The recent financial crisis highlighted the need for better accounting to reflect the substance of relationships between entities. It also highlighted the need for consistency, transparency and comparability in the accounting for and disclosure of such relationships. In May 2011, the International Accounting Standards Board (IASB) issued three new standards, IFRS 10 Consolidated Financial Statements, IFRS 11 Joint Arrangements and IFRS 12 Disclosure of Interests in Other Entities with the aim of increasing the consistency, transparency and comparability across these areas.

What do the new consolidation, joint arrangements and disclosures accounting standards mean to you?

Entities most likely to be affected by these changes are those that:
- Have significant, but not majority (i.e., less than 50%) equity interests in other entities
- Hold potential voting rights over investments, such as options over shares or convertible debt
- Enter into joint arrangements with other entities; entities with joint ventures that are currently accounted for using proportionate consolidation may be particularly impacted
- Operate in the construction, oil & gas or mining industries, which commonly participate in joint arrangements
- Are investment, asset, or fund managers
- Use special purpose entities (now called structured entities) as part of their current operations

Here’s a snapshot of what the new standards will mean:
- A new control model will apply to all entities, including those that were previously referred to as “special purpose entities”
- Determining which entities are considered to be controlled, and therefore consolidated in a group, may significantly change
- Management may be required to exercise significant judgement to determine whether another entity is controlled, particularly where there are options to acquire additional voting interests, or is controlled with less than a majority of voting rights
- Many entities currently using proportionate consolidation to account for joint ventures will be required to apply equity accounting
- Financial statements will disclose increased information about an entity’s relationships with other entities

The new standards could result in:
- Changes to key financial statement performance measures
- The need for changes to systems and processes to gather information, make judgments and comply with disclosure requirements
- The need to communicate with and educate stakeholders
- Investors requesting additional information from investees
Why change the accounting for consolidation and joint arrangements?

The new consolidation standard represents a significant change to the process for determining which entities are included in consolidated financial statements.

The financial crisis was an important factor behind the issuance of the new consolidation standard—it heightened the criticism that some entities were not consolidating other entities they seemed to control, or were funding a distressed entity where previously they had never disclosed a relationship or obligation.

Another objective of the IASB in issuing the new standards was to increase the comparability and transparency of financial reporting. For example, even if management determines that it does not control another entity, management still must disclose the information that it considered in reaching that decision, so its judgement becomes more transparent.

The new standard for joint arrangements aims to better reflect the substance of these arrangements, rather than solely focusing on legal form. It also improves consistency in the accounting for joint ventures by eliminating one of the accounting options available under existing standards.

When will the changes take place?

These new standards are effective for annual periods beginning on or after 1 January 2013. The new standards may be adopted early, but must generally be adopted as a package—that is, all as of the same date. The only exception to this requirement is that IFRS 12 may be adopted early without adopting the other new standards.

Generally, the new standards are effective retrospectively, although certain reliefs and simplifications are available.
What are the new principles?

Consolidated financial statements
The basic elements of the new model for consolidated financial statements are:
► A new control model that applies to all entities, including those that were previously referred to as “special purpose entities”
► Under the new control model, an investor controls an investee when it is exposed, or has rights, to variable returns from its involvement with the investee and has the ability to affect those returns through its power over the investee
► An investor may still have power over an investee even when the investor does not have a majority of the voting rights of that investee
► An investor may have power over specified assets of an investee which are considered to be a separate ‘deemed entity’ (a silo), such that control could exist at a level below a legal entity
► Entities that are controlled by an investor are consolidated in the investor’s group financial statements. Consolidation procedures have not changed as a result of the new control model

Joint arrangements
The basic elements of the proposed model for joint arrangements are:
► A joint arrangement is a contractual arrangement over which two or more parties have joint control
► Joint arrangements are classified into one of two types: joint operations or joint ventures
► The nature and substance of the contractual rights and obligations arising from the arrangement are considered when classifying it as either a joint operation or a joint venture; the legal form or structure of the arrangement is not the most significant factor in classifying the arrangement
► Joint ventures (as newly defined) must be accounted for using the equity method; the new standards do not change how equity accounting is applied
► For joint operations, the joint operator (a newly defined term) will recognise its assets, liabilities, revenues and expenses, and relative shares thereof

Disclosures
► IFRS 12 includes all of the disclosures that are required related to an entity’s involvement with other entities (such as subsidiaries, joint arrangements, associates and structured entities)
► Financial statements will disclose increased information about an entity’s relationship with other entities

Investment entities
The IASB and the US Financial Accounting Standards Board (FASB) expect to issue an exposure draft in the second quarter of 2011 in which they are expected to propose convergence on the accounting by investment entities for their controlled investments. Under these proposals, an investment entity would be required to report investments in entities that it controls at fair value. If finalised, the IASB’s exposure draft would amend the scope of the consolidation requirements in IFRS 10. The IASB has stated that it expects to complete the project on investment entities before IFRS 10 becomes effective (1 January 2013), and that the amendment will have the same effective date, so that investment entities will not have to change twice.

For more information on IFRS 10, 11, and 12, see our IFRS Developments Issue 1 (May 2011) at www.ey.com/ifrs
How will the entity’s business be affected?

The extent of the impact of the new standards depends on the entity’s structure and industry. Entities in the extractive, real estate and construction industries, where joint arrangements are common, are likely to feel the biggest impact from adopting the new standard on joint arrangements. Entities that have significant, but not majority (i.e., less than 50%), equity interests in other entities will likely be impacted by the new consolidation standard, because now they may have to consolidate those other entities. In addition, the new consolidation standard will help lenders, private equity funds, fund managers and asset managers to assess whether they are acting as principal or as agent and, therefore, whether they have to consolidate investments that they manage. However, all entities, regardless of industry, should assess the extent to which they will be impacted by the changes. Some of the most significant financial and operational effects are discussed below.

Management judgement

Adopting these new standards will require time, effort and the exercise of considerable judgement because of the lack of “bright lines”. Many of these judgements will require a comprehensive understanding of an entity’s business, its operations, and legal rights and obligations. Accounting personnel are unlikely to be able to make such judgements alone, and will require input from sources such as operations personnel, and legal counsel. Management should be closely involved in this assessment, and entities may also wish to involve their Audit Committees and independent auditors in discussions on material areas of judgement. Key discussions and decisions should be documented. Assessing and monitoring the impact of the new standards will therefore require substantial management involvement and coordination. Management should plan accordingly and begin this process early. Key assessments include:

Whether an entity has control if it holds less than a majority of voting rights in an investee (de facto control)

Applying the concept of de facto control is likely to be a significant change in practice for entities that have significant, but not majority (i.e., less than 50%) equity interests in other entities, and may result in those other entities being consolidated. Because there are no bright lines, applying this concept will require significant judgement of the facts and circumstances. For example, how large does an investor’s interest need to be relative to others? How widely dispersed do the other investors need to be?

Whether potential voting rights give power

An investor must consider both its potential voting rights and those held by others, and also whether these rights are substantive (i.e., the holder has the practical ability to exercise the right). For example, is the option ‘in the money’? Would the party or parties that hold the rights benefit from their exercise, such as by realising synergies? Are there any barriers to exercising the option such as financial penalties or narrow exercise periods?

Whether rights are merely protective rights

Investors may need to use judgement to assess whether their rights, and rights held by others, give control over the investee or whether they are rights designed merely to protect their interest without giving power. For example, do rights merely restrict an investee from undertaking activities that could significantly change the credit risk of the investee to the detriment of the investor?

Whether a party is a principal or agent

When decision making rights have been delegated or are being held for the benefit of others, it is necessary to assess whether an entity is acting as principal or agent to determine which party has control. Entities will need to consider all facts and circumstances in making this assessment. For example, what range of activities
can the entity direct? What discretion does it have in making decisions about those activities? Is the decision maker’s remuneration for providing its services commensurate with the level of skills needed to provide the services?

In addition, investors should consider whether any other parties are acting on their behalf without a contractual agreement, such that the investor has the ability to direct that party to act on the investor’s behalf (de facto agents). The determination of whether other parties are acting as de facto agents requires judgement, consideration of the nature of the relationship and how those parties interact with each other and the investor.

**Whether structured entities are controlled**
Where structured entities were set up to achieve a desired outcome (for example, to remain off-balance sheet) based on the majority of the risks and rewards, an entity that sponsored the structured entity, designed it, or has continuing involvement with it, will need to assess whether it has control, based on all facts and circumstances. For example, which activities significantly affect the structured entity’s returns? How are those activities directed? What was the purpose of the structured entity, and what risks (both positive and negative) was it designed to absorb, or to pass along to investors?

**Whether silos exist**
In addition to reviewing arrangements at the legal level, management will also need to consider structures within the legal entity, and local laws to identify the existence of any silos within these legal entities. For example, are all of the assets, liabilities and equity of a portion of the legal entity ring-fenced from the rest of the investee?

**When to reassess control**
Entities are required to reassess whether they control an investee (or potential investee) if facts and circumstances indicate that there are changes to one or more of the three elements of control. Judgement will be needed to assess what these indicators may be. For example, have decision making rights changed? Have decision making rights held by another party lapsed? Has there been a change to the investor’s right to returns?

**Whether there is more than one joint arrangement**
It may not always be clear at which level to assess a joint arrangement to determine whether joint control exists. In many cases, this may be at the contract level. However, some contracts may contain more than one joint arrangement, in which case, it is necessary to assess each arrangement within the contract.

**Whether a joint arrangement is a joint operation or a joint venture**
Although the term “joint venture” is commonly used in practice, it is narrowly defined by the new standard for joint arrangements. Judgement may be needed to determine whether the joint arrangement’s legal form, contractual terms and facts and circumstances give the parties rights to the net assets of the arrangement (i.e., a ‘joint venture’), or rights to the assets and obligations for the liabilities of the arrangement (i.e., a ‘joint operation’). For example, if the contractual arrangement establishes that the parties to the joint arrangement are liable for claims raised by third parties, that would indicate that the parties have obligations for the liabilities of the arrangement, which is therefore a joint operation.

**Data accumulation**
New processes and systems (or modifications to existing processes and systems) may be needed to gather information (such as contracts, agreements and other data related to investments), to assess the impact in advance of implementation, to make judgements on an ongoing basis, and to comply with new disclosure requirements. The process of identifying the population of potential investments that require reconsideration could itself be a time consuming and difficult task.

For example:
**Evaluating if an entity has control when it has less than a majority of voting rights**
How will the entity gather information about the rights held by other shareholders? How will the entity keep track of mergers and acquisitions of other entities that may affect the relative rights and dispersal of other shareholders? How will entities determine the date at which other shareholders become dispersed?

**Valuing assets for acquisition accounting**
Acquisition accounting will be required for investments that have not previously been consolidated, but are now deemed to be controlled. This will involve identifying and measuring at fair value all identifiable assets acquired, liabilities assumed and any non-controlling interest in the investee. Does the entity have the expertise to do this in-house or will external assistance be required?
Evaluating a remuneration structure
Evaluating if a remuneration structure is indicative of a party being a principal or an agent will require the gathering and continuous monitoring of market information. Does the entity have the information needed to assess whether the remuneration structure is commensurate with the level of skills needed to provide decision making services? How will management assess whether the agreement includes only terms, conditions and amounts that are usually present in arrangements for similar decision making services negotiated on an arm’s length basis?

Financial statement metrics
For those entities that will have changes to their group composition (that is, new entities will be consolidated, or previously consolidated entities will be de-consolidated) management should consider how key metrics will change. In addition, the impact on key metrics also should be considered when entities are required to transition from proportionate consolidation to the equity method, or from the equity method to recognition of their assets, liabilities, revenue and expenses under a joint operation that was previously classified as a jointly controlled entity. For example, total assets and total liabilities may increase or decrease, as might total revenues and total expenses.

Management should assess how adopting the new standards will impact management information and key performance indicators used internally for monitoring the performance of the business. Management also should assess how such changes will be presented on analyst calls, in earnings releases, and other shareholder communications. By performing an early impact assessment, management will be able to identify the effects of adopting these standards early on, and appropriately communicate this impact to stakeholders. Loan covenant compliance should also be considered. In addition, when bonuses, share-based payment vesting conditions, and other compensation plans depend on a group’s consolidated position, management may need to reassess whether the metrics included in these plans remain appropriate.

Regulatory compliance
The change in financial measures resulting from implementation of the new standards could affect compliance with regulatory requirements in certain industries. For example, this may be the case when entities are required to maintain leverage or gearing ratios within certain levels.

If entities were to consolidate a previously unconsolidated investment operating in a regulated industry, this may expose the group to regulatory requirements not previously considered. In addition, some entities may have a regulatory requirement to report on internal controls of the group. If those entities are now required to consolidate a previously unconsolidated entity, management should evaluate the internal controls it has in place related to the newly consolidated entity.

Tax impact
Management should consider the tax impact of adopting the new standards. In many cases, changes to the consolidated group (either adding new entities, or deconsolidating entities that were previously consolidated) will not change the income tax payable. However, in some cases, a taxable gain or loss may result. Management should also ensure that book and tax bases of newly-consolidated assets and liabilities are carefully tracked, so that the presentation of deferred tax assets and liabilities is correct.
Structuring transactions and arrangements

Management needs to consider the requirements of the new IFRS when negotiating new arrangements or modifying existing ones. If management has historically structured arrangements in a manner that achieved a particular accounting treatment, it will need to consider whether the same results are achieved under the new standards. Although the effective date of these new standards is not until 1 January 2013, management is required to disclose the impact of adopting the new IFRS even before they become effective. An early analysis will help management avoid surprises and ease transition.

How will an investee’s business be affected?

Under the new standards, investors are likely to request more information from an investee. This information will allow investors to assess whether they have control over the investee (or whether control is held by other investors), and it will also allow investors to comply with the additional disclosure requirements of the new standards.

If an investee itself also has investments in other entities, it will need to obtain this same information.

How can Ernst & Young help?

Ernst & Young can bring its multi-disciplinary team of accounting, tax, systems, and IT professionals to your company to assist in assessing what these new IFRS mean to you. In the table below, we outline issues and steps the company should consider related to the new standards, and indicate how Ernst & Young may be able to help you from initial assessment through to adoption.

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<th>Issues and steps</th>
<th>How Ernst &amp; Young can help</th>
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<td>Gain a general understanding of the new standards</td>
<td>► Design and deliver a training session for company personnel</td>
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| Perform a preliminary assessment of the impact of the standards on the entity’s financial statements | ► Advise and provide input into:  
  ► Identifying shortfalls in available information when adopting the new standards  
  ► Gathering all of the necessary information to adopt the new standards  
  ► Identifying the population of interests, investments, and arrangements that may be affected by the new standards  
  ► Determining whether an investor has control, and therefore, whether consolidation is appropriate  
  ► Allocating the purchase price for newly consolidated entities  
  ► Calculating the income statement and balance sheet impact of adopting the new standards  
  ► Assessing the impact on key financial ratios and performance measures for the group  
  ► Assessing the impact of the new standards on planned transactions                |
| Benchmark the entity against peers and others in the industry                    | ► Provide observations of how others are approaching the new standards, problems they have encountered, and solutions developed  
  ► Assist in the evaluation of peers, competitors and industry disclosures related to the expected impact on the financial statements |
| Assess processes for data collection, internal controls and IT systems            | ► Provide observations and insights based on leading practices regarding ways the entity could design its business processes, IT systems and internal controls  
  ► Provide criteria to consider in selecting IT packages and assist in the selection process |
| Assess processes for data collection, internal controls and IT systems            | ► Provide observations and insights based on leading practices regarding ways the entity could design its business processes, IT systems and internal controls |
| Assess tax positions relating to the new standards                               | ► Advise on identifying processes for keeping track of tax bases  
  ► Advise on the accounting implications of differences between book values and tax bases |
| Plan for ultimate adoption of the proposed standard                              | ► Advise on project management and planning, including timeline, tasks and resource allocation |
| Update accounting manuals and accounting policies                                | ► Read and provide input into accounting manuals and policies selected by management |
| Communicate effect of adoption to stakeholders, analysts, regulators and shareholders | ► Advise on developing a communications plan  
  ► Advise on drafting communications |
About Ernst & Young

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About Ernst & Young’s International Financial Reporting Standards Group

The move to International Financial Reporting Standards (IFRS) is the single most important initiative in the financial reporting world, the impact of which stretches far beyond accounting to affect every key decision you make, not just how you report it. We have developed the global resources – people and knowledge – to support our client teams. And we work to give you the benefit of our broad sector experience, our deep subject matter knowledge and the latest insights from our work worldwide. It’s how Ernst & Young makes a difference.

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