquisition date shall be the beginning of the earliest period for which application of paragraph C4(a) is practicable, which may be the current period.
- (b) if the investee is not a business, apply the acquisition method as described in HKFRS 3 but without recognising any goodwill for the investee as of the deemed acquisition date. The deemed acquisition date shall be the beginning of the earliest period for which the application of paragraph C4(b) is practicable, which may be the current period.

The investor shall adjust retrospectively the annual period immediately preceding the date of initial application, unless the beginning of the earliest period for which application of this paragraph is practicable is the current period. When the deemed acquisition date is earlier than the beginning of the immediately preceding period, the investor shall recognise, as an adjustment to equity at the beginning of the immediately preceding period, any difference between:

- (c) the amount of assets, liabilities and non-controlling interests recognised; and
- (d) the previous carrying amount of the investor's involvement with the investee.

If the earliest period for which application of this paragraph is practicable is the current period, the adjustment to equity shall be recognised at the beginning of the current period.

C4B When an investor applies paragraphs C4–C4A and the date that control was obtained in accordance with this HKFRS is later than the effective date of HKFRS 3 as revised in 2008 (HKFRS 3 (2008)), the reference to HKFRS 3 in paragraphs C4 and C4A shall be to HKFRS 3 (2008). If control was obtained before the effective date of HKFRS 3 (2008), an investor shall apply either HKFRS 3 (2008) or HKFRS 3 (issued in 2004).

- C4C When an investor applies paragraphs C4–C4A and the date that control was obtained in accordance with this HKFRS is later than the effective date of HKAS 27 as revised in 2008 (HKAS 27 (2008)), an investor shall apply the requirements of this HKFRS for all periods that the investee is retrospectively consolidated in accordance with paragraphs C4–C4A. If control was obtained before the effective date of HKAS 27 (2008), an investor shall apply either:
- (a) the requirements of this HKFRS for all periods that the investee is retrospectively consolidated in accordance with paragraphs C4–C4A; or
 - (b) the requirements of the version of HKAS 27 issued in 2004 (HKAS 27 (2004)) for those periods prior to the effective date of HKAS 27 (2008) and thereafter the requirements of this HKFRS for subsequent periods.
- C5 If, at the date of initial application, an investor concludes that it will no longer consolidate an investee that was consolidated in accordance with HKAS 27 and HK(SIC)-Int 12, the investor shall measure its interest in the investee at the amount at which it would have been measured if the requirements of this HKFRS had been effective when the investor became involved with (but did not obtain control in accordance with this HKFRS), or lost control of, the investee. The investor shall adjust retrospectively the annual period immediately preceding the date of initial application. When the date that the investor became involved with (but did not obtain control in accordance with this HKFRS), or lost control of, the investee is earlier than the beginning of the immediately preceding period, the investor shall recognise, as an adjustment to equity at the beginning of the immediately preceding period, any difference between:
- (a) the previous carrying amount of the assets, liabilities and non-controlling interests; and
 - (b) the recognised amount of the investor's interest in the investee.
- C5A If measuring the interest in the investee in accordance with paragraph C5 is impracticable (as defined in HKAS 8), an investor shall apply the requirements of this HKFRS at the beginning of the earliest period for which application of paragraph C5 is practicable, which may be the current period. The investor shall adjust retrospectively the annual period immediately preceding the date of initial application, unless the beginning of the earliest period for which application of this paragraph is practicable is the current period. When the date that the investor became involved with (but did not obtain control in accordance with this HKFRS), or lost control of, the investee is earlier than the beginning of the immediately preceding period, the investor shall recognise, as an adjustment to equity at the beginning of the immediately preceding period, any difference between:
- (a) the previous carrying amount of the assets, liabilities and non-controlling interests; and
 - (b) the recognised amount of the investor's interest in the investee.
- If the earliest period for which application of this paragraph is practicable is the current period, the adjustment to equity shall be recognised at the beginning of the current period.
- C6 Paragraphs 23, 25, B94 and B96–B99 were amendments to HKAS 27 made in 2008 that were carried forward into HKFRS 10. Except when an entity applies paragraph C3, or is required to apply paragraphs C4–C5A, the entity shall apply the requirements in those paragraphs as follows:
- (a) An entity shall not restate any profit or loss attribution for reporting periods before it applied the amendment in paragraph B94 for the first time.
 - (b) The requirements in paragraphs 23 and B96 for accounting for changes in ownership interests in a subsidiary after control is obtained do not apply to changes that occurred before an entity applied these amendments for the first time.

- (c) An entity shall not restate the carrying amount of an investment in a former subsidiary if control was lost before it applied the amendments in paragraphs 25 and B97–B99 for the first time. In addition, an entity shall not recalculate any gain or loss on the loss of control of a subsidiary that occurred before the amendments in paragraphs 25 and B97–B99 were applied for the first time.

References to the ‘immediately preceding period’

- C6A Notwithstanding the references to the annual period immediately preceding the date of initial application (the ‘immediately preceding period’) in paragraphs C3B–C5A, an entity may also present adjusted comparative information for any earlier periods presented, but is not required to do so. If an entity does present adjusted comparative information for any earlier periods, all references to the ‘immediately preceding period’ in paragraphs C3B–C5A shall be read as the ‘earliest adjusted comparative period presented’.
- C6B If an entity presents unadjusted comparative information for any earlier periods, it shall clearly identify the information that has not been adjusted, state that it has been prepared on a different basis, and explain that basis.

References to HKFRS 9

- C7 If an entity applies this HKFRS but does not yet apply HKFRS 9, any reference in this HKFRS to HKFRS 9 shall be read as a reference to HKAS 39 *Financial Instruments: Recognition and Measurement*.

Withdrawal of other HKFRSs

- C8 This HKFRS supersedes the requirements relating to consolidated financial statements in HKAS 27 (as amended in 2008).
- C9 This HKFRS also supersedes HK(SIC)-Int 12 *Consolidation—Special Purpose Entities*.

Appendix D

Amendments to other HKFRSs

This appendix sets out the amendments to other HKFRSs that are a consequence of issuing this HKFRS. An entity shall apply the amendments for annual periods beginning on or after 1 January 2013. If an entity applies this HKFRS for an earlier period, it shall apply these amendments for that earlier period. Amended paragraphs are shown with new text underlined and deleted text struck through.

The amendments contained in this appendix when this Standard was issued have been incorporated into the relevant HKFRSs.

HKFRS 10 BC
Revised August 2020 September 2022

*Basis for Conclusions on
Hong Kong Financial Reporting Standard 10*

Consolidated Financial Statements



Hong Kong Institute of
Certified Public Accountants
香港會計師公會

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Basis for Conclusions on IFRS 10 Consolidated Financial Statements

HKFRS 10 is based on IFRS 10 *Consolidated Financial Statements*. In approving HKFRS 10, the Council of the Hong Kong Institute of Certified Public Accountants considered and agreed with the IASB's Basis for Conclusions on IFRS 10. Accordingly, there are no significant differences between HKFRS 10 and IFRS 10. The IASB's Basis for Conclusions is reproduced below. The paragraph numbers of IFRS 10 referred to below generally correspond with those in HKFRS 10.

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Basis for Conclusions on IFRS 10 *Consolidated Financial Statements*

This Basis for Conclusions accompanies, but is not part of, IFRS 10.

Introduction

- BC1 This Basis for Conclusions summarises the International Accounting Standards Board's considerations in developing IFRS 10 *Consolidated Financial Statements*. Individual Board members gave greater weight to some factors than to others. Unless otherwise stated, any reference below to IAS 27 is to IAS 27 *Consolidated and Separate Financial Statements*, and to IAS 28 is to IAS 28 *Investments in Associates*.
- BC2 The Board added a project on consolidation to its agenda to deal with divergence in practice in applying IAS 27 and SIC-12 *Consolidation—Special Purpose Entities*. For example, entities varied in their application of the control concept:
- (a) in circumstances in which an investor controls an investee but the investor has less than a majority of the voting rights of the investee (and voting rights are clearly the basis for control).
 - (b) in circumstances involving special purpose entities (to which the notion of 'economic substance' in SIC-12 applied).
 - (c) in circumstances involving agency relationships.
 - (d) in circumstances involving protective rights.
- BC3 IAS 27 required the consolidation of entities that are controlled by a reporting entity, and it defined control as the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities. SIC-12, which interpreted the requirements of IAS 27 in the context of special purpose entities,¹ placed greater emphasis on risks and rewards. This perceived conflict of emphasis had led to inconsistent application of the concept of control. This was aggravated by a lack of clear guidance on which investees were within the scope of IAS 27 and which were within the scope of SIC-12. As a result, assessing control sometimes resulted in a quantitative assessment of whether the investor had a majority of the risks. Such tests based on sharp 'bright line' distinctions created structuring opportunities to achieve particular accounting outcomes.
- BC4 The global financial crisis that started in 2007 highlighted a lack of transparency about the risks to which investors were exposed from their involvement with 'off balance sheet vehicles' (such as securitisation vehicles), including those that they had set up or sponsored. As a result, the G20 leaders, the Financial Stability Board and others asked the Board to review the accounting and disclosure requirements for such 'off balance sheet vehicles'.
- BC5 In developing IFRS 10, the Board considered the responses to ED 10 *Consolidated Financial Statements*, published in December 2008. Respondents to ED 10 pointed out that the Board and the US Financial Accounting Standards Board (FASB), in their Memorandum of Understanding, had agreed to work towards developing common standards on consolidation by 2011. Therefore, they asked the boards to discuss the consolidation project jointly to ensure that the ensuing standards contained identical, not only similar, requirements. As a result, the Board's deliberations in developing IFRS 10 were conducted jointly with the FASB from October 2009.

¹ To maintain consistency with the terminology used in the original documents this Basis for Conclusions refers to 'special purpose entities (SPEs)' when discussing SIC-12 and 'structured entities' when discussing the exposure draft ED 10 *Consolidated Financial Statements* and the related deliberations and redeliberations. SIC-12 described an SPE as an entity that may be created to accomplish a narrow and well-defined objective, often created with legal arrangements that impose strict and sometimes permanent limits on the decision-making powers of its governing board, trustee or management over the SPE's operations. ED 10 defined a structured entity as an entity whose activities are restricted to the extent that those activities are, in essence, not directed by voting or similar rights.

- BC6 The FASB decided in January 2011 that it would not change the consolidation requirements in US generally accepted accounting principles (GAAP) at this time with one exception. The FASB tentatively decided that it would propose changes to the consolidation requirements relating to both variable interest entities and voting interest entities in the context of assessing whether a decision maker is a principal or an agent. Those proposals would be similar to the requirements developed jointly by the IASB and the FASB regarding the principal/agent assessment, which are included in IFRS 10.
- BC7 ED 10 proposed disclosure requirements for consolidated and unconsolidated investees. In its deliberation of the responses to those proposals, the Board decided to combine the disclosure requirements for interests in subsidiaries, joint arrangements, associates and unconsolidated structured entities within a single comprehensive standard, IFRS 12 *Disclosure of Interests in Other Entities*. The Basis for Conclusions accompanying IFRS 12 summarises the Board's considerations in developing that IFRS, including its consideration of responses to the disclosure proposals in ED 10. Accordingly, IFRS 10 does not include disclosure requirements and this Basis for Conclusions does not describe the Board's consideration of responses to the proposed disclosure requirements in ED 10.

The structure of IFRS 10 and the Board's decisions

- BC8 IFRS 10 replaces the requirements and guidance in IAS 27 relating to consolidated financial statements. It also replaces SIC-12. As part of its consolidation project, the Board is examining how an investment entity accounts for its interests in subsidiaries, joint ventures and associates and what, if any, additional disclosures might be made about those interests. The Board expects to publish an exposure draft on investment entities later in 2011.²
- BC9 In developing IFRS 10, the Board did not reconsider all the requirements that are included in the IFRS. The scope in paragraph 4 and the accounting requirements for consolidated financial statements in paragraphs 19–25 and B86–B99 were carried forward from IAS 27 or SIC-12 to IFRS 10 without being reconsidered by the Board because their reconsideration was not part of the Board's consolidation project.
- BC10 When revised in 2003, IAS 27 was accompanied by a Basis for Conclusions summarising the considerations of the Board, as constituted at the time, in reaching some of its conclusions in that Standard. That Basis for Conclusions was subsequently updated to reflect amendments to the Standard. The Board has incorporated into this Basis for Conclusions material from the Basis for Conclusions on IAS 27 that discusses matters that the Board has not reconsidered. That material is contained in paragraphs denoted by numbers with the prefix BCZ. In those paragraphs cross-references to the IFRS have been updated accordingly and minor necessary editorial changes have been made.

² *Investment Entities* (Amendments to IFRS 10, IFRS 12 and IAS 27), issued in October 2012, introduced an exception to the principle that all subsidiaries shall be consolidated. The amendments define an investment entity and require a parent that is an investment entity to measure its investments in particular subsidiaries at fair value through profit or loss instead of consolidating those subsidiaries. These amendments are discussed in paragraphs BC215–BC317.

BC11 In order to portray the historical background of IFRS 10, the documents recording the Board's approval of the revision of IAS 27 in 2003 and the subsequent amendments are set out after this Basis for Conclusions. In addition, in 2003 and later, some Board members dissented from the revision of IAS 27 and subsequent amendments, and portions of their dissenting opinions relate to requirements that have been carried forward to IFRS 10. Those dissenting opinions are set out after the Basis for Conclusions.

Presentation of consolidated financial statements (2003 revision)

Exemption from preparing consolidated financial statements

BCZ12 Paragraph 7 of IAS 27 (as revised in 2000) required consolidated financial statements to be presented. However, paragraph 8 permitted a parent that was a wholly-owned or virtually wholly-owned subsidiary not to prepare consolidated financial statements. In 2003 the Board considered whether to withdraw or amend this exemption from the general requirement.

BCZ13 The Board decided to retain an exemption, so that entities in a group that are required by law to produce financial statements available for public use in accordance with International Financial Reporting Standards, in addition to consolidated financial statements, would not be unduly burdened.

BCZ14 The Board noted that in some circumstances users can find sufficient information for their purposes about a subsidiary from either its separate financial statements or the consolidated financial statements. In addition, the users of financial statements of a subsidiary often have, or can get access to, more information.

BCZ15 Having concluded that it should retain an exemption, the Board decided to modify the circumstances in which an entity would be exempt and considered the following criteria.

Unanimous agreement of the owners of the minority interests³

BCZ16 The 2002 exposure draft proposed to extend the exemption to a parent that is not wholly-owned if the owners of the minority interests, including those not otherwise entitled to vote, unanimously agree.

BCZ17 Some respondents disagreed with this proposal, largely because of the practical difficulties in obtaining responses from all the minority shareholders. Acknowledging this argument, the Board decided that the exemption should be available to a parent that is not wholly-owned when the owners of the minority interests have been informed about, and do not object to, consolidated financial statements not being presented.

Exemption available only to non-public entities

BCZ18 The Board believed that the information needs of users of financial statements of entities whose debt or equity instruments are traded in a public market were best served when investments in subsidiaries, jointly controlled entities and associates were accounted for in accordance with IAS 27, IAS 28 and IAS 31 *Interests in Joint Ventures*.⁴ It therefore decided that the exemption from preparing consolidated financial statements should not be available to such entities or to entities in the process of issuing instruments in a public market.

³ IAS 27 (as amended in 2008) changed the term 'minority interest' to 'non-controlling interest'.

⁴ IAS 31 was superseded by IFRS 11 *Joint Arrangements* issued in May 2011.

Scope of consolidated financial statements (2003 revision)

Scope exclusions

BCZ19 Paragraph 13 of IAS 27 (as revised in 2000) required a subsidiary to be excluded from consolidation when control is intended to be temporary or when the subsidiary operates under severe long-term restrictions.

Temporary control

BCZ20 In 2003 the Board considered whether to remove this scope exclusion and thereby converge with other standard-setters that had recently eliminated a similar exclusion. It decided to consider this question as part of a comprehensive standard dealing with asset disposals. It decided to retain an exemption from consolidating a subsidiary when there is evidence that the subsidiary is acquired with the intention of disposing of it within twelve months and that management is actively seeking a buyer. The Board's exposure draft ED 4 *Disposal of Non-current Assets and Presentation of Discontinued Operations* proposed to measure and present assets held for sale in a consistent manner irrespective of whether they are held by an investor or in a subsidiary. Therefore, ED 4 proposed to eliminate the exemption from consolidation when control is intended to be temporary and it contained a draft consequential amendment to IAS 27 to achieve this.⁵

Severe long-term restrictions impairing ability to transfer funds to the parent

BCZ21 The Board decided to remove the exclusion of a subsidiary from consolidation when there are severe long-term restrictions that impair a subsidiary's ability to transfer funds to the parent. It did so because such circumstances may not preclude control. The Board decided that a parent, when assessing its ability to control a subsidiary, should consider restrictions on the transfer of funds from the subsidiary to the parent. In themselves, such restrictions do not preclude control.

BCZ22 [Deleted]
–BCZ28

Exemption from preparing consolidated financial statements for an intermediate parent of an investment entity

BC28A In December 2014, the Board amended IFRS 10 to confirm that the exemption from preparing consolidated financial statements set out in paragraph 4(a) of IFRS 10 is available to a parent entity that is a subsidiary of an investment entity. This question came about because an investment entity may measure all of its subsidiaries at fair value through profit or loss in accordance with paragraph 31 of IFRS 10. This decision was consistent with the proposal in the Exposure Draft *Investment Entities: Applying the Consolidation Exception* (Proposed amendments to IFRS 10 and IAS 28), which was published in June 2014.

⁵ In March 2004 the Board issued IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*. IFRS 5 removed this scope exclusion and eliminated the exemption from consolidation when control is intended to be temporary. For further discussion see the Basis for Conclusions on IFRS 5.

BC28B Paragraph 4(a)(iv) of IFRS 10, which is one of the criteria for the exemption from preparing consolidated financial statements, previously specified the requirement that the entity's ultimate or any intermediate parent 'produces consolidated financial statements that are available for public use and comply with IFRSs.' The IFRS Interpretations Committee was asked whether the exemption set out in paragraph 4(a) was available to a parent entity that is a subsidiary of an ultimate, or any intermediate, investment entity parent, if the conditions set out in paragraph 4(a)(i)–(iii) are met, but the investment entity parent does not consolidate any of its subsidiaries. Instead, the investment entity parent prepares financial statements in which all of its subsidiaries are measured at fair value through profit or loss in accordance with paragraph 31 of IFRS 10.

BC28C The Board observed that the exemption for intermediate parent entities was provided because the cost of requiring each intermediate parent entity within a group to prepare consolidated financial statements would outweigh the benefits in cases in which the conditions in paragraph 4(a) of IFRS 10 are met. The Board had previously decided that the conditions in paragraph 4(a) provide safeguards for the users of the intermediate parent's financial statements. In addition, the Board noted that the combination of information available in the consolidated financial statements of the higher level parent and the separate financial statements of the intermediate parent entity provide useful information to users.

BC28D The Board additionally observed that, when an investment entity measures its interest in a subsidiary at fair value, the disclosures required by IFRS 12 are supplemented by those required in IFRS 7 *Financial Instruments: Disclosures* and IFRS 13 *Fair Value Measurement*. Accordingly, the Board decided that this combination of information is sufficient to support the decision to retain the existing exemption from presenting consolidated financial statements for a subsidiary of an investment entity that is itself a parent entity. The Board noted that requiring an intermediate parent that is a subsidiary of an investment entity to prepare consolidated financial statements could result in significant additional costs, without commensurate benefit. The Board noted that this would be contrary to its intention in requiring investment entities to measure investments at fair value, which was to provide more relevant information at a reduced cost, as described in paragraphs BC309 and BC314 of IFRS 10.

BC28E The Board also decided to amend paragraph 17 of IAS 28 *Investments in Associates and Joint Ventures* for the same reasons. Paragraph 17 of IAS 28 uses the same criteria as paragraph 4(a) of IFRS 10 to provide an exemption from applying the equity method for entities that are subsidiaries and that hold interests in associates and joint ventures.

BC28F Furthermore, the Board decided to amend paragraph 6(b) of IFRS 12 to clarify that the relevant disclosure requirements in IFRS 12 apply to an investment entity. Paragraph 6 of IFRS 12 previously stated that IFRS 12 did not apply to an entity's separate financial statements without stating the applicability of IFRS 12 to investment entities. The Board decided to clarify that this scope exclusion does not apply to the financial statements of a parent that is an investment entity and has measured all of its subsidiaries at fair value through profit or loss in accordance with paragraph 31 of IFRS 10. In such cases, the investment entity shall present the disclosures relating to investment entities required by IFRS 12.

Control as the basis for consolidation

BC29 The Board's objective in issuing IFRS 10 is to improve the usefulness of consolidated financial statements by developing a single basis for consolidation and robust guidance for applying that basis to situations where it has proved difficult to assess control in practice and divergence has evolved (see paragraphs BC2–BC4). The basis for consolidation is control and it is applied irrespective of the nature of the investee.

- BC30 Almost all respondents to ED 10 supported control as the basis for consolidation. However, some noted that it can be difficult to identify an investor that has power over investees that do not require substantive continuous decision-making. They suggested that exposure to risks and rewards should be used as a proxy for control when power is not evident. Some respondents were also concerned that applying the proposed control definition to all investees could lead to more structuring opportunities than was the case when applying the requirements in IAS 27 and SIC-12. Others did not think that ED 10 expressed with sufficient clarity the importance of risks and rewards when assessing control.
- BC31 The Board confirmed its view that control should be the only basis for consolidation—an investor should consolidate an investee and present in its consolidated financial statements the investee’s assets, liabilities, equity, income, expenses and cash flows, if the investor has the current ability to direct those activities of the investee that significantly affect the investee’s returns and can benefit by using that ability. An investor that is exposed, or has rights, to variable returns from its involvement with an investee but does not have power over the investee so as to affect the amount of the investor’s return from its involvement does not control the investee.
- BC32 Control as the basis for consolidation does not mean that the consideration of risks and rewards is unimportant when assessing control of an investee. The more an investor is exposed to risks and rewards from its involvement with an investee, the greater the incentive for the investor to obtain decision-making rights that give it power. However, risks and rewards and power are not necessarily perfectly correlated. Therefore, the Board confirmed that exposure to risks and rewards (referred to in IFRS 10 as variable returns) is an *indicator of control* and an important factor to consider when assessing control, but an investor’s exposure to risks and rewards alone does not determine that the investor has control over an investee.
- BC33 The Board observed that to conclude that exposure to risks and rewards is anything more than an indicator of control would be inconsistent with a control model that contains both a power element and a returns element.
- BC34 The Board confirmed that an investor must have exposure to risks and rewards in order to control an investee—without any exposure to risks and rewards (ie variable returns) an investor is unable to benefit from any power that it might have and therefore cannot control an investee.
- BC35 In reaching its conclusions regarding control as the basis for consolidation, the Board also noted the following:
- (a) One of the main objectives of the consolidation project is to develop a consistent basis for determining when an investor should consolidate an investee, irrespective of the nature of the investee. Some respondents to ED 10 suggested including a particular level of exposure to risks and rewards as a presumption of, or proxy for, control, in the context of investees that are not directed through voting or similar rights. The Board concluded that introducing such a presumption for a particular set of investees would contradict the objective of developing a single consistent basis for consolidation that applies to all investees.

- (b) Having a different consolidation model for some investees necessitates defining precisely those investees to which that model applies. There have been difficulties, in practice, in identifying which investees are special purpose entities to which SIC-12 applied. A number of respondents to ED 10 noted that any attempt to split the continuum of investee types into distinct populations and to subject the different populations of entities to different consolidation models would lead to divergence in practice for investees that are not clearly in the specified population sets. For that reason, the Board decided not to carry forward the distinction proposed in ED 10 between different types of investees when assessing control (see paragraphs BC71–BC75).
- (c) Including exposure to risks and rewards as a presumption of, or proxy for, control in particular situations puts more pressure on the measurement of that exposure. The Board was particularly concerned that the need to measure risks and rewards might result in the adoption of a consolidation model based on quantitative criteria (for example, a model focused on the majority of risks and rewards). Any quantitative analysis of risks and rewards would inevitably be complex and, as a consequence, difficult to understand, apply and audit. The Board noted that, depending on the specific facts and circumstances, a quantitative model might identify a controlling party that is different from the party that a qualitative analysis of the power over, and returns from, an investee would identify as the controlling party. The Board's analysis is consistent with concerns raised by the FASB's constituents on the quantitative consolidation model in Interpretation 46 (Revised) *Consolidation of Variable Interest Entities*. The FASB has since issued Statement of Financial Accounting Standard No. 167 *Amendments to FIN 46 (Revised)* to amend Interpretation 46 to require a qualitative analysis focusing on the power over and returns from an investee to determine control.⁶
- (d) The Board believes that having a control model that applies to all investees is likely to reduce the opportunities for achieving a particular accounting outcome that is inconsistent with the economics of an investor's relationship with an investee—ie it will reduce structuring opportunities.

BC36 The Board does not regard control and risks and rewards as competing models. The exposure to risks and rewards, or variable returns as it is expressed in IFRS 10, is an essential element of control. In the great majority of cases the approaches would lead to the same accounting conclusions. However, a control-based model forces an investor to consider all its rights in relation to the investee rather than relying on arbitrary bright lines that are associated with risks and rewards approaches, such as paragraph 10(c) and (d) of SIC-12, which referred to control if the investor has rights to obtain the majority of the benefits of the investee or if the investor retains the majority of the risks related to the investee. The Board believes that an investor will, generally, want to control an investee when it has significant economic exposure. This should reduce the likelihood of structuring simply to achieve a particular accounting outcome.

⁶ SFAS 167 was subsequently nullified by Accounting Standards Update No. 2009-17. The requirements of SFAS 167 have been included in Accounting Standards Update No. 2009-17.

Reputational risk

- BC37 During the financial crisis, some financial institutions provided funding or other support to securitisation or investment vehicles because they established or promoted those vehicles. Rather than allowing them to fail and facing a loss of reputation, the financial institutions stepped in, and in some cases took control of the vehicles. ED 10 did not make any explicit reference to reputational risk in relation to control because the Board decided that having reputational risk in isolation is not an appropriate basis for consolidation. The term 'reputational risk' relates to the risk that failure of an investee would damage an investee's reputation and, therefore, that of an investor or sponsor, compelling the investor or sponsor to provide support to an investee in order to protect its reputation, even though the investor or sponsor has no legal or contractual requirement to do so.
- BC38 Respondents to ED 10 agreed with the Board, almost unanimously, that reputational risk is not an appropriate basis for consolidation. Some, however, were of the view that reputational risk is part of an investor's exposure to risks and rewards and should be considered when determining control of an investee.
- BC39 The Board believes that reputational risk is part of an investor's exposure to risks and rewards, albeit a risk that arises from non-contractual sources. For that reason, the Board concluded that when assessing control, reputational risk is a factor to consider along with other facts and circumstances. It is not an indicator of power in its own right, but may increase an investor's incentive to secure rights that give the investor power over an investee.

Definition of control

- BC40 IFRS 10 states that an investor controls an investee when the investor is exposed, or has rights, to variable returns from its involvement with the investee and has the current ability to affect those returns through its power over the investee.
- BC41 The definition of control includes three elements, namely an investor's:
- (a) power over the investee;
 - (b) exposure, or rights, to variable returns from its involvement with the investee; and
 - (c) ability to use its power over the investee to affect the amount of the investor's returns.

Power

- BC42 ED 10 proposed that in order to control an investee, an investor must have the power to direct the activities of that investee. IAS 27 defines control as the power to govern the financial and operating policies of an entity. The Board decided to change the definition of control because even though power is often obtained by governing the strategic operating and financing policies of an investee, that is only one of the ways in which power to direct the activities of an investee can be achieved. An investor can have the power to direct the activities of an investee through decision-making rights that relate to particular activities of an investee. Indeed, referring to the power to govern the financial and operating policies of an investee would not necessarily apply to investees that are not directed through voting or similar rights.

- BC43 Respondents to ED 10 did not object to changing the definition of control to power to direct the activities of an investee. Many were confused, however, about what the Board meant by ‘power to direct’ and which ‘activities’ the Board had in mind. They asked for a clear articulation of the principle behind the term ‘power to direct’. They also expressed the view that power should relate to significant activities of an investee, and not those activities that have little effect on the investee’s returns.
- BC44 ED 10 described various characteristics of power—power need not be absolute; power need not have been exercised; power precludes others from controlling an investee. ED 10 also implied that power could arise from rights that appeared to be exercisable only at some point in the future when particular circumstances arise or events happen. Respondents to ED 10 were confused about whether power referred to the legal or contractual power to direct, or to the ability to direct, which does not necessarily require the investor to have the legal or contractual right to direct the activities. Some respondents to ED 10 also commented that the statement that power precludes others from controlling an investee was confusing because it implied that an investor with less than a majority of the voting rights in an investee could never have power.
- BC45 In response to the comments from respondents, the Board considered whether power should refer to having the *legal* or *contractual right* to direct the activities, or the *ability* to direct the activities.
- BC46 According to a legal or contractual right approach, some would suggest that an investor has power only when it has an unassailable legal or contractual right to direct. This means having the right to make decisions about the activities of an investee that could potentially be contrary to the wishes of others in every possible scenario, within the boundaries of protective rights. Therefore, for example, an investor with less than half the voting rights of an investee could not have power unless it had additional legal or contractual rights (see paragraph BC101). Also, potential voting rights would not affect the assessment of control until exercised or converted because in and of themselves they do not give the holder the contractual right to direct. A consistent application of this view to ‘kick-out’ (removal) or similar rights would suggest that a decision maker could never have power when such rights are held by others because those rights could be exercised to remove the decision maker.
- BC47 Supporters of the legal or contractual right approach point out that this approach requires less judgement than other approaches and, accordingly, is likely to result in more consistent application of the control definition. They are also concerned that other approaches might result in an investor frequently changing its assessment of control because of changes in circumstances. These changes could be outside the control of the investor (for example, changes in the shareholdings of others or market changes that affect the terms and conditions of potential voting rights).
- BC48 The Board acknowledged that defining power as the legal or contractual right to direct the activities of an investee would require less judgement than some other approaches. Nonetheless, the Board rejected that approach because it would create opportunities for an investor to ignore those circumstances in which the Board believes that an investor controls an investee without having the unassailable legal or contractual right to direct the activities of the investee.
- BC49 In addition, the Board concluded that preparers and others should be able to apply the judgement required by an ‘ability’ approach, as long as the principles underlying that approach were articulated clearly and the IFRS included application guidance, illustrating how control should be assessed.

- BC50 Consequently, the Board concluded that power should refer to having the *current ability* to direct the activities of an investee. The Board observed that the current ability to direct the activities of an investee would, in all cases, arise from rights (such as voting rights, potential voting rights, rights within other arrangements, or a combination of these).
- BC51 In addition, an investor would have the current ability to direct the relevant activities if that investor were able to make decisions at the time that those decisions need to be taken.
- BC52 The Board also noted that an investor can have the current ability to direct the activities of an investee even if it does not actively direct the activities of the investee. Conversely, an investor is not assumed to have the current ability to direct simply because it is actively directing the activities of an investee. For example, an investor that holds a 70 per cent voting interest in an investee (when no other relevant factors are present) has the current ability to direct the activities of the investee even if it has not exercised its right to vote. Even if the remaining 30 per cent of voting rights were held by a single party actively exercising its voting rights, that minority shareholder would not have power.
- BC53 The Board also noted that having the current ability to direct the activities of an investee is not limited to being able to act today. There may be steps to be taken in order to act—for example, an investor may need to initiate a meeting before it can exercise its voting or other rights that give it power. However, such a delay would not prevent the investor from having power, assuming that there are no other barriers that would prevent the investor from exercising its rights when it chooses to do so.
- BC54 In addition, the Board observed that for some investees, particularly those with most of their operating and financing decisions predetermined, decisions that significantly affect the returns of the investee are not made continuously. Such decisions may be made only if particular events occur or circumstances arise. For such investees, having the ability to make those decisions if and when they arise is a source of a current ability to direct the relevant activities.
- BC55 When discussing the principles underlying power, the Board rejected the assertion that an ‘ability’ approach could result in an investee moving *frequently* in and out of consolidation because of changes that are outside the control of the investor (see paragraph BC47). Changes as to which party controls an investee could occur according to any control model, including a ‘contractual rights’ model, when relevant facts and circumstances change. For a discussion of concerns in respect to changes in market conditions and the assessment of potential voting rights see paragraphs BC124 and BC152.

Relevant activities

- BC56 ED 10 did not propose explicit guidance explaining the activities of an investee to which the definition of control referred. In response to comments received from respondents, the Board decided to clarify that in order to control an investee an investor must have the current ability to direct the activities of the investee that *significantly affect the investee’s returns* (ie the relevant activities).
- BC57 The comments on ED 10 suggested that such a clarification would be particularly helpful when assessing control of investees that are not directed through voting or similar rights and for which there may be multiple parties with decision-making rights over different activities.

- BC58 If an investor controls such an investee, its power should relate to the activities of the investee that significantly affect the investee's returns, rather than administrative activities that have little or no effect on the investee's returns. For an investee that is not directed through voting or similar rights it can be difficult to determine which investor, if any, meets the power element of the control definition. There is also a risk that, without adding the modifier 'significant', an investor with very little ability to affect the returns could be considered to have power over that investee (for example, if the investor has the ability to direct the most significant of a number of insignificant activities that have little effect on the investee's returns).
- BC59 Although the guidance included in IFRS 10 in this respect would be particularly helpful in the context of investees that are not directed through voting or similar rights, the Board concluded that the amended wording would work well for all investees. For an investee that is directed through voting or similar rights, it is generally the case that a range of operating and financing activities are those that significantly affect the investee's returns—for example, selling goods or services, purchasing inventory, making capital expenditures or obtaining finance. In that case, an investor that is able to determine the strategic operating and financing policies of the investee would usually have power.

Returns

- BC60 The definition of control in IFRS 10 uses the concept of returns in two ways.
- BC61 In order to have power over an investee an investor must have the current ability to direct the relevant activities, ie the activities that significantly affect the investee's returns. The link to returns was included in the first element of control in order to clarify that having the current ability to direct inconsequential activities is not relevant to the assessment of power and control (see paragraph BC58).
- BC62 The second element of control requires the investor's involvement with the investee to provide the investor with rights, or exposure, to variable returns. This retains the concept that control conveys the rights to returns from an investee. To have control an investor must have power over the investee, exposure or rights to returns from its involvement with the investee and the ability to use its power to affect its own returns. Control is not a synonym of power, because equating power and control would result in incorrect conclusions in situations when an agent acts on behalf of others. ED 10 used the term 'returns' rather than 'benefits' because 'benefits' are often interpreted as implying only positive returns.
- BC63 The Board confirmed its intention to have a broad definition of 'returns' that would include synergistic returns as well as more direct returns, for example, dividends or changes in the value of an investment. In practice, an investor can benefit from controlling an investee in a variety of ways. The Board concluded that to narrow the definition of returns would artificially restrict those ways of benefiting.
- BC64 Although some respondents to ED 10 commented that 'returns' could be interpreted narrowly to refer only to financial returns such as dividends, the Board believed that the broad description of returns included in the IFRS should ensure that the Board's intention to have a broad definition is clear. The Board also confirmed that an investor's returns could have the potential to be wholly positive, wholly negative or both positive and negative.

- BC65 When assessing control of an investee, an investor determines whether it is exposed, or has rights, to variable returns from its involvement with the investee. The Board considered whether this criterion should refer to involvement through instruments that must absorb variability, in the sense that those instruments reduce the exposure of the investee to risks that cause variability.
- BC66 Some instruments are designed to transfer risk from a reporting entity to another entity. During its deliberations, the Board concluded that such instruments create variability of returns for the other entity but do not typically expose the reporting entity to variability of returns from the performance of the other entity. For example, assume an entity (entity A) is established to provide investment opportunities for investors who wish to have exposure to entity Z's credit risk (entity Z is unrelated to any other party involved in the arrangement). Entity A obtains funding by issuing to those investors notes that are linked to entity Z's credit risk (credit-linked notes) and uses the proceeds to invest in a portfolio of risk-free financial assets. Entity A obtains exposure to entity Z's credit risk by entering into a credit default swap (CDS) with a swap counterparty. The CDS passes entity Z's credit risk to entity A, in return for a fee paid by the swap counterparty. The investors in entity A receive a higher return that reflects both entity A's return from its asset portfolio and the CDS fee. The swap counterparty does not have involvement with entity A that exposes it to variability of returns from the performance of entity A because the CDS transfers variability to entity A, rather than absorbing variability of returns of entity A.
- BC67 Consequently, the Board decided that it was not necessary to refer specifically to instruments that absorb variability, although it expects that an investor will typically have rights, or be exposed, to variability of returns through such instruments.

Link between power and returns

- BC68 To have control, an investor must have power and exposure or rights to variable returns and be able to use that power to affect its own returns from its involvement with the investee. Thus, power and the returns to which an investor is exposed, or has rights to, must be linked. The link between power and returns does not mean that the proportion of returns accruing to an investor needs to be perfectly correlated with the amount of power that the investor has. The Board noted that many parties can have the right to receive variable returns from an investee (eg shareholders, debt providers and agents), but only one party can control an investee.

Control is not shared

- BC69 ED 10 proposed that only one party, if any, can control an investee. The Board confirmed this in deliberating IFRS 10. (See further comments regarding joint arrangements in paragraph BC83.)
- BC70 ED 10 proposed that an investor need not have absolute power to control an investee. Other parties can have protective rights relating to the activities of an investee. For example, limits on power are often imposed by law or regulations. Similarly, other parties—such as non-controlling interests—may hold protective rights that limit the power of the investor. During its redeliberations the Board confirmed that an investor can control an investee even if other entities have protective rights relating to the activities of the investee. Paragraphs BC93–BC124 discuss rights that give an investor power over an investee.

Assessing control

- BC71 In developing IFRS 10 the Board, while acknowledging that the factors to be considered in assessing control will vary, had the objective of developing a control model that applies the same concept of control as the basis for consolidation to all investees, irrespective of their nature.
- BC72 In ED 10, the Board set out specific factors to consider when assessing control of a structured entity. ED 10 defined a structured entity as an entity whose activities are restricted to the extent that those activities are, in essence, not directed by voting or similar rights.
- BC73 The Board's intention when including the subsection specifically for structured entities was as a convenience for those assessing control of traditional operating entities that are typically controlled through voting rights—the Board did not want to force those assessing control of traditional operating entities to read, and assess whether to apply, all the guidance relating to structured entities if that guidance was not relevant.
- BC74 However, the vast majority of respondents to ED 10 were opposed to creating a subset of investees for which different guidance would apply when assessing control. In their view, such an approach would perpetuate problems faced in applying the guidance in IAS 27 and SIC-12—two control models leading to inconsistent application and, therefore, potential arbitrage by varying investee-specific characteristics. Respondents also noted that the guidance provided for structured entities should apply generally to all investees. Therefore, they suggested that there should be a single section that combines guidance on assessing control of all investees.
- BC75 The Board was persuaded by this reasoning and decided to combine the guidance for assessing control of an investee within a single section, noting that its intention is to have a single basis for consolidation that could be applied to all investees and that that basis is control. However, the Board acknowledged that the way in which control would need to be assessed would vary depending on the nature of investees.

Understanding the purpose and design of an investee

- BC76 Some respondents to ED 10 expressed the view that involvement in the design of an investee (with restricted activities) is a strong indicator of control and, indeed, in some situations, they would conclude that involvement in the design alone is sufficient to meet the power element of the control definition. SIC-12 included this notion as one of its indicators of control and the accompanying Basis for Conclusions explained that:

SPEs [special purpose entities] frequently operate in a predetermined way so that no entity has explicit decision-making authority over the SPE's ongoing activities after its formation (ie they operate on 'autopilot'). Virtually all rights, obligations, and aspects of activities that could be controlled are predefined and limited by contractual provisions specified or scheduled at inception. In these circumstances, control may exist for the sponsoring party or others with a beneficial interest, even though it may be particularly difficult to assess, because virtually all activities are predetermined. However, the predetermination of the activities of the SPE through an 'autopilot' mechanism often provides evidence that the ability to control has been exercised by the party making the predetermination for its own benefit at the formation of the SPE and is being perpetuated.

- BC77 When developing IFRS 10 the Board confirmed the position in ED 10 that being involved in setting up an investee was not, in and of itself, sufficient to conclude that an investor has control. Being involved in the design does not necessarily mean that an investor has decision-making rights to direct the relevant activities. Often several parties are involved in the design of an investee and the final structure of the investee includes whatever is agreed to by all those parties (including investors, the sponsor of the investee, the transferor(s) of the assets held by the investee and other parties involved in the transaction).
- BC78 Although the success of, for example, a securitisation will depend on the assets that are transferred to the securitisation vehicle, the transferor might not have any further involvement with the vehicle and thereby may not have any decision-making rights to direct the relevant activities. The benefits from being involved in setting up a vehicle could cease as soon as the vehicle is established. The Board concluded that, in isolation, being involved in setting up an investee would not be an appropriate basis for consolidation.
- BC79 The Board confirmed, however, that considering the purpose and design of an investee is important when assessing control. Understanding the purpose and design of an investee is the means by which an investor identifies the relevant activities, the rights from which power arises and who holds those rights. It can also assist in identifying investors that may have sought to secure control and whose position should be understood and analysed when assessing control.
- BC80 The Board noted that understanding the purpose and design of an investee also involves consideration of all activities and returns that are closely related to the investee, even though they might occur outside the legal boundaries of the investee. For example, assume that the purpose of a securitisation vehicle is to allocate risks (mainly credit risk) and benefits (cash flows received) of a portfolio of receivables to the parties involved with the vehicle. The vehicle is designed in such a way that the only activity that can be directed, and can significantly affect the returns from the transaction, is managing those receivables when they default. An investor might have the current ability to direct those activities that significantly affect the returns of the transaction by, for example, writing a put option on the receivables that is triggered when the receivables default. The design of the vehicle ensures that the investor has decision-making authority over the relevant activities at the only time that such decision-making authority is required. In this situation, the terms of the put agreement are integral to the overall transaction and the establishment of the investee. Therefore, the terms of the put agreement would be considered together with the founding documents of the investee to conclude whether the investor has the current ability to direct the activities of the securitisation vehicle that significantly affect the returns of the transaction (even before the default of the receivables).

Different activities significantly affect the returns

- BC81 IAS 27, SIC-12 and ED 10 did not specifically address situations in which multiple parties have decision-making authority over the activities of an investee. Some respondents to ED 10 questioned how the control model would be applied in such situations. Respondents were concerned that the absence of specific guidance would create structuring opportunities to avoid the consolidation of structured entities—they asserted that, without any guidance, power could easily be disguised and divided among different parties so that it could be argued that no one would have power over the investee.

BC82 The Board identified the following situations in which multiple parties may have decision-making authority over the activities of an investee:

- (a) joint control
- (b) shared decision-making that is not joint control
- (c) multiple parties that each have unilateral decision-making rights to direct different activities of an investee that significantly affect the investee's returns.

Joint control

BC83 IFRS 11 *Joint Arrangements* defines joint control as the contractually agreed sharing of control of an arrangement. Joint control exists only when decisions about the relevant activities require the unanimous consent of the parties sharing control. When two or more parties have joint control of an investee, no single party controls that investee and, accordingly, the investee is not consolidated. IFRS 11 is applicable to all investees for which two or more parties have joint control. The Board confirmed that IFRS 10 does not change or amend the arrangements that are now within the scope of IFRS 11.

Shared decision-making that is not joint control

BC84 The power to direct the relevant activities can be shared by multiple parties but those rights may not meet the definition of joint control. For example, five parties each own 20 per cent of entity Z, and each has one seat on entity Z's board of directors. All strategic operating and financing decisions (ie decisions in respect of the activities that significantly affect the returns of entity Z) require the consent of any four of the five directors. The five parties do not jointly control entity Z because unanimous consent is not required for decisions relating to the activities of entity Z that significantly affect its returns. Nevertheless, it is clear that the power to direct the activities of entity Z is shared and no single party controls entity Z. Again, the Board confirmed that the requirements of IFRS 10 do not change or amend the application of IFRSs to such situations.

Multiple parties with decision-making rights

BC85 When discussing the sharing of power, the Board noted that for most investees it will be clear that one party or body has decision-making authority to direct the activities of an investee that significantly affect the investee's returns. For example, for an investee that is directed by voting or similar rights, the governing body or board of directors would typically be responsible for strategic decision-making. Thus, the current ability to direct that body would be the basis for power.

BC86 Nonetheless, it is possible that more than one party has decision-making authority over different activities of an investee and that each such activity may significantly affect the investee's returns—respondents to ED 10 noted the following as examples: multi-seller conduits, multi-seller securitisations, and investees for which the assets are managed by one party and the funding is managed by another. The Board was persuaded by the comments from respondents that IFRS 10 should specifically address situations for which multiple parties each have unilateral decision-making rights to direct different activities of the investee.

BC87 The Board considered whether, for such investees, none of the parties controls the investee because the ability to direct the activities is shared. If those different activities, in fact, significantly affect the returns of the investee, some would reason that it would be artificial to force the parties involved to conclude that one activity is more important than the others. An investor might be required to consolidate an investee when the investor would not have the power to direct *all* the activities of the investee that significantly affect the investee's returns.

- BC88 Nonetheless, the Board decided that when two or more unrelated investors each have unilateral decision-making rights over different activities of an investee that significantly affect the investee's returns, the investor that has the current ability to direct the activities of the investee that *most* significantly affect the investee's returns meets the power element of the control definition. The expectation is that one investor will have that ability to direct the activities that *most* significantly affect the investee's returns and consequently would be deemed to have power. In effect, power is attributed to the party that looks most like the party that controls the investee. However, the Board decided not to prescribe a specific mechanism for assessing which activities of an investee *most* significantly affect the investee's returns.
- BC89 The Board was concerned about creating the potential to avoid consolidation if an investor were to conclude that it has power only when it has the current ability to direct *all* the relevant activities. Such a requirement would be open to abuse because an investor could avoid consolidation by involving other parties in an investee's decision-making.
- BC90 The Board's conclusions result in greater potential for an investee to be consolidated because one party would be deemed to have power when multiple parties have unilateral decision-making authority over different activities of an investee.
- BC91 In reaching its conclusions, the Board noted that the situation in which two or more investors (individually or as a group) have decision-making rights over different activities of an investee that significantly affect the investee's returns is not expected to arise frequently. This is because one party or body usually has overall decision-making responsibility for an investee (see paragraph BC85). The Board believes that its conclusions in this respect will ensure that it does not create an incentive to structure investees to achieve an accounting outcome by involving multiple parties in decision-making when there is no business rationale to do so.
- BC92 The Board noted that in situations where two or more parties have the current ability to direct the activities that most significantly affect the investee's returns and if unanimous consent is required for those decisions IFRS 11 applies.

Rights that give an investor power

- BC93 IAS 27 and SIC-12 do not include guidance on rights that give an investor power, other than voting rights and potential voting rights. In addition, neither discusses the effect that such rights held by other parties have on the rights of an investor.
- BC94 The Board addressed this issue to some extent in ED 10 by including guidance on protective rights. However, comments from respondents to ED 10 suggested that the guidance was not sufficient.
- BC95 The Board decided to address the insufficiency by providing additional guidance about the activities that an investor must be able to direct in order to have power (ie those activities that significantly affect the investee's returns) and by providing guidance on when those rights are substantive. The Board believes that including such guidance should help an investor to determine whether it controls an investee, or whether the rights held by other parties are sufficient to prevent an investor from controlling an investee.

Voting rights

- BC96 As with IAS 27 and ED 10, the Board decided to include guidance in IFRS 10 that addresses the assessment of control of investees that are controlled by voting rights.

Majority of voting rights

- BC97 The Board carried forward the concept from IAS 27, with a modification to the words, that an investor that holds more than half the voting rights of an investee has power over the investee when those voting rights give the investor the current ability to direct the relevant activities (either directly or by appointing the members of the governing body). The Board concluded that such an investor's voting rights are sufficient to give it power over the investee regardless of whether it has exercised its voting power, unless those rights are not substantive or there are separate arrangements providing another entity with power over the investee (such as through a contractual arrangement over decision-making or substantive potential voting rights).

Less than a majority of voting rights

- BC98 In October 2005⁷ the Board stated that IAS 27 contemplates that there are circumstances in which an investor can control an investee without owning more than half the voting rights of that investee. The Board accepted that at that time IAS 27 did not provide clear guidance about the particular circumstances in which this will occur and that, as a consequence, there was likely to be diversity in practice.
- BC99 The Board decided that in ED 10 it would explain clearly that an investor can control an investee even if the investor does not have more than half the voting rights, as long as the investor's voting rights are sufficient to give the investor the current ability to direct the relevant activities. ED 10 included an example of when a dominant shareholder holds voting rights and all other shareholdings are widely dispersed, and those other shareholders do not actively co-operate when they exercise their votes, so as to have more voting power than the dominant shareholder.
- BC100 Respondents to ED 10 expressed mixed views about whether an investor could ever control an investee with less than half the voting rights and without other contractual rights relating to the activities of the investee.
- BC101 Some who supported a 'contractual rights' control model believe that an investor with less than half the voting rights of an investee (and without other contractual rights) cannot control that investee. They reasoned that this is because the investor contractually does not have the unassailable right to direct the activities of the other investee in every possible scenario and cannot necessarily block the actions of others.
- BC102 Supporters of the 'contractual rights' model believe that power should not be defined in a way that relies on the inactivity of other shareholders, as would be the case in an 'ability' model. In addition, they believe that if an investor wishes to control an investee, that investor would need to have a majority of the voting rights, or further contractual rights (in addition to its voting rights if necessary) that guarantee its power over the investee.

⁷ The October 2005 edition of *IASB Update* included a statement from the Board outlining its views on control with less than a majority of voting rights.

BC103 Other respondents supported the ‘ability’ model proposed in ED 10. They agreed with the Board that there are situations in which an investor with less than half the voting rights of an investee can control that investee, even when the investor does not have other contractual rights relating to the activities of the investee. However, they asked the Board to clarify when that would be the case. In particular, they questioned the following:

- (a) The proposals in the exposure draft implied that an investor might have to consolidate an investee simply because the remaining shareholdings are widely dispersed or attendance at shareholder meetings is low, even though the investor might hold only a low percentage of voting rights in that investee (eg 10 per cent or 15 per cent).
- (b) The proposals implied that an investor might be forced to obtain information about the shareholder structure, the degree of organisation and the other shareholders’ future intentions. This would be particularly difficult to obtain if the investor owned a low percentage of the voting rights of an investee.

BC104 The Board noted the concerns raised by respondents but concluded that it would be inappropriate to limit power to situations in which an investor would have the contractual right to direct the activities of an investee, for the reasons noted in paragraphs BC45–BC50. Specifically in the context of voting rights, the Board believes that there are situations in which an investor can control an investee even though it does not own more than half the voting rights of an investee and does not have other contractual rights relating to the activities of the investee.

BC105 In reaching that conclusion, the Board noted that jurisdictions have differing legal and regulatory requirements relating to the protection of shareholders and investors. Those requirements often determine or influence the rights held by shareholders and consequently have an influence on the ability of an investor to have power over an investee with less than half the voting rights. For that reason, the Board concluded that drawing a line at 50 per cent in terms of voting power could lead to inappropriate consolidation conclusions in some jurisdictions.

BC106 The Board also concluded that an ‘ability’ model would result in more appropriate consolidation conclusions not only when applied in different jurisdictions, but also when applied to all investees. This is because the ‘ability’ model would be applied consistently to all investees by considering the rights held by the investor, as well as the rights held by other parties, when assessing control. For example, in the context of voting rights, an investor would assess whether its voting and any other contractual rights would be sufficient to give it the current ability to direct the relevant activities, or whether the voting and other rights held by other shareholders could prevent it from directing the relevant activities if those shareholders chose to act. The model would be applied in a similar way when other parties hold potential voting rights, kick-out rights or similar rights.

BC107 In response to the concerns raised by respondents to ED 10, the Board clarified that its intentions were neither to require the consolidation of all investees, nor to require an investor that owns a low percentage of voting rights of an investee (such as 10 per cent or 15 per cent) to consolidate that investee. An investor should always assess whether its rights, including any voting rights that it owns, are sufficient to give it the current ability to direct the relevant activities. That assessment requires judgement, considering all available evidence.

BC108 The Board decided to add application requirements setting out some of the factors to consider when applying that judgement to situations in which no single party holds more than half the voting rights of an investee. In particular, the Board decided to clarify that it expects that:

- (a) the more voting rights an investor holds (ie the larger its absolute holding), the more likely it will have power over an investee;
- (b) the more voting rights an investor holds relative to other vote holders (ie the larger its relative holding), the more likely the investor will have power over an investee; and
- (c) the more parties that would need to act together to outvote the investor, the more likely the investor will have power over an investee.

BC109 The Board also noted that, in some cases, considering the voting rights and potential voting rights that an investor and others hold, together with contractual rights, will be sufficient to determine whether the investor has power. However, in other cases these factors may not be sufficient to enable a determination to be made and additional evidence would need to be considered for an investor to determine whether it has power. IFRS 10 sets out additional factors to be considered in these circumstances. In particular, the Board noted that the fewer voting rights an investor holds and the fewer parties that would need to act together to outvote the investor, the more reliance would need to be placed on additional evidence to determine whether the investor has power.

BC110 The Board also decided to clarify that if, after all available evidence has been considered, the evidence is not sufficient to conclude that the investor has power, the investor should not consolidate the investee. If an investor controls an investee, that conclusion is reached on the basis of evidence that is sufficient to conclude that the investor's rights give it the current ability to direct the relevant activities. The Board's intention was not to create a presumption that in the absence of evidence to the contrary the shareholder with the largest proportion of voting rights controls an investee.

BC111 It might be the case that when an investor initially acquires voting rights in an investee and assesses control solely by considering the size of that holding and the voting rights held by others, sufficient evidence is not available to conclude that the investor has power. If that is the case, the investor would not consolidate the investee. However, the assessment should be reconsidered as additional evidence becomes available. For example, the voting rights held by an investor and others may be unchanged but over time the investor may have been able to appoint a majority of the investee's board of directors and may have entered into significant transactions with the investee, thereby enabling the overall assessment to be made that the investor now has control and should consolidate the investee.

Potential voting rights

BC112 An investor might own options, convertible instruments or other instruments that, if exercised, would give the investor voting rights.

BC113 IAS 27 referred to those instruments as potential voting rights. According to that standard, the existence and effect of potential voting rights that are currently exercisable or convertible were considered when assessing control. If the options or convertible instruments that give an investor potential voting rights are currently exercisable, IAS 27 required the investor to treat those potential voting rights as if they were current voting rights. According to IAS 27, the investor had to consider all facts and circumstances except the intentions of management and the financial ability to exercise or convert such rights.

- BC114 Because of the revised definition of control, the Board reconsidered potential voting rights in developing the guidance in IFRS 10.
- BC115 The questions that the Board considered with respect to potential voting rights were:
- (a) Can potential voting rights give the holder the current ability to direct the relevant activities of an investee to which those potential voting rights relate?
 - (b) If so, in what situations do potential voting rights give the holder the current ability to direct the relevant activities of that investee?
- BC116 The Board proposed in ED 10 that an investor should assess whether its power from holding potential voting rights, considered together with other facts and circumstances, gives it power over the investee. Such an investor would have power if the governing body acts in accordance with the wishes of the investor, the counterparty to the instrument acts as an agent for the investor or the investor has particular contractual rights that give it power.
- BC117 Most respondents to ED 10 agreed that unexercised potential voting rights, taken in conjunction with other facts and circumstances, could give an investor power. However, many were confused by the application guidance—how would one know whether the decisions of the governing body were in accordance with the wishes of the investor? The respondents suggested that the other situations described in the discussion of power through potential voting rights could lead to power for reasons other than the potential voting rights instrument.
- BC118 The Board concluded that the guidance in IFRS 10 that addresses control should apply to potential voting rights, ie when assessing control, an investor should consider all rights that it and other parties hold, including potential voting rights, to determine whether its rights are sufficient to give it control.
- BC119 The Board observed that concluding that such instruments always or never give the holder control would cause inappropriate consolidation decisions in some cases.
- BC120 Accordingly, the Board concluded that potential voting rights can give the holder the current ability to direct the relevant activities. This will be the case if those rights are substantive and on exercise or conversion (when considered together with any other existing rights the holder has) they give the holder the current ability to direct the relevant activities. The holder of such potential voting rights has the contractual right to ‘step in’, obtain voting rights and subsequently exercise its voting power to direct the relevant activities—thus the holder has the current ability to direct the activities of an investee at the time that decisions need to be taken if those rights are substantive.
- BC121 The Board noted that the holder of such potential voting rights is, in effect, in the same position as a passive majority shareholder or the holder of substantive kick-out rights. The control model would provide that, in the absence of other factors, a majority shareholder controls an investee even though it can take time for the shareholder to organise a meeting and exercise its voting rights. In a similar manner, it can take time for a principal to remove or ‘kick out’ an agent. The holder of potential voting rights must also take steps to obtain its voting rights. In each case, the question is whether those steps are so significant that they prevent the investor from having the current ability to direct the relevant activities of an investee.
- BC122 The Board observed that if power was characterised as requiring either the contractual right to direct the activities or active direction of the activities, the holder of unexercised potential voting rights would never have power without other contractual rights. However, power is the *current ability* to direct the activities of an investee. As such, the Board concluded that there are situations in which substantive potential voting rights can give the holder power before exercise or conversion to obtain those rights.

- BC123 In response to comments from respondents to add clarity about when the holder of potential voting rights has power and to ensure that the control model is applied consistently, the Board added guidance and application examples to help assess when potential voting rights are substantive. Although that assessment requires judgement, the Board believes that an investor should be able to apply the judgement required. This is because potential voting rights exist for a reason—the terms and conditions of the instruments reflect that reason. Therefore, an assessment of the terms and conditions of the instrument (ie the purpose and design of the instrument) should provide information about whether the instrument was designed to give the holder power before exercise or conversion.
- BC124 Some constituents were concerned about whether the proposed model would lead to frequent changes in the control assessment solely because of changes in market conditions—would an investor consolidate and deconsolidate an investee if potential voting rights moved in and out of the money? In response to those comments, the Board noted that determining whether a potential voting right is substantive is not based solely on a comparison of the strike or conversion price of the instrument and the then current market price of its underlying share. Although the strike or conversion price is one factor to consider, determining whether potential voting rights are substantive requires a holistic approach, considering a variety of factors. This includes assessing the purpose and design of the instrument, considering whether the investor can benefit for other reasons such as by realising synergies between the investor and the investee, and determining whether there are any barriers (financial or otherwise) that would prevent the holder of potential voting rights from exercising or converting those rights. Accordingly, the Board believes that a change in market conditions (ie the market price of the underlying shares) alone would not typically result in a change in the consolidation conclusion.

Delegated power (agency relationships)

- BC125 IAS 27 and SIC-12 did not contain requirements or guidance to assess whether a decision maker is an agent or principal. The absence of guidance has allowed divergence to develop in practice. The Board decided to introduce principles that address agency relationships to reduce this divergence.
- BC126 ED 10 proposed criteria to identify an agency relationship on the basis of the following assumptions:
- (a) Both the principal and the agent seek to maximise their own benefits. Therefore, the principal is likely to introduce additional measures that are intended to ensure that the agent does not act against the interest of the principal. For example, the principal may have rights to remove the agent with or without cause.
 - (b) A principal has no incentive to remunerate an agent more than what is commensurate with the services provided. Accordingly, remuneration that is not commensurate with the services provided is an indicator that a decision maker is not an agent.
- BC127 ED 10 included guidance on dual roles and addressed situations in which an investor holds voting rights, both directly and on behalf of other parties as an agent. The exposure draft proposed that when assessing whether an investor acts as an agent or a principal, the investor would exclude the voting rights that it holds as an agent only if it could demonstrate that it is obliged to act in the best interests of other parties or has implemented policies and procedures that ensure the independence of the decision maker in its role as an agent from that as a holder of voting rights directly.

- BC128 Most respondents to ED 10 agreed with the Board that the consolidation standard should provide application guidance to identify an agency relationship. However, some respondents believed that the exposure draft was not clear on whether the Board intended the proposed application guidance to be limited to legal or contractual agency relationships. Most respondents agreed that the form of remuneration can be an indicator of an agency relationship. However, many found the application guidance, in this respect, confusing. They did not agree with the dual role guidance that required an investor to assess in aggregate its rights as an agent and a principal. Nor did they believe that such an investor should automatically exclude its rights as an agent from the control assessment.
- BC129 In response to those comments, the Board decided to base its principal/agent guidance on the thinking developed in agency theory. Jensen and Meckling (1976) define an agency relationship as ‘a contractual relationship in which one or more persons (the principal) engage another person (the agent) to perform some service on their behalf which involves delegating some decision-making authority to the agent.’⁸
- BC130 The Board clarified that, as defined, an agent is obliged to act in the best interests of the parties that delegated the power (ie the principal or principals) and not other parties by way of a wider fiduciary responsibility. The Board did not think it would be appropriate to conclude that every party that is obliged, by law or contract, to act in the best interests of other parties is an agent for the purposes of assessing control. This conclusion, in effect, assumes that a decision maker that is legally or contractually obliged to act in the best interests of other parties will always do so, even if that decision maker receives the vast majority of the returns that are influenced by its decision-making. Although this assumption might be appropriate for some decision makers, the Board observed that it would not be appropriate for all, in particular many investees that are not directed through voting or similar rights. Almost every investment or asset manager could contend that it is contractually obliged to act in the best interests of others. This conclusion could result in virtually every investee that is not directed through voting or similar rights being unconsolidated.
- BC131 The Board observed that the difficulty in developing guidance that addresses agency relationships is that the link between power and returns is often missing. To have control, an investor must have power and be able to use that power for its own benefit.
- BC132 If a decision maker receives a return that is relatively insignificant or varies insignificantly, most would be comfortable concluding that the decision maker uses any decision-making authority delegated to it to affect the returns received by others—this is because the decision maker would not have power for its own benefit. Similarly, if the decision maker held a substantial investment in the investee (say, a 95 per cent investment), most would conclude that the decision maker uses any decision-making authority delegated to it primarily to affect the returns it receives—the decision maker would have power for its own benefit. But at what point, between insignificant and very significant, does the decision maker change from using any decision-making authority primarily for others to using its authority primarily for itself?
- BC133 The Board concluded that the guidance in IFRS 10 that addresses control should apply to agency relationships, ie when assessing control, a decision maker should consider whether it has the current ability to direct the relevant activities of an investee that it manages to affect the returns it receives, or whether it uses the decision-making authority delegated to it primarily for the benefit of other parties.
- BC134 The Board observed that a decision maker always acts as an agent of another party when that other party holds a unilateral substantive right to remove the decision maker. Therefore, a substantive removal right that is held by a single party is a conclusive indicator of an agency relationship.

⁸ M C Jensen and W H Meckling, *Theory of the Firm: Managerial Behavior Agency Costs and Ownership Structure*, Journal of Financial Economics 1976, pp. 305-360.

- BC135 At the FASB's round-table meeting on consolidation in November 2010, participants asked whether a board of directors (or other governing body) can be evaluated as one party when considering whether a single party holds substantive removal rights. The IASB observed that the function of such governing bodies is to act as a fiduciary for the investors and therefore any rights given to an investee's board of directors (or other governing body) is a pass-through mechanism for the exercise of the investors' rights. Thus, the governing body itself cannot be considered to have or restrict decision-making authority over the investee. Rather it is the rights given to such a governing body by the investors and their effect on the decision-making authority that should be considered. Consequently, a governing body is not generally viewed as a single party.
- BC136 In the absence of a substantive removal right that is held by a single party, judgement must be applied when assessing whether a decision maker acts as a principal or an agent. That assessment includes considering the overall relationship between the decision maker, the entity being managed and the other interest holders, taking into account all available evidence.
- BC137 With the exception of substantive removal rights that are held by one party, no single factor would provide conclusive evidence of an agency relationship. The Board observed that, depending on the facts and circumstances, a particular factor may be a strong indicator of an agency relationship and would receive a greater weighting than other factors when assessing control. However, the weighting would depend on the relevant facts and circumstances in each case and it would be inappropriate to specify that any factor would always be more important than the others.

Scope of decision-making authority

- BC138 One of the factors to consider when assessing whether a decision maker is an agent or principal is the scope of its decision-making authority. The Board considered whether a decision maker would always be considered an agent if the breadth of its decision-making authority were restricted by contractual arrangements. The Board rejected such a conclusion for two reasons. First, it noted that it is rare for a parent to have unrestricted power over a subsidiary because debt providers or non-controlling interests often have protective rights that restrict the decision-making powers of a parent to some extent. Consequently, it would be difficult to set a particular threshold of restriction on decision-making that would automatically lead to a conclusion that the decision maker is an agent. The second reason was that it would inappropriately lead to many investees, such as securitisation vehicles, not being classified as a controlled entity by a decision maker even though it might have significant economic interests in the investee as well as discretion in making decisions about the relevant activities of the investee. The Board observed that a decision maker can have power over an investee if it has discretion in directing the relevant activities, even if those activities are restricted when the investee is established.

Rights held by other parties

- BC139 When considering rights held by other parties in the context of a principal/agent analysis, the Board noted that an entity would assess whether those rights are substantive in the same way as any other rights held by other parties, such as voting rights. An entity would assess whether those rights give their holders the practical ability to prevent the decision maker from directing the activities of the investee if the holders choose to exercise those rights.

BC140 Some constituents said that it would be beneficial to address liquidation rights held by other parties. The Board observed that removal rights are defined as ‘rights to deprive the decision maker of its decision-making authority’ and that some other rights (such as some liquidation rights) may have the same effect on the decision-making authority as removal rights. If those other rights meet the definition of removal rights, they should be treated as such regardless of their label. Therefore, the Board concluded that there was no need to add further guidance in this respect in the IFRS.

Exposure to variability of returns

BC141 The Board considered whether to specify that in the absence of other parties having substantive removal rights, a decision maker that receives a particular level of returns or exposure to variability of returns would be deemed to control an investee (for example, exposure to more than half of the variability of returns of an investee). However, the Board rejected developing a model that would specify a particular level of returns that would result in the determination of an agency relationship. Rather, the Board concluded that the more a decision maker is exposed to the variability of returns from its involvement with an investee, the more likely it is that the decision maker is a principal.

BC142 Although prescribing a quantitative approach for assessing returns, and specifying a particular level of returns, might lead to more consistent application of the requirements by removing some of the judgement required, the Board observed that such an approach was likely to lead to inappropriate consolidation conclusions in some situations. It would create a bright line that might encourage structuring to achieve a particular accounting outcome. The Board also noted that when assessing agency relationships, a decision maker’s exposure to variability of returns is not necessarily correlated with the amount of power that it has, unlike the general assumption when investees are controlled by voting rights. Therefore, a decision maker does not necessarily have any more power over an investee when it is exposed, for example, to more than half of the variability of an investee’s returns than when it is not.

Relationship with other parties

BC143 The Board decided that an investor should, when assessing control, consider the nature of its relationships with other parties. An investor may conclude that the nature of its relationship with other parties is such that those other parties are acting on the investor’s behalf (they are ‘de facto agents’). Such a relationship need not involve a contractual arrangement, thereby creating a non-contractual agency relationship. The Board concluded that a party is a de facto agent when the investor has, or those that direct the activities of the investor have, the ability to direct that party to act on the investor’s behalf.

BC144 ED 10 included a list of examples of parties that often act for the investor. The Board’s intention was that an investor would look closely at its relationships with such parties and assess whether the party is acting on behalf of the investor.

BC145 Some respondents said that the list of examples of parties that often act on behalf of an investor was not helpful because they could think of circumstances in which it would be appropriate to regard each of the parties as agents of the investor and other circumstances when it would not. Respondents were unclear about the consequences of concluding that a party acts for an investor.

BC146 The Board clarified its intentions by stating that, when assessing control, an investor would consider its de facto agent's decision-making rights and exposure (or rights) to variable returns together with its own as if the rights were held by the investor directly. In reaching this decision, the Board noted that it would be inappropriate to assume that all other parties listed in paragraph B75 would *always* or *never* act for the investor. It acknowledged that the assessment of whether the nature of the relationship between the investor and the other party is such that the other party is a de facto agent requires judgement, including consideration of the nature of the relationship and the way that the parties interact with each other.

Control of specified assets

BC147 ED 10 introduced the term 'silo'—an investee within a legal structure—without defining it, noting that an investee can comprise more than one entity. This would be the case when the legal and contractual arrangements relating to an investee give one party control of a particular set of assets and liabilities, whereas another party might have control over another set of assets and liabilities within the investee. Respondents to ED 10 requested more guidance in order to apply the concept in practice.

BC148 In response to those requests, IFRS 10 includes application requirements regarding interests in specified assets. This guidance is consistent with the current guidance in US GAAP in that it sets out when a portion of an investee is treated as a separate entity for the purposes of consolidation. The Board noted that this situation arises most often in the context of investees that are not directed through voting or similar rights. However, the Board decided that to restrict the application requirements to investees that are not directed through voting or similar rights would be contrary to the objective of developing a control model that is applied consistently to all investees. In addition, the Board was not aware of any reason for such a restriction. Therefore, the guidance regarding interests in specified assets is applicable to all investees. This is in contrast with US GAAP, which applies this guidance only to portions of variable interest entities.

Continuous assessment

BC149 ED 10 proposed that an investor should assess control continuously. This is because the Board believes that the assessment of control requires consideration of all facts and circumstances and it would be impossible to develop reconsideration criteria that would apply to every situation in which an investor obtains or loses control of an investee. Therefore, the reassessment of control only when particular reconsideration criteria are met would lead to inappropriate consolidation decisions in some cases.

BC150 Most respondents to ED 10 did not comment on the requirement to assess control continuously. Some questioned whether the continuous assessment of control could be interpreted as requiring preparers to reassess control at the end of each reporting period.

BC151 The Board confirmed the proposal in ED 10 to require an investor to assess control continuously, and clarified that this would mean reassessing control when there is a change in relevant facts and circumstances that suggest that there is a change to one or more of the three elements of control. Such reassessment would not be restricted to each reporting date, nor would the requirement necessarily demand the reassessment of all control or potential control relationships at each reporting date.

BC152 Participants in the FASB's round-table meeting on consolidation held in November 2010 expressed concern about the reassessment of control (including a decision maker's status as principal or agent) when there are changes in market conditions, in particular the reassessment of control in the context of potential voting rights. In response to those concerns, the IASB decided to add guidance to address the reassessment of control (including a decision maker's status as principal or agent) when there are changes in market conditions (for the reassessment of control in the context of potential voting rights see paragraph BC124). The Board observed that a change in market conditions alone would not generally affect the consolidation conclusion, or the status as a principal or an agent, for two reasons. The first is that power arises from substantive rights, and assessing whether those rights are substantive includes the consideration of many factors, not only those that are affected by a change in market conditions. The second is that an investor is not required to have a particular specified level of exposure to variable returns in order to control an investee. If that were the case, fluctuations in an investor's expected returns might result in changes in the consolidation conclusion.

BC153 Nonetheless, the Board confirmed that control should be reassessed when relevant facts and circumstances change to such an extent that there is a change in one or more of the three elements of control or in the overall relationship between a principal and an agent.

Accounting requirements

Consolidation procedures

BC154 The application requirements in IFRS 10 explain how potential voting rights should be accounted for in the consolidated financial statements. Paragraphs B89–B91 replace the guidance previously included in the implementation guidance accompanying IAS 27, but are not intended to change consolidation procedures.

Non-controlling interests (2003 revision and 2008 amendments)

BCZ155 The 2008 amendments to IAS 27 changed the term 'minority interest' to 'non-controlling interest'. The change in terminology reflects the fact that the owner of a minority interest in an entity might control that entity and, conversely, that the owners of a majority interest in an entity might not control the entity. 'Non-controlling interest' is a more accurate description than 'minority interest' of the interest of those owners who do not have a controlling interest in an entity.

BCZ156 Non-controlling interest was defined in IAS 27 as the equity in a subsidiary not attributable, directly or indirectly, to a parent (this definition is now in IFRS 10). Paragraph 26 of IAS 27 (as revised in 2000) required minority (non-controlling) interests to be presented in the consolidated balance sheet (statement of financial position) separately from liabilities and the equity of the shareholders of the parent.

BCZ157 As part of its revision of IAS 27 in 2003, the Board amended this requirement to require minority (non-controlling) interests to be presented in the consolidated statement of financial position within equity, separately from the equity of the shareholders of the parent. The Board concluded that a minority (non-controlling) interest is not a liability because it did not meet the definition of a liability in the *Framework for the Preparation and Presentation of Financial Statements*.⁹

⁹ References to the *Framework* in this Basis for Conclusions are to the IASC's *Framework for the Preparation and Presentation of Financial Statements*, adopted by the Board in 2001 and in effect when the Standard was revised and amended.

BCZ158 Paragraph 49(b) of the *Framework* stated that a liability is a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits. Paragraph 60 of the *Framework* explained that an essential characteristic of a liability is that the entity has a present obligation and that an obligation is a duty or responsibility to act or perform in a particular way. The Board noted that the existence of a minority (non-controlling) interest in the net assets of a subsidiary does not give rise to a present obligation, the settlement of which is expected to result in an outflow of economic benefits from the group.

BCZ159 Instead, the Board noted that minority (non-controlling) interests represent the residual interest in the net assets of those subsidiaries held by some of the shareholders of the subsidiaries within the group, and therefore met the *Framework's* definition of equity. Paragraph 49(c) of the *Framework* stated that equity is the residual interest in the assets of the entity after deducting all its liabilities.

Attribution of losses (2008 amendments)

BCZ160 IAS 27 (as revised in 2003) stated that when losses attributed to the minority (non-controlling) interests exceed the minority's interests in the subsidiary's equity, the excess, and any further losses applicable to the minority, is allocated against the majority interest except to the extent that the minority has a binding obligation and is able to make an additional investment to cover the losses.

BCZ161 In 2005 the Board decided that this treatment was inconsistent with its conclusion that non-controlling interests are part of the equity of the group, and proposed that an entity should attribute total comprehensive income applicable to non-controlling interests to those interests, even if this results in the non-controlling interests having a deficit balance.

BCZ162 If the parent enters into an arrangement that places it under an obligation to the subsidiary or to the non-controlling interests, the Board believes that the entity should account for that arrangement separately and the arrangement should not affect how the entity attributes comprehensive income to the controlling and non-controlling interests.

BCZ163 Some respondents to the 2005 exposure draft agreed with the proposal, noting that non-controlling interests share proportionately in the risks and rewards of the subsidiary and that the proposal was consistent with the classification of non-controlling interests as equity.

BCZ164 Other respondents disagreed, often on the grounds that controlling and non-controlling interests have different characteristics and should not be treated the same way. They argued that there was no need to change the guidance in IAS 27 (as revised in 2003) (ie that an entity should allocate excess losses to the controlling interest unless the non-controlling interests have a binding obligation and are able to make an additional investment to cover the losses). The reasons given by those respondents were:

- (a) The non-controlling interests are not compelled to cover the deficit (unless they have specifically agreed to do so) and it is reasonable to assume that, if the subsidiary requires additional capital in order to continue operations, the non-controlling interests would abandon their investments. In contrast, respondents asserted that in practice the controlling interest often has an implicit obligation to maintain the subsidiary as a going concern.

- (b) Often guarantees or other support arrangements by the parent protect the non-controlling interests from losses of the subsidiary in excess of equity and do not affect the way losses are attributed to the controlling and non-controlling interests. Respondents argued that allocating those losses to the parent and non-controlling interests and recognising separately a guarantee would not reflect the underlying economics, which are that only the parent absorbs the losses of the subsidiary. In their view, it would be misleading for financial statements to imply that the non-controlling interests have an obligation to make additional investments.
- (c) Recognising guarantees separately is contrary to the principle of the non-recognition of transactions between owners.
- (d) Loss allocation should take into account legal, regulatory or contractual constraints, some of which may prevent entities from recognising negative non-controlling interests, especially for regulated businesses (eg banks and insurers).

BCZ165 The Board considered these reasons but observed that, although it is true that non-controlling interests have no further obligation to contribute assets to the subsidiary, neither does the parent. Non-controlling interests participate proportionally in the risks and rewards of an investment in the subsidiary.

BCZ166 Some respondents asked the Board to provide guidance on the accounting for guarantees and similar arrangements between the parent and the subsidiary or the non-controlling interests. They also suggested that the Board should require additional disclosures about inter-company guarantees and the extent of deficits, if any, of non-controlling interests.

BCZ167 The Board considered these requests but observed that this was an issue wider than negative non-controlling interests. For example, the parent is not necessarily responsible for the liabilities of a subsidiary, and often there are factors that restrict the ability of a parent to move assets in a group, which means that the assets of the group are not necessarily freely available to the parent. The Board decided that it would be more appropriate to address comprehensively disclosures about non-controlling interests (disclosures about non-controlling interests are included in IFRS 12).

Changes in ownership interests in subsidiaries (2008 amendments)

BCZ168 The Board decided that after control of an entity is obtained, changes in a parent's ownership interest that do not result in a loss of control are accounted for as equity transactions (ie transactions with owners in their capacity as owners). This means that no gain or loss from these changes should be recognised in profit or loss. It also means that no change in the carrying amounts of the subsidiary's assets (including goodwill) or liabilities should be recognised as a result of such transactions.

BCZ169 The Board reached this conclusion because it believed that the approach adopted in the amendments was consistent with its previous decision that non-controlling interests are a separate component of equity (see paragraphs BCZ156–BCZ159).

- BCZ170 Some respondents agreed that non-controlling interests are equity but said that they should be treated as a special class of equity. Others disagreed with the requirement because in their view recognising transactions with non-controlling interests as equity transactions would mean that the Board had adopted an entity approach whereas they preferred a proprietary approach. The Board disagreed with this characterisation of the accounting treatment, noting that the accounting proposed was a consequence of classifying non-controlling interests as equity. The Board did not consider comprehensively the entity and proprietary approaches as part of the amendments to IAS 27 in 2008.
- BCZ171 Many respondents to the 2005 exposure draft suggested alternative approaches for the accounting for changes in controlling ownership interests. The most commonly suggested alternative would result in increases in controlling ownership interests giving rise to the recognition of additional goodwill, measured as the excess of the purchase consideration over the carrying amount of the separately identified assets in the subsidiary attributable to the additional interest acquired.
- BCZ172 Some respondents suggested that when an entity reduces its ownership interest in a subsidiary, without losing control, it should recognise a gain or loss attributable to the controlling interest. They would measure that gain or loss as the difference between the consideration received and the proportion of the carrying amount of the subsidiary's assets (including recognised goodwill) attributable to the ownership interest being disposed of. Respondents supporting this alternative said that it would provide relevant information about the gains and losses attributable to the controlling interest arising on the partial disposal of ownership interests in subsidiaries.
- BCZ173 The Board rejected this alternative. Recognising a change in any of the assets of the business, including goodwill, was inconsistent with the Board's decision in IFRS 3 *Business Combinations* (as revised in 2008) that obtaining control in a business combination is a significant economic event. That event causes the initial recognition and measurement of all the assets acquired and liabilities assumed in the business combination. Subsequent transactions with owners should not affect the measurement of those assets and liabilities.
- BCZ174 The parent already controls the assets of the business, although it must share the income from those assets with the non-controlling interests. By acquiring the non-controlling interests the parent is obtaining the rights to some, or all, of the income to which the non-controlling interests previously had rights. Generally, the wealth-generating ability of those assets is unaffected by the acquisition of the non-controlling interests. That is to say, the parent is not investing in more or new assets. It is acquiring more rights to the income from the assets it already controls.
- BCZ175 By acquiring some, or all, of the non-controlling interests the parent will be allocated a greater proportion of the profits or losses of the subsidiary in periods after the additional interests are acquired. The adjustment to the controlling interest will be equal to the unrecognised share of the value changes that the parent will be allocated when those value changes are recognised by the subsidiary. Failure to make that adjustment will cause the controlling interest to be overstated.
- BCZ176 The Board noted that accounting for changes in controlling ownership interests as equity transactions, as well as ensuring that the income of the group and the reported controlling interests are faithfully represented, is less complex than the other alternatives considered.

- BCZ177 Some respondents disagreed with the proposal because they were concerned about the effect on reported equity of the subsequent acquisition of non-controlling interests by the parent. They seemed to be particularly concerned about the effect on the reported leverage of an entity that acquires non-controlling interests and whether this might, for example, cause those entities to have to renegotiate loan agreements.
- BCZ178 The Board observed that all acquisitions of an entity's equity reduce the entity's equity, regardless of whether it is an acquisition of the parent's ordinary or preference shares or non-controlling interests. Hence, the treatment of a subsequent acquisition of non-controlling interests is consistent with the general accounting for the acquisition by an entity of instruments classified as equity.
- BCZ179 The Board understands the importance of providing owners of the parent with information about the total changes in their reported equity. Therefore, the Board decided to require entities to present in a separate schedule the effects of any changes in a parent's ownership interest in a subsidiary that do not result in a loss of control on the equity attributable to owners of the parent (this disclosure requirement is now in IFRS 12).

Loss of control (2008 amendments)

- BCZ180 A parent loses control of a subsidiary when it loses the power to govern the financial and operating policies of an investee so as to obtain benefit from its activities. Loss of control can result from the sale of an ownership interest or by other means, such as when a subsidiary issues new ownership interests to third parties. Loss of control can also occur in the absence of a transaction. It may, for example, occur on the expiry of an agreement that previously allowed an entity to control a subsidiary.
- BCZ181 On loss of control, the parent-subsidiary relationship ceases to exist. The parent no longer controls the subsidiary's individual assets and liabilities. Therefore, the parent derecognises the individual assets, liabilities and equity related to that subsidiary. Equity includes any non-controlling interests as well as amounts previously recognised in other comprehensive income in relation to, for example, foreign currency translation.
- BCZ182 The Board decided that any investment the parent has in the former subsidiary after control is lost should be measured at fair value at the date that control is lost and that any resulting gain or loss should be recognised in profit or loss. Some respondents disagreed with that decision. They asserted that the principles for revenue and gain recognition in the *Framework* would not be satisfied for the retained interest. The Board disagreed with those respondents. Measuring the investment at fair value reflected the Board's view that the loss of control of a subsidiary is a significant economic event. The parent-subsidiary relationship ceases to exist and an investor-investee relationship begins that differs significantly from the former parent-subsidiary relationship. Therefore, the new investor-investee relationship is recognised and measured initially at the date when control is lost.
- BCZ183 The Board decided that the loss of control of a subsidiary is, from the group's perspective, the loss of control over some of the group's individual assets and liabilities. Accordingly, the general requirements in IFRSs should be applied in accounting for the derecognition from the group's financial statements of the subsidiary's assets and liabilities. If a gain or loss previously recognised in other comprehensive income would be reclassified to profit or loss on the separate disposal of those assets and liabilities, the parent reclassifies the gain or loss from equity to profit or loss on the indirect disposal of those assets and liabilities through loss of control of a subsidiary.

BCZ184 The Board also discussed the accounting when an entity transfers its shares in a subsidiary to its own shareholders with the result that the entity loses control of the subsidiary (commonly referred to as a spin-off). The International Financial Reporting Interpretations Committee had previously discussed this matter, but decided not to add the matter to its agenda while the business combinations project was in progress. The Board observed that the issue was outside the scope of the business combinations project. Therefore, the Board decided not to address the measurement basis of distributions to owners in the amendments to IAS 27.

Multiple arrangements

BCZ185 The Board considered whether its decision that a gain or loss on the disposal of a subsidiary should be recognised only when that disposal results in a loss of control could give rise to opportunities to structure transactions to achieve a particular accounting outcome. For example, would an entity be motivated to structure a transaction or arrangement as multiple steps to maximise gains or minimise losses if an entity were planning to dispose of its controlling interest in a subsidiary? Consider the following example. Entity P controls 70 per cent of entity S. Entity P intends to sell all of its 70 per cent controlling interest in entity S. Entity P could initially sell 19 per cent of its ownership interest in entity S without loss of control and then, soon afterwards, sell the remaining 51 per cent and lose control. Alternatively, entity P could sell all of its 70 per cent interest in entity S in one transaction. In the first case, any difference between the amount by which the non-controlling interests are adjusted and the fair value of the consideration received on the sale of the 19 per cent interest would be recognised directly in equity, whereas the gain or loss from the sale of the remaining 51 per cent interest would be recognised in profit or loss. In the second case, a gain or loss on the sale of the whole 70 per cent interest would be recognised in profit or loss.

BCZ186 The Board noted that the opportunity to conceal losses through structuring would be reduced by the requirements of IAS 36 *Impairment of Assets* and IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*. Paragraph 12 of IAS 36 includes significant changes to how an entity uses or expects to use an asset as one of the indicators that the asset might be impaired.

BCZ187 Once an asset meets the criteria to be classified as held for sale (or is included in a disposal group that is classified as held for sale), it is excluded from the scope of IAS 36 and is accounted for in accordance with IFRS 5. In accordance with paragraph 20 of IFRS 5 'an entity shall recognise an impairment loss for any initial or subsequent write-down of the asset (or disposal group) to fair value less costs to sell...'. Therefore, if appropriate, an impairment loss would be recognised for the goodwill and non-current assets of a subsidiary that will be sold or otherwise disposed of before control of the subsidiary is lost. Accordingly, the Board concluded that the principal risk is the minimising of gains, which entities are unlikely to strive to do.

BCZ188 The Board decided that the possibility of such structuring could be overcome by requiring entities to consider whether multiple arrangements should be accounted for as a single transaction to ensure that the principle of faithful representation is adhered to. The Board believes that all the terms and conditions of the arrangements and their economic effects should be considered in determining whether multiple arrangements should be accounted for as a single arrangement. Accordingly, the Board included indicators in paragraph 33 of IAS 27 (as revised in 2008) to assist in identifying when multiple arrangements that result in the loss of control of a subsidiary should be treated as a single arrangement (those indicators are now in paragraph B97 of IFRS 10).

BCZ189 Some respondents disagreed with the indicators that were provided in the exposure draft. They said that the need for guidance on when multiple arrangements should be accounted for as a single arrangement indicates a conceptual weakness in the accounting model developed in the exposure draft. Moreover, such guidance would be unnecessary under other alternatives for accounting for decreases in ownership interests. The Board acknowledges that guidance on multiple arrangements would be unnecessary under some other accounting alternatives. However, the Board does not accept that this means that those models are conceptually superior.

BCZ190 Some respondents suggested that IAS 27 should include examples rather than indicators for when multiple transactions should be treated as a single transaction or arrangement, but that those examples should not be regarded as a complete list. The Board considered that suggestion, but decided to confirm the indicators that were proposed in the exposure draft. The Board believed that the indicators could be applied to a variety of situations and were preferable to providing what could be an endless list of examples to try to capture every possible arrangement.

Effective date and transition

Effective date

BC191 The Board decided to align the effective date for the IFRS with the effective date for IFRS 11, IFRS 12, IAS 27 *Separate Financial Statements* and IAS 28. When making this decision, the Board noted that the five IFRSs all deal with the assessment of, and related accounting and disclosure requirements about, a reporting entity's special relationships with other entities (ie when the reporting entity has control or joint control of, or significant influence over, another entity). As a result, the Board concluded that applying IFRS 10 without also applying the other four IFRSs could cause unwarranted confusion.

BC192 The Board usually sets an effective date of between twelve and eighteen months after issuing an IFRS. When deciding the effective date for those IFRSs, the Board considered the following factors:

- (a) the time that many countries require for translation and for introducing the mandatory requirements into law.
- (b) the consolidation project was related to the global financial crisis that started in 2007 and was accelerated by the Board in response to urgent requests from the leaders of the G20, the Financial Stability Board, users of financial statements, regulators and others to improve the accounting and disclosure of an entity's 'off balance sheet' activities.
- (c) the comments received from respondents to the Request for Views *Effective Date and Transition Methods* that was published in October 2010 regarding implementation costs, effective date and transition requirements of the IFRSs to be issued in 2011. Most respondents did not identify the consolidation and joint arrangements IFRSs as having a high impact in terms of the time and resources that their implementation would require. In addition, only a few respondents commented that the effective dates of those IFRSs should be aligned with those of the other IFRSs to be issued in 2011.

BC193 With these factors in mind, the Board decided to require entities to apply the five IFRSs for annual periods beginning on or after 1 January 2013.

BC194 The majority of the respondents to the Request for Views supported early application of the IFRSs to be issued in 2011. Respondents stressed that early application was especially important for first-time adopters in 2011 and 2012. The Board was persuaded by these arguments and decided to permit early application of IFRS 10 but only if an entity applies it in conjunction with the other IFRSs (ie IFRS 11, IFRS 12, IAS 27 (as amended in 2011) and IAS 28 (as amended in 2011)) to avoid a lack of comparability among financial statements, and for the reasons noted in paragraph BC191 that triggered the Board's decision to set the same effective date for all five IFRSs. Even though an entity should apply the five IFRSs at the same time, the Board noted that an entity should not be prevented from applying any of the disclosure requirements of IFRS 12 early if by doing so users gained a better understanding of the entity's relationships with other entities.

Transition

BC195 IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* states that retrospective application results in the most useful information to users because the information presented for all periods is comparable.

BC196 In reaching its conclusions, the Board observed that IFRS 10 might result in an investor consolidating investees that were not previously consolidated or not consolidating investees that were previously consolidated. If an investor is required to consolidate a previously unconsolidated investee and has been accounting for its investment in that investee using proportionate consolidation or the equity method, the Board noted that the investor would often have the information available to consolidate the investee retrospectively as if IFRS 10 had always been in place. This is also likely to be the case if an investor no longer consolidates an investee that it previously consolidated but would now have to account for its investment in the investee using the equity method.

BC196A IFRS 3 *Business Combinations* was initially issued in 2004 and was then substantially revised in 2008. Those revisions apply prospectively. The Board noted that, when developing the transition guidance in paragraphs C4–C4A, it had not specified which version of IFRS 3 should be used when an investor concludes that it shall consolidate an investee that was not previously consolidated and over which control was obtained before the effective date of IFRS 3 (revised in 2008). Applying the current version of IFRS 3 in such cases may provide more comparable information.

BC196B However, as noted in BC196, if an investor has been accounting for its investment in such an investee using proportionate consolidation or the equity method, it will have already identified the fair values, goodwill and other amounts required to apply IFRS 3 (issued in 2004). Allowing investors to use existing information in such cases reduces the risk of using hindsight and may provide a more reliable basis for consolidation. Consequently, if control was obtained before the effective date of IFRS 3 (2008), the Board decided to allow entities to use either IFRS 3 (2008) or IFRS 3 (2004) in applying the transition requirements.

- BC196C Similarly, IAS 27 *Consolidated and Separate Financial Statements*, as issued in 2003, was substantially revised in 2008. Those revisions apply prospectively. The requirements of IAS 27 (revised in 2008) have been carried forward into IFRS 10. For the same reasons as those described in BC196A–BC196B relating to IFRS 3, if control was obtained before the effective date of IAS 27 (2008), the Board also decided to allow entities to use either IAS 27 (2008) or IAS 27 (2003) in applying the transition requirements.
- BC197 In addition, the Board acknowledged that retrospective application of IFRS 10 may not be practicable in some circumstances. If an investor on initial application of IFRS 10 consolidates an investee it previously did not consolidate and it is impracticable to apply the provisions of IFRS 10 retrospectively, the reporting entity would apply the acquisition method in IFRS 3 with the acquisition date being the beginning of the earliest period for which application of those requirements is practicable (goodwill would not be recognised for an investee that is not a business).
- BC198 If an investor on initial application of IFRS 10 ceases to consolidate an investee that was previously consolidated, the investor measures its retained interest in the investee on the date of initial application, at the amount at which the interest would have been measured if the requirements of IFRS 10 had been effective when the investor first became involved with (but did not obtain control in accordance with this IFRS), or lost control of, the investee. If, in accordance with IFRS 10, the investor never obtained control, then it would eliminate the previous consolidation from the date that it first became involved with the investee and account for that interest in accordance with other IFRSs as applicable. Alternatively, the investor may have obtained control in accordance with both IAS 27 and IFRS 10, but then later lost control in accordance with IFRS 10 but not IAS 27. In this case, the investor would cease to consolidate from the date control was lost as defined by IFRS 10. If measurement of the retained interest at the date the investor first became involved with (but did not obtain control in accordance with this IFRS), or lost control of, the investee is impracticable, the investor would apply the requirements in IFRS 10 for accounting for a loss of control at the beginning of the earliest period for which application of those requirements is practicable. The earliest period may be the current period.
- BC199 As stated in paragraph BC192, respondents to the Request for Views also commented on the transition requirements of the IFRSs to be issued in 2011. In relation to the transition requirements relating to consolidation, the Board noted that the majority of the respondents to the Request for Views had agreed with limited retrospective application for IFRS 10.
- BC199A The Board identified a need to clarify the transition guidance that was intended to achieve limited retrospective application of IFRS 10. The Board noted that the main intention when issuing IFRS 10 was to ensure consistent accounting for transactions when IFRS 10 was applied for the first time (ie 1 January 2013 for a calendar-year entity, assuming no early application). In other words, the intention was to use the date of initial application as the point at which to determine the interests that should be accounted for in accordance with IFRS 10. The Board also noted that the intention was to provide transition relief if the consolidation conclusion would be the same whether applying IAS 27/SIC-12 or IFRS 10 at the date that IFRS 10 was applied for the first time. The Board concluded that, in those situations, the incremental benefit to users of applying IFRS 10 retrospectively would not outweigh the costs.

- BC199B Consequently, the Board confirmed that the ‘date of initial application’ means the beginning of the annual reporting period for which IFRS 10 is applied for the first time. The Board amended the transition guidance to confirm that an entity is not required to make adjustments to the previous accounting for its involvement with entities if the consolidation conclusion reached at the date of initial application is the same whether applying IAS 27/SIC-12 or IFRS 10. In making this clarification, the Board confirmed that the transition relief in paragraph C3(b) would also apply to interests in investees that were disposed of before the date of initial application of IFRS 10, (ie 1 January 2013 for a calendar-year entity, assuming no early application).
- BC199C In clarifying how an entity should retrospectively adjust its comparative information on initial application of IFRS 10, the Board acknowledged that presenting all adjusted comparatives would be burdensome for preparers in jurisdictions where several years of comparatives are required. Without changing the requirement to apply the recognition and measurement requirements of IFRS 10 retrospectively, the Board decided to limit the requirement to present adjusted comparatives to the annual period immediately preceding the date of initial application. This is consistent with the minimum comparative disclosure requirements contained in IAS 1 *Presentation of Financial Statements* as amended by *Annual Improvements to IFRSs 2009–2011 Cycle* (issued May 2012). Those amendments confirmed that when an entity applies a changed accounting policy retrospectively, it shall present, as a minimum, three statements of financial position (ie 1 January 2012, 31 December 2012 and 31 December 2013 for a calendar-year entity, assuming no early application of this IFRS) and two of each of the other statements (IAS 1 paragraphs 40A–40B). Notwithstanding this requirement, the Board confirmed that an entity is not prohibited from presenting adjusted comparative information for earlier periods. The Board noted that if all comparative periods are not adjusted then entities should be required to state that fact, clearly identify the information that has not been adjusted, and explain the basis on which it has been prepared.
- BC199D The Board also considered the disclosure requirements of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*. On the initial application of an IFRS, paragraph 28(f) of IAS 8 requires an entity to disclose, for the current period and for each prior period presented, the amount of any adjustment for each financial statement line item affected. Changes in the consolidation conclusion on transition to IFRS 10 are likely to affect many line items throughout the financial statements. The Board agreed that this requirement would be burdensome for preparers and so agreed to limit the disclosure of the quantitative impact of any changes in the consolidation conclusion to only the annual period immediately preceding the date of initial application. An entity may also present this information for the current period or for earlier comparative periods, but is not required to do so.
- BC199E The Board considered whether IFRS 1 *First-time Adoption of Financial Reporting Standards* should be amended to allow first-time adopters to use the transition guidance of IFRS 10. It was noted that some respondents to the exposure draft had commented that, particularly when an investee is disposed of or control is lost during the comparative period, the cost of providing temporary consolidation information is not justified. The Board noted that this raised broader issues with the application of IFRS 1 and, rather than address this issue in the context of clarifying IFRS 10 transition relief, it would be more appropriately addressed in the context of IFRS 1 itself.

Transitional provisions (2008 amendments)

BCZ200 To improve the comparability of financial information across entities, amendments to IFRSs are usually applied retrospectively. Therefore, the Board proposed in its 2005 exposure draft to require retrospective application of the amendments to IAS 27, on the basis that the benefits of retrospective application outweigh the costs. However, in that exposure draft the Board identified two circumstances in which it concluded that retrospective application would be impracticable:

- (a) accounting for increases in a parent's ownership interest in a subsidiary that occurred before the effective date of the amendments. Therefore, the accounting for any previous increase in a parent's ownership interest in a subsidiary before the effective date of the amendments should not be adjusted.
- (b) accounting for a parent's investment in a former subsidiary for which control was lost before the effective date of the amendments. Therefore, the carrying amount of any investment in a former subsidiary should not be adjusted to its fair value on the date when control was lost. In addition, an entity should not recalculate any gain or loss on loss of control of a subsidiary if the loss of control occurred before the effective date of the amendments.

BCZ201 The Board concluded that the implementation difficulties and costs associated with applying the amendments retrospectively in these circumstances outweigh the benefits of improved comparability of financial information. Therefore, the Board decided to require prospective application. In addition, the Board concluded that identifying those provisions for which retrospective application of the amendments would be impracticable, and thus prospective application would be required, would reduce implementation costs and result in greater comparability between entities.

BCZ202 Some respondents were concerned that the transitional provisions were different for increases and decreases in ownership interests. They argued that accounting for decreases in non-controlling interests retrospectively imposes compliance costs that are not justifiable, mainly because the requirement to account for increases prospectively reduces comparability anyway. The Board accepted those arguments and decided that prospective application would be required for all changes in ownership interests (those transitional provisions are now in Appendix C of IFRS 10). The revised transitional provisions will lead to increases and decreases in ownership interests being treated symmetrically and the recasting of financial statements being limited to disclosure and presentation. The recognition and measurement of previous transactions will not be changed upon transition.

BCZ203 In response to practical concerns raised by respondents, the Board also decided to require prospective application of the requirement to allocate losses in excess of the non-controlling interests in the equity of a subsidiary to the non-controlling interests, even if that would result in the non-controlling interests being reported as a deficit balance (this transitional provision is now in Appendix C of IFRS 10).

Withdrawal of IAS 27 (2008) and SIC-12

BC204 IFRS 10 identifies the principle of control and determines how to identify whether an investor controls an investee and therefore should consolidate the investee. IFRS 10 also identifies the principles for preparation of consolidated financial statements. IFRS 10 supersedes the requirements related to consolidated financial statements in IAS 27 (as amended in 2008) and SIC-12.

BC205 IFRS 10 does not address the accounting for investments in subsidiaries, jointly controlled entities and associates in separate financial statements as specified in IAS 27. The parts of IAS 27 that relate to separate financial statements have been included in the amended IAS 27.

Summary of main changes from ED 10

BC206 The main changes made by IFRS 10 from the exposure draft ED 10 published in 2008 are:

- (a) IFRS 10 includes application guidance on all the following topics:
 - (i) the meaning of 'power', 'activities' and 'returns' within the definition of control.
 - (ii) when assessing control of an investee:
 - understanding the purpose and design of an investee.
 - different activities of an investee that significantly affect the investee's returns.
 - a discussion of rights that give an investor power and protective rights.
 - power to direct the activities of an investee without a majority of the voting rights, including potential voting rights.
 - contractual and non-contractual agency relationships.
- (b) IFRS 10 requires retrospective application of its requirements subject to the practicability exemption in IAS 8. The exposure draft had proposed prospective application using the requirements of IFRS 3 or the requirements relating to the loss of control on the date of first applying the IFRS.¹⁰

Cost-benefit considerations

BC207 The objective of general purpose financial reporting is to provide information about the financial position, performance and changes in financial position of a reporting entity that is useful to a wide range of users in making economic decisions. To attain this objective, the Board seeks to ensure that an IFRS will meet a significant need and that the overall benefits of the resulting information justify the costs of providing it. Although the costs of implementing a new IFRS might not be borne evenly, users of financial statements benefit from improvements in financial reporting, thereby facilitating the functioning of markets for capital and credit and the efficient allocation of resources in the economy.

BC208 The evaluation of costs and benefits is necessarily subjective. In making its judgement, the Board considered the following:

- (a) the costs incurred by preparers of financial statements;
- (b) the costs incurred by users of financial statements when information is not available;
- (c) the comparative advantage that preparers have in developing information, compared with the costs that users would incur to develop surrogate information;
- (d) the benefit of better economic decision-making as a result of improved financial reporting; and
- (e) the costs of transition for users, preparers and others.

BC209 The Board observed that IFRS 10 will improve the usefulness of consolidated financial statements by developing a single basis for consolidation (control) and robust guidance for applying that basis to situations in which it has proved difficult to assess control in practice and divergence has evolved. IFRS 10 introduces a definition of control of an investee that is applied consistently when assessing whether an investor should consolidate an investee, irrespective of the nature of the investee. IFRS 10 also requires retrospective application of the requirements subject to the practicability exemptions in IAS 8 that will result in comparable information for all periods presented.

¹⁰ *Investment Entities* (Amendments to IFRS 10, IFRS 12 and IAS 27), issued in October 2012, introduced an exception to the principle that all subsidiaries shall be consolidated. The amendments define an investment entity and require a parent that is an investment entity to measure its investments in particular subsidiaries at fair value through profit or loss instead of consolidating those subsidiaries. These amendments are discussed in paragraphs BC215–BC317.

- BC210 Users prefer information that is comparable from reporting period to reporting period for an individual entity and between different entities in a particular reporting period. The Board concluded that IFRS 10 provides much clearer principles that underlie the definition of control of an investee and provides more application guidance when assessing control than the requirements it replaces. As a consequence, users should have more comparable and verifiable information about the activities controlled by the reporting entity.
- BC211 If the requirements in an IFRS are not clear, or there is no guidance, the preparer will often have to seek independent advice and engage with its auditors to resolve uncertainty about how to account for a particular type of transaction. These costs should decrease if the requirements in the revised IFRS are clearer. Accordingly, because IFRS 10 addresses the concerns conveyed to the Board about the absence of guidance in IAS 27 and SIC-12, the Board concluded that preparers will benefit from the new requirements. The Board accepts that any new IFRS will cause preparers to incur one-off costs associated with learning the new requirements and reassessing their accounting. However, the Board's assessment is that the benefits from providing clearer principles and more application guidance outweigh those costs.
- BC212 The changes to the definition of control will inevitably lead to some reporting entities consolidating some entities that were previously not consolidated and ceasing consolidation of some entities, or both. The Board does not think it is appropriate to consider whether there will be 'more or less consolidation' by applying the new proposals. However, the clarifications in relation to less than a majority of the voting rights will lead to more consolidation. In the case of what SIC-12 referred to as special purpose entities, the Board believes that the new requirements will result in more appropriate consolidation.
- BC213 Given the benefits for users and preparers noted in paragraphs BC209–BC211 the Board believes that the benefits of IFRS 10 outweigh the costs.
- BC214 This project also considered disclosure requirements in relation to consolidation. Those requirements, and the related costs and benefits, are assessed in the Basis for Conclusions on IFRS 12.

Exception to consolidation for investment entities (2012 amendments)

Background

- BC215 In October 2012, the Board issued *Investment Entities* (Amendments to IFRS 10, IFRS 12 and IAS 27), which provides an exception to consolidation for a class of entities that are defined as 'investment entities'. The Board added the Investment Entities project to its agenda in the course of its deliberations on IFRS 10 as a response to the comments received on ED 10.
- BC216 The Board had considered this issue previously. In 2002, the respondents to the Exposure Draft of IAS 27 asked the Board to provide an exception to consolidation for the subsidiaries of venture capital organisations, private equity entities and similar organisations. At that time, the Board decided not to introduce such an exception because it did not think that it should differentiate between the types of entity, or the types of investment, when applying a control model of consolidation. It also did not agree that management's reasons for holding an investment should determine whether or not that investment is consolidated. The Board concluded that for investments under the control of venture capital organisations, private equity entities and similar organisations, users' information needs are best served by financial statements in which those investments are consolidated, thus revealing the extent of the operations of the entities they control.

- BC217 The scope of the proposals in ED 10 was the same as the scope of the proposals in IAS 27. IAS 27 required reporting entities to consolidate all controlled entities, regardless of the nature of the reporting entity. Respondents to ED 10 questioned the usefulness of financial statements of investment entities that consolidate investees that the investment entity controls. They pointed out that some national accounting requirements, including United States Generally Accepted Accounting Principles (US GAAP), have historically provided industry-specific guidance that requires investment entities to measure all of their investments, including those that they control, at fair value. The respondents argued that an investment entity holds investments for the sole purpose of capital appreciation, investment income (such as dividends or interest), or both. Users of the financial statements of these investment entities told the Board that the fair value of the investments and an understanding of how the investment entity measures the fair value of its investments is the most useful information.
- BC218 Furthermore, respondents to ED 10 argued that consolidated financial statements of an investment entity may hinder users' ability to assess an investment entity's financial position and results, because it emphasizes the financial position, operations and cash flows of the investee, rather than those of the investment entity. Often, an investment entity holds non-controlling interests in some entities that are reported at fair value, as well as controlling interests in other entities that are consolidated in accordance with current principles in IFRSs. Reporting investments on more than one basis hinders comparability within the financial statements, because all investments are held by an investment entity for a similar purpose—returns from capital appreciation, investment income, or both. In addition, some of the items consolidated may be measured at historical cost, which distorts the performance assessment of the investment entity and does not reflect the way in which the business of the entity is managed.
- BC219 Respondents to ED 10 also argued that when an investment entity consolidates entities that it controls, it is not required to provide the disclosures related to fair value measurements that would be required if the subsidiaries were measured at fair value. For example, IFRS 7 relates only to recognised financial assets and liabilities. There is no requirement to provide disclosures related to fair value for investments in consolidated subsidiaries. Information about fair value and the methodology and inputs used for determining fair value is vital for users to make investment decisions about investment entities. Investors in an investment entity are interested in the fair value of their interest in that entity and often transact with it on a fair value basis (ie their investment in the investment entity is based on a share of the net assets of that entity). Reporting the fair value of substantially all of the net assets of an investment entity allows the investors in that entity to more easily identify the value of their share of those net assets.
- BC220 In response to this feedback, the Board published an Exposure Draft *Investment Entities* (*Investment Entities* ED) in August 2011. The *Investment Entities* ED proposed that investment entities would be required to measure their investments in subsidiaries (except those subsidiaries that provide investment-related services) at fair value through profit or loss in accordance with IFRS 9 *Financial Instruments* (or IAS 39,¹¹ if IFRS 9 has not yet been adopted).¹² The majority of respondents to the *Investment Entities* ED broadly supported the proposed exception to consolidation for the reasons outlined in paragraphs BC217–BC219.
- BC221 The Board conducted its deliberations leading to the publication of the *Investment Entities* ED and the final investment entities requirements jointly with the FASB. The similarities and differences between the investment entities guidance in IFRS and US GAAP are discussed further in paragraphs BC289–BC291.

¹¹ IFRS 9 *Financial Instruments* replaced IAS 39. IFRS 9 applies to all items that were previously within the scope of IAS 39.

¹² In December 2014, the Board issued *Investment Entities: Applying the Consolidation Exception* (Amendments to IFRS 10, IFRS 12 and IAS 28). These amendments clarified which subsidiaries of an investment entity are consolidated in accordance with paragraph 32 of IFRS 10, instead of being measured at fair value through profit or loss (see paragraphs BC240A–BC240I).

Scope of the project

BC222 The *Investment Entities* ED proposed a limited-scope exception to consolidation for investment entities. A number of respondents to the *Investment Entities* ED asked the Board to expand the scope of its proposals.

BC223 Some respondents asked the Board to expand the scope of the project to require an investment entity to measure all of its investments at fair value. However, the Board noted that, in most cases, existing IFRSs require or permit investments held by an investment entity to be measured at fair value. For example an entity:

- (a) may elect the fair value option in IAS 40 *Investment Property*; and
- (b) would be required to measure its financial assets at fair value through profit or loss in accordance with IFRS 9 (or IAS 39¹³) when those assets are managed on a fair value basis.

Consequently, the Board decided to limit the scope of the project to only providing an exception to consolidation for investment entities.

BC224 Other respondents requested an extension of the proposed exception to consolidation. In particular, respondents from the insurance industry requested an exception to consolidating their interests in insurance investment funds. They argued that presenting the fair value of their interests in insurance investment funds as a single line item, along with a single line item for the current value of their liability to policyholders who receive the returns from those investment funds, would provide more useful information to users than consolidation. The Board noted that providing an exception to consolidation for insurers' interests in insurance investment funds is outside the scope of the *Investment Entities* project, which was meant to provide an exception to consolidation for investment entities. In addition, any additional exceptions to consolidation would require the Board to do further work to define the entities that could apply those exceptions. The Board noted that this additional exception to consolidation was not contemplated in the scope of the project nor was it exposed for comment. Consequently, the Board decided not to extend the proposed exception to consolidation.

BC225 Other respondents asked the Board to provide guidance permitting an investor in an investment entity to use the reported net asset value (NAV) per share of that investment entity as a practical expedient for measuring the fair value of its investment in that investment entity. Similar guidance exists in US GAAP. The Board considered providing such a practical expedient in their deliberations on IFRS 13 but decided against it because, at the time, there was no specific accounting guidance for investment entities in IFRS and because there are different practices for calculating NAVs in jurisdictions around the world. The Board decided that it is outside the scope of the *Investment Entities* project to provide fair value measurement guidance for investments in investment entities. The Board developed the definition of an investment entity to identify which entities should qualify for an exception to consolidation. The definition was not designed to decide which entities should qualify for a fair value measurement practical expedient. Moreover, the Board still has concerns that NAV could be calculated differently in different jurisdictions. Consequently, the Board decided not to provide an NAV practical expedient for fair value measurement as part of the *Investment Entities* project.

¹³ IFRS 9 *Financial Instruments* replaced IAS 39. IFRS 9 applies to all items that were previously within the scope of IAS 39.

BC226 The Board has decided to adopt an entity-based approach to the exception to consolidation. That is, the exception to consolidation is based on the type of entity that owns the subsidiary. The Board considered providing an asset-based approach to the exception to consolidation. Under an asset-based approach, an entity would consider its relationship with, and the characteristics of, each of its subsidiaries (that is, each individual asset) to decide whether fair value measurement is more appropriate than consolidation. However, the Board decided to retain the entity-based exception to consolidation that was proposed in the *Investment Entities* ED. The Board was concerned that an asset-based approach would significantly broaden the exception to consolidation by making the exception available to any entity holding relevant assets. This would represent a significant conceptual change to the consolidation model that the Board has developed in this IFRS. In addition, the Board believes that investment entities have a unique business model that makes reporting subsidiaries at fair value more appropriate than consolidation. An entity-based approach captures the unique business model of investment entities.

BC227 The Board also considered providing an option to allow investment entities to either consolidate subsidiaries or measure them at fair value through profit or loss. However, the Board believes that providing this option would be inconsistent with their view that fair value information is the most relevant information for all investment entities. Moreover, providing an option would reduce comparability between different investment entities. Consequently, the Board decided that an investment entity should be required to measure its subsidiaries at fair value through profit or loss.

Approach to assessing investment entity status

BC228 In the *Investment Entities* ED, the Board proposed six criteria that must be met in order for an entity to qualify as an investment entity. These criteria were based on guidance in US GAAP (Topic 946 *Financial Services—Investment Companies* in the *FASB Accounting Standards Codification*®).

BC229 Many respondents expressed concern that requiring an entity to meet all six criteria proposed in the *Investment Entities* ED would be too prescriptive. They thought that the proposed criteria inappropriately focused on the structure of an investment entity rather than on its business model and did not allow for the use of judgement in determining whether an entity is an investment entity. These respondents stated that a less prescriptive approach to assessing the criteria would result in more consistent reporting by entities with similar business models.

BC230 In addition, many respondents argued that the six proposed criteria in the *Investment Entities* ED did not provide a general description of an investment entity and an explanation of why fair value measurement is more relevant for the subsidiaries of an investment entity. Because the concept of an investment entity is new to IFRS, those respondents argued that the guidance should include a more general definition of an investment entity (rather than merely criteria to be an investment entity) and a justification for the exception to consolidation.

BC231 In response to the comments from respondents, the Board decided to provide a definition of an investment entity based on some of the criteria originally proposed in the *Investment Entities* ED. An entity that meets the definition of an investment entity would not consolidate its controlled subsidiaries (other than those subsidiaries that provide investment-related services or activities).¹⁴

¹⁴ In December 2014, the Board issued *Investment Entities: Applying the Consolidation Exception* (Amendments to IFRS 10, IFRS 12 and IAS 28). These amendments clarified which subsidiaries of an investment entity are consolidated in accordance with paragraph 32 of IFRS 10, instead of being measured at fair value through profit or loss (see paragraphs BC240A–BC240I).

- BC232 The Board agreed with respondents who stated that some of the proposed criteria were too strict and would inappropriately exclude some structures from qualifying as investment entities. The Board believes that there are structures in practice in which an entity does not meet one or more of the criteria that were described in the *Investment Entities* ED, but should still qualify as an investment entity. For example, the *Investment Entities* ED required an investment entity to have more than one investor; the Board thinks that some pension funds, sovereign wealth funds, and other investment funds with a single investor should qualify as investment entities. Moreover, respondents commented that the application guidance in the *Investment Entities* ED provided too many exceptions to the strict criteria.
- BC233 Consequently, the Board decided that an entity would not be required to satisfy the remaining criteria to meet the definition of an investment entity and qualify for the exception to consolidation. However, the Board noted that the remaining criteria represent typical characteristics of an investment entity and decided to include these typical characteristics in the investment entities guidance to help entities determine whether they qualify as an investment entity. If an entity does not display one or more of the typical characteristics, it indicates that additional judgement is required in determining whether the entity meets the definition of an investment entity. Consequently, the Board also decided that an investment entity that does not have one or more of the typical characteristics would be required to disclose how it still meets the definition of an investment entity.
- BC234 The Board thinks that it is very unlikely that an entity that displays none of the typical characteristics of an investment entity would meet the definition of one. However, it may be possible in rare circumstances. For example, a pension fund that has a single investor and does not issue equity ownership interests could qualify as an investment entity even if it only holds a single investment temporarily (eg at commencement or wind-down of the entity).
- BC235 The Board believes that defining an investment entity and describing its typical characteristics achieves a balance between clearly defining those entities that qualify for the exception to consolidation and avoiding the use of bright lines. In addition, this approach allows the definition to stand on its own, with application guidance providing clarification rather than exceptions.

Definition of an investment entity

- BC236 The definition of an investment entity has three essential elements that differentiate investment entities from other types of entities.

Investment management services

- BC237 The Board noted that one of the essential activities of an investment entity is that it obtains funds from investors in order to provide those investors with investment management services. The Board believes that this provision of investment management services differentiates investment entities from other entities. Consequently, the Board decided that the definition of an investment entity should state that an investment entity obtains funds from an investor or investors and provides the investor(s) with investment management services.

Business purpose

- BC238 The Board believes that an entity's activities and business purpose are critical to determining whether it is an investment entity. An investment entity collects funds from investors and invests those funds to obtain returns solely from capital appreciation, investment income, or both. Consequently, the Board decided that the definition of an investment entity should state that an investment entity commits to its investor(s) that its business purpose is to provide investment management services and invest funds solely for returns from capital appreciation, investment income, or both.
- BC239 The *Investment Entities* ED did not allow an entity to qualify as an investment entity if it provided substantive investment-related services to third parties. While some respondents agreed with this, others argued that an investment entity should be allowed to provide such services to third parties. They argued that the provision of these investment-related services to third parties is simply an extension of the investment entity's investing activities and should not prohibit an entity from qualifying as an investment entity. The Board agreed with these arguments, concluding that the provision of such services is within the business model of an investment entity. Although such an entity may earn fee income from the provision of investment-related services, its sole business purpose is still investing for capital appreciation, investment income, or both (whether that is for itself, for its investors or for external parties).
- BC240 The Board noted that an investment entity may sometimes hold an interest in a subsidiary that provides investment-related services for its investment activities. The Board did not think that the existence of such a subsidiary should prohibit an entity from qualifying as an investment entity, even if those services were substantial or were provided to third parties in addition to the entity. The Board views such services as an extension of the operations of the investment entity and therefore concluded that subsidiaries that provide those services should be consolidated.
- BC240A In December 2014, the Board issued *Investment Entities: Applying the Consolidation Exception* (Amendments to IFRS 10, IFRS 12 and IAS 28). This amended paragraphs 32, BC85C and B85E of IFRS 10 to clarify which subsidiaries of an investment entity should be consolidated instead of being measured at fair value. The amendments were made in response to a request for the Board to clarify how to apply paragraph 32 when the subsidiary of an investment entity itself meets the definition of an investment entity and provides services that relate to the parent's investment activities.
- BC240B The Board decided to clarify that an investment entity shall measure at fair value through profit or loss all of its subsidiaries that are themselves investment entities. This is consistent with its decision not to distinguish between investment entity subsidiaries established for different purposes (see paragraph BC272). This was supported by the majority of respondents to both the *Investment Entities* ED and the Exposure Draft *Investment Entities: Applying the Consolidation Exception* (Proposed amendments to IFRS 10 and IAS 28), published in June 2014 (the '*Consolidation Exception* ED').
- BC240C Some respondents to the *Consolidation Exception* ED suggested that requiring an investment entity to measure each investment entity subsidiary at fair value as a single item results in a loss of information about each subsidiary's underlying investments and the activities of that subsidiary. They suggested that an investment entity parent should be able to apply a 'dual-model' of consolidation, which would allow an investment entity parent to show its directly and indirectly held investments at fair value while consolidating other activities. This is similar to the asset-based approach previously rejected by the Board (see paragraph BC226).

BC240D The Board acknowledged some of the potential benefits of an asset-based approach. In particular, this approach may better avoid some structuring issues, particularly in multi-layer groups in which different types of subsidiaries are held at different levels within the group. However, the Board decided that developing a broader principle-based approach, together with guidance to enable consistent application, would be too difficult to achieve within the limited scope of the consolidation exception clarification project. In addition, the Board decided that such an approach and related guidance could not be developed within the short time frame that was needed to provide the necessary clarification before the end of 2014. These decisions were, in part, based on the variety of suggestions provided by respondents to the *Consolidation Exception* ED about which activities should be consolidated and which should be measured at fair value.

BC240E The Board noted that the requirement in paragraph 32 of IFRS 10 to consolidate particular subsidiaries of an investment entity was intended to be a limited exception, capturing only operating subsidiaries that support the investment entity parent's investing activities as an extension of the operations of the investment entity parent. It was not intended to capture subsidiaries that are themselves investment entities. The definition of an investment entity requires that the investment entity's business purpose and, therefore, its core activity is providing investment management services to its investors and investing the funds obtained from its investors solely for returns from capital appreciation, investment income, or both. When the Board decided that providing investment-related services to third parties would not prevent an entity from qualifying as an investment entity, it recognised that investment entities could benefit from synergies between the core investing activities and the provision of investment-related services to third parties.

BC240F The Board noted that, therefore, when an entity assesses whether it qualifies as an investment entity, it considers whether providing services to third parties is ancillary to its core investing activities. However, the definition of an investment entity requires that the purpose of the entity is to invest solely for capital appreciation, investment income (such as dividends, interest and rental income) or both (see paragraph B85B of IFRS 10). Consequently, an entity whose main purpose is to provide investment-related services in exchange for consideration from third parties has a business purpose that is different from the business purpose of an investment entity. This is because the entity's main activity is earning fee income in exchange for its services. In contrast, for an entity that qualifies as an investment entity, such fee income, which could be substantial in amount, will be derived from its core investment activities, which are designed for earning capital appreciation, investment income or both.

BC240G The Board decided that requiring an investment entity to measure all of its subsidiaries that are themselves investment entities at fair value through profit or loss is consistent with the entity-based approach and decided to confirm its proposal in the *Consolidation Exception* ED. Consequently, when an investment entity parent assesses whether a subsidiary should be measured at fair value in accordance with paragraph 31 of IFRS 10 or, instead, should be consolidated in accordance with paragraph 32 of IFRS 10, the parent assesses whether the subsidiary meets the definition of an investment entity. If so, the investment entity parent measures its investment entity subsidiary at fair value through profit or loss in accordance with paragraph 31.

BC240H If the subsidiary is not an investment entity, the investment entity parent assesses whether the main activities undertaken by the subsidiary support the core investment activities of the parent. If so, the subsidiary's activities are considered to be an extension of the parent's core investing activities and the subsidiary would be consolidated in accordance with paragraph 32 of IFRS 10. The Board noted that a subsidiary of an investment entity that provides support services to its parent and other members of the group, such as administration, treasury, payroll and accounting services, is considered to be providing those services as an extension of the operations of the parent. Such a non-investment entity subsidiary would be consolidated in accordance with paragraph 32 of IFRS 10.

BC240I The Board concluded that these outcomes are consistent with its basic decision that measuring all investments of investment entities at fair value through profit or loss provides the most relevant information, except for operating subsidiaries that act as an extension of the investment entity parent.

- BC241 The Board considered prohibiting investment entities from engaging in some activities, such as providing financial support to its investees or actively managing its investees. However, the Board understands that an investment entity may engage in these activities in order to maximise the overall value of the investee (ie to maximise capital appreciation), rather than to obtain other benefits. Consequently, the Board believes that these activities can be consistent with the overall activities of an investment entity and should not be prohibited as long as they do not represent a separate substantial business activity or source of income other than capital appreciation.
- BC242 The Board was concerned that an entity that meets the definition of an investment entity could be inserted into a larger corporate structure to achieve a particular accounting outcome. For example, a parent entity could use an ‘internal’ investment entity subsidiary to invest in subsidiaries that may be making losses (eg research and development activities on behalf of the overall group) and would record its investments at fair value, rather than reflecting the underlying activities of the investee. To address these concerns and to emphasise the business purpose of an investment entity, the Board decided to include a requirement that an investment entity, or other members of the group containing the entity, should not obtain benefits from its investees that would be unavailable to other parties that are not related to the investee. In the Board’s view, this is one of the factors that differentiate an investment entity from a non-investment entity holding company. If an entity or another member of the group containing the entity obtains benefits from its investees that are unavailable to other investors, then the investment will benefit that entity or the group in some operating or strategic capacity and the entity will therefore not qualify as an investment entity.
- BC243 However, the Board also clarified that an investment entity may have more than one investment in the same industry, market or geographical area in order to benefit from synergies that increase the capital appreciation of those investments. It noted that such a fact pattern may be common in the private equity industry. Some Board members expressed concern that allowing transactions or synergies between investments may artificially increase the fair value of each investment and, consequently, inappropriately increase the assets reported by the investment entity. However, the Board decided that trading transactions or synergies that arise between the investments of an investment entity should not be prohibited because their existence does not necessarily mean that the investment entity is receiving any returns beyond solely capital appreciation, investment income, or both.

Exit strategy

- BC244 The Board believes that a parent with operating subsidiaries often plans to own and operate its subsidiaries indefinitely to realise returns from those operations. However, the Board does not think that an entity that holds its investments indefinitely, especially its subsidiaries, should qualify as an investment entity. Accordingly, the Board considered requiring an exit strategy for substantially all investments held by an investment entity, including debt investments.
- BC245 However, respondents to the *Investment Entities* ED noted that some investment funds that would otherwise qualify as investment entities may hold a significant amount of debt investments to maturity and therefore would not have an exit strategy for those debt investments. For example, the Board understands that, in some cases, private equity funds may make both debt and equity investments in their investees. The debt investments may have shorter maturities than the anticipated term of the fund’s equity investment and may be held to maturity. Moreover, an investment entity may hold debt instruments to maturity to manage liquidity risk or to mitigate the risk from holding other types of more volatile investments. Although the entity does not have an exit strategy for these debt investments, it does not plan to hold them indefinitely—even if the entity does not plan to sell these investments before maturity, the vast majority of debt investments have a limited life.

- BC246 The Board decided that such an entity should not be prohibited from qualifying as an investment entity, provided that substantially all of its investments (including debt investments) are measured at fair value. The Board noted that debt investments may be measured at fair value in accordance with IFRS 9 or IAS 39¹⁵ even in the absence of an exit strategy.
- BC247 However, the Board decided that an investment entity must have an exit strategy for substantially all of its investments that can be held indefinitely (typically equity investments and non-financial assets). The Board does not think it is appropriate for an entity to qualify for an exception to consolidation if that entity is holding equity investments indefinitely and is not planning to realise capital appreciation from those investments. Although the exit strategy may vary depending on circumstances, potential exit strategies that include a substantive time frame for exiting from the investment should still be identified and documented for equity and non-financial investments in order to meet the definition of an investment entity.
- BC248 The Board noted that an entity may fail to meet this component of the definition of an investment entity if it is formed in connection with an investment entity investee for legal, regulatory, tax or similar business reasons (eg a ‘blocker’ entity or a ‘master-feeder’ structure), and that that investee holds investments on behalf of the entity. The Board decided that the entity should not be prohibited from qualifying as an investment entity merely because it does not have an exit strategy for the investee, if that investee qualifies as an investment entity and has appropriate exit strategies for its own investments.

Fair value measurement

- BC249 In the development of IFRS 10 and the *Investment Entities* ED, the Board heard that fair value information is the primary driver of the decision-making processes both of the management of, and the investors in, investment entities. Many respondents stated that both management and investors evaluate the performance of an investment entity by reference to the fair value of its investments. The Board heard that some investors in investment entities disregard the consolidated financial statements of investment entities and instead rely on non-GAAP fair value reports.
- BC250 The basis for the exception to consolidation that is provided to investment entities is that fair value information is the most relevant for an investment entity’s investments, including its investments in subsidiaries. The Board therefore decided that an essential feature of the definition of an investment entity is that the entity would use existing IFRS requirements or accounting policy options to measure substantially all of its investments at fair value. The Board does not think that an entity that fails to elect the fair value measurement options available in IAS 28 *Investments in Associates and Joint Ventures* or IAS 40, or that accounts for more than an insignificant amount of its financial assets at amortised cost under IFRS 9 or IAS 39,¹⁶ should qualify as an investment entity.
- BC251 The Board noted that some investments may be measured at fair value in the statement of financial position, with fair value changes recognised in other comprehensive income rather than through profit or loss, and agreed that this would satisfy the fair value measurement element of the definition of an investment entity.

¹⁵ IFRS 9 *Financial Instruments* replaced IAS 39. IFRS 9 applies to all items that were previously within the scope of IAS 39.

¹⁶ IFRS 9 *Financial Instruments* replaced IAS 39. IFRS 9 applies to all items that were previously within the scope of IAS 39.

BC252 The Board considers that a significant distinguishing characteristic of an investment entity is that investors in an investment entity are primarily interested in fair value and make their investing decisions based on the fair value of the investment entity's underlying investments. The Board notes that this is partly because, in many cases, investors in an investment entity transact with it on a fair value basis (for example, on the basis of a net asset value per share, which is calculated using the fair value of the entity's underlying investments). Similarly, the Board believes that fair value should also be used by an investment entity's key management personnel to assess the entity's performance and to make investing decisions. Consequently, the Board decided that, in order to meet the definition of an investment entity, an entity should demonstrate that fair value is the primary measurement attribute used to evaluate the performance of its investments, both internally and externally.

Regulatory requirements

BC253 The Board considered whether to include a reference to regulatory requirements in the definition of an investment entity. The Board noted that the FASB proposed, in their own Exposure Draft, that any entity that was regulated as an investment company under the US Securities and Exchange Commission's Investment Company Act of 1940 would automatically be considered to be an investment company for US GAAP financial reporting purposes. Some respondents to the Board's *Investment Entities* ED also asked the Board to include a reference to regulatory requirements in the definition of an investment entity, which would allow any entity regulated as an investment entity to fall within the scope of the investment entity requirements.

BC254 However, the Board was concerned that:

- (a) the regulatory requirements in different jurisdictions may result in similar entities qualifying as an investment entity in one jurisdiction but not in another;
- (b) regulatory requirements may change over time, resulting in an ever-changing population of entities that would be eligible for an exception to consolidation; and
- (c) it would have no control over which entities would qualify for the exception to consolidation.

Consequently, the Board decided not to reference regulatory requirements in the definition of an investment entity.

Typical characteristics of investment entities

BC255 The Board identified several 'typical characteristics' of an investment entity. The Board decided that these typical characteristics could be used to help an entity decide if it meets the definition of an investment entity. The absence of any of these typical characteristics may indicate that an entity does not meet the definition of an investment entity. However, an entity that does not display all of these typical characteristics could, nevertheless, meet the definition of an investment entity.

BC256 The Board identified the following typical characteristics of an investment entity:

- (a) more than one investment (paragraphs BC257–BC258);
- (b) more than one investor (paragraphs BC259–BC260);
- (c) unrelated investors (paragraphs BC261–BC262); and
- (d) ownership interests (paragraphs BC263–BC267).

More than one investment

- BC257 The *Investment Entities* ED proposed that an investment entity should hold more than one investment. However, respondents provided examples of entities that they believed should qualify as investment entities, but that only hold a single investment. These included single investment funds set up because the required minimum investment is too high for individual investors, or investment funds that hold a single investment temporarily.
- BC258 The Board agreed with these arguments and therefore decided that an investment entity would not be required to hold more than one investment. However, the Board understands that investment entities typically invest in more than one investment as a means of diversifying their portfolio and maximising their returns. Consequently, investing in more than one investment is described as a typical characteristic of an investment entity in this IFRS.

More than one investor

- BC259 The presence of more than one investor was originally proposed as a requirement in the *Investment Entities* ED. However, respondents provided many examples of investment funds with a single investor. These included funds that temporarily have a single investor, government-owned investment funds, funds wholly-owned by pension plans and endowments, and funds set up by an investment manager for an unrelated single investor with a unique investment strategy.
- BC260 The Board does not think that there is a conceptual reason why an investment fund with a single investor should be disqualified from being an investment entity. However, the Board thinks that having more than one investor would make it less likely that the entity, or other members of the group that contains the entity, would obtain benefits other than capital appreciation or investment income from its investment. Consequently, the Board decided to include the presence of more than one investor as a typical characteristic of an investment entity rather than as part of the definition of an investment entity.

Unrelated investors

- BC261 The *Investment Entities* ED proposed that an investment entity be required to have investors that are unrelated to the entity or its parent (if any), partly to prevent entities from structuring around the requirement to have more than one investor. However, respondents provided examples of entities with related investors that they believed should qualify as investment entities. For example, a separate 'parallel' entity may be formed to allow the employees of an investment entity to invest in a fund that mirrors the investments in the main fund. The Board agreed with the respondents' arguments and decided that an investment entity would not be required to have investors that are unrelated to the investment entity or to other members of the group that contains the investment entity.
- BC262 However, the Board understands that investment entities typically have unrelated investors. Again, having unrelated investors is one way to help ensure that the entity, or another member of the group that contains the entity, does not receive returns from investments that are other than capital appreciation or investment income. Having investors that are unrelated to the entity or its parent (if any), is therefore described as a typical characteristic of an investment entity in this IFRS.

Ownership interests

- BC263 An investment entity would typically have ownership interests in the form of equity or similar (eg partnership) interests that entitle investors to a proportionate share of the net assets of the investment entity. This characteristic explains in part why fair value is more relevant to investment entity investors: each unit of ownership in the investment entity entitles an investor to a proportionate share of the net assets of that investment entity. The value of each ownership interest is linked directly to the fair value of the investment entity's investments.
- BC264 However, the Board believes that this form of ownership interests in an entity should not be the deciding factor as to whether it is an investment entity. Respondents provided examples of entities that do not have units of ownership in the form of equity or similar interests but provide investors with a proportionate share of their net assets. For example, a pension fund or sovereign wealth fund with a single direct investor may have beneficiaries that are entitled to the net assets of the investment fund, but do not have ownership units. In addition, respondents noted that funds with different share classes or funds in which investors have discretion to invest in individual assets would be disqualified from investment entity status because they did not provide each investor with a proportionate share of net assets.
- BC265 The Board does not believe that an entity that provides its investors only a return of their investment plus interest should qualify as an investment entity. Fair value information is more relevant to investors that are entitled to a specifically identifiable portion of the investment entity's net assets and are, therefore, exposed to the upside and downside of the investment entity's performance.
- BC266 However, the Board agreed that the requirement proposed in the *Investment Entities* ED (that an investment entity's ownership interests entitle investors to a proportionate share of its net assets) would have inappropriately excluded certain structures from investment entity status. As an alternative, the Board considered requiring that an investment entity's ownership interests be in the form of equity or similar interests. However, the Board was concerned that this would put too much emphasis on the debt/equity classification in IAS 32 *Financial Instruments: Presentation* and would inappropriately exclude some structures whose ownership interests were classified as debt. Moreover, the Board was also concerned that including the 'ownership interest' concept as part of the definition of an investment entity would put too much emphasis on the form of the entity, rather than emphasising its business model.
- BC267 Consequently, the Board decided not to include ownership interests as part of the definition of an investment entity but that it should instead be regarded as a typical characteristic of an investment entity.

Reassessment and change of status

- BC268 The Board included guidance in the *Investment Entities* ED on reassessing investment entity status. A few respondents asked the Board to clarify this guidance.
- BC269 In the *Investment Entities* ED, the Board proposed that an entity would reassess its investment entity status whenever facts or circumstances changed. The Board decided to retain this requirement unchanged because it is consistent with the requirements for reassessment elsewhere in IFRS, including the general reassessment requirements in IFRS 10. The Board noted that they do not believe that the reassessment of facts and circumstances in other situations is considered unduly onerous for preparers or their auditors.

BC270 The Board decided that, when an entity loses investment entity status, it should account for that change as a ‘deemed acquisition’. That is, the investment entity would use the fair value of the investment at the date of the change of status as the ‘deemed’ consideration transferred to obtain control of the investee. This recognises the change in status in the same way as a business combination achieved in stages, as described in IFRS 3. This would result in the recognition of goodwill or a gain on a bargain purchase.

BC271 The Board also decided that, when an entity becomes an investment entity, the entity should account for the change in status as a ‘deemed disposal’ or ‘loss of control’ of its subsidiaries. The fair value of the investment at the date of the change of status should be used as the consideration received when applying the guidance in IFRS 10. The Board considered how to account for the gain or loss on the ‘deemed disposal’ and decided to recognise it as a gain or loss in profit or loss. This treats the change in the business purpose of the investor as a significant economic event and is consistent with the rationale for gains and losses being recognised in profit or loss in IFRS 10 when control is lost.

Parent of an investment entity

Investment entity parent of an investment entity subsidiary

BC272 The *Investment Entities* ED proposed that an investment entity would measure all of its subsidiaries at fair value (except for those subsidiaries providing investment-related services), even those investees who were themselves investment entities. Some respondents questioned this proposal and suggested that at least some investment entity subsidiaries should be consolidated (for example, wholly-owned investment entity subsidiaries that are created for legal, tax or regulatory purposes). However, the Board thinks that fair value measurement of all an investment entity’s subsidiaries (except for those subsidiaries providing investment-related services or activities) would provide the most useful information and therefore decided to retain this proposal. The Board considered requiring an investment entity to consolidate only those investment entity subsidiaries that are formed for legal, tax or regulatory purposes, but decided against this because there is no conceptual basis for distinguishing between different investment entity subsidiaries. Moreover, the Board thinks that it would be very difficult to distinguish between an investment entity subsidiary formed for a specific legal, tax or regulatory purpose and those that are set up only for other business reasons.

BC273 The Board considered whether it should require certain investment entity parents to attach the financial statements of their investment entity subsidiaries to the parent’s financial statements. Some respondents argued that it would be essential for users of the financial statements of an investment entity parent to have information about the underlying investments of its investment entity subsidiary, particularly when the investment entity parent has only one investment entity subsidiary (eg ‘master-feeder funds’).

BC274 However, the Board decided against requiring financial statements of an investment entity subsidiary to be attached to the financial statements of an investment entity parent. The Board believed that it would be difficult to define which types of structures should be covered by such a requirement. Moreover, the Board thought that such a requirement would be inconsistent with the proposal that fair value information is always the most relevant information for investment entities.

Non-investment entity parent of an investment entity subsidiary

- BC275 The Board also considered whether to retain investment entity accounting in the financial statements of a non-investment entity parent. In the *Investment Entities* ED, the Board proposed that a non-investment entity parent of an investment entity subsidiary would be required to consolidate all of its subsidiaries; that is, the exception to consolidation available to an investment entity would not be available to its non-investment entity parent.
- BC276 The Board noted that the majority of respondents disagreed with the proposal, arguing that if fair value information is more relevant than consolidation at an investment entity subsidiary level, it is also more relevant information at the non-investment entity parent level.
- BC277 The Board acknowledged the comments received but decided to retain the proposal to require all non-investment entity parents to consolidate all of their subsidiaries.
- BC278 The Board has decided to provide an exception to consolidation because of the unique business model of investment entities. Non-investment entities do not have this unique business model; they have other substantial activities besides investing, or do not manage substantially all of their assets on a fair value basis. Consequently, the argument for a fair value measurement requirement is weakened at a non-investment entity level.
- BC279 The Board also noted that the decision to define an investment entity and describe its typical characteristics rather than requiring an investment entity to meet a number of criteria has increased the population of entities that could qualify as investment entities, and has also increased the amount of judgement needed to determine whether an entity is an investment entity. For example, an entity with a single investor, or an entity that provides day-to-day management services or strategic advice to its subsidiary, can qualify as an investment entity under this IFRS, when such entities would have been excluded under the *Investment Entities* ED.
- BC280 The Board was concerned that some of these changes would increase the likelihood that a non-investment entity parent could achieve different accounting outcomes by holding subsidiaries directly or indirectly through an investment entity. The Board noted that, for example, a non-investment entity parent may elect to hold subsidiaries through an investment entity subsidiary in order to hide leverage or loss-making activities.
- BC281 In addition, the Board considered the practical difficulties in retaining the exception to consolidation when a non-investment entity parent and an investment entity subsidiary invest in the same investment or when an investment entity subsidiary holds a subsidiary that invests in the equity of a non-investment entity parent.
- BC282 The Board noted that the retention of the specialised accounting used by an investment company subsidiary at a non-investment company level is a long-standing requirement in US GAAP. However, US GAAP has industry-specific guidance for a number of industries, and the application of that industry-specific guidance by a subsidiary is retained by a parent entity, regardless of whether the parent entity is part of that industry. IFRSs generally do not contain such industry-specific guidance.

BC283 Some respondents to the *Investment Entities* ED noted that not retaining the fair value accounting of an investment entity subsidiary in its non-investment entity parent's financial statements seems inconsistent with IAS 28 *Investments in Associates and Joint Ventures*. IAS 28 allows a parent that indirectly holds an investment in an associate through a venture capital organisation, mutual fund, unit trust or similar entity to measure that portion of the investment at fair value through profit or loss in accordance with IFRS 9 or IAS 39.¹⁷ The Board acknowledged the inconsistency but thought it was important to keep the retention of fair value accounting that is currently allowed for venture capital organisations, mutual funds, unit trusts and similar entities. The Board also noted that the difference between using the equity method and fair value measurement for investments in associates and joint ventures is smaller than that between consolidation and fair value measurement for investments in subsidiaries.

Transition

BC284 The Board proposed in the *Investment Entities* ED that the exception to consolidation should be applied prospectively. Some respondents disagreed with the proposal, arguing that retrospective application would result in more useful information. In addition, they noted that retrospective application should not be onerous because investment entities would be expected to have information about the fair value of their investments. Those respondents also argued that retrospective application would be consistent with the other transition requirements in IFRS 10.

BC285 The Board agreed with these arguments and decided to require retrospective application of the exception to consolidation, subject to specific transition reliefs, such as:

- (a) a relief for when it is impracticable to identify the fair value of investments;
- (b) a relief for when an investment entity disposes of investments prior to the date of initial application; and
- (c) a relief from providing comparative information for more than one period preceding the date of initial application.

BC286 The Board also noted that entities that adopt these amendments early may not have adopted IFRS 13, which has an effective date of 1 January 2013. Consequently, the Board decided that when an investment entity has not yet adopted IFRS 13, it may use the fair value amounts previously reported to investors or to management, as long as those amounts represent the amount for which the investment could have been exchanged between knowledgeable, willing parties in an arm's length transaction at the date of the valuation. The Board noted that if previously used fair value measurements are not available, it may be impracticable to measure fair value without using hindsight. In such cases, transition relief is available.

BC287 The Board also decided to require first-time adopters to apply the requirements retrospectively, subject to specific transition reliefs.¹⁸

BC287A The Board decided that no specific transition guidance was needed and, therefore, an entity should apply *Investment Entities: Applying the Consolidation Exception* (Amendments to IFRS 10, IFRS 12 and IAS 28) retrospectively in accordance with IAS 8. However, the Board decided that an entity need only present the quantitative information required by paragraph 28(f) of IAS 8 for the annual period immediately preceding the date of initial application of this IFRS (the 'immediately preceding period') when the amendments are first applied.

¹⁷ IFRS 9 *Financial Instruments* replaced IAS 39. IFRS 9 applies to all items that were previously within the scope of IAS 39.

¹⁸ *Annual Improvements to IFRS Standards 2014-2016 Cycle*, issued in December 2016, amended IFRS 1 *First-time Adoption of International Financial Reporting Standards* by deleting the short-term exemption for first-time adopters (see paragraph BC99 of IFRS 1), because it was no longer applicable.

Effective date and early application

BC288 The Board decided on a 1 January 2014 effective date for the requirements for investment entities. The Board noted that because these requirements provide an exception to consolidation, they should have the same effective date as the revised consolidation requirements in IFRS 10 (annual periods beginning on or after 1 January 2013). However, given that the investment entities requirements were published in October 2012, the Board did not believe that a 1 January 2013 effective date would give adequate time for implementation between the publication and effective dates. However, the Board decided to permit early application of the investment entity requirements. The Board noted that it expects many entities to apply the requirements early. Some investments in subsidiaries may not have been consolidated in accordance with IAS 27 and SIC-12 but, without the exception to consolidation, would need to be consolidated in accordance with IFRS 10. The Board noted that it would be potentially confusing to users of financial statements and time-consuming for the investment entity to consolidate a subsidiary in one accounting period and then carry the same investee at fair value in the following period. In addition, investment entities should already have the fair value information needed for implementation. Finally, the exception to consolidation has been a long-standing request from the investment entity industry. Consequently, the Board believes that many investment entities will want to adopt the requirements early.

Joint deliberations with the FASB

BC289 The Board deliberated this project jointly with the FASB. US GAAP has had comprehensive accounting guidance for investment companies for many years (contained in Topic 946 *Investment Companies*). By deliberating this project jointly, the boards hoped to achieve as similar guidance as possible. To that end, they came up with similar definitions of investment entities and guidance on how to assess investment entity status.

BC290 However, the scope of the project was different for the IASB and the FASB. The IASB's Investment Entities project started during the deliberations on the Consolidations project and was only intended to provide an exception to consolidation for investment entities. The FASB was seeking to improve and converge the definition of an investment company with that of the IASB because it already has comprehensive accounting and reporting guidance for investment companies.

BC291 While the boards reached many common decisions, as a result of this scope difference, and other jurisdictional differences, the IASB and the FASB came to different decisions in a number of areas. These include:

- (a) whether there should be a requirement that an investment entity measure and evaluate substantially all of its investments on a fair value basis rather than identifying such an activity as a typical characteristic of an investment entity;
- (b) whether there should be a reference to existing regulatory requirements in the definition of an investment entity;
- (c) whether an investment entity is permitted to provide investment-related services to third parties other than its own investors;
- (d) the accounting by an investment entity parent for an investment entity subsidiary; and
- (e) the accounting by a non-investment entity parent for an investment entity subsidiary.

Effects analysis for investment entities

BC292 The Board is committed to assessing and sharing knowledge about the likely costs of implementing proposed new requirements and the likely ongoing costs and benefits of each new IFRS—the costs and benefits are collectively referred to as ‘effects’. The Board gains insight on the likely effects of the proposals for new or revised IFRSs through its formal exposure of proposals, analysis and consultations with relevant parties.

BC293 In evaluating the likely effects of introducing an exception to consolidation for investment entities to IFRS 10, the Board has considered the following factors:

- (a) how the changes to IFRS 10 affect the financial statements of an investment entity;
- (b) how those changes improve the comparability of financial information between different reporting periods for an investment entity and between different investment entities in a particular reporting period;
- (c) how the changes will improve the quality of the financial information available to investors and its usefulness in assessing the future cash flows of an investment entity;
- (d) how users will benefit from better economic decision-making as a result of improved financial reporting;
- (e) the likely effect on compliance costs for preparers, both on initial application and on an ongoing basis; and
- (f) whether the likely costs of analysis for users are affected.

Financial statements of investment entities

BC294 Before the exception to consolidation for investment entities was issued, IFRS 10 (and its predecessor, IAS 27) required reporting entities to consolidate all controlled entities, regardless of the nature of the reporting entity. Consequently, the assets, liabilities and non-controlling interests of each subsidiary were aggregated with those of the parent to represent the group of entities as a single reporting entity.

BC295 Respondents to ED 10 argued that an investment entity often holds non-controlling investments in some entities that are reported at fair value, as well as subsidiaries that are consolidated in accordance with current principles in IFRS. Reporting investments on more than one basis hinders comparability within the financial statements, because all investments are held by an investment entity for a similar purpose—capital appreciation, investment income, or both. In addition, some of the items consolidated would be measured at historical cost, which distorts the performance assessment of the investment entity and does not reflect the way in which the business of the entity is managed.

BC296 The exception to consolidation will change the way in which an investment entity parent reports its interest in an entity that it controls. Rather than consolidating its subsidiaries, an investment entity is now required to recognise a subsidiary as a single-line investment measured at fair value through profit or loss in accordance with IFRS 9 (or IAS 39,¹⁹ if IFRS 9 has not yet been adopted).

BC297 Accordingly, the exception to consolidation will affect investment entities that hold, as investments, controlling interests in other entities. However, although the changes are important to those entities affected, the changes are only expected to affect a narrow range of entities. Only those entities that meet the definition of an investment entity and hold controlling interests in other entities will be affected by these changes.

¹⁹ IFRS 9 *Financial Instruments* replaced IAS 39. IFRS 9 applies to all items that were previously within the scope of IAS 39.

- BC298 The entities most likely to be affected are:
- (a) private equity or venture capital funds; these have business models in which it is more likely that it would be beneficial to take a larger interest in a company, or control investees through debt and equity investment.
 - (b) master-feeder or fund-of-funds structures where an investment entity parent has controlling interests in investment entity subsidiaries.
- BC299 Some pension funds and sovereign wealth funds may also be affected; these may meet the definition of an investment entity and may also hold controlling investments in other entities.
- BC300 Other types of entities may meet the definition of an investment entity, such as mutual funds and other regulated investment funds, but are less likely to hold controlling investments in other entities. Instead, they tend to hold lower levels of investments in a wider range of entities. Consequently, the exception to consolidation is less likely to affect these entities.

Comparability

- BC301 An investment entity's control of an investee may change from one reporting period to the next. Without the exception to consolidation, an investment entity could be required to consolidate an investment in one period and present it as an investment measured at fair value through profit or loss in the following period (or vice versa). This would reduce comparability between reporting periods. With the introduction of the exception to consolidation, an investment entity can report all investments at fair value, regardless of whether those investments are controlled. This will improve the comparability between reporting periods.
- BC302 Many respondents to ED 10 and the *Investment Entities* ED pointed out that some national accounting requirements, including US GAAP, have historically had industry-specific guidance that requires investment entities to measure investments that they control at fair value. Some of these respondents argued that investment entities were actively choosing to adopt those national accounting requirements rather than IFRS so that they could measure all of their investments at fair value. Respondents also pointed out that some investment entities that followed IFRS provided non-GAAP information about the fair value of all of their investments. Consequently, comparability of the financial statements of different investment entities was hindered. The Board expects the introduction of the exception to consolidation to encourage adoption of IFRS among investment entities and to eliminate the need to provide non-GAAP information about fair value. This should improve the comparability of financial statements of different investment entities.

Usefulness of financial statements in assessing the future cash flows of an entity

- BC303 Consolidated financial statements of an investment entity emphasise the financial position, operations and cash flows of the investee, rather than merely those of the investment entity. The exception to consolidation will reduce the information about the cash flows of those subsidiaries. However, the main business purpose of an investment entity is to invest funds solely for capital appreciation, investment income, or both. The relevant cash flows relating to these activities are those of the investment entity itself. Consolidating the cash flows of a subsidiary may hinder users' ability to predict the cash flows that may be passed on to investors. The Board therefore believes that these amendments will improve the quality of the financial information reported by an investment entity and will make that information more useful in assessing the future cash flows of the investment entity.

Better economic decision-making

- BC304 One of the essential features of an investment entity is that, in order to make better investment decisions, it measures and evaluates substantially all of its investments on a fair value basis. Presenting consolidated financial statements does not reflect this method of management. Requiring an investment entity to account for its investments in subsidiaries at fair value provides a better insight into the information that management uses to evaluate the performance of its investments.
- BC305 In addition, investors in an investment entity are typically entitled to a proportionate share of the net assets of the entity when they withdraw their investment. Reporting the fair value of substantially all of the net assets of the investment entity allows the investors to more easily identify the value of their share of those net assets. As a result, the Board expect significant benefits for most users of investment entity financial statements arising from the provision of more fair value information.
- BC306 However, some respondents in some jurisdictions objected to the exception to consolidation because it undermines the control-based approach to consolidation used in IFRS 10. These respondents noted that an exception to consolidation would deprive financial statement users of information about the activities of subsidiaries and the economic effects of the relationships between an investment entity and its subsidiaries. In addition, some respondents expressed concern that an exception to consolidation may encourage structuring to avoid consolidation, which would result in a loss of such information to users.
- BC307 The Board acknowledges these arguments, but notes that the exception to consolidation has been introduced in response to comments from users that the most useful information for an investment entity is the fair value of its investments. Users also commented that consolidated financial statements of an investment entity may hinder users' ability to assess an investment entity's financial position and results, because it emphasises the financial position, operations and cash flows of the investee, rather than those of the investment entity.
- BC308 In developing these amendments, the Board deliberately restricted the population of entities that would qualify for the exception to consolidation. In particular, the Board prohibited the use of the exception to consolidation by non-investment entity parents of investment entities, in order to address respondents' concerns about structuring and to restrict the use of the exception to situations where fair value information would be more relevant than information arising from the consolidation of subsidiaries.

Effect on compliance costs for preparers

- BC309 The Board expects that the introduction of the exception to consolidation will result in significant compliance cost savings for preparers, particularly on an ongoing basis. This expectation is based on the feedback the Board has received from respondents to the *Investment Entities* ED and conversations with entities that are expected to qualify as investment entities.
- BC310 On initial application, there may be some costs involved in identifying and documenting some of the additional disclosures introduced. In particular, investment entities will need to collect information to comply with the general disclosure requirements of IFRS 7, IFRS 13 and the amended requirements of IFRS 12. However, the Board has been told that the majority of investment entities will already have much of the fair value information that they need in order to comply with the new requirements, because they already measure substantially all of their investments on a fair value basis and many elect to provide this information to their investors already. The Board expects this to mitigate the initial and ongoing costs of applying the exception to consolidation.

- BC311 In arriving at its decisions, the Board has considered those costs and believes that the benefits of the information produced as a result of its decisions would outweigh the costs of providing that information. In addition, the initial application costs will be more than offset by the cost savings resulting from the removal of the need to gather information from subsidiaries in order to consolidate details of their financial performance, position and cash flows on a line-by-line basis.
- BC312 As described in paragraphs BC275–BC283, the Board decided not to expand the scope of the project to allow a non-investment entity parent to retain the fair value accounting of its investment entity subsidiary. Consequently, the compliance cost savings described above will not be available to non-investment entity parents. Because these entities are not within the scope of these amendments, they may incur ongoing costs because they will have two different bases of accounting within the group. At the investment entity subsidiary level, subsidiaries held by the investment entity will be measured at fair value, but at the non-investment entity parent level, those subsidiaries will be consolidated.

How the costs of analysis for users are affected

- BC313 The likely effect of these amendments on the costs of analysis for users of financial statements is expected to be outweighed by the benefits of improved reporting, given that these amendments have been developed on request from users. However, the extent of the benefit will depend on existing practice.
- BC314 In general, these amendments will provide improved information about the fair values of investments and the way in which the fair value is measured. Such information could reduce the cost of analysis by providing information more directly to users of financial statements. However, in many cases, investment entities already provide investors with fair value information, although this is often done in an alternative report rather than in the financial statements. This serves to emphasise that the main benefit of the changes is a reduction in costs to preparers because it eliminates what they see as a cumbersome reporting requirement that has little value.
- BC315 For analysts or potential investors that use financial statements to analyse investment entities from different countries, the existing problems of diversity in accounting models creates costs that would be reduced by standardised accounting requirements.
- BC316 In addition, the Board expects that the requirement to apply the exception to consolidation retrospectively will mitigate some of the transition costs for users. However, some of the transition reliefs will mean that users may receive less information on transition. In particular, the fact that investment entities will be required to provide only one period of comparative information may affect users who might otherwise receive more than one period of comparative information. However, again, the Board expects the benefits to outweigh the costs incurred as a result of the implementation of these amendments.

Summary

- BC317 In summary, the cost savings resulting from implementing these amendments are expected to be significant for investment entities and the users of their financial statements. Additionally, the implementation of the investment entities amendments should result in the benefits of increased comparability between entities and across jurisdictions, and more relevant reporting of information used by investors in making economic decisions.

Dissenting opinions

Dissent of Tatsumi Yamada from IAS 27 (as revised in 2003)

Cross-references have been updated.

- DO1 Mr Yamada dissents from this Standard because he believes that the change in classification of minority interests in the consolidated balance sheet, that is to say, the requirement that it be shown as equity, should not be made as part of the Improvements project. He agrees that minority interests do not meet the definition of a liability under the *Framework for the Preparation and Presentation of Financial Statements*,²⁰ as stated in paragraph BCZ158 of the Basis for Conclusions, and that the current requirement, for minority interests to be presented separately from liabilities and the parent shareholders' equity, is not desirable. However, he does not believe that this requirement should be altered at this stage. He believes that before making the change in classification, which will have a wide variety of impacts on current consolidation practices, various issues related to this change need to be considered comprehensively by the Board. These include consideration of the objectives of consolidated financial statements and the accounting procedures that should flow from those objectives. Even though the Board concluded as noted in paragraph BC27, he believes that the decision related to the classification of minority interests should not be made until such a comprehensive consideration of recognition and measurement is completed.²¹
- DO2 Traditionally, there are two views of the objectives of consolidated financial statements; they are implicit in the parent company view and the economic entity view. Mr Yamada believes that the objectives, that is to say, what information should be provided and to whom, should be considered by the Board before it makes its decision on the classification of minority interests in IAS 27. He is of the view that the Board is taking the economic entity view without giving enough consideration to this fundamental issue.
- DO3 Step acquisitions are being discussed in the second phase of the Business Combinations project, which is not yet finalised at the time of finalising IAS 27 under the Improvements project. When the ownership interest of the parent increases, the Board has tentatively decided that the difference between the consideration paid by the parent to minority interests and the carrying value of the ownership interests acquired by the parent is recognised as part of equity, which is different from the current practice of recognising a change in the amount of goodwill. If the parent retains control of a subsidiary but its ownership interest decreases, the difference between the consideration received by the parent and the carrying value of the ownership interests transferred is also recognised as part of equity, which is different from the current practice of recognising a gain or a loss. Mr Yamada believes that the results of this discussion are predetermined by the decision related to the classification of minority interests as equity. The changes in accounting treatments are fundamental and he believes that the decision on which of the two views should govern the consolidated financial statements should be taken only after careful consideration of the ramifications. He believes that the amendment of IAS 27 relating to the classification of minority interests should not be made before completion of the second phase of the Business Combinations project.

²⁰ The reference is to the IASC's *Framework for the Preparation and Presentation of Financial Statements*, adopted by the Board in 2001 and in effect when the Standard was revised.

²¹ Paragraph BC27 of the Basis for Conclusions on IAS 27 (as revised in 2003) was deleted as part of the amendments to IAS 27 in 2008. The paragraph stated: The Board acknowledged that this decision gives rise to questions about the recognition and measurement of minority interests but it concluded that the proposed presentation is consistent with current standards and the *Framework* and would provide better comparability than presentation in the consolidated balance sheet with either liabilities or parent shareholders' equity. It decided that the recognition and measurement questions should be addressed as part of its project on business combinations.

Dissent of Philippe Danjou, Jan Engström, Robert P Garnett, Gilbert Gélard and Tatsumi Yamada from the amendments to IAS 27 issued in January 2008 on the accounting for non-controlling interests and the loss of control of a subsidiary

Cross-references have been updated.

- DO1 Messrs Danjou, Engström, Garnett, Gélard and Yamada dissent from the 2008 amendments to IAS 27.

Accounting for changes in ownership interests in a subsidiary

- DO2 Messrs Danjou, Engström, Gélard and Yamada do not agree that acquisitions of non-controlling interests in a subsidiary by the parent should be accounted for in full as equity transactions.
- DO3 Those Board members observe that the consideration paid for an additional interest in a subsidiary will reflect the additional interest's share in:
- (a) the carrying amount of the subsidiary's net assets at that date;
 - (b) additionally acquired goodwill; and
 - (c) unrecognised increases in the fair value of the subsidiary's net assets (including goodwill) since the date when control was obtained.
- DO4 Paragraphs 23 and B96 of IFRS 10 require such a transaction to be accounted for as an equity transaction, by adjusting the relative interests of the parent and the non-controlling interests. As a consequence, the additionally acquired goodwill and any unrecognised increases in the fair value of the subsidiary's net assets would be deducted from equity. Those Board members disagree that such accounting faithfully represents the economics of such a transaction.
- DO5 Those Board members believe that an increase in ownership interests in a subsidiary is likely to provide additional benefits to the parent. Although control has already been obtained, a higher ownership interest might increase synergies accruing to the parent, for example, by meeting legal thresholds provided in company law, which would give the parent an additional level of discretion over the subsidiary. If the additional ownership interest has been acquired in an arm's length exchange transaction in which knowledgeable, willing parties exchange equal values, these additional benefits are reflected in the purchase price of the additional ownership interest. Those Board members believe that the acquisition of non-controlling interests by the parent should give rise to the recognition of goodwill, measured as the excess of the consideration transferred over the carrying amount of the subsidiary's net assets attributable to the additional interest acquired. Those Board members acknowledge that this amount also includes unrecognised increases in the fair value of the subsidiary's net assets since the date when control was obtained. However, on the basis of cost-benefit considerations, they believe that it is a reasonable approximation of the additionally acquired goodwill.

- DO6 Messrs Danjou, Gélard and Yamada agree that, in conformity with the *Framework for the Preparation and Presentation of Financial Statements*,²² non-controlling interests should be presented within the group's equity, because they are not liabilities. However, they believe that until the debates over the objectives of consolidated financial statements (ie what information should be provided and to whom) and the definition of the reporting entity have been settled at the conceptual level, transactions between the parent and non-controlling interests should not be accounted for in the same manner as transactions in which the parent entity acquires its own shares and reduces its equity. In their view, non-controlling interests cannot be considered equivalent to the ordinary ownership interests of the owners of the parent. The owners of the parent and the holders of non-controlling interests in a subsidiary do not share the same risks and rewards in relation to the group's operations and net assets because ownership interests in a subsidiary share only the risks and rewards associated with that subsidiary.
- DO7 In addition, Messrs Danjou and Gélard observe that IFRS 3 *Business Combinations* (as revised in 2008) provides an option to measure non-controlling interests in a business combination as their proportionate share of the acquiree's net identifiable assets rather than at their fair value. However, paragraph BC207 of the Basis for Conclusions on IFRS 3 (as revised in 2008) states that accounting for the non-controlling interests at fair value is conceptually superior to this alternative measurement. This view implies that the subsidiary's portion of goodwill attributable to the non-controlling interests at the date when control was obtained is an asset at that date and there is no conceptual reason for it no longer to be an asset at the time of any subsequent acquisitions of non-controlling interests.
- DO8 Mr Garnett disagrees with the treatment of changes in controlling interests in subsidiaries after control is established (paragraphs BCZ168–BCZ179 of the Basis for Conclusions). He believes that it is important that the consequences of such changes for the owners of the parent entity are reported clearly in the financial statements.
- DO9 Mr Garnett believes that the amendments to IAS 27 adopt the economic entity approach that treats all equity interests in the group as being homogeneous. Transactions between controlling and non-controlling interests are regarded as mere transfers within the total equity interest and no gain or loss is recognised on such transactions. Mr Garnett observes that the non-controlling interests represent equity claims that are restricted to particular subsidiaries, whereas the controlling interests are affected by the performance of the entire group. The consolidated financial statements should therefore report performance from the perspective of the controlling interest (a parent entity perspective) in addition to the wider perspective provided by the economic entity approach. This implies the recognition of additional goodwill on purchases, and gains or losses on disposals of the parent entity's interest in a subsidiary.
- DO10 If, as Mr Garnett would prefer, the full goodwill method were not used (see paragraphs DO7–DO10 of the dissenting views on IFRS 3), the acquisition of an additional interest in a subsidiary would give rise to the recognition of additional purchased goodwill, measured as the excess of the consideration transferred over the carrying amount of the subsidiary's net assets attributable to the additional interest acquired.

²² The reference is to the IASC's *Framework for the Preparation and Presentation of Financial Statements*, adopted by the Board in 2001 and in effect when the Standard was amended.

- DO11 Mr Garnett does not agree with the requirement in paragraph B96 of this IFRS that, in respect of a partial disposal of the parent's ownership interest in a subsidiary that does not result in a loss of control, the carrying amount of the non-controlling interests should be adjusted to reflect the change in the parent's interest in the subsidiary's net assets. On the contrary, he believes that the carrying amount of the non-controlling interests should be adjusted by the fair value of the consideration paid by the non-controlling interests to acquire that additional interest.
- DO12 Mr Garnett also believes that it is important to provide the owners of the parent entity with information about the effects of a partial disposal of holdings in subsidiaries, including the difference between the fair value of the consideration received and the proportion of the carrying amount of the subsidiary's assets (including purchased goodwill) attributable to the disposal.

Loss of control

- DO13 Mr Garnett disagrees with the requirement in paragraph B98 of this IFRS that if a parent loses control of a subsidiary, it measures any retained investment in the former subsidiary at fair value and any difference between the carrying amount of the retained investment and its fair value is recognised in profit or loss, because the retained investment was not part of the exchange. The loss of control of a subsidiary is a significant economic event that warrants deconsolidation. However, the retained investment has not been sold. Under current IFRSs, gains and losses on cost method, available-for-sale and equity method investments are recognised in profit or loss only when the investment is sold (other than impairment). Mr Garnett would have recognised the effect of measuring the retained investment at fair value as a separate component of other comprehensive income instead of profit or loss.

Accounting for losses attributable to non-controlling interests

- DO14 Mr Danjou disagrees with paragraph B94 of this IFRS according to which losses can be attributed without limitation to the non-controlling interests even if this results in the non-controlling interests having a deficit balance.
- DO15 In many circumstances, in the absence of any commitment or binding obligation of the non-controlling interests to make an additional investment to cover the excess losses of the subsidiary, the continuation of the operations of a subsidiary will be funded through the contribution of additional capital by the parent and with the non-controlling interests being diluted. In those circumstances, the deficit balance attributable to the non-controlling interests that would result from the amendment in paragraph B94 does not present faithfully the equity of the consolidating entity.
- DO16 Mr Danjou believes that the Standard should therefore not preclude the allocation against the parent equity of losses that exceed the non-controlling interests in a consolidated subsidiary when the facts and circumstances are as outlined in paragraph DO15.

Appendix

Amendments to the Basis for Conclusions on other IFRSs

This appendix contains amendments to the Basis for Conclusions on other IFRSs that are necessary in order to ensure consistency with IFRS 10 and the related amendments to other IFRSs. Amended footnotes are shown with new text underlined and deleted text struck through.

The amendments contained in this appendix when IFRS 10 was issued have been incorporated into the Basis for Conclusions on the relevant IFRSs.

HKFRS 10 IE
Revised August 2020 September 2022

Illustrative Examples
Hong Kong Financial Reporting Standard 10

Consolidated Financial Statements



Hong Kong Institute of
Certified Public Accountants
香港會計師公會

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Illustrative Examples

These examples accompany, but are not part of, the IFRS.

Example 1

- IE1 An entity, Limited Partnership, is formed in 20X1 as a limited partnership with a 10-year life. The offering memorandum states that Limited Partnership's purpose is to invest in entities with rapid growth potential, with the objective of realising capital appreciation over their life. Entity GP (the general partner of Limited Partnership) provides 1 per cent of the capital to Limited Partnership and has the responsibility of identifying suitable investments for the partnership. Approximately 75 limited partners, who are unrelated to Entity GP, provide 99 per cent of the capital to the partnership.
- IE2 Limited Partnership begins its investment activities in 20X1. However, no suitable investments are identified by the end of 20X1. In 20X2 Limited Partnership acquires a controlling interest in one entity, ABC Corporation. Limited Partnership is unable to close another investment transaction until 20X3, at which time it acquires equity interests in five additional operating companies. Other than acquiring these equity interests, Limited Partnership conducts no other activities. Limited Partnership measures and evaluates its investments on a fair value basis and this information is provided to Entity GP and the external investors.
- IE3 Limited Partnership has plans to dispose of its interests in each of its investees during the 10-year stated life of the partnership. Such disposals include the outright sale for cash, the distribution of marketable equity securities to investors following the successful public offering of the investees' securities and the disposal of investments to the public or other unrelated entities.

Conclusion

- IE4 From the information provided, Limited Partnership meets the definition of an investment entity from formation in 20X1 to 31 December 20X3 because the following conditions exist:
- (a) Limited Partnership has obtained funds from the limited partners and is providing those limited partners with investment management services;
 - (b) Limited Partnership's only activity is acquiring equity interests in operating companies with the purpose of realising capital appreciation over the life of the investments. Limited Partnership has identified and documented exit strategies for its investments, all of which are equity investments; and
 - (c) Limited Partnership measures and evaluates its investments on a fair value basis and reports this financial information to its investors.
- IE5 In addition, Limited Partnership displays the following typical characteristics of an investment entity:
- (a) Limited Partnership is funded by many investors;
 - (b) its limited partners are unrelated to Limited Partnership; and
 - (c) ownership in Limited Partnership is represented by units of partnership interests acquired through a capital contribution.

- IE6 Limited Partnership does not hold more than one investment throughout the period. However, this is because it was still in its start-up period and had not identified suitable investment opportunities.

Example 2

- IE7 High Technology Fund was formed by Technology Corporation to invest in technology start-up companies for capital appreciation. Technology Corporation holds a 70 per cent interest in High Technology Fund and controls High Technology Fund; the other 30 per cent ownership interest in High Technology Fund is owned by 10 unrelated investors. Technology Corporation holds options to acquire investments held by High Technology Fund, at their fair value, which would be exercised if the technology developed by the investees would benefit the operations of Technology Corporation. No plans for exiting the investments have been identified by High Technology Fund. High Technology Fund is managed by an investment adviser that acts as agent for the investors in High Technology Fund.

Conclusion

- IE8 Even though High Technology Fund's business purpose is investing for capital appreciation and it provides investment management services to its investors, High Technology Fund is not an investment entity because of the following arrangements and circumstances:
- (a) Technology Corporation, the parent of High Technology Fund, holds options to acquire investments in investees held by High Technology Fund if the assets developed by the investees would benefit the operations of Technology Corporation. This provides a benefit in addition to capital appreciation or investment income; and
 - (b) the investment plans of High Technology Fund do not include exit strategies for its investments, which are equity investments. The options held by Technology Corporation are not controlled by High Technology Fund and do not constitute an exit strategy.

Example 3

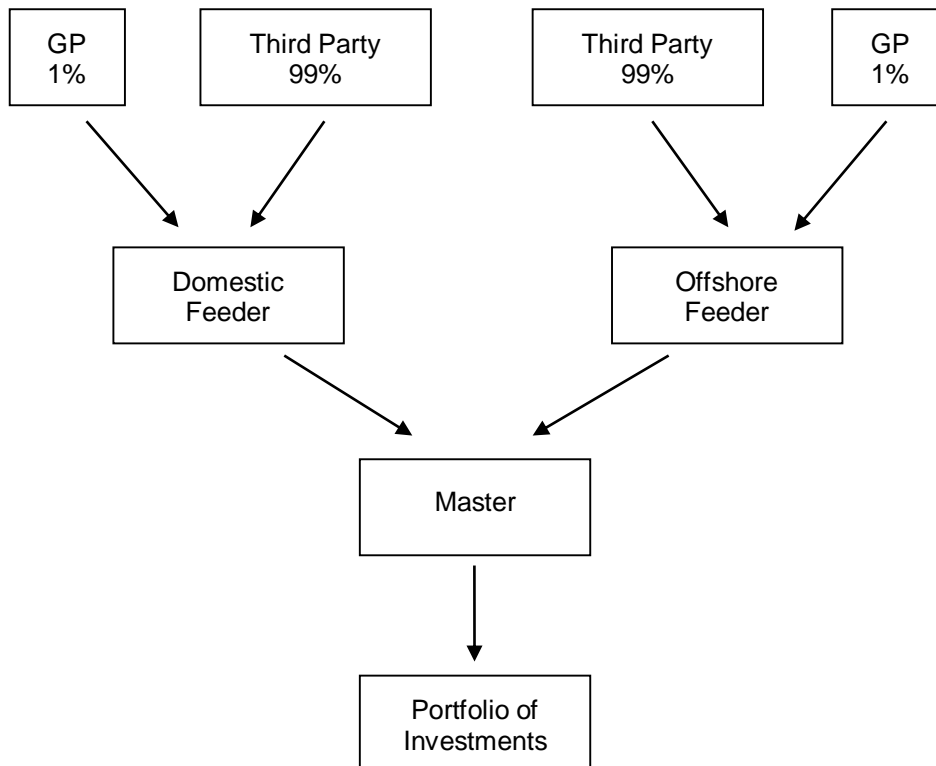
- IE9 Real Estate Entity was formed to develop, own and operate retail, office and other commercial properties. Real Estate Entity typically holds its property in separate wholly-owned subsidiaries, which have no other substantial assets or liabilities other than borrowings used to finance the related investment property. Real Estate Entity and each of its subsidiaries report their investment properties at fair value in accordance with IAS 40 *Investment Property*. Real Estate Entity does not have a set time frame for disposing of its property investments, but uses fair value to help identify the optimal time for disposal. Although fair value is one performance indicator, Real Estate Entity and its investors use other measures, including information about expected cash flows, rental revenues and expenses, to assess performance and to make investment decisions. The key management personnel of Real Estate Entity do not consider fair value information to be the primary measurement attribute to evaluate the performance of its investments but rather a part of a group of equally relevant key performance indicators.
- IE10 Real Estate Entity undertakes extensive property and asset management activities, including property maintenance, capital expenditure, redevelopment, marketing and tenant selection, some of which it outsources to third parties. This includes the selection of properties for refurbishment, development and the negotiation with suppliers for the design and construction work to be done to develop such properties. This development activity forms a separate substantial part of Real Estate Entity's business activities.

Conclusion

- IE11 Real Estate Entity does not meet the definition of an investment entity because:
- Real Estate Entity has a separate substantial business activity that involves the active management of its property portfolio, including lease negotiations, refurbishments and development activities, and marketing of properties to provide benefits other than capital appreciation, investment income, or both;
 - the investment plans of Real Estate Entity do not include specified exit strategies for its investments. As a result, Real Estate Entity plans to hold those property investments indefinitely; and
 - although Real Estate Entity reports its investment properties at fair value in accordance with IAS 40, fair value is not the primary measurement attribute used by management to evaluate the performance of its investments. Other performance indicators are used to evaluate performance and make investment decisions.

Example 4

- IE12 An entity, Master Fund, is formed in 20X1 with a 10-year life. The equity of Master Fund is held by two related feeder funds. The feeder funds are established in connection with each other to meet legal, regulatory, tax or similar requirements. The feeder funds are capitalised with a 1 per cent investment from the general partner and 99 per cent from equity investors that are unrelated to the general partner (with no party holding a controlling financial interest).



- IE13 The purpose of Master Fund is to hold a portfolio of investments in order to generate capital appreciation and investment income (such as dividends, interest or rental income). The investment objective communicated to investors is that the sole purpose of the Master-Feeder structure is to provide investment opportunities for investors in separate market niches to invest in a large pool of assets. Master Fund has identified and documented exit strategies for the equity and non-financial investments that it holds. Master Fund holds a portfolio of short- and medium-term debt investments,

some of which will be held until maturity and some of which will be traded but Master Fund has not specifically identified which investments will be held and which will be traded. Master Fund measures and evaluates substantially all of its investments, including its debt investments, on a fair value basis. In addition, investors receive periodic financial information, on a fair value basis, from the feeder funds. Ownership in both Master Fund and the feeder funds is represented through units of equity.

Conclusion

- IE14 Master Fund and the feeder funds each meet the definition of an investment entity. The following conditions exist:
- (a) both Master Fund and the feeder funds have obtained funds for the purpose of providing investors with investment management services;
 - (b) the Master-Feeder structure's business purpose, which was communicated directly to investors of the feeder funds, is investing solely for capital appreciation and investment income and Master Fund has identified and documented potential exit strategies for its equity and non-financial investments.
 - (c) although the feeder funds do not have an exit strategy for their interests in Master Fund, the feeder funds can nevertheless be considered to have an exit strategy for their investments because Master Fund was formed in connection with the feeder funds and holds investments on behalf of the feeder funds; and
 - (d) the investments held by Master Fund are measured and evaluated on a fair value basis and information about the investments made by Master Fund is provided to investors on a fair value basis through the feeder funds.
- IE15 Master Fund and the feeder funds were formed in connection with each other for legal, regulatory, tax or similar requirements. When considered together, they display the following typical characteristics of an investment entity:
- (a) the feeder funds indirectly hold more than one investment because Master Fund holds a portfolio of investments;
 - (b) although Master Fund is wholly capitalised by the feeder funds, the feeder funds are funded by many investors who are unrelated to the feeder funds (and to the general partner); and
 - (c) ownership in the feeder funds is represented by units of equity interests acquired through a capital contribution.

Amendments to guidance on other IFRSs

The following amendments to guidance on IFRSs are necessary in order to ensure consistency with IFRS 10 and the related amendments to other IFRSs. Amended paragraphs are shown with new text underlined and deleted text struck through.

The amendments contained in this appendix when IFRS 10 was issued have been incorporated into the guidance on the relevant IFRSs.