

*A practical guide
to IFRSs 10 and 12*
Questions and answers

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Introduction

IFRS 10 and IFRS 12 were issued in May 2011. Any new standard presents challenges and questions when preparers of financial statements start implementation. IFRS 10 retains the key principle of IAS 27 and SIC 12: all entities that are controlled by a parent are consolidated. However, some of the detailed guidance is new and may result in changes in the scope of consolidation for some parent companies. Early experience suggests that the new requirements will have the greatest

impact on consolidation decisions for structured entities (or ‘special purpose entities’) and for pooled funds managed by a third party. This publication sets out our views on some of the most common issues that arise during the implementation of the new standards. We trust you will find it helpful. For further guidance on IFRS 10, please see our [‘Practical guide to IFRS: Consolidated financial statements – redefining control’](#) and [the supplement for the asset management industry](#) (both on pwc.com/ifrs and pwcinform.com).

Section A – Power

Part I: Relevant activities

Question A1 – Assessing power when different investors control activities in different periods

An investor has power over an investee when the investor has existing rights that give it the current ability to direct the relevant activities of the investee (IFRS 10.10). Can an investor have power currently if its decision-making rights relate to an activity that will only occur at a future date?

X and Y set up a new company to construct and operate a toll road. X is responsible for the construction of the toll road, which is expected to take two years. Thereafter, Y has authority on all matters related to toll road operation. Is it possible for Y to have power over the company during the construction phase although X is responsible for construction and has authority to make decisions that need to be made currently?

Solution

Y may have power currently even though it cannot yet exercise its decision-making rights. The investor that has the ability to direct the activities that most significantly affect the returns of the investee has power over the investee (IFRS 10.B13). The criteria in IFRS 10.B13 example 1 should be applied, which include consideration of:

- the purpose and design of the investee;
- the factors that determine profit margin, revenue and value of the investee. For example, the construction of the road may be under the supervision of the national roads authority. X is contracted to build the road under government supervision and, subject to audit, will recover its costs plus a specified percentage of margin. That margin will be returned through adjustment of the amount of tolls that will flow to X, so that X has first call on the

cash flows generated by tolls. Y will manage the toll road operations, including maintenance, and will have to be able to claim a management fee equivalent to any residual cash in the entity after all operating expenses have been paid, including payments to X. Y has the ability to set tolls. Alternatively, the arrangement could set out that the government regulates the tolls that can be charged with little variation in expected revenue but gives the investee more discretion over how the toll road is constructed, with X and Y sharing equally in the net cash flows of the investee;

- the effect on the investee's returns resulting from each investor's decision-making authority with respect to the factors in b); and
- investors' exposure to variability of returns.

Question A2 – Re-assessment of power

When should an investor reassess control?

Assume the same fact pattern as in question A1, except that:

- two years have passed and the toll road has been fully constructed; and
- Y has entered bankruptcy, and X has assumed management of the toll road operations and is in discussions with the national roads authority to continue managing those operations.

Should X reassess whether it has control of the investee in this situation?

Solution

Yes, X should make this reassessment because there has been a change that affects the power criterion (IFRS 10.B80).

Question A3 – Can decisions made when an entity is formed be considered as relevant activities?

A structured entity (SE) was set up by a sponsoring bank to invest in bonds. The most important activity that affects the

returns of the SE is the bond selection process. The bonds were selected upon set-up of SE by the sponsoring bank, and the incorporation documents state that no further bonds may be purchased. No further bond selection decisions are therefore required after the SE is set up.

Does the sponsoring bank have power over the SE solely by virtue of its power to select the bonds in which the SE invests?

Solution

Asset selection, on its own, is unlikely to give the sponsoring bank power in this scenario. The bonds cannot be replaced, so the power to select bonds (the relevant activity) ceased when the SE was established. However, the sponsoring bank's active involvement in the design of the SE indicates that the bank had the opportunity to give itself power. All of the contractual arrangements related to the SE and other relevant facts and circumstances should be carefully assessed to determine if the bank has power over the SE (IFRS 10.B51). Power might arise from rights that are contingent on future events (see Question A7).

Part II: Potential voting rights

Question A4 – Can an option provide power when the option holder does not have the operational ability to exercise?

Investors X and Y own 30% and 70% respectively of a manufacturing company ('Investee'). Investee is controlled by voting rights, manufactures a specific product for which the patent is owned by Y, and is currently managed by Y. X has an out-of-the-money call option over the shares held by Y. The patent used by Investee will revert to Y if the call option is exercised, unless there is a change in control of Y, Y breaches the terms of the contract between the parties or Y enters bankruptcy. Investee cannot manufacture the product without Y's patent, which is not replaceable. Neither party expects the call option to be exercised. The purpose of the call option is to allow X to take control of Investee in exceptional

situations. Does the option provide X with power over Investee?

Solution

The option held by X is unlikely to be regarded as substantive. There are substantial operational barriers to the exercise of the call option by X. Further, X will not obtain benefits from the exercise of the call option absent the occurrence of one or more of the events described above. The design of the call option suggests that the call option is not intended to be exercised (IFRS 10.B48). The option is therefore unlikely to confer power upon X.

Question A5 – Can an option provide power when the option holder does not have the financial ability to exercise the option?

Investors X and Y own 30% and 70% respectively of a company ('Investee') that is controlled by voting rights. X has a currently-exercisable, in-the-money call option over the shares held by Y. However, X is in financial distress and does not have the financial ability to exercise the option. Investee is profitable. Does the option provide X with power over Investee?

Solution

A currently exercisable in-the-money option is likely to convey power. X may not be able to exercise the option itself without seeking finance from a third party or might exercise the option and immediately re-sell its interest in Y. If X could sell the option itself or otherwise obtain economic benefits from the exercise, the option will provide power of the Investee. An option that was out-of-the-money might mean there are significant barriers that would prevent the holder from exercising it [IFRS 10.B23(c)]. An option is therefore generally not substantive if it is not possible for the option holder to benefit from exercising it.

The purpose and design of such an option also needs to be considered (IFRS 10.B48).

Question A6 – Can an option provide power if it is out of the money?

Investors X and Y hold 30% and 70% respectively of a company ('Investee') that is controlled by voting rights. X has a currently-exercisable, out-of-the-money call option over the shares held by Y. Can the option provide X with power over the Investee?

Solution

Yes, such an option can provide X with power if it is determined to be substantive. This will require judgement based on all of the facts and circumstances. The relevant considerations are set out below.

X must benefit from the exercise of the option in order for it to be substantive (IFRS 10.B23(c)). The option is out of the money, which might indicate that the potential voting rights are not substantive (IFRS 10 para B23(a)(ii)). However, X may benefit from exercising the option even though it is out of the money. X might achieve other benefits – such as synergies from exercising the call option – and might, overall, benefit from exercising the option. The option is likely to be substantive in those circumstances (IFRS 10.B23c).

Part III: Structured entities

A structured entity is one that has been designed so that voting or similar rights are not the dominant factor in deciding who controls it (IFRS 12 Appendix A). For such entities, the criteria in IFRS 10.B51 to B54 should be applied in order to determine which investor, if any, has power.

Many structured entities may run on 'auto-pilot' such that no ongoing decisions need to be made after the structured entity has been set up. The assessment of power may be challenging for such entities, as there appear to be no significant decisions over which power is required.

IFRS 10.10 requires an investor to have the current ability to direct the relevant activities of the investee in order to have

control. If there are truly no decisions to be made after an entity has been set up, none of the investors have such a 'current ability to direct' and so no one would consolidate the investee. However, this assessment must be made carefully after considering all relevant factors including those set out below. In our view, such entities are expected to be rare.

The purpose and design of the structured entity should be considered when assessing control. Involvement in the purpose and design of a structured entity does not of itself convey power; it may indicate who is likely to have power (IFRS 10.B17 and B51).

If decisions that significantly affect returns are required only if some trigger event happens (for example, default of receivables or downgrade of collateral held by the structured entity), these should be looked to in determining who has power, no matter how remote the triggering event is. These decisions should be considered in light of the purpose and design of the entity and the risks that it was intended to pass on. For example, decisions regarding the management of defaulting bonds are more likely to be relevant activities when the structured entity was set up to expose investors to the bonds' credit risk, no matter how remote default might be at inception of the vehicle.

The possibility that non-contractual power may exist should also be considered. It will be important to assess how any decisions over any relevant activities are actually made in practice (IFRS 10.B18).

If the investee has some form of 'special relationship' with the investor, the existence of such a relationship could also suggest that the investor may have power (IFRS 10.B19).

Contractual arrangements such as call rights, put rights and liquidation rights established at the investee's inception should also be assessed. When these contractual arrangements involve activities that are closely related to the investee, these activities should be considered as relevant activities of the

investee when determining power over the investee (IFRS 10.B52). If an investor has an explicit or implicit commitment to ensure that an investee continues to operate as designed, this may also indicate it has power over relevant activities. Such a commitment may increase the investor's exposure to variability of returns and thus give it an incentive to obtain rights sufficient to give it power (IFRS 10.B54).

Finally, if an investor has disproportionately large exposure to variability of returns, it has an incentive to obtain power to protect its exposure; the facts and circumstances should therefore be closely examined to determine if it has power (IFRS 10.B20).

Question A7 – Contingent power

Can an investor have power if it can make decisions only upon a contingent event but cannot make any decisions currently?

Solution

An investor may have power in this situation. When an investor can direct an activity that will only occur in the future upon the occurrence of an event, that power should be considered even before the occurrence of that event (IFRS 10.B13; IFRS 10 example 1). Contingent power is a key consideration in assessing who controls those structured entities where no decisions may be required or permitted unless the contingent event occurs (IFRS 10.B53). Contingent power is not necessarily protective only (IFRS 10.B26).

Question A8 – Can reputational risk give control?

A bank sets up a structured entity (SE) to acquire and hold pre-specified financial assets that the entity purchases from traded markets, and to issue asset-backed securities to investors. The bank has no further interest in, or decision-making rights over, the SE once it is set up. However, the bank's reputation will suffer if the SE fails. The bank will, in such circumstances, consider providing financial support to the SE, even though it has no obligation to do so, in order to protect its own reputation. How does reputational risk impact the conclusion on control?

Solution

Reputational exposure may create an implicit commitment for the bank to ensure that the SE operates as designed; however, this alone does not provide conclusive evidence that the bank has power (IFRS 10.B54). The bank was also involved in the design and set-up of the SE; however, this consideration, again, does not provide conclusive evidence of power (IFRS 10.B51). If no other indicators of power exist, the bank is unlikely to control the SE. Reputational exposure on its own is generally not an appropriate basis for consolidation (IFRS 10.BC37).

However, all of the facts and circumstances should be carefully examined to establish whether the bank has control. Reputational exposure on its own is not sufficient to convey control, but it may increase the investor's exposure to variability of returns and so give it an incentive to obtain rights sufficient to give it power (IFRS 10.BC39).

Section B – Exposure to variability

An investor must have exposure to an investee's variable returns before the investor can meet the control criterion and consolidate the investee (IFRS 10.7). 'Variable returns' is a broad concept under IFRS 10; the standard sets out examples ranging from dividends to economies of scale, cost savings, tax benefits, access to future liquidity and access to proprietary knowledge (IFRS 10.B56 to B57). Even fixed interest and fixed performance fees are considered 'variable' returns, as they expose the investor to the credit risk of the investee because the amount recoverable is dependent on the investee's performance.

To meet the criterion in IFRS 10.7(b), the investor's involvement in the investee needs to be one that absorbs variability from the investee rather than contributes variability to it (IFRS 10.BC66 and 67). For example, a party that borrows money from an investee at a plain vanilla interest rate contributes variability from its own credit risk to the investee; it is therefore not exposed to variable returns from the investee in the absence of other interests in it. Conversely, an ordinary shareholder in an investee absorbs fluctuations in the residual returns of the investee; the shareholder is therefore exposed to variable returns (absorbs variability).

Question B1 – What types of instrument absorb variability from an investee, and which instruments create variability in an investee?

Solution

Whether an instrument creates or absorbs variability may not always be that clear. We would generally expect the instruments in list I below to absorb variability of an investee and those in list II to create variability.

I. Instruments that in general absorb variability of an investee and therefore, if the holder's degree of exposure to variable returns is great enough and the other tests in IFRS 10 are met, could

cause the holder of such instruments to consolidate the investee:

- equity instruments issued by the investee;
- debt instruments issued by the investee (irrespective of whether they have a fixed or variable interest rate);
- beneficial interests in the investee;
- guarantees of the liabilities of the investee given by the holder (protects the investors from suffering losses);
- liquidity commitments provided to the investee; and
- guarantees of the value of the investee's assets.

II. Instruments that generally contribute variability to an investee and therefore do not, in themselves, give the holder variable returns and cause the holder of such instruments to consolidate the investee:

- amounts owed to an investee;
- forward contracts entered into by the investee to buy or sell assets that are not owned by it;
- a call option held by the investee to purchase assets at a specified price; and
- a put option written by the investee (transfers risk of loss to the investee).

Question B2 – Does a contract with an entity create or absorb variability?

A structured entity (SE) holds C2m of high-quality government bonds. The SE enters into a contract whereby – in return for an upfront premium from the contract counterparty 'A' – the SE agrees to pay A C2m if there is default on a specified debt instrument issued by an unrelated company (Z). The SE has no other assets or liabilities, and is financed by equity investments from investors.

SE was set up for the purpose of entering into the contract with A to protect A against Z's default on a specified debt instrument and to expose SE's investors to the credit risk of Z.

A is potentially exposed to the credit risk of SE if Z defaults on a specified debt instrument. Does this mean that A has exposure to variable returns of SE through its purchased credit default swap (IFRS 10.7b)?

Solution

Yes, A does have exposure to variable returns of SE through its potential exposure to SE's credit risk. However, this credit exposure is likely to be small relative to the credit risk of Z, given the quality of the government bonds. Additionally, the SE is financed by equity investors and has no other liabilities, which reduces the credit risk to which A is potentially exposed. The contract is likely to have contributed more variability into the SE than it absorbs and is unlikely, on its own, to cause A to consolidate the SE.

Further, the purpose and design of SE is to transfer Z's credit risk to SE, not to transfer the SE's exposure to government bonds to A. Such a purpose and design supports a conclusion that the contract with A was designed primarily to transfer risk into the SE.

It is therefore unlikely the contract would cause A to consolidate the SE.

Question B3 – What assets should an investor look to in assessing control?

The assets recorded by an entity for accounting purposes do not always correspond to assets that are legally owned by the entity. The assessment of control could differ depending on whether the accounting or legal assets are considered. Should an entity focus on accounting or legal assets or on something else?

A Seller transfers legal title to receivables with a principal amount of C100 to a structured entity ('Buyer SE'). In return, Buyer SE pays C93 cash and agrees that if it collects more than C93 of principal on the underlying receivables, it will pay the excess to the Seller. The Seller therefore remains exposed to the risk that the underlying receivables may not be collected in full, up to an amount of C7. It has been assessed that

the exposure created by this deferred consideration of C7 causes the Seller to retain substantially all of the risks and rewards of those receivables under IAS 39. The Seller cannot therefore derecognise those receivables under IAS 39; and the Buyer SE, correspondingly, cannot recognise those receivables (IAS 39.AG50). Instead, the Buyer SE records a receivable from the Seller.

From a legal perspective, the Buyer SE owns 100% of the underlying receivables, of which the Seller is exposed to C7. From an accounting perspective, the Buyer SE has a receivable due from the Seller – that is, the Seller is a debtor of the Buyer SE, and the Seller is not therefore exposed to the variability of the Buyer SE.

Does the Seller have exposure to variability of Buyer SE for purposes of assessing control under IFRS 10?

Solution

Yes, the Seller has exposure to variability of Buyer SE.

IFRS 10 requires a consideration of the purpose and design of an entity (IFRS 10.B5), which includes 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 (IFRS 10.B8).

It is therefore necessary to look at the underlying risks to which the Buyer SE is exposed and the risks that the Buyer SE passes on to investors. This assessment of risks should be based on an assessment of the economic risks of the Buyer SE.

Economically, the Buyer SE is exposed to all the risks of the receivables, but some of those risks are passed on to the Seller via the deferred consideration mechanism. The Seller is therefore exposed to variability of the Buyer SE. The Seller is also potentially exposed to the credit risk of the Buyer SE (for example, if the Buyer SE collects all the monies from the underlying receivables but is unable to pay out the last C7 to the Seller due to unforeseen circumstances).

Section C – Principal-agent analysis

Certain decision-makers may be obligated to exercise their decision powers on behalf of other parties and do not exercise their decision powers for their own benefit. IFRS 10 regards such decision-makers as ‘agents’ that are engaged to act on behalf of another party (the ‘principal’). A principal may delegate some of its power over the investee to the agent, but the agent does not control the investee when it exercises that power on behalf of the principal (IFRS 10 para B58). Power normally resides with the principal rather than the agent (IFRS 10 para B59). There may be multiple principals, in which case each of the principals should assess whether it has power over the investee (IFRS 10.B59). An agent does not control and so will not consolidate the investee.

The overall relationship between the decision-maker and other parties involved with the investee must be assessed to determine whether the decision-maker acts as an agent. The standard sets out a number of specific factors to consider:

- The decision-maker is an agent if a single party can remove them without cause (IFRS 10.B65).
- The decision-maker cannot be an agent if remuneration is at other than normal market terms (IFRS 10.B69-B70).
- The scope of the decision-maker’s authority over investee may be wide and indicate that the decision-maker may have power; or narrow, pointing to the converse (IFRS 10.B62-63).
- Substantive rights held by other parties may indicate that the decision-maker is an agent (IFRS 10.B64-67).
- The magnitude and variability of the decision-maker’s remuneration may indicate that he is acting on his own behalf rather than on behalf of others (IFRS 10.B68).

Similarly, the magnitude and variability of the decision-maker’s exposure to returns from other interests in the investee may indicate that he is acting on

his own behalf rather than on behalf of others (IFRS 10.B71-72).

Question C1 – Determination of the principal

IFRS 10.B59 states “...*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...*”.

A decision-maker (a fund manager) is determined to be an agent in relation to the fund it manages, in which there are multiple investors. What considerations should be looked to in determining which (if any) of the investors should consolidate the fund?

Investors A, B and C invest in 15%, 30%, and 55% respectively of a fund that is managed by an external fund manager. The fund manager has wide powers to make investment decisions, and the investors cannot direct or veto these decisions. The fund manager can be removed only by a unanimous vote from all three investors and has been assessed to be an agent under IFRS 10.

Should investors A, B or C attribute the fund manager’s decision powers to themselves when they each consider whether they have power over the fund?

Solution

An agent does not control an investee (IFRS 10.B58). The manager does not therefore control the fund. Rather it is primarily acting on behalf of the other investors (the principals).

However, although an agent “*is a party primarily engaged to act on behalf of and for the benefit of another party or parties (the principal(s))*”, this does not necessarily mean that any one of the principals controls the entity.

Where there are multiple principals, each principal should assess whether it has

power over the investee by considering all the factors in the consolidation framework (IFRS 10.B59) – that is, power, exposure to variable returns and the ability to use power to affect returns.

For example, if a fund has many widely-dispersed investors all of whom have a small holding, and the investors do not have substantive rights to remove the fund manager or to liquidate the fund nor to direct the decisions made by the fund manager, then none of the investors would have control.

Conversely, if a single investor has a large holding in the fund and the other investors are dispersed and the investor has the practical ability to remove the fund manager or direct the decisions it makes, then it is likely that the investor has power and controls the fund.

Therefore, with regards to the example fact pattern, the investors should not attribute the fund manager's decision powers to themselves. The fund manager is an agent for all three investors. As the agent acts for multiple principals, each of the principals must assess whether it has power (IFRS 10.B59). None of the investors has the unilateral power to direct or remove the fund manager. Therefore, none of them on their own have the ability to direct the relevant activities of the fund (IFRS 10.B9).

Question C2 – Is an annual re-appointment requirement considered to be a substantive right?

Substantive removal rights held by other parties may indicate that the decision-maker is an agent. Is a requirement to re-appoint the decision-maker on an annual basis an example of a substantive removal right?

Fund X is managed by a fund manager, which is required to be appointed by the board of Fund X on an annual basis. All of the members of the board are independent of the fund manager and appointed by other investors. The fund management service can be performed by other fund managers in the industry. Effectively, the annual appointment requirement provides the board with a

mechanism to replace the fund manager if necessary. Is the annual appointment requirement a substantive removal right?

Solution

Yes, this is likely to be a substantive removal right (IFRS 10 example 14C). The fund manager should consider the removal right along with other relevant factors, including its fees and other exposure to variable returns, in order to determine whether it is an agent.

Question C3 – Is a removal right with a one-year notice period requirement a substantive removal right?

Fund X is managed by a fund manager, which can be removed by the board of Fund X with a one-year notice period. All of the members of the board are independent of the fund manager and appointed by the investors of Fund X; the majority are independent of the fund manager. The fund management service can be performed by other fund managers in the industry. Is the removal right substantive given that a one-year notice period is required?

Solution

In our view, a positive appointment of an asset manager for a limited period (see Question C2) is different from an indefinite contract with a removal right exercisable with a notice period. The reappointment right creates a mechanism by which the asset manager's performance is positively considered. A removal right is only exercised from the point that the service is unsatisfactory. It may be assumed that where an asset manager is appointed for one year, its services will not be unsatisfactory on the first day of appointment. Our view is that a one-year re-appointment right is more likely to be substantive than a one-year notice period because the long notice period may provide a barrier to its exercise.

The guidance on substantive rights is relevant when considering notice periods. Questions that an asset manager should ask in assessing the impact of notice

periods on the principal-agent determination include:

- How long is the notice period?
- Is there only a short window during which notice can be given?
- Will the decisions taken within the notice period significantly affect the returns of the fund?

Question C4 – Is an intermediate holding company an agent of its parent?

Holdco, a wholly-owned subsidiary of Parent, owns 100% of Opco, an operating company. The only business purpose of Holdco is to hold investments in Opco. Holdco issues listed debt and is required by local law to prepare consolidated financial statements where required by IFRS.

Is Holdco an agent or de facto agent of Parent (and therefore does not control Opco) if:

- Parent and Holdco have the same managing directors;
- Holdco's managing directors are Parent's employees; or
- Holdco is managed by a trust office that is contractually bound to act fully in accordance with Parent's decisions?

Solution

No. A decision-maker is an agent/de facto agent only when it has been delegated those decision-making powers by another party. IFRS 10.B59 states: *“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.”*

Holdco controls Opco directly in all three scenarios, as it holds the shares in Opco, and Holdco's management can dictate Opco's policies through the voting power given by Opco's shares. Regardless of the degree of Parent's representation or

control of Holdco's governing body, the direct investment in Opco and power over Opco are both held by the corporate entity Holdco. Any party that governs Holdco accesses that power by becoming a representative of Holdco. Similarly, any party that owns Holdco accesses the returns of Opco through Holdco.

As power over Opco belongs, in the first place, to Holdco rather than Parent, Parent has not delegated any power to Holdco; Holdco is not therefore an agent of Parent. As Holdco is also exposed to variability of Opco's returns, Holdco should consolidate Opco.

Question C5 – Employees as de facto agents

Employees of the reporting entity may take on management roles in an investee. Are employees in key management personnel (KMP) roles considered the de facto agents of a reporting entity, in relation to the reporting entity's investees?

Entity X manages and has full decision-making authority over a fund. X grants performance-based awards to its KMP whereby they receive shares in the managed funds if certain conditions are met. X also requires that part of the KMP's cash bonuses is invested directly in the funds. The KMP may also invest their own funds. X does not hold any direct interest in the fund.

As X does not have any direct interest in the fund (other than a management fee), this might suggest that X does not have significant exposure to variable returns. However, the KMP may in substance be holding their shares on behalf of X. The right of the KMP to invest in the funds may be a form of compensation and so provide indirect benefits to X. This will impact both the exposure to variable returns criterion (IFRS 10.7b) and the principal-agent analysis (IFRS 10.7c, IFRS 10.B74) of control.

Do KMP act as de facto agents of X?

Solution

Judgement is required to assess whether:

- (a) the KMP might use their investments on behalf of X; or
- (b) the investments are the personal assets of the KMP, over which the reporting entity has no power.

This judgement should be made based on facts and circumstances, for example,

- the position of the KMP within the company;
- the reason KMP are holding those investments;
- whether those shares have vested (and whether the KMP could resign and retain their investments);
- whether the shares were granted by X or purchased using KMP's own resources;
- any restrictions on transfers of those shares by KMP without X's approval; and
- how KMP vote on those investments in practice.

If the KMP are de facto agents, their shareholdings will be attributed to X when deciding whether X should consolidate the fund.

Question C6 – If a decision-maker is remunerated at market rate, does this mean that it is an agent?

A fund manager ('FM') is given wide investment powers over an equity fund that it manages. The fund manager receives an annual fee of 2% of the net asset value of the fund, which is consistent with the fee structure of similar funds.

Can the fund manager conclude that it is an agent for fund investors and therefore does not control the fund, by virtue of the fact that it only receives market remuneration?

Solution

No, the fund manager cannot conclude that it is an agent on this basis alone.

The other factors in IFRS 10 must also be considered. For example, if the fund manager has a direct investment in the fund, that should be considered (IFRS 10. B71-72). The fund manager also needs to consider the magnitude and potential variability of its remuneration relative to the returns of the investee (IFRS 10. B68, B72). An asset manager may choose to reduce its fee for relationship purposes if the returns of the fund are very low. This would preserve a return for the other investors and effectively increase the variability of the fund manager's return. IFRS 10 examples 13 to 16 provide guidance on how to assess such exposure.

A fund manager is a principal if it accepts a fee structure that is not commensurate with the services provided and does not include 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 (IFRS 10 B69). However, the converse is not true – that is, the fact that remuneration is market-based is not sufficient to conclude that the fund manager is an agent (IFRS 10. B70). However, a manager with no direct interest in a fund that receives a market-based fee is likely to be an agent.

Section D – Silos

IFRS 10.B76 discusses situations where part of an entity should be considered to be a ‘deemed separate entity’ (or ‘silo’) for purposes of consolidation. Where part of an entity constitutes a silo, control over the silo should be assessed separately from the rest of the entity (IFRS 10.B78/B79).

IFRS 10.B77 specifies the criteria for a part of an entity to be considered a silo. IFRS 10.B77 states: “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.’”

The above paragraph requires a consideration of whether a ring-fence exists around the assets and liabilities of the silo. In practice, such ring-fences may not be absolute and may be subject to breach upon occurrences of contingent events. The question arises whether such breaches will fail the definition of a silo.

Where the breaches could occur only in improbable scenarios that have no commercial substance, the words ‘in substance’ in IFRS 10.B77, in our view, indicate that substance should be emphasised over form, and there will nevertheless be a silo under IFRS 10

However, the words ‘if and only if’ and ‘only source of payment’ in IFRS 10.B77,

also suggest a very high hurdle for regarding a breach as having no commercial substance. In our view, an event with a low likelihood may have commercial substance if it is introduced for a genuine purpose. This would be indicated, inter alia, if the presence of that clause was a factor that investors considered in making investment decisions.

The question as to whether silos exist in such situations will require judgement based on facts and circumstances.

Question D1 – Is an unprotected insurance company cell a silo?

An insurance company C has established a separate ‘cell’ within itself to hold assets and insurance liabilities that are ring-fenced from the other assets and liabilities of C in the normal course of operations. The cell is not a separate legal entity but exists within the legal form of X.

An external investor E, which has no interest in the remainder of C, is exposed to all the residual returns of the cell. The purpose of setting up the cell is to transfer the insurance risk associated with the insurance liabilities to E.

Although the cell is ring-fenced from the rest of C in the normal course of operations, the ring-fence will be broken when the insurance losses of the cell exceed the assets of the cell and E is unable to fund those additional losses. In that case, C will have to inject assets to cover the insurance liabilities that E is unable to fund. Such losses are considered to be possible but remote.

Does the cell constitute a silo under IFRS 10.B77?

Solution

No, the cell does not constitute a silo. Although the ring-fence only breaks down upon remote insurance losses, this is a contingent event that is part of the risk that the structure has been set up to protect against. The occurrence of such a

scenario cannot therefore be regarded as non-substantive; the break-down of the ring-fence in such a scenario will preclude the cell from being regarded as a silo.

Question D2 – Are sub-funds of an umbrella fund silos?

An umbrella fund (UF) sets up two sub-funds (SF1 and SF2). All three funds exist within the same legal entity, but the assets of each fund are protected from claims from the other funds in the normal course of business. However, this protection is broken if either SF1 or SF2 defaults on its liabilities to parties other than the investors in the fund (for example, tax liabilities or liabilities for regulatory levies). When a default of that nature occurs, the relevant creditors can seek to recover payments from all of the remaining assets of the legal entity. These default events are considered to be possible but remote.

Do UF, SF1 and SF2 constitute silos under IFRS 10.B77?

Solution

The sub-funds are unlikely to be silos in this fact pattern. The possibility of default is remote, but the contingency appears to be substantive, as it gives greater security to certain creditors.

Question D3 – Is an individual pool in a multi-seller conduit a silo?

A multi-seller conduit (MSC) is set up by a sponsor S to purchase 'pools' of debt assets from third-party asset sellers. These assets include mortgages, credit card receivables, car loans, trade receivables, securities, etc. External investors invest separately in commercial

paper issued separately by these pools of assets. The commercial paper issued by each pool is less than the amount of assets in the relevant pool – that is, there is over-collateralisation within each pool that provides credit enhancement to the investors in the commercial paper issued by that pool.

In addition, the MSC benefits from a programme-wide credit enhancement in the form of a guarantee from S, up to a maximum amount that approximates 10% of the MSC's total assets. This credit enhancement can be used to make up for defaults on the debt assets in excess of the over-collateralisation in the relevant pool that would otherwise have the effect that the commercial paper issued by any pool of assets could not be paid. Such defaults are deemed to be possible but unlikely.

The assets and liabilities within each pool are segregated from other pools in the normal course of operations, except for the above programme-wide credit enhancement.

Does each pool constitute a silo?

Solution

No, the pools are not silos. The liability ring-fence breaks down in the event of defaults in excess of the over-collateralisation in the relevant pool. Although such defaults are considered unlikely to occur, they are the primary risk against which the programme-wide credit enhancement is meant to protect; they are therefore substantive contingencies. A breakdown of the ring-fence upon the occurrence of such contingencies will therefore cause the pools to fail the definition of a silo.

Section E – Disclosure

IFRS 12's objective is to require entities to disclose information that helps readers of financial statements to evaluate the nature of, risks and financial effects associated with the entity's interests in subsidiaries, associates, joint arrangements and unconsolidated structured entities. To meet this objective, an entity should disclose the following:

- significant judgements and assumptions it has made in determining the nature of its interest in another entity or arrangement; and
- information about its interests in subsidiaries and unconsolidated structured entities.

An investor's interest in a structured entity "*refers to contractual and non contractual involvement that exposes an entity to variability of returns from the performance of the other entity*". [IFRS 12 App A].

An interest in a structured entity can include any of the following:

- a debt instrument;
- an equity instrument;
- a contractual arrangement;
- a participation right;
- a residual interest;
- a lease;
- the provision of funding;
- liquidity support;
- credit enhancement; and
- a guarantee.

However, a typical customer supplier relationship is not considered to be an interest in a structured entity.

Question E1 – Does an interest purchased for trading purposes require disclosure under IFRS 12?

A trading company (TC) regularly buys and sells securities to earn trading profits. At the reporting date, TC holds a small amount (<1%) of a structured entity (SE) that it had acquired shortly before the reporting date and that was sold shortly after the reporting date. Is TC required to make the disclosures relating to interests in unconsolidated SEs (IFRS 12.24 to 31) for the units it holds in F?

Solution

Yes, the disclosures are required if the interest held in SE is material to TC. TC would consider all relevant factors in assessing materiality. The general requirement in IFRS 12.24 is to disclose information that enables the users of its financial statements:

- (a) to understand the nature and extent of its interests in unconsolidated structured entities; and
- (b) to evaluate the nature of, and changes in, the risks associated with its interests in unconsolidated SEs. Such factors include: the size of the investment in the SE; how long it is held for; whether it is a senior or junior interest and the degree of risk associated with it; and the purpose for holding it.

Some of the IFRS 12 disclosure requirements overlap with existing IFRS 7 disclosures and need not be repeated.

Section F – Transition provisions

Question F1 – What is the ‘date of initial application’?

The IFRS 10 transition requirements make various references to the ‘date of initial application’. What date is meant by the ‘date of initial application’?

Solution

The date of initial application is the beginning of the annual reporting period in which IFRS is applied for the first time – that is, 1 January 2013 for entities with a calendar year end that adopt IFRSs 10 and 12 for annual periods beginning on or after 1 January 2013.

Question F2 – Application of previous standards

Parent P acquired 49% of Company X in 2005. It was determined that P did not control X under IAS 27. However, under IFRS 10, P would have controlled X since 2005.

P would like to apply the provisions of IFRS 3 (2004) and IAS 27 (2004) to this acquisition for the periods prior to 1 July 2009 when P adopted IFRS 3 (2008) and IAS 27 (2008). This decision would have an impact on certain assets and liabilities recorded (for example, IFRS 3 (2004) permitted the capitalisation of directly-attributable transaction costs whereas IFRS 3 (2008) did not).

Is this permitted?

Solution

Yes, P has a choice to apply, on a consistent basis, either IFRS 3 (2004)/IAS 27 (2004) or IFRS 3 (2008)/IAS 27 (2008) to the periods prior to 1 July 2009 (IFRS 10.C4B, C4C).

Question F3 – Limitation of restatement of comparatives

Parent P acquired 49% of Company X in 2005. It was determined that P did not control X under IAS 27. Instead, X was equity-accounted in accordance with IAS 28. P adopted IFRS 10 on 1/1/2013, and under IFRS 10, P would have controlled X since 2005.

For regulatory purposes, P has to prepare two years of comparative financial information. Although P has determined that it is practicable to apply IFRS 10 retrospectively, it would like to limit the restatement to the 2012 comparatives only.

Is this permitted?

Solution

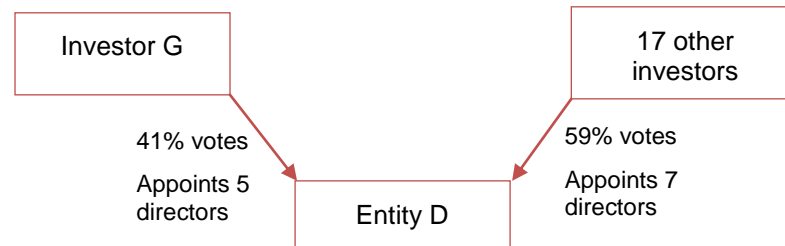
Yes, P can do so under IFRS 10 (IFRS 10.C6A). However, it should also consider any relevant regulatory requirements and whether these require the other two years of comparatives to be restated.

If only the 2012 comparatives are restated, any earlier difference between the previous equity-accounted carrying value of P’s interest in X, and the assets, liabilities and non-controlling interest of X consolidated under IFRS 10, is recognised in equity at 1 January 2012 (IFRS 10.C4a). The earlier comparatives can remain unadjusted. IAS 8 requirements for the disclosure of each financial statement line item affected for 2012 and 2013 should be followed (IAS 8.28).

P should clearly identify the information that has not been adjusted, state that it has been prepared on a different basis and explain that basis (IFRS 10.C6B).

Section G – Comprehensive case studies

Case study 1 – Assessing de facto control for an operating entity



- Entity D manufactures and sells glass bottles to entity G at market price. The majority of sales (95%) are made to entity G; however, entity D can also sell to other customers without additional cost.
- Entity D was established to allow entity G to gain a steady supply of glass bottles.

Entity D issues two classes of shares. Entity G holds Class A shares. The 17 other investors hold Class B shares. Both classes have equal voting rights. Details of the shares are as follows:

	Class A shares	Class B shares
Holder of shares	Investor G	17 other investors
% of total shareholder voting rights attributable to each class	41%	59%
Number of directors appointed by each class of shareholders	5	7

The 6 largest Class B investors hold 14%, 8%, 7%, 6%, 5% and 4% respectively. All other investors hold less than 3% each. The Class B investors have, in the past, participated actively in meetings and, on occasion, rejected resolutions put forward by entity G.

Strategic decisions are made at shareholders' meetings, and operational decisions are made at directors' meetings. Daily operations are handled by a Manager, based on powers granted by the shareholders and directors.

Does entity G have control of entity D?

Solution

Entity G does not seem to control entity D in this circumstance. Power over entity D is exercised mainly through shareholders' and directors' meetings. Entity G does not have majority

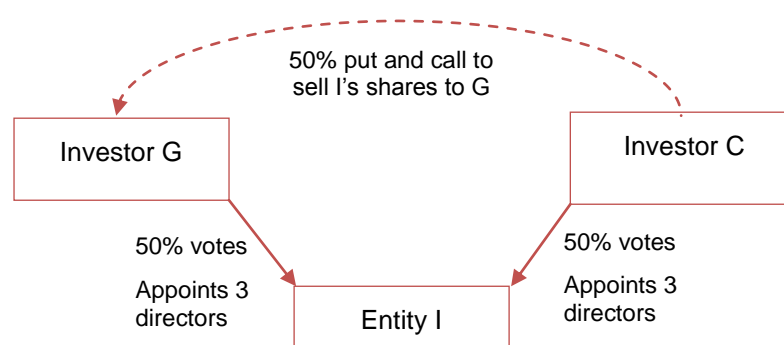
representation in both meetings. IFRS 10 App B para B41 indicates that an investor with less than a majority of the voting rights may have de facto control if the criteria in IFRS 10 App B para B42 to B46 are met.

However, de facto control does not seem to exist. A minimum of six Class B investors could collaborate and outvote entity G. Similarly, six directors (out of the seven directors not appointed by G) could collaborate to outvote the five directors appointed by entity G.

Under IFRS 10 App B para B44 example 6, de facto control did not exist where only two other investors needed to collaborate. Under see IFRS 10 App B para B45 example 7, the situation was unclear where 11 other shareholders needed to collaborate.

Collaboration by six investors falls in between. However, the remaining 17 investors have participated actively in past meetings and, on occasion, outvoted entity G. This suggests that entity G does not have de facto control of entity D [IFRS 10 App B para B45].

IFRS 10 App B, para B46 indicates that if the situation is unclear after considering all factors, there is no de facto control. Entity G does not seem to meet the 'clear' evidence of de facto required by the standard. The standard states that economic dependence alone does not lead to the investor having power over the investee [IFRS 10 App B para B40].



The purpose of this transaction was to allow entity G to bring in entity C, an expert in agriculture, to advise entity G and assist entity G in managing production costs, and also to provide a more consistent supply of raw materials.

Further information on entity I:

- Entity G appoints the CEO; entity C appoints the plant manager (second-in-command).
- Entity I is contractually required to produce and sell sufficient malt to meet entity G's needs, although it is also allowed to sell malt to entity C or to other customers nominated by entity C if entity I has excess capacity.
- Selling price to entity G is based on a formula that takes all costs incurred by entity I and adds a margin that is calculated to give I a 10% gross margin on costs incurred.
- Agreements require entity C to provide entity I with market intelligence and advice, and develop and execute supply chain plans to help entity I to acquire raw materials.

Case study 2 – Assessing control with put and call options

Entity G set up entity I, a malt producer. Entity G initially owned 100% of entity I. Thereafter, entity G sold 50% to entity C and at the same time:

- entered into a put and call over entity D's 50% interest; and
- entered into a series of agreements that stipulate the terms set out in the rest of this case study.

- Entity C receives fees that are commensurate with the services provided.
- The contracts with entity C are automatically terminated with no penalties if either of the options is exercised.

Some of entity I's relevant activities are controlled by contract (for example, customer selection and the sale price of malt). However, operational decisions (for example, capital, repairs and maintenance expenditure, choice of suppliers, employee hiring and firing, etc) are made at shareholders' and/or directors' meetings. Unanimous consent is required for both shareholder and board decisions.

Terms of put and call

- Call held by entity G allows entity G to buy 50% of entity I from entity C at fair value. Similarly, the put held by entity C allows entity C to sell 50% of entity I to entity G at fair value. Upon exercise of either the put or the call,

entity G regains control of entity I, and the contracts with entity C are terminated.

- Both puts and calls are exercisable only upon any of the following events:
 - Change of control, liquidation or bankruptcy of the option writer (for example, entity G can exercise its call if there is a change of control in entity C);
 - Entity G and entity C reach a decision deadlock which cannot be resolved; or
 - For the call only, 10 years after the agreement.
- The options are designed to allow entity C to exit at fair value when the above unanticipated events, or a decision deadlock, makes such an exit necessary, so that entity G regains control of entity I.
- As the options' exercise price is at fair value, they are always at the money, including at inception of the options and at the reporting date.
- In the event of a decision deadlock, it will be beneficial for entity G to exercise the call option to regain control of entity I, as the call option will be at the money (as strike price is at fair value), due to the synergies between entity G and entity I.

Under IFRS 10, does entity G control entity I?

Solution

Some of the relevant activities are controlled by contract, and these appear to be fixed and cannot be changed. Unless there is excess capacity, entity I must sell to entity G at the designated price.

However, an assessment must be made of all of the contracts and other arrangements (for example, shareholdings and board representation) that give rights over the relevant activities of I to determine whether each investor has rights sufficient to give it power over entity I.

Purpose and design

Arguably, the purpose and design of the entire transaction, including the options, was to ensure that entity G retains control of entity I [IFRS 10 App B para B48], as follows:

- Entity I was set up to supply malt to entity G, while entity C supplies expertise. This suggests that entity I is likely to be set up on behalf of entity G, while entity C's involvement is mainly advisory.
- The strike prices of the options are at fair value, which ensure that the strike price does not pose an economic barrier for either party to exercise the option.

Parties involved in the design of entity I

Entity I was established by entity G when it was wholly-owned; however, both entity G and entity C were involved in setting up the above contractual arrangements.

Options

The put and call arrangements allow entity G to take control of all decisions in the event of a decision deadlock. If either option is exercised, the other agreements also terminate, allowing entity G to regain control of the critical factors such as customer selection and selling price of malt. Although the options are only exercisable in limited situations such as a decision deadlock, they are substantive. A decision deadlock is the main event that necessitates the power to decide on the direction of relevant activities [IFRS 10 App B para B24].

Parties that have a commitment to ensure that entity I operates as designed

Entity G has a greater interest to ensure that entity I operates as designed as entity G is taking malt output from entity I. The put and call arrangement that provides entity C with an exit plan also seems to suggest that entity G has the greatest commitment in this respect.

Other factors in IFRS 10 App B paras B18-B20

The activities of entity I appear to be conducted on behalf of entity G (for example, to ensure the malt supply).

Entity G appears to satisfy the power criterion in relation to entity I. Entity G also has exposure to the variability of entity I through its 50% interest, and nothing in the facts suggest that entity G is not a principal. Entity G therefore controls entity I.

Case study 3 – Assessing control for a debt restructuring structured entity with limited activities

Background and purpose

A corporate entity ('the Corporate') wishes to raise long-term debt with a non-vanilla interest rate – for example, debt whose coupon varies with an underlying index, such as an inflation or equity index. This may be to provide an economic hedge – for example, if some or all of the Corporate's income tends to vary with inflation – or as part of a wider structured transaction – for example, to achieve tax benefits.

However, the market for such non-vanilla debt is illiquid. The Corporate enters into a transaction involving a structured entity (SE) as described below.

Facts

- Corporate, in conjunction with a Bank, sets up an SE. Corporate issues the desired non-vanilla notes (the 'Structured Notes') to the SE. The returns on the Structured Notes are linked to returns on a specified index (for example, inflation or equity index).
- The shares of the SE are held by an independent third party – in this case, a charitable trust. However, the share capital is negligible, and the voting rights confer no substantive rights, as all these have been specified by contractual arrangements.
- Bank enters into a swap ('the Swap') with the SE to exchange the index-

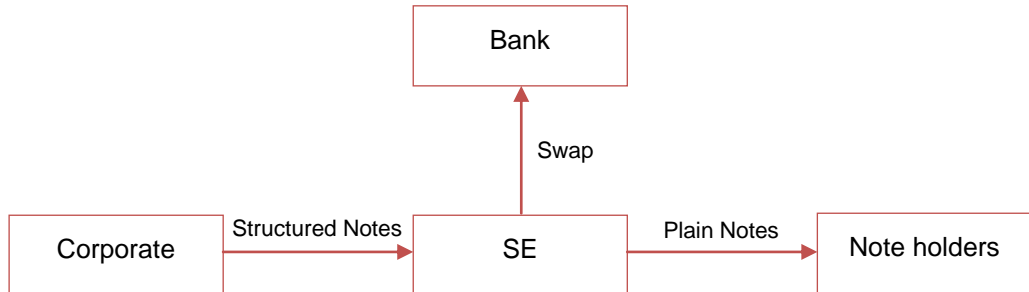
linked rate on the notes issued for a fixed coupon using a derivative. Payments under the Swap are made on a net basis and are made quarterly to match the coupon payment dates on the 'Plain Notes' (see below). If in any period (including on maturity or liquidation) a net payment is due from the SE under the Swap, that payment ranks senior to all other amounts payable by the SE.

- SE issues vanilla fixed rate notes ('the Plain Notes') to note-holders.
- Note-holders are a dispersed group of numerous investors who do not represent a reporting entity. No individual note-holder owns more than 5% of the notes. They are represented by a trustee ('the Trustee'). The Trustee can be removed by a majority vote of the note-holders without cause, receives fixed remuneration and has been assessed to act as an agent for the note-holders under IFRS 10. The Trustee is not a related party of the Corporate, Bank or note-holders. This example does not consider the agent/principal requirements in IFRS 10.
- As long the Corporate and Bank perform under the Structured Notes and the Swap respectively, there is no need (or permission required) for any party to direct the SE's activities. The SE will use the cash receipts from the Structured Notes, net of the cash paid or received under the Swap, to service the Plain Notes issued to the market. The SE does not require other activities.
- The Plain Notes are not guaranteed by either the Bank or the Corporate. However, if the Plain Notes default, the Trustee appointed by the note-holders could seize the assets of the SE and seek payment from the Corporate on the underlying Structured Notes to recover the monies due on the Plain Notes. If the Swap is in a net receivable position from the SE, the Bank can also seek to recover its net receivable position from the assets of the SE. In such a case, the Bank's claim ranks senior to that of the note-holders.
- If the Bank defaults while the swap is in a payable position to the SE, the Trustee of the note-holders also has

the ability to claim from the Bank on behalf of the note-holders.

- The Structured Notes give rise to both credit risk (the risk that the Corporate and hence the SE will default) and

variability due to the structured coupon. Assume for the purposes of this example that both are significant.



Analysis under IFRS 10

Does the SE have relevant activities?

After the SE is set up, no decisions can or will be made unless the Corporate defaults. If the Corporate defaults on the Structured Notes, the SE will default on the Plain Notes. The Trustee of the notes in such cases has the ability to seize the assets of the SE and decide how to recover monies from the Corporate.

Although this decision is based on a contingent event, this does not prevent it from being a relevant activity [IFRS 10 App B para B53]. This decision can potentially affect the returns of the SE

significantly if the contingency arises [IFRS 10 App A]. The SE therefore has relevant activities.

Who controls the SE?

There are a number of factors that need to be assessed in order to identify which party controls the SE and thus consolidates it. We have assessed each party in turn below using the three factors necessary for control in IFRS 10: power, exposure to variable returns and the ability to use power to affect returns. The Trustee is assessed as acting as an agent in this circumstance and has not been considered further in the analysis of control.

The Corporate

IFRS 10 indicator	Assessment
Power	<p>The Corporate was involved in the design of the SE at the inception of the transaction and ultimately is the initiator of the transaction; this may indicate that the Corporate has power or had the opportunity to obtain rights that would have given it power over the SE. However IFRS 10 App B51 states that: “..being involved in the design of an investee alone is not sufficient to give an investor control...”</p> <p>Furthermore, IFRS 10 para BC 77 supports this notion, given that there are several parties (Corporate, Bank and Trustees) involved in the design of the SE and final structure. We would therefore need to look to other rights that may give the Corporate power in this circumstance.</p> <p>It could be argued that the SE’s activities are conducted on behalf of the Corporate for the purpose of raising funds. The SE was designed to conduct activities that are closely related to the Corporate; the Corporate</p>

	<p>therefore has direct involvement in the relevant activities of the SE. An important point is that if the Corporate did not exist, the SE would not exist, indicating that there may be a ‘special relationship’ between the Corporate and the SE [IFRS 10 App B para B19(b) and (c)]. However, IFRS 10 App B para B19 notes that the existence of an indicator of a special relationship does not necessarily mean that the power criterion is met. It can also be argued that the SE has a special relationship simultaneously with the note-holders and the Bank. The ‘special relationship’ indicator is not therefore sufficient to determine that the Corporate has power over the SE.</p> <p>Despite the indicators that the Corporate may have been able to give itself power, the Corporate has no ongoing power over the relevant activities of the SE. There are no conclusive indicators that the Corporate has power. So in the absence of other indicators, the Corporate does not have power over the SE.</p>
Exposure to variable returns	<p>The Structured Notes issued by the Corporate and held by the SE create rather than absorb variability in the SE because:</p> <ul style="list-style-type: none"> • the Corporate becomes a debtor of the SE, hence exposing the SE to the Corporate’s credit risk; and • the coupons of the Structured Notes are variable based on the underlying index, creating further variability for the SE. <p>As the Corporate has no other interests in the SE, the Corporate is not exposed to the variability of the returns generated by the SE [IFRS 10 App B para B56]. This is further supported by IFRS 12 para B9, which states: <i>“Some instruments are designed to transfer risk from a reporting entity to another entity. 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.”</i></p> <p>The Corporate is not therefore exposed to variable returns in the manner envisaged by IFRS 10 App B paras B55 and B56.</p>
Conclusion	The Corporate has neither power nor exposure to variable returns; the Corporate does not control the SE.

The Bank

IFRS 10 indicator	Assessment
Power	<p>Similar to the corporate, the Bank is a key party involved in the design of the SE at inception. However, the presence of this indicator alone is not sufficient to conclude that the Bank has power over the investee.</p> <p>It can be argued that the relationship between the Bank and the SE is also special, in that the SE has been set up to allow the Bank to engage in a swap [IFRS 10 App B para B19c]. However, IFRS 10 App B para B19 also indicates that the existence of such an indicator of a special relationship does not mean that the power criterion is met.</p> <p>The bank is also exposed to some variability of the SE (see returns section below). IFRS 10 App B para B20 states that a large exposure to variability of returns is an indicator that an investor may have power. However, IFRS 10 App B para B20 also states that this factor, in itself, does not determine whether there is power (and indeed, the note-holders are also exposed to variability – see below).</p>

	<p>The analysis suggests that the Bank has incentives to obtain power, but power is not ‘deduced’, absent further evidence of such power.</p> <p>One factor that suggests the Bank has power is that the Bank has asset-recovery powers in the event that the SE defaults (for example, if the structured notes default) when the swap is a receivable from the SE. However, the exposure of the Bank in such situations is likely to be small (see ‘Returns’ section below), and correspondingly, the extent of power it can exercise is likely to be limited compared to the power exercisable by note-holders to recover their much larger exposure from the Plain Notes. The senior status of the swap also suggests that the purpose and design was to transfer credit risk exposure and associated powers to the note-holders, not the Bank. The Bank therefore appears to have protective rights to protect its interests, rather than power over relevant activities [IFRS 10 App B para B27].</p> <p>The Bank therefore fails the power criterion in IFRS 10 para 7a on the grounds that the Bank does not have substantive rights that allow the Bank to direct those activities of the SE that have the greatest impact on the SE’s returns [IFRS 10 para 13].</p>
Exposure to variable returns	<p>The Bank is exposed to variable returns given the nature of the Swap. The Swap is designed to absorb some of the variability in relation to the SE’s returns, as it absorbs the variability inherent in the index that is included in the structured coupon and exchanges it for a fixed amount.</p> <p>Our view is that certain plain vanilla derivatives may contribute rather than absorb variability or may be ‘typical customer supplier relationship’ in the definition of ‘interest’ in IFRS 12 App A. This would imply that such derivatives do not constitute ‘interests’ and do not therefore give rise to exposure to variable returns. However, the Swap is not a ‘plain-vanilla derivative’ or a ‘typical customer supplier relationship’, as the Bank was involved in setting up the SE to whom it issued this Swap, with the objective of transferring the SE’s specific exposure to index variability to the Bank.</p> <p>In addition, if the Bank was owed monies under the swap agreement on the occurrence of default, it would be exposed to the risk of loss (credit risk). However, its exposure to credit risk is limited because (a) the swap is settled regularly so the amount outstanding is likely to be relatively small, (b) the Bank may owe money under the Swap rather than be owed an amount by the SE and (c) the Bank would be paid before the note-holders.</p> <p>There is therefore some support to indicate that the Bank is exposed to some variability in returns, primarily via absorbing the variability associated with the structured coupon on the notes.</p>
Conclusion	<p>The Bank does not appear to have power over the SE; it does not therefore control the SE.</p> <p>Although the Bank does not control the SE, it holds an interest in an unconsolidated structured entity. The Bank should therefore make the disclosures required by IFRS 12 paras 24 to 31.</p>

Each note-holder

IFRS 10 indicator	Assessment
Power	<p>The SE is economically dependent on note-holders to finance its operations [IFRS 10 App B para B19bi], which indicates a ‘special relationship’ may exist between the note-holders and the SE. However, the fact that there is an indicator of a special relationship does not necessarily mean that the power criterion is met.</p> <p>The note-holders are also exposed to variability (see next section). A large exposure to variability of returns is an indicator of power. However, this exposure in itself does not determine whether the investor has power. Further, all note-holders, as well as the Bank, have exposure. This indicator is not therefore conclusive in determining who should consolidate.</p> <p>The Trustee, acting as agent of the note-holders, has powers upon default by the Corporate. However, due to the diverse and unrelated nature of the note-holders, and the fact that a majority vote is required to remove the Trustee, none of the note-holders have the unilateral power to direct the Trustee or its powers over the SE. The Trustee’s powers cannot therefore be attributed to any individual note-holder. This is consistent with IFRS 10 App B para B59, which states that when an agent acts for multiple principals, each of those principals still needs to assess whether it has power.</p> <p>The individual note-holders are therefore unlikely to have power.</p>
Exposure to variable returns	<p>Each note-holder has exposure to significant downside variability, as this relationship has been designed so they absorb most or all of the variability arising from a default by the Corporate. On such a default, the only other party that may be owed amounts by the SE is the Bank; but its exposure to credit risk is limited as (a) the swap is settled regularly so the amount outstanding is likely to be relatively small, (b) the Bank may owe money under the Swap rather than be owed an amount by the SE and (c) the Bank would be paid before the note-holders.</p>
Conclusion	<p>None of the note-holders individually has sufficient power to constitute control. If one note-holder had the power to direct the trustee unilaterally, a different analysis may result.</p> <p>Although the note-holders do not control the SE, they hold an interest in an unconsolidated structured entity. The note-holders should therefore give the disclosures required by IFRS 12 paras 24 to 31.</p>

Conclusion

None of the parties consolidates the SE.

Case study 4 – Assessing control of an issuer of commercial mortgage-backed securities managed by a third-party servicer acting on behalf of investors

Background and purpose

Commercial mortgage-backed securitisations exist for a number of reasons. A bank that has originated or acquired commercial mortgages may require funding for those assets. The bank may also seek to pass on some of its exposure to loss on the mortgages. Finally, there may be an opportunity for the bank to create marketable securities of a particular risk profile that are attractive to investors and thereby reduce its funding costs and earn fees from its involvement in the transaction.

Note: many commercial mortgage-backed securitisations contain additional features not illustrated here.

Facts

- Bank sets up a structured entity (SE) and transfers to it commercial mortgages with a value of C100. The shares of the SE, which are held by independent third parties (a charitable trust), have no decision-making authority due to the rigid contractual arrangements in place.
- The mortgages held by the SE are contractually-specified and do not change over the life of the SE (a static portfolio).
- The historical, as well as the expected, future default rate of these mortgages is approximately 5%. The likelihood of a default rate of more than 10% is considered remote.
- A third-party servicer administers the mortgage portfolio in the SE under a servicing agreement that sets out servicing standards. The servicer will receive management fees of 8bps (that is, 0.08%) of the outstanding principal of loans, which are not dependent on the servicer's performance.
- SE issues two tranches of debt. A senior tranche of C80 is issued to a dispersed, unrelated group of note-holders in the market that do not constitute a

reporting entity and are represented by a trustee. No individual senior debt-holder owns more than 5% of the senior notes. A junior tranche (subordinated liabilities) of C20 is held by the bank. The SE's liability in respect of both tranches is limited to the collections from the mortgages it holds. If the SE is not able to repay either tranche due to defaults in the underlying mortgages, this does not constitute a legal default by the SE (that is, debt holders cannot take actions against the SE such as seizing its assets, placing the SE under liquidation, etc). Any residual amount in the SE after payment of all parties is allocated to the junior notes upon termination of SE.

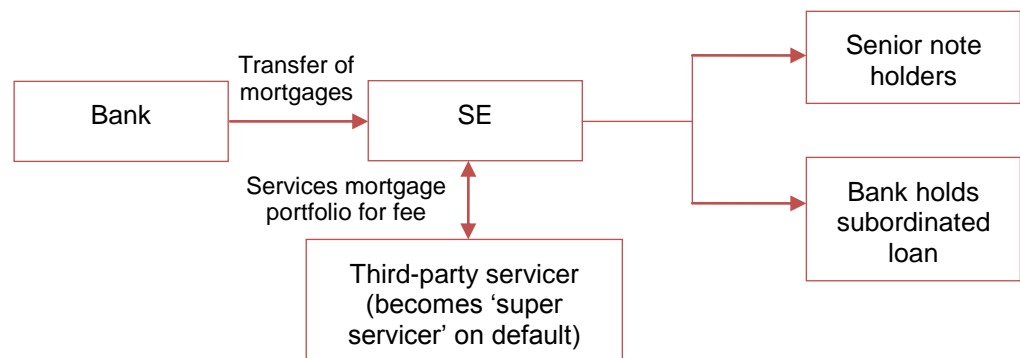
- The servicer assumes the status of the 'super-servicer' in case of default on one or more of the underlying commercial mortgages. Management fees on the defaulted mortgages are increased from 8bps (0.08%) to 25 bps (0.25%) of the outstanding principal of defaulted mortgages; and a performance-related fee is paid equivalent to 1% of any collections from mortgages that have defaulted. The higher management fees are designed to cover the higher costs of managing the structure, and the performance fees are designed to incentivise the super-servicer to maximise collections. The servicer can therefore obtain a minimum fee of 0.25% of the outstanding principal of defaulted mortgages and a maximum of 1.25%. For the purposes of this case study, assume that:
 - The magnitude of the management fee (between 8bps and 25bps) has been assessed to be insignificant compared to the SE's much higher overall expected returns on its mortgage portfolio. The magnitude of the performance fee is also expected to be insignificant, as this is only 1% of collections on defaulted mortgages, which in turn are expected to comprise only 5% of the portfolio.
 - The variability of the management fee relative to the SE's returns has also been assessed to be insignificant, as the fee is based on principal, which is relatively stable. The variability of the performance

fee is assessed to be insignificant, as it is only 1% of collections on defaulted mortgages, which in turn are expected to comprise only 5% of the portfolio.

- The servicer's fee ranks ahead of payments on the junior and senior notes.
- The servicer's fees are commensurate with the services provided and the remuneration agreement does not include terms or conditions that are not customarily present in similar agreements.
- The servicer must make decisions in the best interests of all investors (that is, Bank and senior note-holders) and in accordance with the SE's governing agreements. Nevertheless, if there is a

default, the servicer has significant decision-making discretion.

- The bank can remove the servicer if a breach of contract occurs. 'Breach of contract' includes a return on the senior notes of less than 20%, a condition that is met as soon as any defaults occur. The effect is therefore that the Bank can unilaterally remove the servicer upon default of the underlying receivables. No other party has kick-out rights.
- It is improbable that none of the mortgages will default at the reporting date. The servicer is easily replaceable.



Analysis under IFRS 10

Does the SE have relevant activities?

There are two key functions within the SE: servicing of mortgages and, in the event of default, collection. The act of servicing mortgages on a day-to-day basis does not constitute a relevant activity, as this does not significantly affect the returns of the SE and is generally pre-determined by a contractual arrangement. However, collection of receivables on default is a relevant activity because it is the only activity that will significantly affect the SE's returns. The fact that this right is exercisable only upon default does not prevent this from

being a substantive (rather than a protective) right over the relevant activity of the SE [IFRS 10 App B para B53].

An investor who has the ability to direct the activities of the SE after default would potentially have power where activities are pre-determined until default.

The SE therefore has relevant activities.

Who controls the SE?

There are a number of factors that need to be assessed in order to identify which party controls the SE and thus consolidates it. We have assessed each party below.

The servicer/super-servicer

IFRS 10 indicator	Assessment
Power	<p>The servicer gains significant decision-making discretion upon default of mortgages. IFRS 10 App B para B53 indicates the servicer has power to direct the relevant activities of the SE.</p> <p>The Servicer therefore has power over the SE (though it may be using that power as agent – see below).</p>
Exposure to variable returns	<p>IFRS 10 App B para B57b says that an example of returns is: <i>“...remuneration for servicing an investee’s assets or liabilities , fees and exposure to loss from providing credit or liquidity support, residual interest in the investee’s assets and liabilities on liquidation of the investee.....”</i></p> <p>Although the servicer obtains a fixed management fee, IFRS 10 App B para B56 clarifies that even fixed performance fees comprise variable returns. The servicer receives a variable performance fee that also gives it exposure to variable returns. As such, the servicer is exposed to variable returns.</p>
Link between power and returns	<p>Based on the principal-agent guidance in IFRS 10, the servicer has wide discretion to manage and renegotiate defaulted assets, which may indicate its role as being more in the nature of principal [IFRS 10 App B para B60a].</p> <p>However, IFRS 10 App B para B65 indicates that when a single party can remove the decision-maker without cause, this on its own is sufficient to conclude that the decision-maker is an agent. The servicing contract states that the servicer can only be removed on breach of contract. However, breach of contract is defined to include a return on the senior notes of less than 20%, a condition that is met as soon as any defaults occur. The effect is therefore that the Bank has the unilateral right to remove the servicer on a default of the underlying receivables. As explained above, the only relevant activity is managing receivables upon default; and the only time when the servicer can exercise such power is upon default. At such time, the Bank immediately acquires the power to remove the servicer. Such removal rights are, in substance, equivalent to those unilateral, unconditional removal rights referred to in IFRS 10 App B para B65. The right is also substantive from the Bank’s point of view, as the Bank can benefit from exercising it through recovering more or less on its junior notes.</p> <p>The Servicer’s remuneration does not need to be considered – it is an agent by virtue of the single-party removal right. However, it is insignificant when compared to the much higher overall returns expected on the SE’s mortgage portfolio</p> <p>The servicer is therefore an agent.</p>
Conclusion	The servicer does not control the SE because it is an agent.

The Bank (junior note-holder)

IFRS 10 indicator	Assessment
Power	<p>The Bank has the power to unilaterally remove the servicer, but this is contingent upon some of the mortgages defaulting, or the servicer otherwise breaching the servicing contract. Such a right is substantive because:</p> <ul style="list-style-type: none"> • there are no barriers in the fact pattern to prevent the Bank from exercising this right [IFRS 10 App B para B23a]; • the Bank does not require any other party's approval to exercise the right [IFRS 10 App B para B23b]; • the Bank will benefit from the exercise of the rights because it acquires the power to affect the returns from its junior notes [IFRS 10 App B para B23c]; • the right is exercisable when decisions about relevant activities need to be made even though it is not currently exercisable [IFRS 10 App B para B24]. As explained in the previous section, the only relevant activity in this scenario is the management of receivables upon default, and the Bank is able to exercise this right once such default occurs. <p>Treatment of this right as substantive is also in accordance with IFRS 10 App B para B26, which specifies that not all contingent powers are protective. This substantive removal right allows the Bank to direct the servicer via the threat of removal. The servicer's powers are therefore imputed to the Bank for purposes of the IFRS 10 analysis [IFRS10 App B para B59]. As explained above, the servicer has wide powers over the relevant activities.</p> <p>Based on the above considerations, the Bank has power due to its substantive ability to remove the servicer.</p>
Exposure to variable returns	The bank is exposed to variable returns, as it owns the junior notes, which are expected to absorb the majority of residual variability.
Conclusion	The Bank therefore controls the SE.

The note-holders (senior note-holder)

IFRS 10 indicator	Assessment
Power	<p>The following factors suggest that the note-holders have opportunities/incentives to obtain power:</p> <ul style="list-style-type: none"> • The SE is economically dependent on the note-holders for financing via the senior tranche [IFRS 10 App B para B19bi]. However, IFRS 10 App B para B19 states that the existence of a single indicator does not mean that the power criterion is met. This is not therefore a conclusive indicator. Further, this criterion is also met for the Bank as well as for every note-holder. • The note-holders have limited exposure to downside variability through their holdings of senior notes [IFRS 10 para B20]. However IFRS 10 App B para B20 also states that the extent of an investee's exposure in itself does not necessarily result in power. <p>There are no conclusive indications that any of the note-holders have power over the SE. Further, IFRS 10 App B para B16 indicates that only</p>

	<p>one investor can control an investee. As explained above, there are strong indications that the Bank has power.</p> <p>None of the Note-holders therefore has power over the SE.</p>
Exposure to variable returns	<p>The note-holders are exposed to variability through their holdings of senior notes, as the SE may not be able to pay off the senior notes in full if the underlying mortgages default.</p> <p>However, the Bank is exposed to even more variable returns via its holding of junior notes.</p>
Conclusion	<p>As none of the note-holders has power over the SE, none of the note-holders controls the SE.</p> <p>Although the note-holders do not control the SE, they hold an interest in an unconsolidated structured entity. The note-holders should therefore make the disclosures required by IFRS 12 paras 24 to 31.</p>

Conclusion

Based on the above analysis, the Bank controls the SE.

Case study 5 – Assessing control of an issuer of credit-linked notes with limited activities and derivatives that enhance risk

Background and purpose

A credit-linked note structure may be set up for various reasons, the most common being:

- to enable a bank to obtain credit protection on loans it holds; and
- to enable a bank to create marketable securities of a particular risk profile that are attractive to investors. The bank will earn fees from creating and marketing the structure.

Facts

- Bank sets up a structured entity (SE), and enters into a credit default swap (CDS) with the SE, for which it pays the SE a premium at market rates. Under the CDS, if a stipulated commercial debt security ('the Risky Asset') defaults, the SE will pay to the Bank the par value of that security. Any liability of the SE to the Bank in respect of the CDS has priority to all other liabilities of the SE.
- Shares of the SE, which are held by independent third parties (for example, a charitable trust), have no significant decision-making rights due

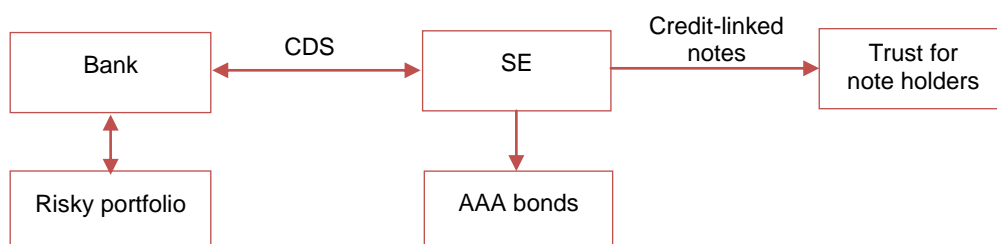
to the restrictions imposed by the contractual agreements.

- SE invests in AAA bonds whose maturity matches that of the CDS and the notes issued by the SE (see next bullet point). In the event that the AAA bonds are downgraded below AAA, the Trustee is required to sell the bonds and buy replacement bonds with an AAA rating.
- SE issues a single tranche of credit-linked notes ('the Notes') to a large number of dispersed, unrelated investors (the 'note-holders'), which do not form a reporting entity. No individual note-holder owns more than 5% of the notes. The returns on the Notes are linked to the returns from the AAA bonds and the payments on the CDS. The note-holders are represented by a Trustee, which can be removed by a majority vote of the note-holders without cause. The Trustee receives a fixed level of remuneration that is consistent with market rates for its level of services. The Trustee has been assessed to act as an agent for the note-holders under IFRS 10. This example does not therefore consider the requirements for agent/principal in IFRS 10.
- The SE's liability in respect of the Notes is limited to the par amount adjusted for CDS receipts/payments.

If the SE is not able to repay the notes in full due to a credit event on the CDS, it does not constitute a legal default by the SE (that is, debt holders cannot take actions against the SE such as seizing its assets, placing the SE under liquidation, etc.).

- However, a default on the notes will arise if the SE is not able to repay the

notes due to default of the bonds. If this occurs, both the Bank (if the CDS is a net receivable from the SE) and the note-holders as a group, as represented by the Trustee, have normal powers under bankruptcy laws (for example, seizure of assets, liquidation of SE, etc.) to recover any amounts due from the SE.



Analysis under IFRS 10

What are the SE relevant activities?

The following relevant activities exist within the SE:

- Asset-replacement decision in the event that bonds are downgraded;
- asset seizure and recovery powers on a default by the SE (for example, if the bonds were to default and amounts were due to the Note-holders and/or the Bank).

Although these decisions are based on contingent events, this does not prevent

them from being relevant activities (IFRS 10 B53), and these decisions can potentially affect the returns of the SE significantly if the contingency arises (IFRS 10 Appendix A). Accordingly, the SE does have relevant activities.

Who controls the SE?

There are a number of factors that need to be assessed in order to identify which party controls the SE and thus consolidates it. The Trustee is assessed as acting as an agent in this circumstance and has not been considered further in the analysis of control. We have assessed each other party below.

The Bank

IFRS 10 indicator	Assessment
Power	<p>The following indicators suggest that the Bank has the opportunity and incentive to provide itself with power. However, these indicators do not by themselves provide the Bank with power:</p> <ul style="list-style-type: none"> • The Bank was involved in the design of the SE at the inception of the transaction and is the initiator of the transaction; this gives the Bank the opportunity to obtain power over the SE. However, IFRS 10 App B para B51 states that: “...being involved in the design of an investee alone is not sufficient to give an investor control...”. This is not therefore conclusive. • The Bank has an implicit commitment to ensure that the SE operates as designed (B54). However, IFRS 10 App B para B54 also states that this indicator, by itself, does not give an investor power.

	<p>If both the Risky Asset and the AAA bonds default, the Bank has asset-recovery powers over the SE. The Bank therefore has some decision-making rights over the SE. However, the Bank has less decision-making rights than the Trustee for the note-holders (see below), which has power over asset seizure and recovery, as well as asset replacement in the event of the AAA bonds being downgraded.</p> <p>When multiple parties have decision-making rights, the party that has the right to direct the activity that most significantly affects returns has power over the investee (IFRS 10.13). The Trustee is likely to be in a stronger position than the Bank to affect returns because:</p> <ul style="list-style-type: none"> • the Trustee also has asset replacement powers; and • the credit risk that the Trustee needs to mitigate by exercising its recovery powers is more significant than the credit risk to which the Bank is exposed (see ‘Exposure to variable returns’ below). <p>The power criterion in IFRS 10.7a does not therefore support consolidation by the Bank.</p>
Exposure to variable returns	<p>The CDS principally contributes variability to the SE for the following reasons:</p> <ul style="list-style-type: none"> • The CDS exposes the SE to losses arising from the Risky Asset – for example, if there is a credit event on the risky asset. • Although the CDS potentially subjects the Bank to SE’s credit risk, this risk is considered small relative to the risk contributed by the Risky Asset. This risk is further mitigated by the senior status of the CDS and the high quality of the AAA bonds. • The SE’s purpose in entering into the CDS is usually one of the following: <ul style="list-style-type: none"> ○ to mitigate the Bank’s exposure to the Risky Asset by transferring it to the SE; or ○ to improve returns to note-holders by transferring more risk (and returns) to the SE. <p>In both cases, a view of the CDS as contributor of variability will be more consistent with the purpose and design. For the purpose of assessing exposure to variable returns, it is irrelevant that the Bank’s exposure to CDS variability may be mitigated/ minimised by the Bank’s other assets/ liabilities (that is, whether or not the Bank holds the Risky Asset does not affect the analysis of control).</p> <p>The CDS therefore principally contributes variability to the SE. As such, the Bank does not have significant exposure to variable returns of the SE.</p>
Conclusion	<p>The Bank does not control the SE, as the power criterion does not support consolidation and the Bank does not have significant exposure to variable returns (IFRS 10 B56).</p>

Each note-holder

IFRS 10 indicator	Assessment
Power	<p>The SE is economically dependent on the notes to finance its operations, which indicates that there may be a ‘special relationship’ between the note-holders and the SE (B19(b)(i)). However, IFRS 10 App B para B19 notes that the existence of an indicator of a special relationship does not necessarily mean that the power criterion is met.</p> <p>The note-holders have greater exposure to variability than any other party (see below). , IFRS 10 App B para B20 states that, having a large exposure to variability of returns is an indicator that the investor may have power. However, this paragraph also states that this is not conclusive, as the extent of the investor’s exposure does not in itself determine whether an investor has power over the investee.</p> <p>The Trustee has the following powers:</p> <ul style="list-style-type: none">• collateral replacement rights in the event of a downgrade; and• asset seizure and liquidation rights in the event of a default on the AAA bonds. <p>As the Trustee is an agent of the note-holders, the question exists as to whether the above powers can be attributed to the note-holders. However, due to the diverse and unrelated nature of the note-holders, none of the note-holders has either the unilateral power to direct the Trustee or a substantive right to remove the Trustee. The Trustee’s powers cannot therefore be attributed to any individual note-holder. This is consistent with IFRS 10 para B59, which states that when an agent acts for multiple principals, each of those principals still needs to assess whether it has power.</p> <p>In the absence of any conclusive indicator of power, the individual note-holders are unlikely to have power.</p>
Exposure to variable returns	<p>The note-holders absorb the variability from the CDS (IFRS 10 B8), as well as from credit risk on the underlying AAA bonds (although the latter would be low). The structure is designed such that the note-holders absorb variability, as the loan notes are linked directly to the Risky Asset. The Note-holders are therefore exposed to variable returns from the SE.</p>
Conclusion	<p>The individual note-holders do not control the SE, as none has power over the SE. A different analysis may result if a single note-holder could unilaterally direct the trustee.</p> <p>Although the note-holders do not control the SE, they hold an interest in an unconsolidated structured entity. The note-holders should therefore give the disclosures required by IFRS 12 paras 24 to 31.</p>

Conclusion

None of the parties consolidates the SE.