
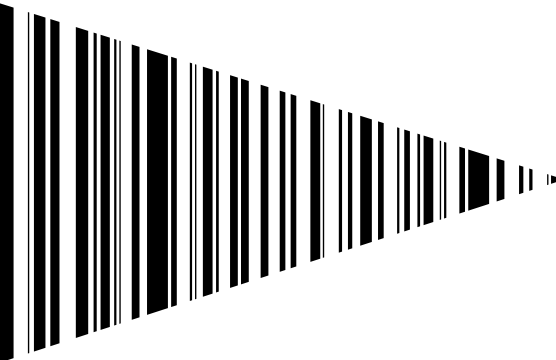


Consolidated financial statements



Significant changes are on the horizon for consolidated financial statements. An Exposure Draft (ED) (issued by the IASB) proposes new requirements, that could potentially impact all entities holding investments.

Summary of proposed changes

The ED is the culmination of a lengthy project to produce a single IFRS on consolidation replacing IAS 27 *Consolidated and Separate Financial Statements* and SIC-12 *Consolidation - Special Purpose Entities*.

Definition of control of an entity

A new definition of control of an entity is proposed that would apply to all types of investment structures. The proposed definition is 'the power of a reporting entity to direct the activities of another entity to generate returns for the reporting entity'.

The definition consists of three elements:

- ▶ Power - refers to the 'ability to direct the activities of another'. Power to 'govern the strategic operating and financing policies' as referred to today is only one way in which this control can be achieved, therefore potentially more entities may be caught
- ▶ Returns - these may be positive or negative and must vary according to the activities of the controlled entity
- ▶ Link between power and benefits - the power held by the reporting entity should be commensurate with the returns that the reporting entity is exposed to. The underlying assumption in the ED is that the entity receiving the greatest returns from another entity is likely to have the greatest power over that entity

The ED proposes that control must be current and must be reassessed on a continuous basis - concepts on which the existing standard is silent.

Currently exercisable options and convertible instruments

Simply holding currently exercisable options that, if exercised, would give the reporting entity more than half of the voting rights in the entity will no longer be sufficient to demonstrate control of that entity. Rather the ED proposes that entities holding such options, need to assess whether, when taken with other arrangements in place, they have the power to direct the activities of another entity.



A reporting entity does not control an entity if it is acting as an agent on behalf of another party.

Control of another entity, with less than the majority of voting rights

The ED proposes that a reporting entity holding less than a majority of voting rights may still have power to direct the activities of another. It proposes additional guidance to determine whether power exists in such cases.

In particular, it proposes that an entity has power to direct the activities of another entity, if:

- a. It has more voting rights than any other party; and
- b. Its voting rights are sufficient to give it the ability to determine the strategic operating and financing policies.

To determine if the voting rights are sufficient, the ED proposes numerous factors that could be considered, similar to the other arrangements that are evaluated when considering if currently exercisable options and convertible instruments give sufficient power. This will therefore require an assessment of all facts and circumstances in each situation.

Approval or veto rights of other parties

The ED proposes that a reporting entity can still control another entity even though other parties have protective rights in that other entity. The protective rights must however be limited to rights that do not affect the reporting entity's ability to direct the strategic operating and policies of the entity. Much of the guidance included in the ED has been taken over from the US literature.

Agency arrangements

The ED specifically notes that a reporting entity does not control an entity if it is acting as an agent on behalf of another party. Additional guidance is proposed to evaluate the role of 'kick-out rights' of managers and the receipt of variable fee as remuneration. Unconditional rights to remove the entity from a management control function indicate that another entity (the principal) has retained the power to direct the activities of the entity (therefore an agency relationship exists). However, the right to remove the entity only in exceptional circumstances such as bankruptcy or breach of contract is indicative of having only protective rights. Similarly, when an entity receives a fee that is commensurate with the services provided or in the case of performance fee arrangements, there is no requirement to repay fees already received if the value of the portfolio of assets decreases in a subsequent period, indicates that the entity is acting as an agent.

In situations where a reporting entity acts simultaneously in the role of a principal and agent, such as where a fund manager holds investments on its own account and within funds that it manages, the ED proposes to put the onus on the reporting entity to demonstrate that it does not use the power it has as an agent for its own benefits.

Structured entities

The ED introduces a new term 'structured entities' (SE) to replace 'special purpose entities' (an SPE). An SE is an entity whose activities are restricted to the extent that they are not directed by a governing body.



The ED does not have 'bright line requirements' setting out when a reporting entity should consolidate an SE. Rather, an entity needs to consider all facts and circumstances to determine whether it has the power to direct the activities that cause the returns of the SE to vary.

Example

In an asset securitisation structure, the ED notes that the party with the power to direct how any defaulting receivables are managed controls the entity. This is because managing the defaulting receivables is the only activity that causes the returns of the entity to vary.

The ED notes the following should be considered:

- ▶ What is the purpose and design of the SE?
- ▶ What returns does the reporting entity earn from its involvement with the SE?
- ▶ To what extent are the activities of the SE predetermined?
- ▶ Does the reporting entity have the ability to change the restrictions or predetermined strategic policies of the SE?
- ▶ What is the effect of any related arrangements?
- ▶ Whether the entity is acting as an agent in its relationship with the SE.

Increased disclosures

The ED proposes significant new disclosure requirements including:

- ▶ a description of the judgements made in deciding whether or not an entity controls another entity
- ▶ any restrictions that are a consequence of assets and liabilities being held by subsidiaries including the extent to which non-controlling interests can restrict the activities of such subsidiaries
- ▶ the nature of, and risks associated with, the reporting entity's involvement with structured entities that the reporting entity does not control. Involvement in this context includes both contractual and non-contractual arrangements that exposes the reporting entity to risk. This includes disclosure of the value of assets transferred to SEs at the date of transfer, income earned from the reporting entity's involvement with SEs, and a description of the type of income. This information would be disclosed by relevant category (determined based on the risk). It is proposed that this quantitative information is disclosed for the current period and the preceding two reporting periods. It is also proposed that the maximum exposure to losses from involvement with an SE is disclosed and the basis of how this exposure is determined

Transitional provisions

The ED proposes that entities should apply the new IFRS prospectively. As such, if at the date of adoption a reporting entity identifies an entity which should now be consolidated, the reporting entity will need to account for it as a business combination. Similarly if a reporting entity considers that it no longer controls a subsidiary, it will need to account for it as a disposal at that date.

Business impact

Overall, it would appear that the proposals are going to require a greater level of judgement to be exercised by management, when assessing whether one entity controls another - in particular those entities holding currently exercisable options and structured entities. This in turn is likely to lead not only to a time-consuming exercise, but to an increase in disclosures.

However, using the same criteria to consolidate all entities should result in greater consistency for the preparation of financial statements.

The proposal that control is a continuous assessment raises the possibility that, entities may 'flip in and out' of the group from one period to the next. Hence, many entities will need to put additional procedures in place to make this reassessment and respond to changes in circumstances, including the need to fair value the underlying net assets when gaining control and to fair value the investment when losing control.

Comments on the Exposure Draft are due by 20 March 2009

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