

CONSOLIDATED FINANCIAL STATEMENTS

IFRS10 (EFFECTIVE DATE: 1 JANUARY 2013)

5.1. INTRODUCTION

The objective of IFRS10 is to establish principles for the presentation and preparation of consolidated financial statements when an entity controls one or more other entities. IFRS10 determines when an entity should present consolidated financial statements and sets out the accounting principles to be applied in the preparation thereof.

5.2 SCOPE

An entity that is a parent is required to present consolidated financial statements that satisfy the requirements of IFRS10 with the exception of:-

5.2.1 A parent that meets all of the following conditions:-

- The parent itself is a wholly owned subsidiary or if a partially owned subsidiary, the other owners of the parent (including those not otherwise entitled to vote) have been informed about and do not object to the parent not presenting consolidated financial statements;
- The parent's debt or equity instruments are not publicly traded;
- The parent is not in the process of issuing any class of instruments in public markets; and
- The ultimate or intermediate parent of parent produces consolidated financial statements available for public use that comply with IFRSs.

5.2.2 Post-employment benefit plans or other long-term benefit plans to which ``

IAS19 Employee Benefits apply, are not required to apply the requirement of IFRS10.

5.3. KEY TERMINOLOGY

- **Consolidated Financial statements**

The financial statements of a group in which the assets, liabilities, equity, income, expenses and cash flows of the parent and its subsidiaries are presented as those of a single economic entity.

- **Control of Investee**

An investor controls an investee when the investor 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.

- **Parent**

An entity that controls one or more entities.

- **Power**

Existing rights that give the current ability to direct the relevant activities.

- **Protective rights**

Rights designed to protect the interest of the party holding those rights without giving that party power over the entity to which those rights relate.

- **Decision maker**

An entity with decision-making rights that is either a principal or an agent of other parties.

- **Group**

A parent and its subsidiaries.

- **Non-controlling interest**

Equity of a subsidiary not attributable directly or indirectly to a parent.

- **Relevant activities**

Activities of the investee that significantly affect the investee's returns.

5.4. **CONCEPT OF CONTROL**

An investor determines whether it is a parent by assessing whether it controls one or more investees. An investor considers all relevant facts and circumstances when assessing whether it controls an investee.

An investor controls an investee when it has all of the following:

- Power over investee.
- Exposure (or rights) to variable returns through its relationship with the investee.
- The ability to use its power over the investee to affect the amount of the returns to which it is exposed.

Should facts and circumstances indicate that any of the above-mentioned three elements of control have changed the investor should reassess whether it controls the investee.

NB: Power arises from rights. Such rights can be straight forward (i.e. through voting rights) or be complex (e.g. embedded in contractual arrangements). An investor that holds only protective rights cannot have power over an investee and so cannot control and investee.

5.4.1 Assessing control

The broad categories of factors to be considered when assessing control per IFRS10 are as follows:-

- Relationship with other parties.
- The purpose and design of the investee.
- Power of investee.
- Exposure (or rights) to variable returns.
- The link between power and returns.
- Continuous assessment.

5.4.2 Relationships with other parties

- In order for an investor to control the investee, it should be able to exercise control unilaterally. If the consent of one or more other investors is required in order to exercise control so that no investor individually controls the investee, IFRS10 is NOT applied to the investment. Instead the investor considers if it is a party to a joint arrangement in terms of IFRS11 or it has significant influence in terms of IAS28.
- An investor with decision making rights determines whether it acts as principal or as an agent of other parties. An agent is a party primarily engaged to act on behalf and for the benefit of another party and therefore does not control the investee when it exercises its decision-making authority. An essential characteristic of an agent is that it receives market-related remuneration for exercising its decision-making power.

Besides the remuneration to which the decision-maker is entitled the investor should also consider all of the following factors when determining whether the decision-maker is its agent.

- **The scope of the decision-maker's authority**

This is evaluated by considering:-

- i) The activities that are permitted in terms of the decision-making agreement and specified by law and;
- ii) The discretion that the decision-maker has when making decisions about these activities.

By carrying out this evaluation, it can be established whether the decision-maker has the ability to direct the relevant activities.

- **The rights held by the investor and other parties**

Substantive rights held by the investor and other parties may affect the decision maker's ability to direct the relevant activities of the investee.

If the investor holds substantive removal rights and can remove the decision-maker without cause, this in isolation, is sufficient to determine that the decision-maker is an agent of the investor and no further evaluation is required.

- **Exposure to variability of returns from other interests**

If the decision-maker holds other interests (e.g. investments, guarantees) in an investee and these, are over and above the remuneration it receives, the decision-maker is likely to be a principal and not an agent of the investor or another party. This exposure of the decision-maker should be evaluated relative to the total variability of returns of the investee.

NB: A decision-maker that is a principal in its own right, while not an agent of the investor may still be a de facto agent of another. A de facto agent can control an investee and be required to present consolidated financial statements even though the ultimate control over the investee rests elsewhere e.g. an interim parent may be a de facto agent of the ultimate parent.

5.4.3 **The purpose and design of the investee**

By considering the purpose and design of the investee it may be clear that, an investee is controlled through proportionate voting rights attached to equity instruments i.e. voting rights would be dominant factor in determining control of the investee.

In some situations, holding the majority of voting rights does not necessarily provide the investor with control over the investee. The design of the investee may be such that a contractual agreement provides the ability to direct the relevant activities of the investee to a party that hold little (or even no) voting power, while the voting rights of other parties relate only to insignificant activities outside the scope of the contractual agreement.

5.4.4 Power over investee

An investor has power over an investee when:-

- it has existing rights;
 - that gives it the current ability
 - to direct the activities that significantly affects the investees returns (relevant activities).
- According to IFRS10, the following examples of rights can individually or in combination, give an investor power over an investee.
 - i) voting rights.
 - ii) rights to appoint, reassign or remove members of the investee's key personnel who have the ability to direct the relevant activities.
 - iii) rights to appoint or remove another entity (e.g. service provider) that directs the relevant activities.
 - iv) rights to direct the investee to enter (or veto any changes to) transactions for the benefit of the investor.
 - v) other rights (e.g. contractual rights) that give the investor the current ability to direct the relevant activities.
 - IFRS10 requires that when assessing whether it has power over another entity, an investor considers its existing substantive rights. Substantive rights are those rights that the holder has the practical ability to exercise. Substantive rights include ordinary shares that currently carry voting power as well as potential ordinary shares (e.g.

options to purchase ordinary shares) that are practically exercisable at the date that power is assessed.

NB: It is only the investor's substantive rights that are taken into account when assessing power.

5.4.4.1 Protective rights

As protective rights by definition do not provide a holder with power over investee, an investor that hold only protective rights cannot have power nor prevent another party from having power over an investee. The following are examples of protective rights

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- Rights of a lender under a loan covenant – a loan agreement may place restrictions, on new borrowings of the payment of dividends.
- The right of a party holding non-controlling interest to approve for example:-
 - capital expenditure greater than required in the ordinary course of business.
 - issue of equity or debt instruments.
 - the liquidation of investee.
 - changes in the founding documents of investee.
- The right of lender to seize assets of investee in the case of default.

NB: Thus the holder of protective rights cannot interfere with significant day-to-day decisions related to relevant activities of the investee.

5.4.4.2 Voting rights

Voting rights are the most common way in which the activities of an investee are directed. The following issues should be considered where this is the case.

i) **Power with a majority of voting rights**

Generally speaking, an investor holding more than half of the voting rights of an investee has power when the holder of the majority voting rights can:

- direct the relevant activities; or
- appoint a majority of members of the governing board that directs the relevant activities.

ii) **A majority of voting rights, but no power**

Such a situation arises if:-

- the investor's voting rights are not substantive;

- the voting rights do not provide the investor with the current ability to direct the relevant activities; or
- another entity, that is not an agent of the investor, holds existing rights that provide it with the current ability to direct the relevant activities.

iii) **Power without a majority of voting rights**

An investor may hold power without a majority of voting rights even though the investee's relevant activities are normally directed through voting rights, for example:-

- Contractual arrangements between the investor and other vote holders.
- Rights arising from other types of contractual agreements e.g. a management contract.
- The existence of potential voting rights. These are, considered only, when they are substantive. Voting rights are substantive if the holder has the practical ability to exercise these rights.

iv) The nature and the circumstances around the investor's voting rights, e.g. the size of the investors holding relative to the size (and dispersion) of the holdings of other vote holders.

5.4.5 **Exposure (or Rights) to variable returns**

IFRS10 requires an investor to assess whether its returns from involvement with the investee are variable as well as how variable those returns are on the basis of the substance of the arrangement (substance over legal form).

NB: An investor is exposed (or has rights) to variable returns from its involvements with the investee, when the investor's returns from the investee have the potential to vary as a result of the investee's performance. Variable returns may affect both the degree of potential returns (e.g. magnitude of returns) and/the direction of the returns (i.e. whether the returns are positive or negative).

5.4.6 **The link between power and returns**

An investor controls an investee if the investor not only has power over the investee and exposure (or rights) to variable returns from its involvement with the investee, but also has the ability to use its power to affect the returns it receives.

5.4.7 Continuous assessment

An investor should reassess whether or not it controls an investee whenever facts or circumstances indicate that there have been changes to one or more of the elements of control, for example:-

- There may be a change in how power over an investee may be exercised.
 - for example, a change to decision-making rights can mean that relevant activities are no longer directed by means of voting rights, but by way of a contract. This could cause other parties to hold power over the investee, previously held by the investor.
 - an entity does not need to be involved in the event in question. For example, the contractual decision-making rights of another party may lapse and as a result, an investor gain power over the investee.
- An investor's exposure (or rights) to variable returns may change.
 - an entity loses control over an investee if it ceases to be entitled to returns or to be exposed to obligations e.g. if a performance-related fees contract is terminated.
- The link between power and returns may have changed.
 - in this respect the investor's status as a principal or agent in its relationship with the investee may change e.g. if voting rights of various parties involved are renegotiated.

5.5. CONSOLIDATION PROCEDURES

5.5.1 General principles

Consolidated financial statements

- combine like items of assets, liabilities, equity, income, expenses and cash flows of the parent with those of its subsidiaries.

- offset (eliminate) the carrying amount of the parent's investment in each subsidiary and the parent's portion of equity of each subsidiary (IFRS3 Business Combinations explains how to account for any related goodwill).
- eliminate in full intragroup assets and liabilities, equity, income, expenses and cash flows relating to transactions between entities of the group (profits or losses resulting from intragroup transactions that are recognized in assets, such as inventory and non-current assets, are eliminated in full).

A reporting entity includes the income and expenses of a subsidiary in the consolidated financial statements from the date it gains control until the date when the reporting entity ceases to control the subsidiary. Income and expenses of the subsidiary are based on the amounts of the assets and liabilities recognized in the consolidated financial statements at the acquisition date.

5.5.2 Reporting date

The parent and subsidiaries are required to have the same reporting dates, or consolidation based on additional financial information prepared by subsidiary, unless impracticable. Where impracticable, the most recent financial statements of the subsidiary are used, adjusted for the effects of significant transactions or events between the reporting dates of the subsidiary and consolidated financial statements. The difference between the date of the subsidiary's financial statements and that of the consolidated financial statements shall be no more than three months.

5.5.3 Uniform Accounting Policies

Consolidated financial statements should be prepared using uniform accounting policies for like transactions and other events in similar circumstances. If a subsidiary uses accounting policies that differ from those of the group, appropriate adjustments need to be made before commencing the consolidation process.

5.5.4 Non-controlling interests (NCIs)

A parent presents non-controlling interests in its consolidated statements of financial position within equity, separately from the equity of the owners of the parent.

A reporting entity attributes the profit or loss and each component of other comprehensive income to the owners of the parent and to the non-controlling interests.

The proportion allocated to the parent and non-controlling interests are determined on the basis of present ownership interests.

5.5.5 Changes in ownership interests

Changes in a parent's ownership interest in a subsidiary that do not result in the parent losing control of the subsidiary are equity transactions (i.e. transactions with owners in their capacity as owners). When the proportion of the equity held by non-controlling interest changes, the carrying amounts of the controlling and non-controlling interests are adjusted to reflect the changes in their relative interests in the subsidiary. Any difference between the amount by which the non-controlling interests are adjusted and the fair value of the consideration paid or received is recognized directly in equity and attributable to the owners of the parent.

If a parent loses control of a subsidiary, the parent (IFRS10:25):

- derecognizes the assets and liabilities of the former subsidiary from the consolidated statement of financial position.
- recognizes any investment retained in the former subsidiary at its fair value when control is lost and subsequently accounts for it and for any amounts owed by or to the former subsidiary in accordance with relevant IFRSs. That fair value is regarded as the fair value on initial recognition of a financial asset in accordance with IFRS9 *Financial Instruments* or, when appropriate, the cost on initial recognition of an investment in an associate or joint venture.
- recognizes the gain or loss associated with the loss of control attributable to the former controlling interest.

Disclosures

There are no disclosures specified in IFRS10. Instead, IFRS12 *Disclosure of Interests in Other Entities* outlines the disclosures required.

5.6. PRACTICE QUESTIONS (With answers)

Question 5.6.1 : Removal rights held by investor

Notai Ltd has invested in an investment fund managed by Chimusoro, the fund manager. Chimusoro has decision-making rights that provides him with the current ability to direct all the relevant activities of the fund, within the parameters of the founding document. Chimusoro receives market related compensation for his services of 1% of the net asset value of the fund.

Notai Ltd holds a 5% interest in the investment fund. In addition, Notai Ltd holds a right with which it can terminate the services of Chimusoro at any time and without consulting other parties by giving Chimusoro 30 days notice. Notai Ltd does not have to show just cause for the decision to remove Chimusoro.

Required:

Does Notai Ltd control the investment fund? Motivate your answer. (Adapted GAAP 2012)

Solution 5.6.1

As Notai Ltd holds a removal right that it can exercise on its own, Chimusoro (the decision-maker) directs all the relevant activities of the fund, and according to IFRS10, no further consideration is necessary in determining who controls the investment fund. Chimusoro is an agent of Notai Ltd. Notai Ltd would take into consideration Chimusoro's decision-making rights together with its own when determining whether or not it controls the investment fund.

Question 5.6.2 : (Remuneration)

Notai Ltd hold an investment in an investment fund managed by Chimusoro, a fund manager. The fund manager has decision-making rights that provide him with the current ability to direct all the relevant activities of the fund, within the parameters of the founding document.

Chimusoro receives compensation for his services of 1% of the net asset value of the fund. Market-related compensation for services of this nature amounts to 3% of assets under management plus a performance-based component.

Required:

Explain whether Notai Ltd has control over the investment fund or not. (Adapted GAAP 2012).

Solution 5.6.2

The remuneration received by the fund manager is not market related. Accordingly, Chimusoro cannot be an agent of Notai Ltd. On this basis, Notai Ltd does not control the investment fund. Notai Ltd would consider whether Chimusoro may still be a de facto

agent. In addition, Chimusoro would determine whether he is a principal in respect of the investment fund and consider whether he control the investee.

Question 5.6.3 : Substantive Rights

Taguta Ltd holds 20% of the voting rights of Shinga Ltd. In addition, Taguta enters into a forward contract that obligates it to acquire ordinary shares with an additional 35% of the voting rights in Shinga Ltd. The forward contract will be settled in 22 days time. In the relationship of Taguta Ltd and Shinga Ltd, voting rights are the only relevant factor in determining power and all significant decisions regarding the relevant activities are required to be taken on a shareholders' meeting. 30 days notice is required by law to call a shareholders' meeting.

Required:

Does Taguta Ltd have power over Shinga Ltd? Motivate your answer. (Adapted GAAP 2012).

Solution 5.6.3

Taguta Ltd has power over Shinga Ltd as it has substantive voting rights of 55% (20% + 35%). The voting rights under the contract are substantive from the date that Taguta Ltd enters into the contract, as they will be exercisable on the first date that significant decisions relating to relevant activities may be taken.

Tutorial Note

In the above scenario, if a shareholders' meeting had been scheduled for 2 days after Taguta Ltd entered into the forward contract, Taguta Ltd would only acquire substantive rights under the forward contract immediately after the close of the meeting in question. This is because the voting rights will only be exercisable at subsequent meetings.

The same situation would apply if Taguta Ltd had entered into an option instead of a forward contract, exercisable 22 days from the date of issuance, provided that there are not other barriers to the exercise of the option (e.g. the option is deeply in the money and Taguta Ltd has the financial resources to exercise the option).

Question 5.6.4 : Potential voting rights held by Investor

Zihombe Ltd holds 30% of the voting rights in Kadiki Ltd, whose relevant activities are directed through voting rights. Zihombe Ltd holds an option to acquire an additional 25% of the voting rights in Kadiki Ltd that is deeply in the money. The option is currently exercisable and there are no other barriers to prevent Zihombe Ltd from exercising its option.

Required:

Does Zihombe Ltd have powers over Kadiki Ltd? Motivate your answer.

Solution 5.6.4

Zihombe Ltd has power over Kadiki Ltd. As the option is deeply in the money the exercise of the option is to the benefit of Zihombe. As the option is currently exercisable and there are no other barriers preventing Zihombe Ltd from exercising its option, the potential voting rights in Kadiki Ltd are substantive. Zihombe would consider its current voting rights of 30% together with the potential of the option (25%) to determine that it controls a majority of the voting rights (55%).

