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**THE INSTITUTE OF
CHARTERED ACCOUNTANTS OF SRI LANKA**



SLFRS 10 – Consolidated Financial Statements

Today's agenda

- ▶ **Scope of SLFRS 10**
- ▶ **Definition of control**
- ▶ **Power**
- ▶ **Disclosure requirements**
- ▶ **Investment Entities**
- ▶ **Consolidation Procedures**

Why consolidation?

- **Question:** Why are entities required to present consolidated financial statements?
 - Provide information about economic entity
 - Investors need information about all assets and liabilities of combined entity

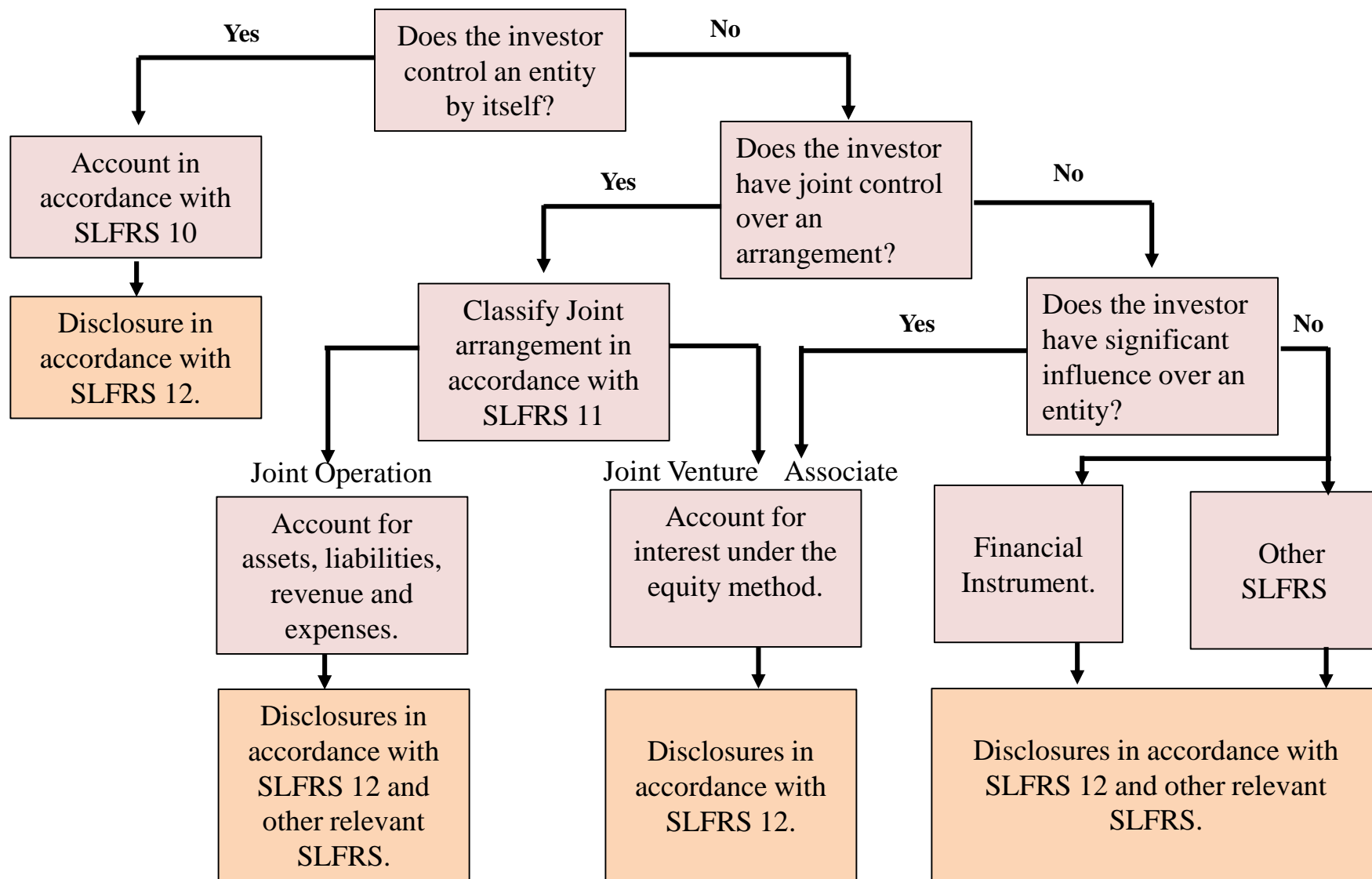
◆ SLFRS 10 addresses:

- ◆ Preparation and presentation of consolidated financial statements of a group of entities under the control of an investor/parent

◆ **An investor/parent must present consolidated financial statements, except where all of the following apply:**

- ◆ It is itself a wholly-owned subsidiary or it is a partially-owned subsidiary and its other owners have been informed and do not object to the parent not presenting consolidated financial statements
- ◆ The ultimate or any intermediate parent produces SLFRS consolidated financial statements available for public use
- ◆ Its debt and equity instruments are not traded in a public market
- ◆ It did not file, nor is in the process of filing its financial statements for the purpose of issuing any class of financial instruments in a public market, and

Interaction between SLFRS 10, SLFRS 11, SLFRS 12 and LKAS 28



Assessing control

Definition of control

The control model under SLFRS 10 is based on the existence of three elements of **control**. When all of these three elements of control are present then an investor is considered to control an investee and consolidation is required .

“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.”

Control therefore comprises three elements:

Power

- ▶ Ability to direct the relevant activities

Variable returns

- ▶ The *investor* is exposed, or has rights, to variable returns from its involvement with the investee

Link : power

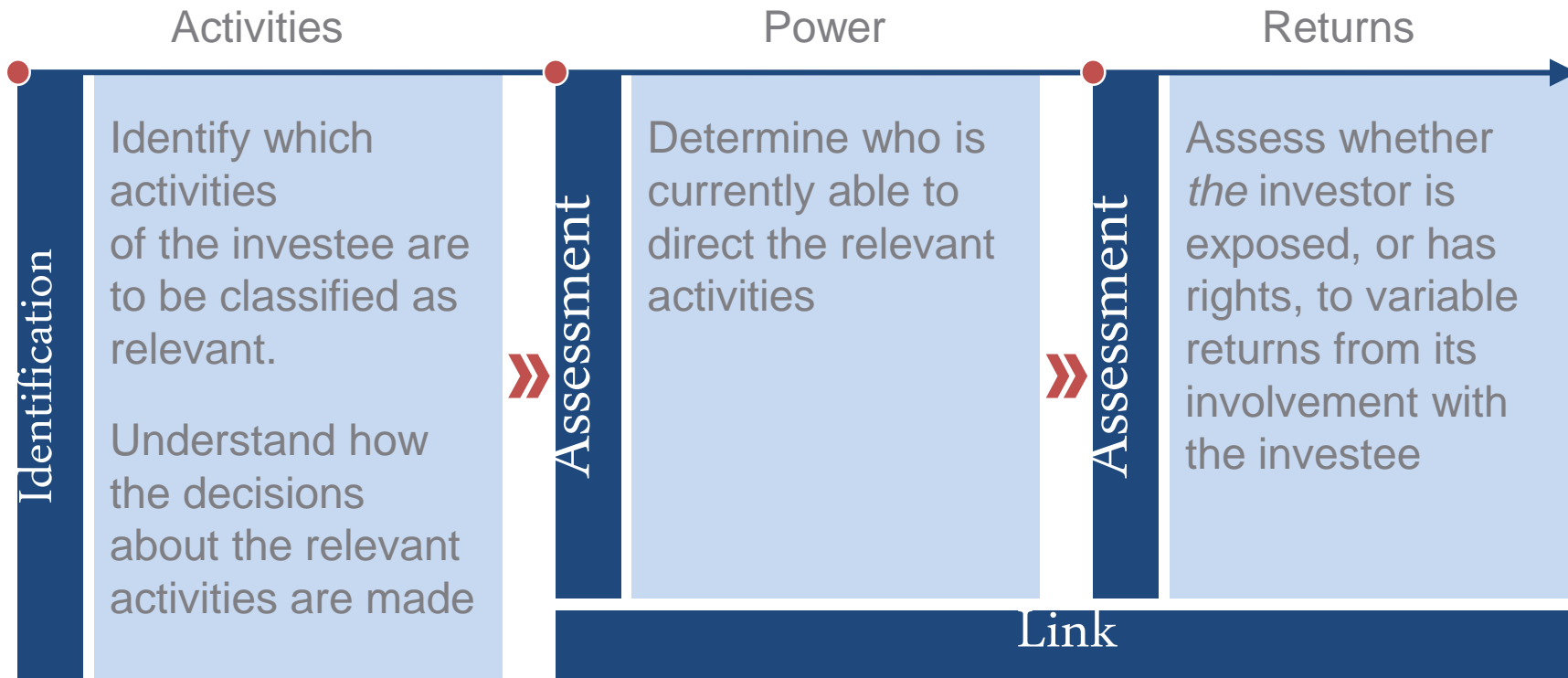
and returns

- ▶ Ability of the *investor* to use its power over the investee to affect the amount of variable returns

Assessing control

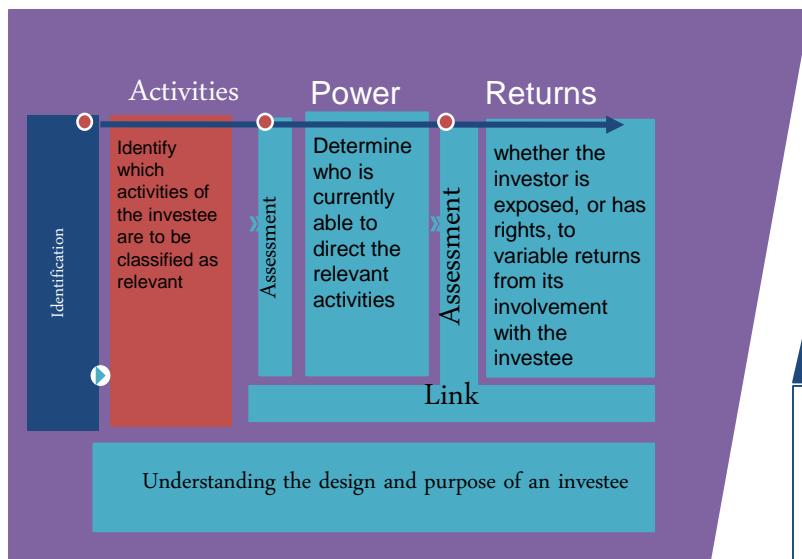
- ▶ To apply the Control model several initial steps are necessary before the assessment of whether each of the three elements of control are present .
The steps are
- ▶ **Identify the Investee**
The assessment of control is made at the each investee level
- **Understand the purpose and design of the Investee**
Identify the relevant activities of the investee and how decisions about these relevant activities are made

Assessing control Approach



▶ Understanding the design and purpose of an investee

Assessing control Relevant activities



Decisions, e.g.:

- ▶ Business policies
- ▶ Financing structure
- ▶ Budgets
- ▶ Appointing/removing management

Examples of relevant activities:

- ▶ Buying and selling goods and services
- ▶ Managing financial assets
- ▶ Selecting, acquiring or disposing of assets
- ▶ Researching and developing new products or processes
- ▶ Funding structure and obtaining funding

Definition of control

- ▶ In some cases, it will be obvious that one party controls another party

Example:

- ▶ One entity holds 100% of the voting rights of an operating entity
 - ▶ Clear that operating and financial policies are the relevant activities of that entity
 - ▶ Clear that voting rights are what gives power over operating and financial policies
 - ▶ Therefore, whoever has the votes, has power
 - ▶ If the voting shares also entitle the holder to returns, then the holder has control
- ▶ However, in other cases, it might not be clear whether a party controls another party:
In these cases, it is helpful to think through 3 steps:
 - ▶ Identifying the **relevant activities**
 - ▶ Evaluating what gives **power** over those activities
 - ▶ Assessing whether the holder is exposed to **variable returns**

Definition of control

Identifying relevant activities – Example 1

- Two investors form an investee to develop and market a medical product
 - One investor is responsible for developing and obtaining regulatory approval
 - Other investor is responsible for manufacturing and marketing
- Determine which activity most significantly affects returns
 - Purpose and design of the investee
 - Factors that affect profit margin, revenue, etc.
 - Effect on returns from each decision-maker's authority
 - Investors' exposure to variability of returns



Definition of control

Identifying relevant activities – Example 2

- Entity holds receivables – only activities:
 - Purchase receivables and service on daily basis
 - Collection of principal and interest payments
 - Passing through payments to investors in entity
- Upon default, receivable is put back to investor
- Relevant activity = managing defaults
 - Only activity that significantly affects returns
- Investor who manages defaults has power
 - Would control, if other two criteria are also met

Definition of control

Evaluating power

Power is having existing rights that give an investor the current ability to direct the relevant activities

- Main aspects of power:
 - Arises from rights
 - Need not be exercised
 - Does not arise from protective rights
 - Can exist even if others participate in directing the relevant activities (e.g., they have significant influence)
- Evidence that an investor directed activities in the past is an indicator of power, but is not conclusive

Power – Current ability

- Does the investor have the current ability to exercise power?
 - Rights need to be substantive (i.e. the holder must have the practical ability to exercise those rights)
- Factors to consider – whether?
 - Economic or other barriers exist
 - Multiple parties have to agree to exercise right
 - Holders would benefit from exercising the right
 - Right is currently exercisable
 - ‘Current’ does not necessarily mean ‘this instant’

Power – Majority of voting rights

- Majority of voting rights normally gives power to direct the relevant activities when:
 - Voting rights are substantive
 - Voting rights direct the relevant activities
 - Holder is not an agent of the investor
- This might not be the case when:
 - Other legal requirements, other contractual arrangements restrict the ability to direct the relevant activities
 - Activities are subject to direction by government, court, administrator, receiver, liquidator, or regulator

Definition of control

Assessing returns

Returns can be only positive, only negative or positive and negative, but must have the potential to vary as a result of the investee's performance

- **Examples:**
 - Dividends, distributions of economic benefits, changes in the value of an investment
 - Remuneration, fees, residual interests, tax benefits, exposure from providing support
 - Synergies, cost savings, economies of scale, scarce resources, proprietary knowledge

Definition of control

What changed or is more explicit?

- ▶ **Protective rights**
- ▶ **De facto control**
- ▶ **Potential voting rights**
- ▶ **Delegated rights (principal-agency relationships)**
- ▶ **Relationships with other parties (“*de facto* agents”)**
- ▶ **Increased use of judgement**
- ▶ **Continuous assessment**

Who’s affected?

- ▶ **Fund and asset managers**
- ▶ **Entities that have been delegated power (e.g., “operators”)**
- ▶ **Financial services – structured entities**
- ▶ **Holder of significant (but not majority) interests or options**

Power – Protective rights

- Protective rights do not give power
- When are rights merely protective rights?
 - Fundamental changes in the activities of an investee
 - Only apply in exceptional circumstances
- Examples of protective rights include the right to:
 - Restrict an investee from undertaking activities that could significantly change the credit risk of the investee
 - Approve an investee's capital expenditures (greater than the amount spent in the ordinary business)
- Protective rights do not prevent another investor from having control

Power – Protective rights Franchises

- A franchise agreement often gives the franchisor rights, which generally:
 - Are designed to protect the brand
 - Do not have a significant effect on franchisee's returns
- Assess whether rights give franchisor power:
 - Who benefits from activities of franchisee?
 - What are the relevant activities?
 - How was the franchisee established and structured?
 - How does the franchisor support the franchisee?
 - What is franchisor's exposure to variability of returns?

Power – De facto control

- An investor may have the power with less than half of the voting rights
- Consider facts and circumstances:
 - Contractual rights arising from other arrangements
 - Size of the investor's holding of voting rights relative to the size and dispersion of other vote holders
 - Voting rights (absolute amount)
 - Voting rights relative to other vote holders
 - Number of other vote holders that would need to act together
 - Potential voting rights
 - Additional facts & circumstances
 - Voting patterns at previous shareholders meetings

Power – De facto control

Practical issues

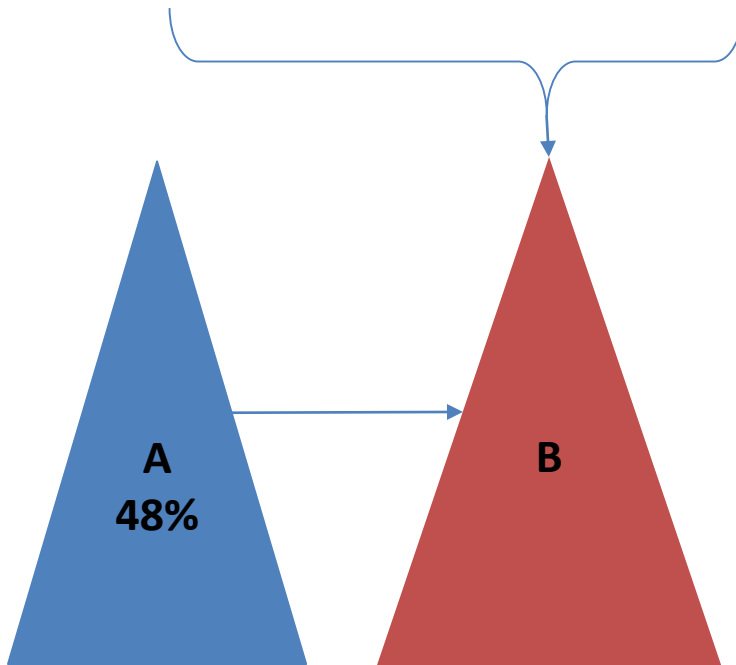
- How should the exact date at which control is obtained (or lost) be determined?
- How is the exact date at which the other investors became ‘widely dispersed’ determined?
- How large should an investor’s interest be relative to other vote-holders, or how widely dispersed must they be for the investor to have power?
- How relevant are past voting patterns? How far should you look back?
- How will you gather all information?
 - Past voting patterns
 - Relationships between other shareholders

Power – De facto control

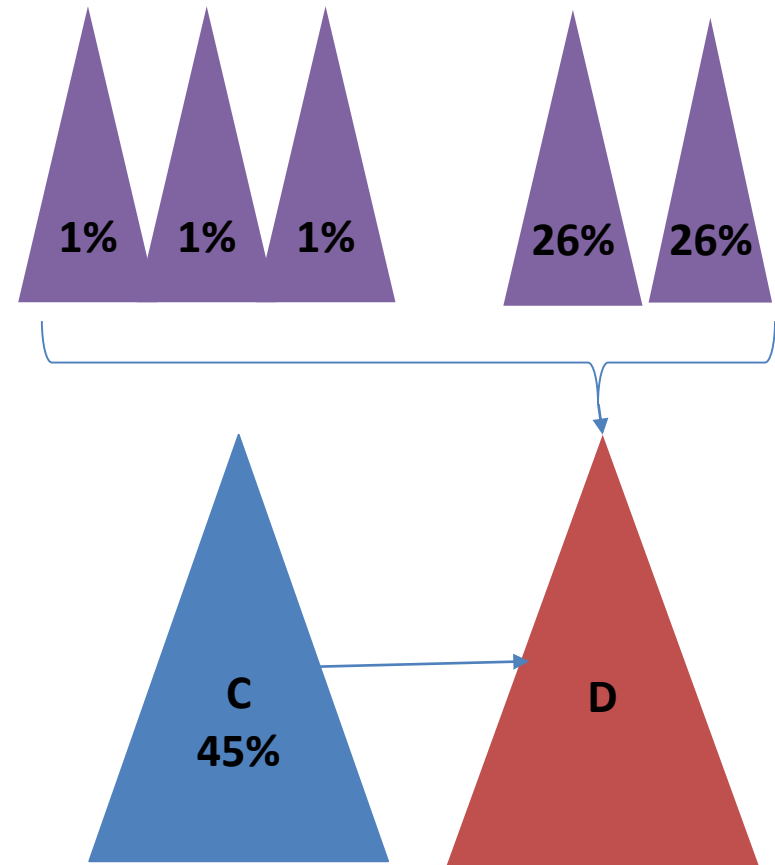
Examples 1 and 2

Example 1 –

52% widely dispersed



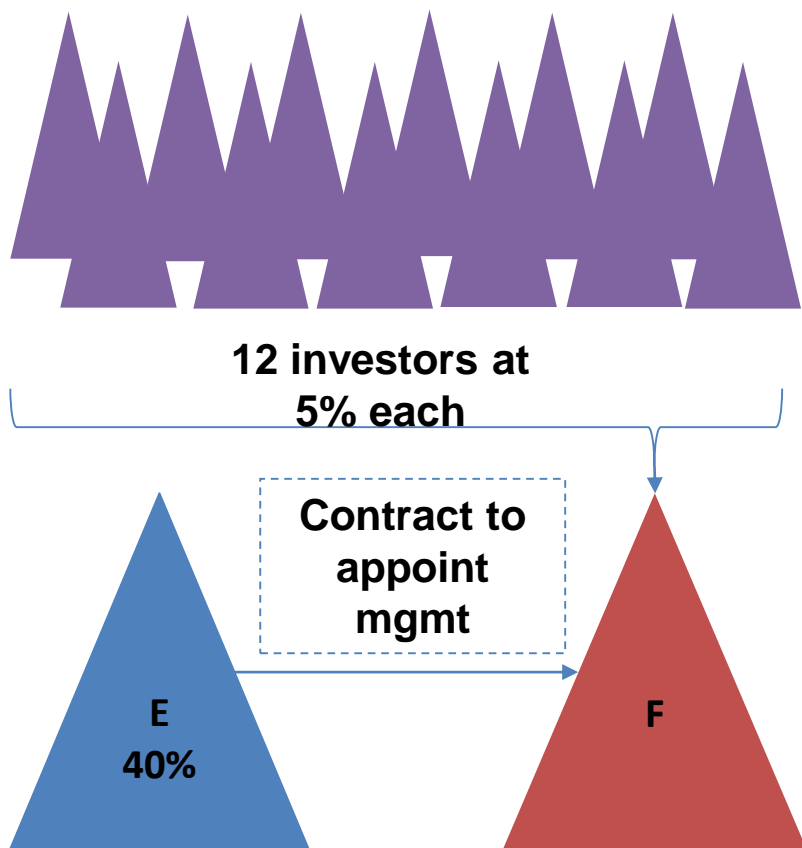
Example 2 –



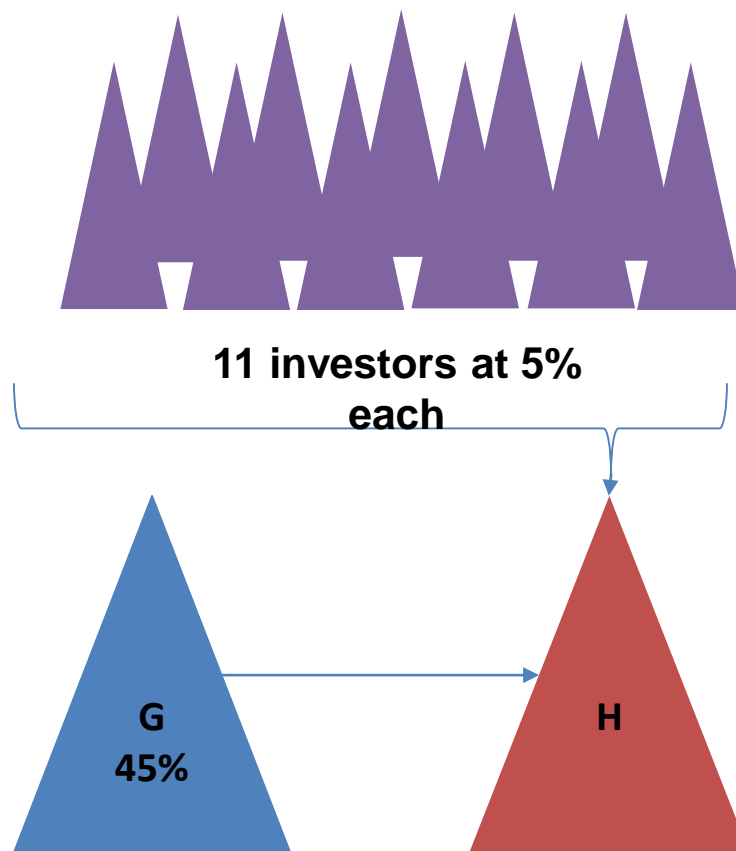
Power – De facto control

Examples 3 and 4

Example 3 –



Example 4 –



Power – Potential voting rights

- An investor may have the power through holding potential voting rights
- All facts and circumstances must be considered:
 - Substance of the rights
 - Exercisability
 - Barriers
 - Benefits
 - Purpose and design
 - Other involvement the investor has with the investee
 - Investor's apparent expectations, motives and reasons for agreeing the terms of the instrument

Power – Potential voting rights Example 1

- Investee's AGM is in eight months
- 30 days needed for shareholders to call meeting
- Investor holds option to acquire the majority of shares in the investee that is exercisable in 25 days and is deeply in the money
- Conclusion: Investor with options has power
 - Existing shareholders are unable to direct relevant activities because a special meeting cannot be held for 30 days, when option could have been exercised
 - Investor holding the option can direct relevant activities, even before the option is exercisable

Power – Potential voting rights Example 2

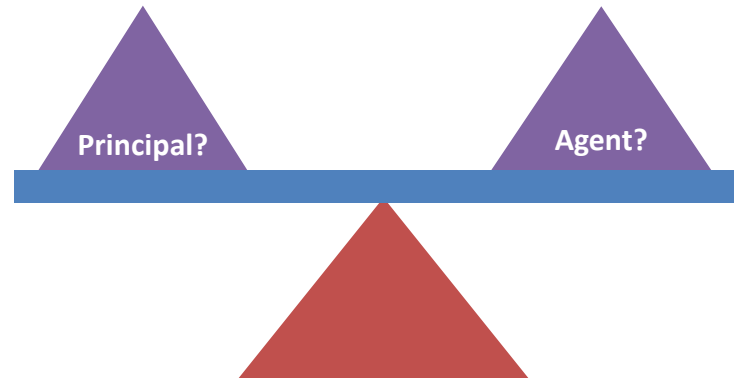
- Investor A holds 70% of the voting rights
- Investor B has:
 - 30% of the voting rights of the investee
 - Option to acquire half of investor A's voting rights
 - Exercisable for the next two years
 - Fixed price and deeply out of the money (expected to remain so)
- Investor A has power – it has been actively directing the relevant activities of the investee
- Investor B does not have power – the terms and conditions are such that the options are not considered substantive

Power – Potential voting rights Practical issues

- When is the exercise/conversion price considered a barrier?
 - Could financing be obtained?
- When are options “deeply out of the money”?
 - What period do you consider?
- When are options “currently exercisable”?
- Would the holder benefit from the exercise?
- How will you gather information?
 - Do other shareholders have potential voting rights, barriers, or incentives that you are unaware of?

Power – Delegated rights Overview

- An agent is a party engaged to act on behalf of another party or parties (the principal(s))
- A principal may delegate some or all decision-making authority to the agent
- An agent does not control an investee
- All facts and circumstances must be considered



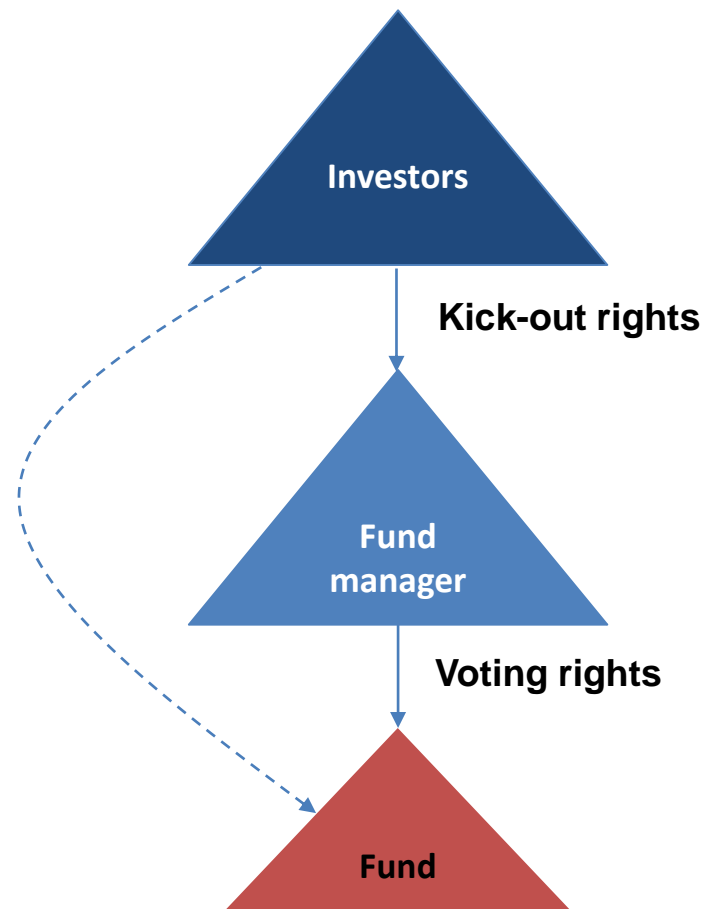
Power – Delegated rights Scope of decision-making

- Range of activities that are permitted by the decision-making agreement or by law
 - Whether relevant activities have been delegated
- Discretion that the decision-maker has when making decisions about those activities
- Level of involvement that the decision-maker had in determining the scope of its authority
 - Opportunity and incentive to gain power
- Purpose and design
 - Risks to which the investee was designed to be exposed
 - Risks investee was designed to pass on to investors



Power – Delegated rights Rights held by other parties

- Held by a single investor → decision-maker is an agent
- More parties that have to agree → more likely that decision-maker is a principal
- Removal rights held by an independent board who can remove decision-maker for any reasons → more likely decision-maker is an agent



Relationships with other parties

De facto agents

- Consider whether the investor has the ability to direct other parties (i.e., 'de facto agents') to act on its behalf?
Examples:
 - Related parties (IAS 24)
 - A party that cannot finance its operations without subordinated financial support from the investor
 - A party with same Board or key management personnel
- Rights and returns of *de facto* agents are considered together with investor's own, when evaluating control

Continuous assessment

- Reassess if facts and circumstances suggest change to one of criteria of control
- Examples:
 - Changes to how activities are directed
 - Changes in exposure to variable returns
- Market conditions change:
 - If affect one of control criteria – re-evaluate control
 - If do not affect one of control criteria – no re-evaluation



Investment Entities

Investment Entities - Exception

▶ A parent that is an investment entity to measure its investments in particular subsidiaries at fair value through profit or loss in accordance with LKAS 39 with limited exceptions.

Ex: private equity or venture capital funds; funds structures where an investment entity parent has controlling interests in investment entity subsidiaries;

What is an Investment entity?

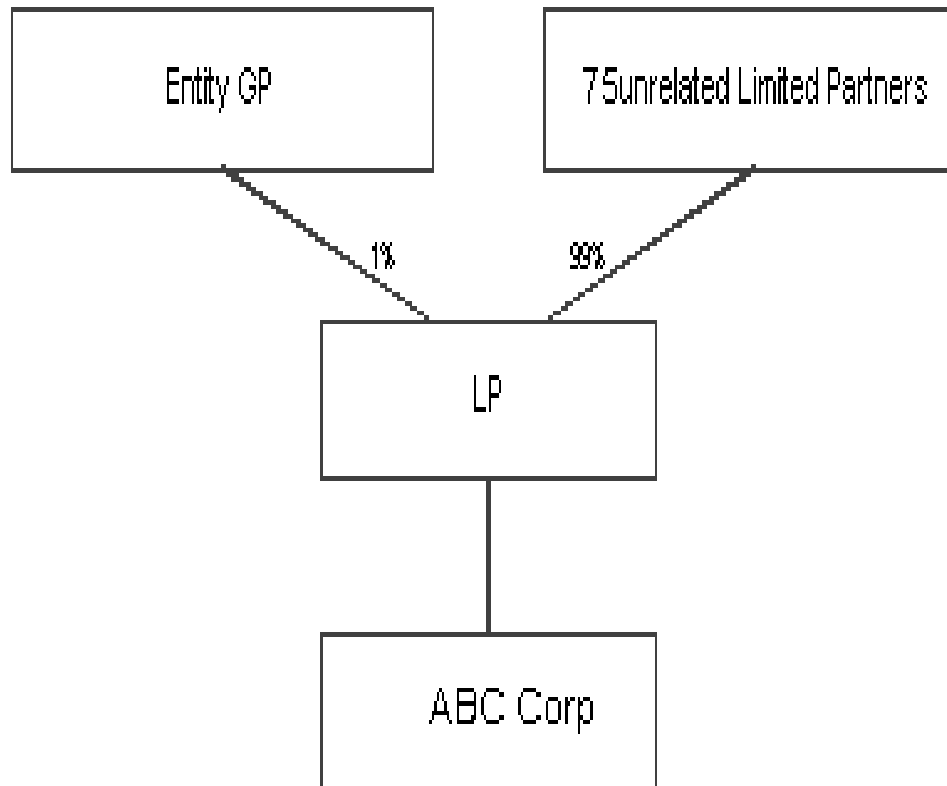
- An investment entity is an entity that:
 - (a) obtains funds from one or more investors for the purpose of providing those investors with investment management services;
 - (b) commits to its investors that its business purpose is to invest funds solely for returns from capital appreciation, investment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

Example

- An entity, Limited Partnership (LP) is formed in 2013 with a 10-year life. The offering memorandum states that LP'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 LP) provides 1% of the capital to LP and has responsibility of identifying suitable investments for the partnership. Approximately 75 limited partners, who are unrelated to Entity GP, provide 99% of the capital to the partnership.
- LP begins its investment activities in 2013 but no investments are identified until 2014 when LP acquires a controlling interest in ABC Corp.

Example - Cont

- The group structure at 31.12.2014 is illustrated as follows:



Example – Cont;

- In 2015, LP acquires equity interests in five additional operating companies.
- LP measures and evaluates its investments on a fair value basis and this information is provided to Entity GP and the external investors.
- LP plans to dispose of its interests in each of its investees during the 10 year stated life of the partnership.

Analysis

- ▶ LP has obtained funds from limited partners and is providing them with investment management services;
- ▶ ·LP's only activity is acquiring equity interests in operating companies with the purpose of realising capital appreciation over the life of the investments.
- ▶ LP has identified and documented exit strategies for its investments, all of which are equity investments; and
- ▶ ·LP measures and evaluates its investments on a fair value basis and reports this financial information to its investors

In addition, LP displays the following typical characteristics of an investment entity:

- ▶ ·LP is funded by many investors;
- ▶ ·its limited partners are unrelated to LP; and
- ▶ ·ownership in LP is represented by units of partnership interests acquired through a capital contribution.

Typical characteristics:

- ▶ it has more than one investment;
- ▶ it has more than one investor;
- ▶ it has investors that are not related parties of the entity; and
- ▶ it has ownership interests in the form of equity or similar interests.

Absence indicates that additional judgment is required in determining whether the entity is an investment.

Disclosure is required by SLFRS 12 of the reasons for the entity concluding that it is nonetheless, an investment entity.



Consolidation

Accounting Requirements - Consolidation

- Combine like items of assets, liabilities, equity, income, expenses and cash flows of the parent with those of its subsidiaries.
- offset (eliminate) the carrying amount of the parent's investment in each subsidiary and the parent's portion of equity of each subsidiary (SLFRS 3 explains how to account for any related goodwill).

Accounting Requirements - Consolidation

- 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.
- LKAS 12 *Income Taxes* applies to temporary differences that arise from the elimination of profits and losses resulting from intragroup transactions.

Uniform accounting policies

- ▶ 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.

Reporting date

- 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, additional financial information as of the same date as the financial statements of the parent, **unless it is impracticable to do so.**
- 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.
- **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.**

Acquiring Additional Shares after Control Obtained

- ◆ This is accounted for as an equity transaction between owners (like acquisition of 'treasury shares')
- ◆ No gain or loss is recognised
- ◆ Goodwill is not remeasured

Increase in Ownership after Control Obtained

◆ A increases its 70% investment in B to 85% for CU4,500

◆ Carrying amount of non-controlling interest CU7,500

◆ Accounting by A in consolidated accounts

Dr. Non-controlling interest <i>(15% / 30% x 7,500)</i>	3,750	
Dr. Equity	750	
Cr. Cash		4,500

- ◆ **Partial disposal of an investment in a subsidiary while control is retained is accounted for as an equity transaction with owners, and gain or loss is not recognised**
- ◆ **Partial disposal of an investment in a subsidiary that results in loss of control triggers re-measurement of the residual holding to fair value**
- ◆ **Any difference between fair value and carrying amount is a gain or loss on the disposal, recognised in profit or loss**
 - ◆ Thereafter apply LKAS 28 or LKAS 39/SLFRS 9, as appropriate, to the retained holding

Loss of Control

◆ Loss of control

- ◆ Must derecognise goodwill and other assets and liabilities of subsidiary where control lost
 - ◇ Gain or loss will be recognised in income statement on disposal
- ◆ Treat any interest retained as if sold and immediately reacquired at fair value
 - ◇ Gain or loss on re-measurement to fair value is part of overall gain or loss on disposal of subsidiary
 - ◇ Effectively loss of control involves exchanging a subsidiary for something new rather than retaining part of existing interest

THANK YOU