

## IASB publishes standards for consolidation and joint arrangements

On 12 May 2011, the IASB has finished its project to improve accounting requirements for consolidation and joint arrangements by publishing three new IFRS and two revised standards:

- IFRS 10 *Consolidated Financial Statements*
- IFRS 11 *Joint Arrangements*
- IFRS 12 *Disclosure of Interests in Other Entities*
- IAS 27 *Separate Financial Statements* (2011)
- IAS 28 *Investments in Associates and Joint Arrangements* (2011).

|                                    | Accounting                | Disclosures | Separate Financial Statements |
|------------------------------------|---------------------------|-------------|-------------------------------|
| Subsidiaries                       | IFRS 10                   | IFRS 12     | IAS 27 (2011)                 |
| Associates                         | IAS 28 (2011)             |             |                               |
| Joint ventures                     | IFRS 11 and IAS 28 (2011) |             |                               |
| Joint operations                   | IFRS 11                   |             | IFRS 11                       |
| Unconsolidated structured entities | IFRS 9 / IAS 39           |             | IFRS 12                       |

All new standards are effective for annual periods beginning or after 1 January 2013. The standards are subject to the endorsement process of the EU. Early adoption is permitted provided that the entire consolidation suite is adopted at the same time.

### **IFRS 10: Consolidation**

*Consolidation: A new single control model*

IFRS 10 *Consolidated Financial Statements* introduces a single model in the control analysis to determining which investees should be consolidated. The consolidation procedures are carried forward from IAS 27 (2008).

The control model is based on three elements: An investor controls an investee when (1) it is exposed or has rights to variable (e.g. residual) returns from its involvement with that investee, (2) has the ability to affect those returns through its power over that investee and (3) there is a link between power and returns.

The approach comprises a series of indicators of control, but no hierarchy is provided: preparers are required to analyze all facts and circumstances and apply their judgement in making the control

assessment. For example, the standard emphasizes the need to understand the design and purpose of an investee and stresses the need to take into account evidence of power, which are likely to be highly judgemental areas.

Control is usually assessed over a legal entity, but also can be assessed over only specified assets and liabilities of an investee. In such a case that portion of the investee is a deemed separate entity (referred to as a *silo*) for the purpose of applying the consolidation requirements. In consequence, the control conclusion could change for SPEs currently in the scope of SIC-12

In assessing control, the investor also needs to analyze substantial potential voting rights as well as currently exercisable potential voting rights. This is likely to change the control conclusion in some cases: currently exercisable potential voting rights might not be considered substantive and vice versa.

Control is assessed on a continuous basis, i.e. it is reassessed as facts and circumstances change considerably.

### *Assessment of IFRS 10 and potential impacts on accounting practices*

IFRS 10 refers to the same criteria of control assessment as IAS 27 but IFRS 10 builds up a causal link between them. IFRS 10 requires a qualitative analysis taking into account all circumstances of each case. The one-sided view of voting rights won't be appropriate anymore.

Beyond this, there will be other practical consequences for preparers. For instance, the assessment of *de facto* control requires knowledge about the investor's substantive rights and also insight into other shareholders. In practice, it may be challenging for an entity to gather this information, especially at the point at which the dominant shareholding position is established.

Management will need to monitor potential voting rights to determine whether they are substantive, which could include the need to assess the investor's practical ability to exercise those rights, for example.

For further information, please refer to our new brochure "First Impressions: Consolidated financial statements". → [Link!](#)

### **IFRS 11: Joint Arrangements**

#### *What is a joint arrangement?*

All parties to a joint arrangement are within the scope of IFRS 11, even if all of those parties do not share in the joint control. A *joint arrangement* is an arrangement over which two or more parties have joint control. Joint control exists only when the unanimous consent of those parties sharing control is required to make decisions about the relevant activities (those that significantly affect the returns of the arrangement).

After determining that joint control exists, joint arrangements are divided into two types, each having its own accounting model, defined as follows.

- A *joint operation* is one whereby the jointly controlling parties, known as the *joint operators*, have rights to the assets and obligations for the liabilities, relating to the arrangement.

- A *joint venture* is one whereby the jointly controlling parties, known as the *joint venturers*, have rights to the net assets of the arrangement.

#### *Accounting for the joint arrangement*

Under IFRS 11, a company will no longer have a free choice between a one-line pick-up of their net share of a joint venture entity (“equity accounting”) or inclusion of its share of each asset, liability, revenue and expense individually (“proportionate consolidation”). IFRS 11 requires that joint venturers be equity accounted while for joint operators or other parties to a joint operation, the investor’s interest in the individual assets, liabilities, revenues and expenses will be recognised.

#### *Transactions between a joint operator and a joint operation*

When a joint operator sells or contributes assets to a joint operation, such transactions are in effect transactions with other parties to the joint operation. The joint operator recognises gains and losses from such transactions only to the extent of the other parties’ interests in the joint operation. The full amount of any loss is recognised immediately by the joint operator, to the extent that these transactions provide evidence of impairment of any assets to be sold or contributed.

When a joint operator purchases assets from a joint operation, it does not recognise its share of the gains or losses until those assets have been sold to a third party. The joint operator’s share of any losses is recognised immediately, to the extent that these transactions provide evidence of impairment of those assets.

#### *Assessment of IFRS 11 and potential impacts on accounting practices*

We expect that in practice, many, but not all, jointly controlled entities under IAS 31 will be classified as joint ventures under IFRS 11. Although there may be relatively few joint arrangements that change classification, all joint arrangements will need to be re-assessed on transition to IFRS 11. As the classification of a joint arrangement requires identification and assessment of the structure, legal form, contractual arrangement and other facts and circumstances, this is expected to be an area of judgement that requires careful consideration in practice.

The transition from proportionate consolidation to the equity method will affect all of an entity’s financial statement line items, notably decreasing revenue, gross assets and gross liabilities. If the joint venture is profitable and a taxable entity, then the transition will also decrease profit before tax as tax expenses of the joint arrangement no longer will be included in the tax line.

As a consequence of this transition, entities may need to:

- consider the effect on existing contracts, e.g. debt agreements and remuneration agreements, and performance measures; and
- communicate the expected effects of transition to shareholders and other stakeholders, including managing analysts’ expectations.

For further information, please refer to our new brochure “First Impressions: joint arrangements”. → [Link!](#)

#### ***IFRS 12: Disclosure of interests in other entities***

### *Scope extended to structured entities*

IFRS 12 contains the disclosure requirements for entities that have interests in subsidiaries, joint arrangements (i.e. joint operations or joint ventures), associates and/or unconsolidated structured entities. *Interests* are widely defined as contractual and non-contractual involvement that exposes an entity to variability of returns from the performance of the other entity.

The required disclosures aim to provide information in order to enable users to evaluate:

- the nature of, and risks associated with, an entity's interests in other entities; and
- the effects of those interests on the entity's financial position, financial performance and cash flows.

The following specific disclosure areas are addressed in IFRS 12:

- significant judgments and assumptions made in determining the nature of interests in an entity or arrangement;
- interests in subsidiaries;
- interests in joint arrangements and associates; and
- interests in unconsolidated structured entities.

### *Assessment of IFRS 12 and potential impacts on accounting practices*

We expect particular interest in the new disclosures related to structured entities, especially in the financial services sector. Entities will need to:

- understand what a structured entity is in the context of their operations; in this context the IASB envisages it unlikely that structured entities will be significantly different from special purpose entities under current guidance;
- apply judgement in assessing whether they are 'involved' with a structured entity, which has the potential to broaden the transactions and relationships to which the disclosures may apply, particularly for those who sponsor, or perhaps even transact with, but do not consolidate structured entities; and
- assess the level of disclosure that they believe will be meaningful to users of the financial statements.

Although these new IFRSs aren't effective immediately, companies need to start assessing whether they will have a change in their consolidation conclusion or in the method of accounting for joint arrangements. The introduction of IFRS 10 and 11 could change the shape of the balance sheet for organisations in industries such as the mining, property and financial sectors, requiring preparers and investors to adjust to a new financial reporting regime. Further, all companies need to reassess their disclosure given on interests in other entities, esp. relating to structured entities.