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# Learning objectives

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- ▶ Understand what is meant by the group?
- ▶ What is the problem? Fraudulent activities in the past.
  - ▶ The accounting game at Enron
  - ▶ Frauds in the Telco Industries
- ▶ What is a “business entity”?  
(Substance over form)



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# Topics

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- ▶ Background, objectives and core principle
  - ▶ New definition of control
  - ▶ Assessing control
  - ▶ Business impact
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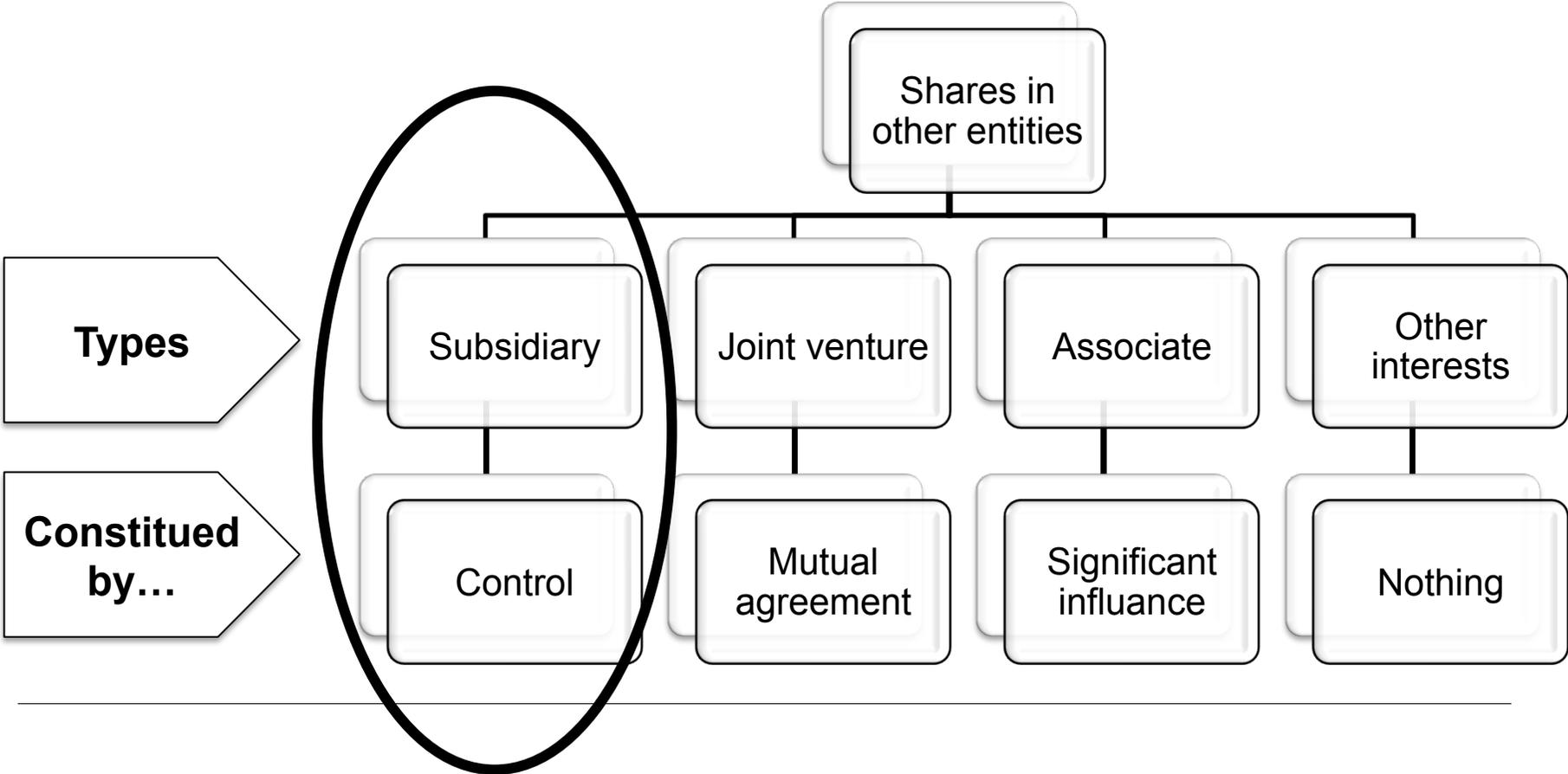
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# **BACKGROUND, OBJECTIVES AND CORE PRINCIPLE**

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# Classification entities

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# Background, objectives and core principle

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## Background

- ▶ Inconsistent application of the concept of control due to perceived conflict between IAS 27 and SIC-12 (the “old rules”)
- ▶ Global financial crisis highlighted the lack of transparency about risk of exposure from off-balance-sheet entities/interests

## Objectives

- ▶ Develop a single control model that is applicable to all types of entities to eliminate the perceived inconsistency between IAS 27 and SIC-12
- ▶ Improve disclosures

## Core principle – remained unchanged

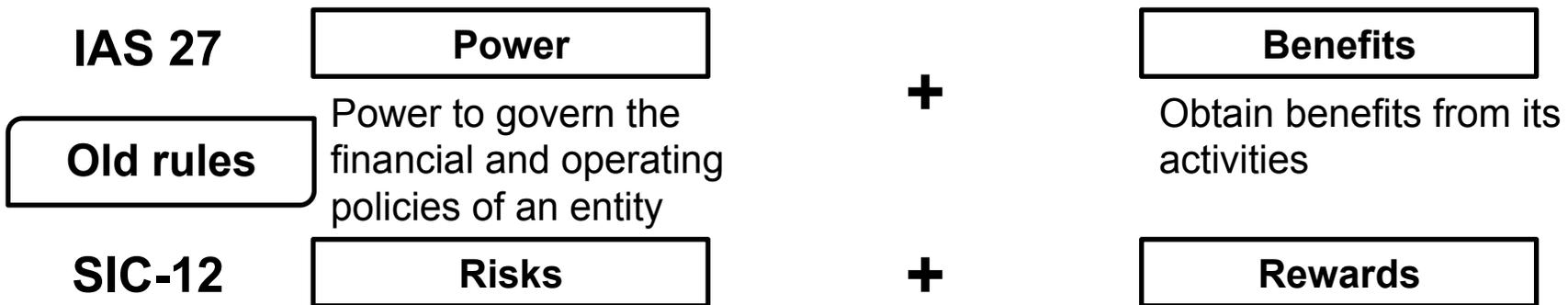
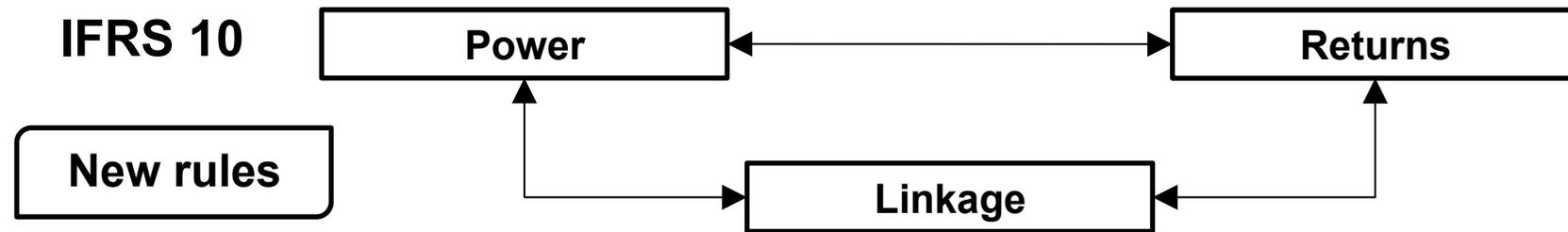
- ▶ A group presents consolidated financial statements as those of a single economic entity
  - ▶ Consolidated financial statements include all controlled entities
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# **NEW DEFINITION OF CONTROL**

# New definition of control

“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.”



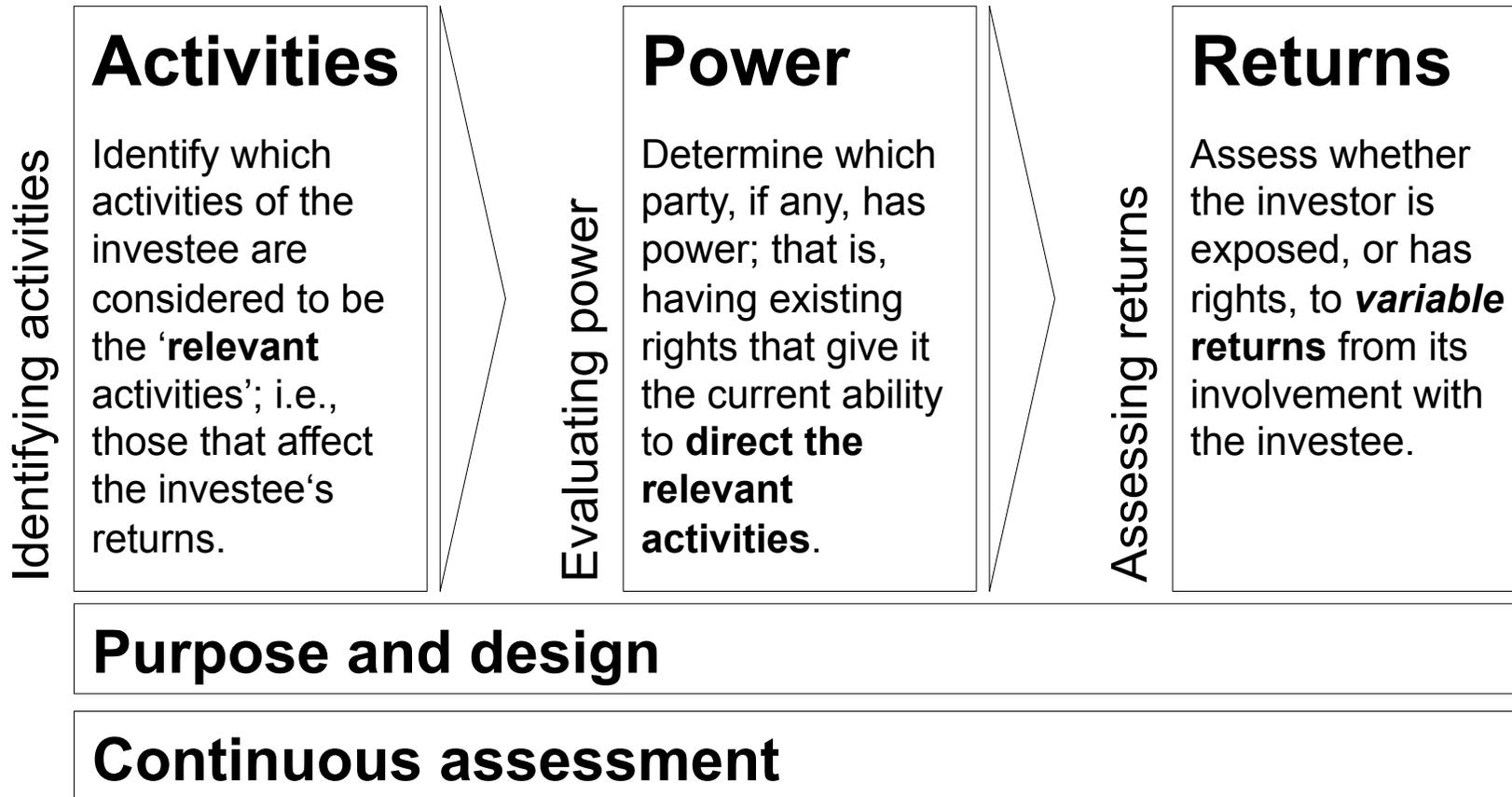
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# **ASSESSING CONTROL**

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# Assessing control: overview

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# Identifying relevant activities: overview

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Identifying activities

## Activities

Identify which activities of the investee are considered to be the 'relevant activities'; i.e., those that affect the investee's returns.

- ▶ **Examples of activities that may affect investee's returns:**
  - ▶ Determining or changing operating and financing policies
  - ▶ Making capital decision
  - ▶ Appointing, remunerating and terminating employment of service providers or key management personnel
- ▶ **If two investors both direct different relevant activities, one has to identify which investor can most significantly affect returns**
- ▶ **Purpose and design**

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# Activity 1 debrief: identifying relevant activities – example 1

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- ▶ Two investors, C and D, form an investee E to acquire, dispose and manage an investment property portfolio (fund).
  - ▶ Investor C is responsible for acquisitions and disposals of the investment properties of the portfolio whilst investor D is responsible for the management of the existing investment properties of the portfolio.
  - ▶ The investment agreement states that the fund will hold no more than five investment properties at any one time, and indicates a planned Internal Rate of Return (IRR) on each property.
  - ▶ If an investment property achieves an IRR less than planned for three consecutive years, investor C is required to evaluate whether the investment property needs to be replaced considering the forecast of the respective investment property, the overall return of the portfolio of investment properties and available properties in the market.
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# Activity 1 debrief: identifying relevant activities – example 1 (cont.)

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## Key points

- ▶ The level of activity associated with the acquisition and disposal of investment properties is based on the expected IRR of both the individual investment properties and the fund.
- ▶ If IRR levels are expected to be achievable and realistic on the properties initially acquired, then the level of acquisition and disposal activities would be low and the most relevant activity will therefore be the management of the investment properties.
- ▶ If the level of activities relating to acquisitions and disposals is high and is expected to remain high, this may indicate that the acquisitions and disposals of investment properties are the most relevant activity.

**This information is not sufficient to decide who consolidates.**

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## Activity 1 debrief: identifying relevant activities – example 2

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- ▶ Investor A transfers receivables to investee B, an entity created solely for the purpose of purchasing and servicing those receivables.
  - ▶ Investee B fully funds the acquisition of the receivables by issuing two different tranches of debt: a senior tranche (90% of debt) to the market and a junior tranche (10% of debt) to investor A.
  - ▶ There are few, if any, activities to perform once investee B is set up unless the counterparties to the receivables default on payment.
  - ▶ Investor A retains the customer relationships and is responsible for managing those receivables in the event of default. A third-party servicer collects the cash flows from the receivables and passes them to the investors.
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## **Activity 1 debrief: identifying relevant activities – example 2 (cont.)**

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### **Key points**

- ▶ The significant relevant activity is the management of the receivables upon default, as this activity significantly affects investee B's returns.
- ▶ A has the ability to make decisions about the relevant activity.
- ▶ A has exposure to variable returns from investee B.

**Therefore, A will consolidate B.**

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# Assessing power: overview

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- ▶ **Main aspects of power:**
  - ▶ Power arises from rights.
  - ▶ Power is the current ability to direct and need not be exercised.
  - ▶ Power relates to direction of the relevant activities.
- ▶ **Other considerations:**
  - ▶ Evidence that the investor directed activities in the past is an indicator of power, but is not conclusive.
  - ▶ An investor that holds only protective rights cannot have power over an investee.

Evaluating power

## Power

Determine which party, if any, has power; that is, having existing rights that give it the current ability to direct the relevant activities.

Assessing returns

## Returns

Assess whether the investor is exposed, or has rights, to variable returns from its involvement with the investee.

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# Substantive rights

“Power is the existing rights that give an investor the current ability to direct the relevant activities.”

- ▶ Rights can either be substantive or protective.
  - ▶ Factors to consider in assessing whether a right is substantive:
    - ▶ Are there **barriers** that would prevent the holder from exercising their rights?
    - ▶ Do the holders have the **practical ability** to exercise their rights when exercise requires agreement by more than one investor?
    - ▶ Would the investor that holds the rights **benefit** from their exercise of conversion?
    - ▶ Are the rights **currently exercisable or convertible**?
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# Assessing returns

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- ▶ **Can be positive, negative or both**
- ▶ **Examples:**
  - ▶ Dividends, distributions of economic benefits, changes in value
  - ▶ Remuneration, fees, residual interests, tax benefits
  - ▶ Synergistic returns, saving costs, economies of scale
- ▶ **Returns that appear 'fixed' may actually be 'variable'**
  - ▶ Bond with 'fixed' interest payments – exposed to credit risk
  - ▶ Fixed fee for managing investment – exposed to performance risk
- ▶ **Exposure to returns is an indicator of control:**
  - ▶ Greater the exposure ⇨ greater incentive to obtain power

Assessing returns

## Returns

Assess whether the investor is exposed, or has rights, to **variable** returns from its involvement with the investee.

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## What is different/more explicit?

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- ▶ Power with less than majority voting rights
  - ▶ Potential voting rights
  - ▶ Delegated rights
  - ▶ Power over specified assets ('silos')
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# Power with less than majority of voting rights

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- ▶ An investor may have the power to direct the relevant activities with less than half of the voting rights.
- ▶ All facts and circumstances must be considered:
  - ▶ Contractual arrangements with other shareholders
  - ▶ Contractual rights arising from other arrangements
  - ▶ The investor's voting rights: size of the investor's holding of voting rights relative to the size and dispersion of other vote holders (**facto control**)
  - ▶ Potential voting rights held by the investor and other parties

**If it is not clear from considering these factors that the investor has power, the investor does not control the investee.**

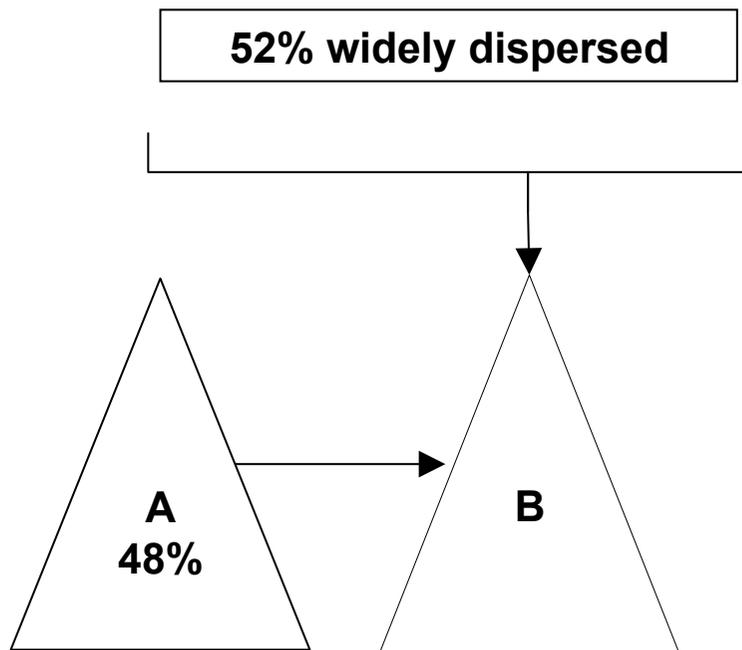
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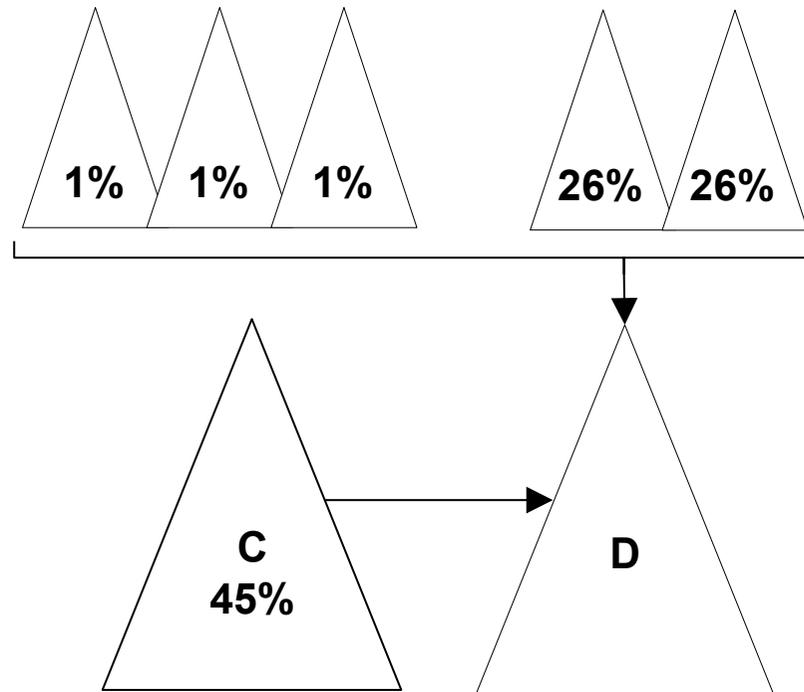
# Assessing power – power with less than majority of voting rights

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Example 1 – A has power



Example 2 – C does not have power

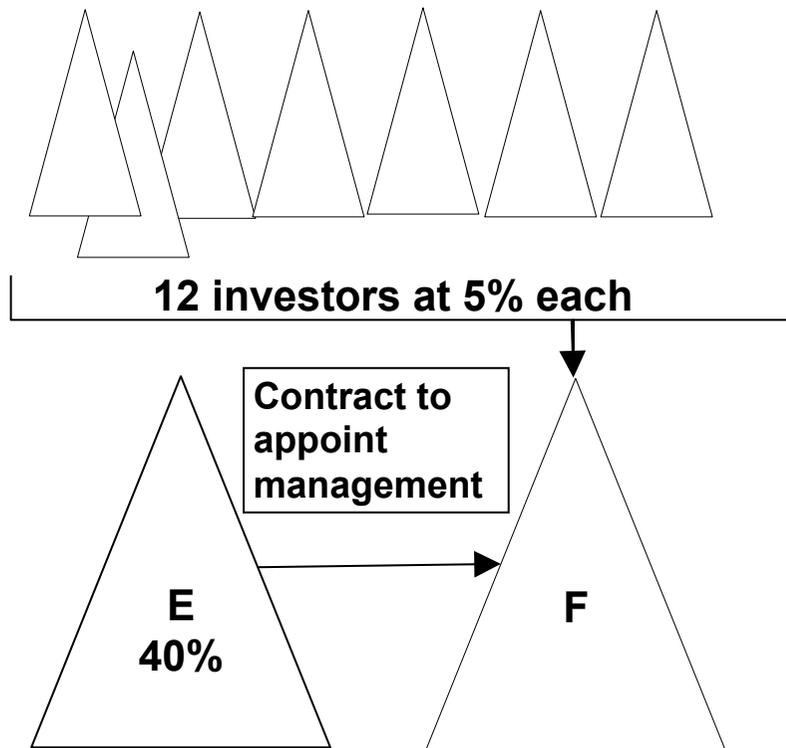


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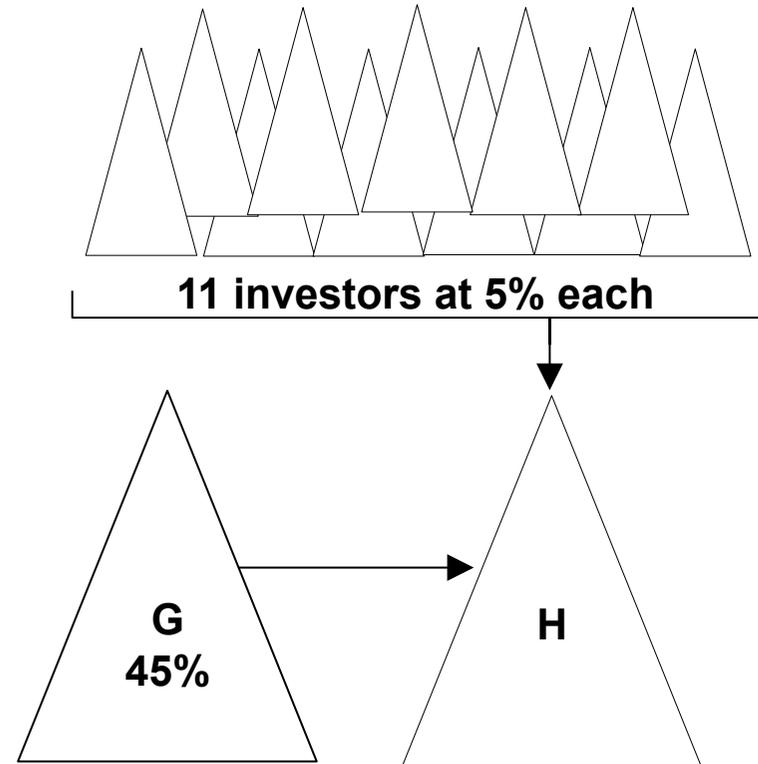
# Assessing power – power with less than majority of voting rights (cont.)

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**Example 3 – E has power**



**Example 4 – not conclusive**

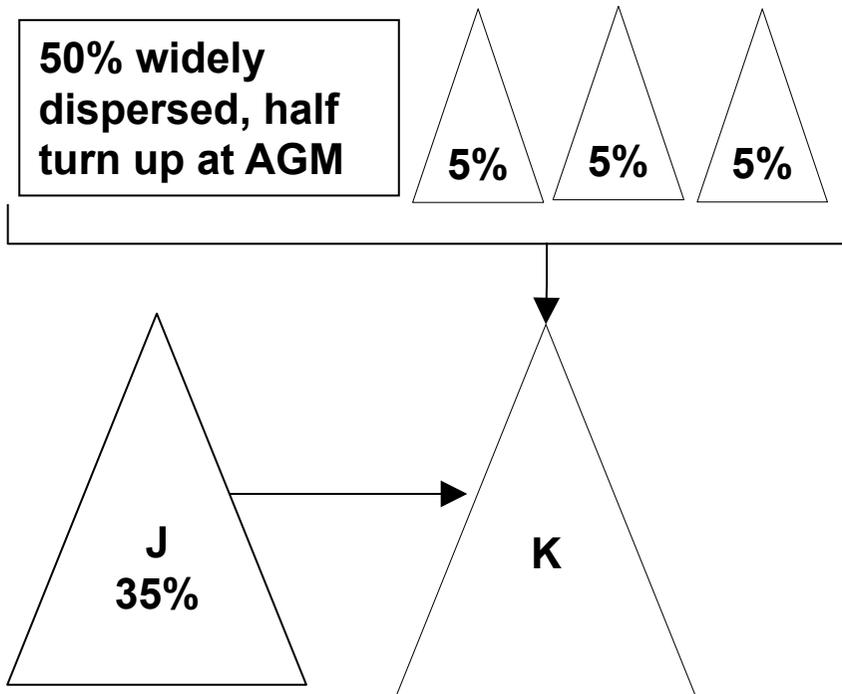


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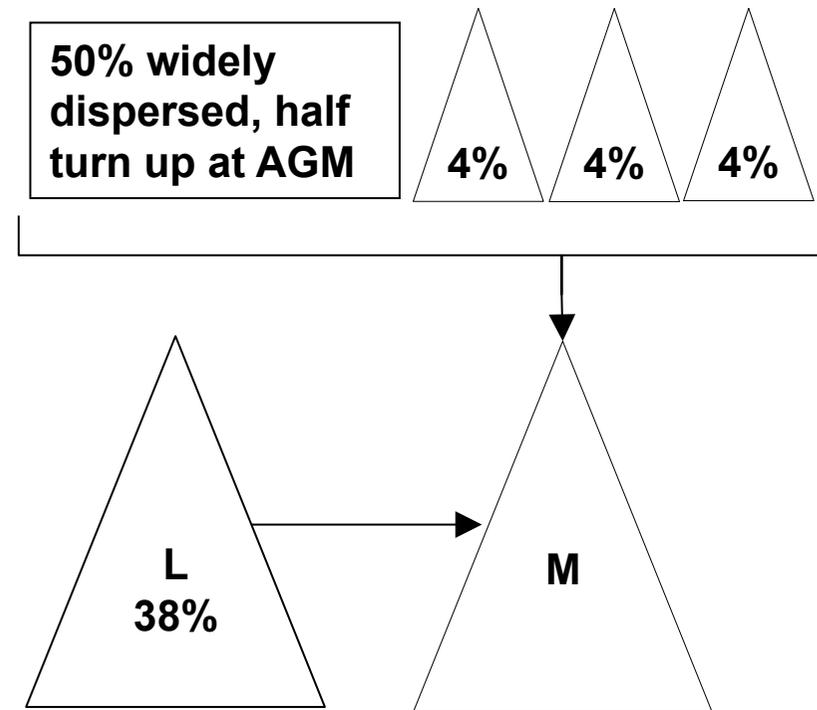
# Assessing power – power with less than majority of voting rights (cont.)

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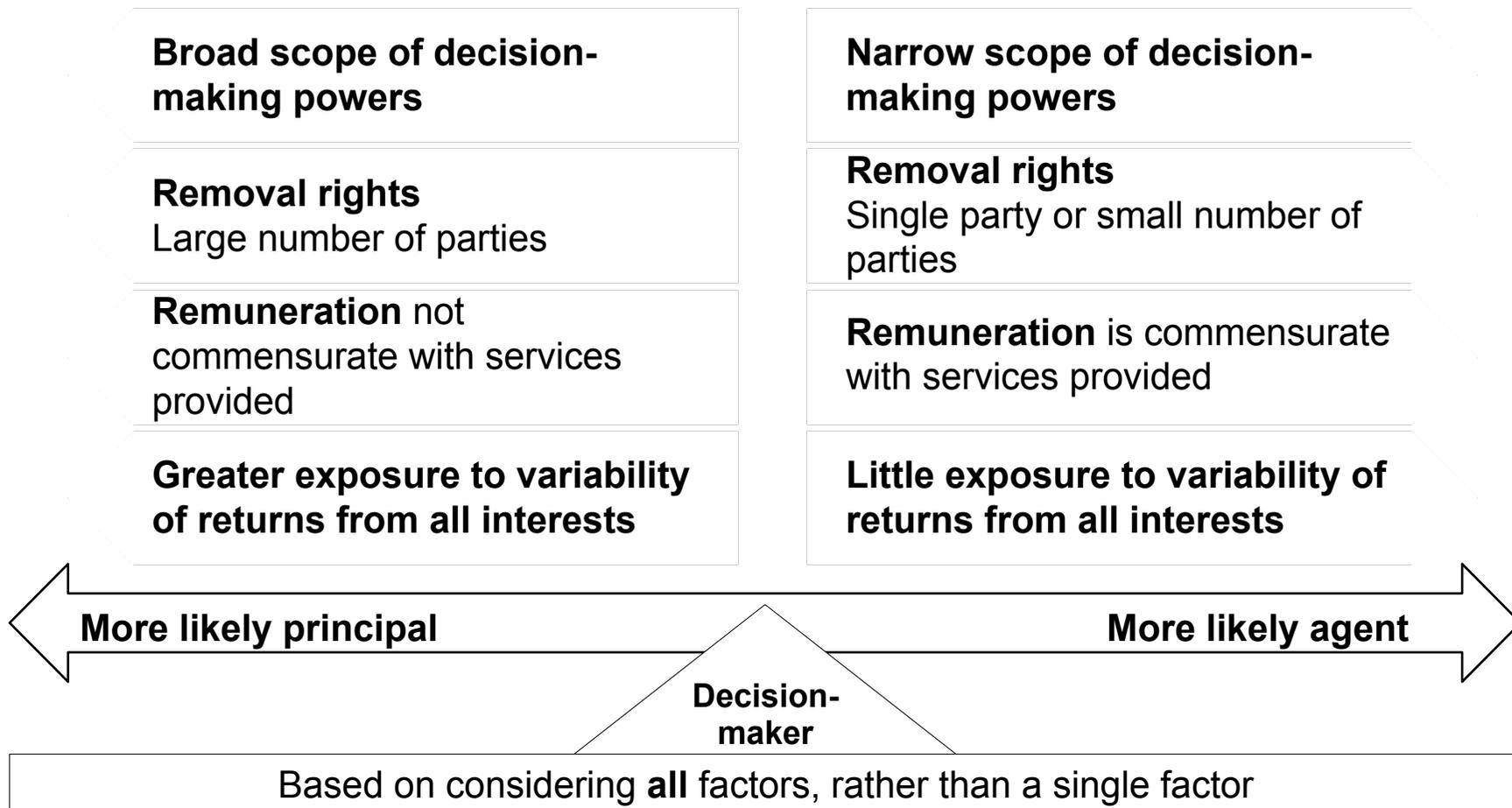
**Example 5 – J does not have power**



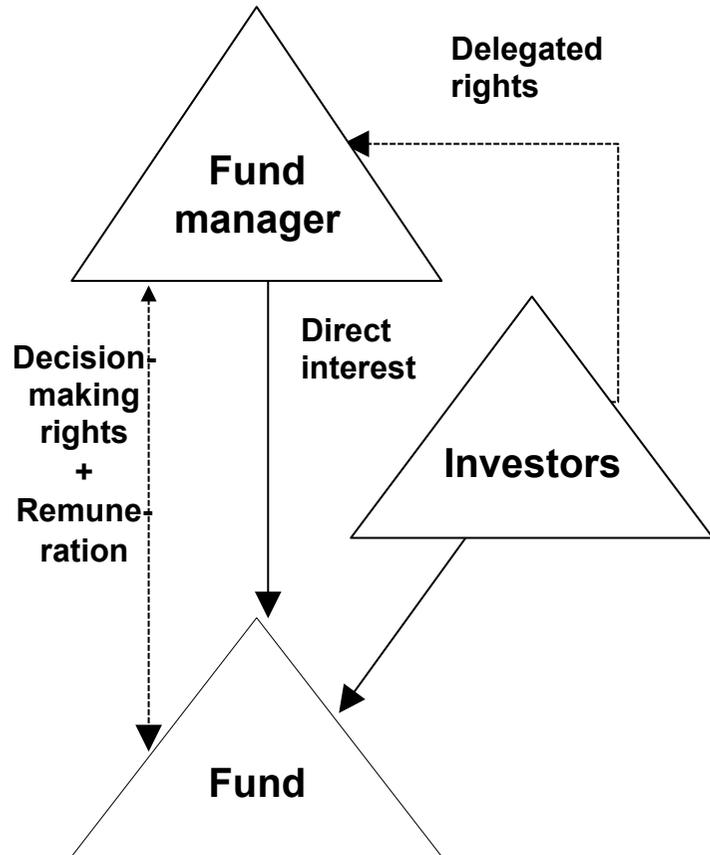
**Example 6 – L has power**



# Delegated rights – link between power and returns



# Delegated rights: examples



	Example 1	Example 2	Example 3
Decision-making scope	Broad discretion	Broad discretion	Broad discretion
Rights held by other investors	Simple majority, for cause	Simple majority, for cause	Independent board, for any reason
Remuneration	1% of NAV 20% of profits if hurdle rate achieved	1% of NAV 20% of profits if hurdle rate achieved	1% of NAV 20% of profits if hurdle rate achieved
Other interests	2% direct interest	20% direct interest	20% direct interest
Conclusion	Agent	Principal	Agent

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## Control over specified assets ('silo')

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- ▶ An investor treats a portion of an investee as a deemed separate entity (silo) if and only if the following conditions are satisfied:
    - ▶ Specified assets of the investee are the only source of payment for specified liabilities of, or specified other interest 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.
    - ▶ None of the returns from the specified assets can be used by the remaining investee and none of the liabilities of the silo are payable from the assets of the remaining investee.
    - ▶ In substance, all the assets, liabilities and equity of the silo are ring-fenced from the investee.
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# **BUSINESS IMPACT**

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# Business impact

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- ▶ Judgement required to assess which party has control over another entity, based on facts and circumstances – **no 'bright lines'**
  - ▶ May result in changes to the entities being consolidated and will impact key metrics of financial performance:
    - ▶ Assessment of impact on debt covenants and management remuneration
    - ▶ Communication with stakeholders
  - ▶ Consideration of new guidance when new arrangements are negotiated or existing ones are modified
  - ▶ Additional procedures required to assess control on a continuous basis (information gathering regarding investee and behaviour of other shareholders)
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