**Solutions manual**

**Chapter 1**

**Text objectives and introduction to consolidation**

**(Pages 36-40)**

***Q1.1 Important terminology in AASB 10 (Section 1.2)***

The terms will be defined with reference to the following organisational structure.

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*Parent entity*: A parent is an entity that has one or more subsidiaries (AASB 10.Appendix A). In the above illustration, A Ltd is the parent entity of B Ltd and C Ltd because it has direct control over B Ltd and indirect control over C Ltd. It should be noted that B Ltd is also a parent entity to C Ltd.

*Ultimate parent entity*: The ultimate parent entity in the above illustration is A Ltd because it has ultimate control over the A Ltd Group, B Ltd, the B Ltd Group and C Ltd.

*Subsidiary*: A subsidiary is an entity, including an unincorporated entity such as a partnership that is controlled by another entity known as the parent (AASB 10.Appendix A). In the above illustration, B Ltd and C Ltd are subsidiaries to A Ltd because A Ltd controls them through a singular line of power. C Ltd is also a subsidiary to B Ltd.

*Group:* A group consists of a parent (entity) and all its subsidiaries (AASB 10.Appendix A). In the above illustration, the A Ltd group comprises A Ltd and its controlled entities B Ltd and C Ltd. It should be noted that there is also a B Ltd group made up of B Ltd (parent entity of the B Ltd group) and C Ltd (its subsidiary).

***Q1.2******Rationale for groups (Section 1.3)***

There are a number of advantages of conducting business activities using multiple entities rather than a single entity. The Companies and Securities Advisory Committee (2000) identified the following potential benefits of conducting economic activity through a corporate group structure.

1. Reducing commercial risk or maximising potential returns through diversification. Often diversification is achieved through incorporating or acquiring new companies.
2. Attracting capital without forfeiting control. Management may not wish to allow outside investors to increase their level of control of the parent entity, but want outside investment as part of their overall business. This can be achieved by allowing outside shareholders to acquire shares in a subsidiary.
3. Lowering the risks of legal liability, including environmental and consumer liability. By setting up a number of separate subsidiaries, other group assets can be isolated and protected from high liability risks. In other words, high-risk activities are ‘quarantined’ in a limited liability entity.
4. Providing better security for proposed loans. By transferring assets into a separate entity, a potential lender will have the opportunity to obtain a first charge over specific assets. This could benefit the group by facilitating a lower cost of borrowing, particularly through project financing.
5. To comply with regulatory requirements. Some multinational groups need to comply with the foreign rules which require that business operations be conducted through a subsidiary that is incorporated in the foreign jurisdiction.

***Q1.3 Consolidated financial statements (Section 1.4.1)***

The objective of consolidated financial statements is to show the operating results and financial position of a cluster of business entities related by control (i.e., a group) as if they were operating as a single accounting entity controlled by the same management (the parent of the group). The consolidated statement of comprehensive income reports the profit or loss that arises from transactions with parties that are external to the group. Similarly, the consolidated statement of financial position shows the assets controlled by the group, the liabilities the group owes to external parties and the equity of the collective owners of the group. The consolidated statement of changes in equity explains the change in consolidated equity between the end of the previous period and the end of the current period, while the consolidated cash flow statement reports the cash flows that have occurred between the group and parties external to the group.

Consolidated financial statements provide financial information based on the group’s point of view. The parent entity and other non-controlling interests in subsidiaries are both regarded as stakeholders in the group and consolidated financial statements are not slanted towards any specific ownership interest within the group. The group concept of consolidation adopts a global perspective and, for accounting purposes, there is no distinction between the parent interest and non-controlling interest. However, for disclosure purposes, AASB 10 requires an allocation of total consolidated equity between the parent entity interest and non-controlling interest.

***Q1.4******Entity concept of consolidation (Section 1.5.6)***

The entity concept of consolidation requires consolidated financial statements to be prepared from the perspective of the group and only includes transactions the group has undertaken with external parties. Accordingly, it will include/exclude:

1. All assets and liabilities of the parent and controlled entities as these are assets controlled and liabilities incurred respectively by the group;
2. All inter-entity transactions are eliminated in full regardless of the level of parent entity’s ownership in controlled entities. The purpose of this is so only transactions external to the group are disclosed in the consolidated financial statements;
3. Non-controlling interest is disclosed as an equity item in the consolidated financial statements as it is seen as an external equity resource supplier to a group; *and*
4. Non-controlling interest is calculated on the contributed equity amount of a partly owned subsidiary. The contributed equity amount is not the amount recorded in the partly owned subsidiary’s single entity financial statements. It is the amount the partly owned subsidiary contributes to the group financial performance and position.

Points 1 (by AASB 10.B86(a)), 2 (by AASB 10.B86(c)) and 3 (by AASB 10.B94) have been clearly incorporated in the provisions of AASB 127. Point 4 is implicit in AASB 10.B86(b).

*Q1.5 Adoption of consolidation accounting in Australia (Section 1.5)*

Refer to Section 1.5.2 of the textbook and directly to the articles by Whittred (1987b) and Walker and Mack (1988) if possible.

##### Whittred’s argument

Whittred argues that the emergence of an innovative debt market spurred the popularity of producing full consolidated statements because the debt covenants in loan contracts referred explicitly to the consolidated accounting numbers and ratios of all members in the corporate group that were jointly and severally liable under such contracts.

The Whittred argument is that consolidated financial reporting in Australia was adopted as a mechanism to reduce agency costs. In particular, the agency costs of management–shareholding contracting and shareholder–debtholder contracting.

##### A brief review of agency theory

Jensen & Meckling (1976) describe the agency relation as follows:

*a contract under which one or more persons (‘principal’) engage another person (‘agent’) to perform some service on their behalf which involves delegating some decision‑making power to the agent*

The principals and the agent in an entity setting are as follows:

* Principal = the shareholders and debtholders of the entity
* Agent = management.

In agency theory, all individuals are assumed to choose actions that maximise their own personal welfare. A problem arises when the interests of the principal and agent do not coincide. The agent may act in its self-interest rather than in the best interests of the principal. Assuming rational expectations, shareholders and bondholders anticipate this divergence and reduce the price they are willing to pay for the entity’s shares or bonds (debentures). This decrease in market value is known as the ‘residual loss’.

To reduce the residual loss, monitoring and bonding contracts are written.

Monitoring contracts go further than observing behaviour via audited financial reports, and include direct incentives for the agent to act in the principal's best interest; for example, management compensation plans where management's wealth is a function of salary, with bonuses based on reported profit and stock options.

The agent may also contract to ensure that the principal's best interests will not be harmed and provide for retribution if they are harmed (i.e., the agent places ‘bonds’ on its own behaviour). For example, management may write a bonding agreement, which reduces its ability to harm bond or debtholders.

The important point to note here is that there is an incentive for management and shareholders–debtholders to enter into contracts in order to reduce the residual loss of the agency relationship and these contracts typically have covenants that are based on accounting information. The costs of these contracts (including the procurement of relevant accounting information) will be borne while there is benefit to entity value at the margin.

In particular, debt covenants that reduce agency costs by tying together the interests of managers–shareholders and creditors often include:

1. Covenants to restrict the production-investment opportunities of the firm;
2. Covenants restricting dividend policy to a function of net profit;
3. Covenants restraining financing policy, usually expressed as gearing ratios such as debt/assets and interest cover; and
4. Covenants for increased financial disclosures.

##### Walker and Mack’s argument

Walker and Mack argue that regulatory factors rather than ‘agency theory’ explain the emergence of consolidated financial reporting by Australian entities. The evidence in Walker and Mack is suggestive of a progressive strengthening of the reporting requirements that apply to parent entities in Australia. The existence of institutional, regulatory and economic changes during the period prior to formal consolidation requirements makes it difficult to determine the relative importance of the factors that contributed to the development of these requirements.

*Q1.6 Consolidation accounting loopholes (Sections 1.5.3 and 1.5.4)*

# Practices used

Prior to the introduction of a standard on consolidated financial statements, parent companies were able to avoid consolidation of effectively controlled entities by astute use of the fact that the definition of a subsidiary in the then *Companies Act 1981* (and the *Companies Act 1961* before it) related only to corporations and relied on majority ownership. Because of this rather loose definition of a subsidiary, three practices were developed to avoid consolidation of certain controlled companies.

1. *The interposed unit trust*: One avoidance practice was to interpose a non-corporate entity between a parent company and a subsidiary company. For example, a holding company could set up a unit trust (refer to Figure 1.3 in the text) in which it held all the units, with the unit trust used to hold the shares in a controlled company. This practice relied on the *Companies Act 1981* defining the group in terms of corporate entities only. Under the prevailing legislation, a trust was not a ‘subsidiary’ (because a trust is not a company) so it did not have to be consolidated and any companies in which the trust held shares also escaped consolidation.
2. *Technical definition of consolidation*:The second avoidance practice was based on the fact that the term ‘consolidation’ under the 1981 Companies Code (and the Corporations Law briefly until July 1991), did not necessarily mean consolidated accounts. As a consequence of this interpretation, it was common practice to omit finance subsidiaries from the group provided adequate justification was given. Their omission was justified on the dubious grounds that their operations were fundamentally different from other companies in the group. Section 1.7.6 of the text notes that recent changes to AASB 10 have resulted in certain ‘investment entities’ being exempted from the requirement to consolidate their subsidiaries. Although this exemption is quite limited, it does represent a backward step from the general principle that all controlled entities should be included in consolidated financial reports.
3. *Majority ownership loophole*:The third avoidance practice relied on a legalistic interpretation that the subsidiary definition in the *Companies Act 1981* required ownership of more than half of the ordinary voting shares of a company. In practice, it became generally accepted that a company holding 50% or 49.9%, or some lower percentage of the ordinary voting shares in another company, did not have to classify that other company as a subsidiary. Whether one company had *de facto* control over another company was frequently treated as being irrelevant to the subsidiary definition. Therefore, majority share ownership was central to consolidation practice and corporate managers with incentives to exclude or remove a company from the consolidation need only arrange a shareholding of 50% or less. None of these companies would be deemed subsidiaries because of the absence of majority share ownership.

**How did the consolidation standard attempt to put a stop these dubious practices?**

The first consolidation standard (issued as AAS 24 in June 1990) attempted to stop the previously mentioned practices by the following.

* Substituting the words ‘parent entity’ for ‘holding company’ and redefined ‘subsidiary’ as an entity (not necessarily a company) that is controlled by another entity. This meant that non-corporate entities, such as trusts and partnerships, had to be consolidated in addition to companies controlled by a parent entity. Therefore, the interposed unit trust technique could no longer be used to avoid consolidating less performing and/or highly geared companies.
* Requiring all subsidiaries to consolidate. There were to be no exceptions to this basic principle.
* Stating that the control criterion, rather than majority ownership, would be used as the trigger to determine whether consolidation would take place. The control criterion established economic substance rather than legal form as determining the boundaries of the group subject to consolidation.

# Has the attempt been successful?

The consolidation standards (AAS 24, AASB 1024, AASB 127 and AASB 10) have increased the frequency of consolidation of non-corporate entities and less-than-majority-owned companies (refer to Table 1.3 in the text) and, using this as a criterion, it could be argued that the standards were successful.

AASB 1024 also introduced greater uniformity to consolidation accounting practices. Because of the absence of a prior standard on consolidation accounting, a wide variety of consolidation practices were in use and had become regarded as acceptable. AASB 1024 set out to remedy this problem and addressed other significant issues including:

* The adoption of the group concept as the basis for the techniques of full consolidation;
* The disclosure of consolidated equity items disaggregated into equity attributable to the parent entity and equity attributable to non-controlling interest arising from partly owned subsidiaries;
* The method of dealing with profits and losses arising from transactions within the group; and
* The methods of accounting for increases and decreases in the level of ownership interest.

AASB 10 has provided greater clarification on a number of topics associated with the determination of control including more guidance on principal–agent relationships, the determination of *de facto* control, and guidance on the application of the control concept in the context of the not-for-profit sector.

***Q1.7 Special Purpose Entities (SPEs) (Section 1.5.5)***

As their name implies, Special Purpose Entities (SPEs) are entities such as trusts or companies that are created for a specific purpose and to exist separately from the entity that created them. In the text, the example was provided of SPEs created to allow financial institutions like banks to ‘securitise’ certain types of financial assets which could then be on-sold via the SPE to third-party investors. The SPE is primarily a vehicle through which the bank transfers its interests and the risks associated with the financial assets to the third-party investors. By using the SPE, the bank seeks to argue that it has ‘sold’ the financial assets to the SPE and so no longer has any responsibility should the financial assets become impaired. The banks argue that the SPE is a separate entity over which the bank has no control (this argument is often based on the SPE being created using a constitution that is on ‘auto-pilot’ and so the bank is not involved in the day-to-day running of the SPE).

Although using SPEs in this way can make good economic sense (e.g., the bank can transfer risk and generate cash flows from the sale of the financial assets), these practices were highly criticised during the Global Financial Crisis because it has been argued that the non-consolidation of SPEs with the financial institutions that created them meant that many investors were misled or uninformed about the riskiness of what they were buying. IFRS 10 (AASB 10) was issued as a direct response to these criticisms. The new guidance provided in IFRS 10 (AASB 10) is designed to ensure that SPEs can only be left off-balance sheet if the entity that created them does not have control of the SPE (it especially addresses the cases of *de facto* control arrangements).

##### *Q1.8 When consolidated financial statements must be prepared (Section 1.6.1)*

For a detailed discussion on which entities must prepare consolidated financial statements, refer to Section 1.6.1 of the text. AASB 10.Aus 3.1 applies to:

1. *each entity that is required to prepare financial reports in accordance with Part 2M.3 of the Corporations Act and that is a reporting entity*
2. *general purpose financial statements of each other reporting entity, and*
3. *financial statements that are, or are held out to be, general purpose financial statements.*

Chapter 2M.3 s. 292 states:

*(1) A* [*financial report*](http://www.austlii.edu.au/au/legis/cth/consol_act/ca2001172/s9.html#financial_report) *and a* [*directors*](http://www.austlii.edu.au/au/legis/cth/consol_act/ca2001172/s9.html#director)*' report must be prepared for each* [*financial year*](http://www.austlii.edu.au/au/legis/cth/consol_act/ca2001172/s9.html#financial_year) *by:*

1. *all disclosing entities; and*
2. *all public companies; and*
3. *all large proprietary companies; and*
4. *all* [registered](http://www.austlii.edu.au/au/legis/cth/consol_act/ca2001172/s1276.html#registered) *schemes.*

*Small proprietary companies*

*(2) A* small *proprietary* [*company*](http://www.austlii.edu.au/au/legis/cth/consol_act/ca2001172/s9.html#company) *has to prepare the* [*financial report*](http://www.austlii.edu.au/au/legis/cth/consol_act/ca2001172/s9.html#financial_report) *and* [*directors*](http://www.austlii.edu.au/au/legis/cth/consol_act/ca2001172/s9.html#director)*' report only if:*

1. *it is directed to do so under* [section 293](http://www.austlii.edu.au/au/legis/cth/consol_act/ca2001172/s293.html) *or* [294](http://www.austlii.edu.au/au/legis/cth/consol_act/ca2001172/s294.html)*; or*
2. *it was* [*controlled*](http://www.austlii.edu.au/au/legis/cth/consol_act/ca2001172/s9.html#control) *by a* [*foreign*](http://www.austlii.edu.au/au/legis/cth/consol_act/ca2001172/s9.html#foreign_company)[*company*](http://www.austlii.edu.au/au/legis/cth/consol_act/ca2001172/s9.html#foreign_company) *for all or part of the year and it is not consolidated for that period in* [*financial statements*](http://www.austlii.edu.au/au/legis/cth/consol_act/ca2001172/s9.html#financial_statements) *for that year* [*lodged*](http://www.austlii.edu.au/au/legis/cth/consol_act/ca2001172/s9.html#lodge) *with* [*ASIC*](http://www.austlii.edu.au/au/legis/cth/consol_act/ca2001172/s9.html#asic) *by:*

*(i) a* [registered](http://www.austlii.edu.au/au/legis/cth/consol_act/ca2001172/s1276.html#registered)[foreign](http://www.austlii.edu.au/au/legis/cth/consol_act/ca2001172/s9.html#foreign_company)[company](http://www.austlii.edu.au/au/legis/cth/consol_act/ca2001172/s9.html#foreign_company)*; or*

*(ii) a* [company](http://www.austlii.edu.au/au/legis/cth/consol_act/ca2001172/s9.html#company)*,* [registered](http://www.austlii.edu.au/au/legis/cth/consol_act/ca2001172/s1276.html#registered) *scheme or* [disclosing entity](http://www.austlii.edu.au/au/legis/cth/consol_act/ca2001172/s9.html#disclosing_entity)*.*

The general requirement to prepare consolidated financial statements is dealt with by AASB 10.Aus4.2.

*Notwithstanding paragraphs 4(a) and Aus4.1, the ultimate Australian parent shall present consolidated financial statements that consolidate its investments in subsidiaries in accordance with this Standard when either the parent or the group is a reporting entity or both the parent and the group are reporting entities.*

A reporting entity is an entity in respect of which it is reasonable to expect the existence of users who rely on the entity’s general purpose financial statement for information that will be useful to them for making and evaluating decisions about the allocation of scarce resources. A reporting entity can be a single entity or a group comprising a parent and all its subsidiaries (SAC 1.40)

**The financial statements that must be prepared**

The financial statements required by s. 295 are prescribed in AASB 101. More specifically AASB 101.10 requires that the following financial statements be included as part of the content of a financial report:

* A statement of financial position;
* A statement of comprehensive income;
* A statement of changes in equity;
* A cash flow statement; and
* Notes.

##### Note that only the consolidated financial statements need to be provided to shareholders of the parent entity (refer to Solution to Q1.10).

***Q1.9******Preparation of consolidated financial statements (Section 1.6.1)***

1. A large proprietary company with a substantial loan and a wholly owned subsidiary

It appears that See Pty Ltd only has to provide financial information for ‘inside shareholders’ (Mr P and his sons) and its banker (BMI Limited). Both of these users are in a position to command the specific financial information that they need (i.e., specific purpose financial reports). For example, as part of the terms and conditions of the loan agreement See Pty Ltd must provide monthly cash flow data to BMI Limited. It follows that See Pty Ltd and the See Pty Ltd group entity are non-reporting entities.

Conclusion: See Pty Ltd is not required to prepare consolidated financial statements.

1. A listed company with a wholly owned subsidiary

As discussed in Section 1.4.1 of chapter one, the definition of reporting entity specifically includes a group with a parent entity that is a listed corporation (i.e., listed on the ASX) as a reporting entity. In addition to this, 20% of the shareholders of A Ltd presumably do not participate in the management of A Ltd and as such would be unable to command the information they require about A Ltd or the A Group. It follows, therefore, that the A Group has users who rely on general purpose financial reports for information for decision making. Thus the A Group is a reporting entity.

Conclusion: A Limited must prepare consolidated financial statements.

1. A significant large proprietary company with control over ten subsidiaries

SAC 1.21 includes ‘economic or political importance/significance’ as an indicator of a reporting entity. Where there are hundreds of employees that are dependent on a corporate group for their economic welfare and many customers that are reliant on the satisfactory performance of contracts, it would seem appropriate to classify the group entity as a reporting entity. This result holds irrespective of the tight ownership interests in the group.

Conclusion: B Pty Limited must prepare consolidated financial statements.

1. Investment company with significant borrowings in receivership

The third arm of AASB 10.7 definition of control relates to the ability of the entity to use its power to obtain benefits from the activities of the other entity. The receiver appointed by Northpac is instructed under a fiduciary arrangement to act as an agent to protect the interests of Northpac and the other secured creditors. The receiver will only be paid fees for services rendered and will not be obtaining any other benefits.

Conclusion: The receiver is not required to consolidate B Ltd.

***Q1.10 Relevance of parent entity’s financial statements (Section 1.6.3)***

The purpose of this question is to consider whether a parent entity’s separate financial statements are or are not relevant and if they add value to a complex group’s consolidated financial statements.

As stated in Section 1.6.3, most parent entities prepare consolidated financial statements and have the choice of disclosing the parent entity’s financial information in the notes to the consolidated financial statements. This choice has been made possible by the *Corporations Amendment (Corporate Reporting Reform) Act of 2010* and ASIC Class Order 10/654. This choice could cause a dilemma for financial statement users as the effects of this decision must be considered by management before making this choice.

For information to be relevant, it must assist users with their economic decisions. From a shareholder’s perspective, it is commonly used to determine return on investment through dividends and capital growth and for a lender as an indicator of capacity to repay and risk. If the parent entity is a trading entity in its own right then it is quite likely financial statement users would consider the parent entity separate financial statements useful as it provides information about its financial performance in a reporting period and exposure to debt/risk. An example would be a parent entity for a complex group whose principle activities are financial services. The parent entity role could be to provide home loans while at the same time controlling the activities within the group. Financial statement users would need the parent’s separate financial statements to assess risk of their loan receivables.

If the parent entity’s role is purely to make strategic policy decisions for the group and the operations are undertaken by the controlled entities within the group, then it is highly likely financial statement users would not find the parent entity’s separate financials relevant as it would only contain dividend revenue, management fees, investments in controlled entities and loans to/from controlled entities. An example is a complex group in the mineral and resources industry. All property, plant and equipment, and debt are recognised in the controlled entities’ financial statements. Accordingly, the group’s consolidated financial statements would be more relevant to financial statement users.

##### *Q1.11 Definition and indicators of control (Section 1.7.2)*

Appendix A and AASB 10.6 define control as follows:

*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.*

AASB 10.7 indicates that there are three essential components to this definition of control, namely: (1) the investor has power over the investee; (2) the investor has exposure or rights to variable returns from its involvement in the investee; and (3) the investor must be able to use the power it has over the investee to affect the amount of the investor’s returns. It is most important to understand that in any given investor-investee relationship, all three of these components must be satisfied before ‘control’ can be confirmed and a parent–subsidiary relationship established. As the AASB 10 definition of control is focused on the economic substance of the investor–investee relationship, simple ‘bright line’ tests such as having more than 50% of the voting shares of the investee are not sufficient to determine the existence of control.

**Power over the investee**

AASB 10.10 indicates that an investor has power over the investee when the investor has existing rights that give it the current ability to direct the relevant activities of the investee. Relevant activities are defined in AASB 10.Appendix A as “activities of the investee that significantly affect the investee’s returns”. Relevant activities are those activities that generate value from the investee. An investor must be able to direct the relevant activities of the investee to satisfy the ‘power’ criterion of the control definition. AASB 10.B5–B13 of Appendix B provide guidance on how to identify an investee’s relevant activities. AASB 10.B5 notes that to identify the relevant activities, it will be necessary to consider the purpose and design of the investee. Although the identification of relevant activities will always depend on the particular facts of the situation, AASB 10.B11 provides some common examples of relevant activities including the buying and selling of goods or services, managing the investee’s financial and non-financial assets or developing new intellectual property.

The investor must have rights that give it the current ability to direct the investee’s relevant activities. Note that the investor does not have to be exercising those rights to have power over the investee. The investor can be ‘passive’ but still have power. For example, A Ltd may own 80% of C Ltd and B Ltd may own the remaining 20% of C Ltd. As at 30th June, 2016 B Ltd may be actively involved on a day-to-day basis in the management of C Ltd’s operations. However, in the absence of any other information, B Ltd does not control C Ltd for the purposes of AASB 10. Although A Ltd has not exercised the power that comes from its 80% holding of C Ltd’s voting shares, it has the current capacity to do so if it wished. It could out vote B Ltd and veto any of B Ltd’s decisions with regard to the relevant activities of C Ltd. Consequently, based on these limited facts, A Ltd would control C Ltd. In this example, A Ltd’s rights are determined by its superior voting power that come from it holding the issued share capital of C Ltd. AASB 10.B22 identifies these types of rights as being ‘substantive rights’; that is, a substantive right is one that the investor has the practical ability to exercise.

Substantive rights are not limited to those that arise from holding equity in the investee. Substantive rights could arise from a legal contract or from legislation or other regulations for example. As the name implies, substantive rights are identified on the basis of the ‘substance’ of the investor–investee relationship rather than its apparent form. For example, it was noted in section 1.5.3 that traditional tests of parent/subsidiary relationships were based on the percentage of voting equity held by the investor in the investee. Typically, an investor entity having a share ownership of more than 50% in the investee was viewed as giving rise to control over the investee. However, under the notion of power in AASB 10, an investor could have power over an investee if it held less than 50% of the voting power of the investee, and even, in some cases if it had no equity ownership at all. These types of situation in which the investor has power only without a majority of voting rights is often called *de facto* power. Clearly, in such situations, the sound exercise of professional judgement is paramount and the facts in each case need to be carefully assessed. AASB 10.B41–B45 provide specific guidance on other factors and circumstances that should be considered when assessing the existence of *de facto* control. In general, evidence should be gathered as to whether there are sufficient rights held by other parties that could act as a counter-veiling power to that held by the investor. A discussion of *de facto* power also highlights that the investor’s control over an investee could be temporary but the existence of so-called ‘temporary control’ does not exempt the investor from consolidating the investee for the period of time that control existed.

Some types of rights that are held by an entity are ‘protective’ rights rather than substantive rights. Appendix A of AASB 10 defines protective rights as:

*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.*

Examples of protective rights are given in AASB 10.B28 and include the right of a lender to seize any assets from a borrower if the borrower breaches specific provisions of its loan contract. Protective rights can be common in the not-for-profit sector where governments, for example, may place a variety of restrictions on the activities of some charities or other entities. As noted by the definition, protective rights are not a basis for establishing power over an investee for the purposes of AASB 10.

**Exposure or rights to variable returns**

The second component of the control definition requires that the investor entity’s own returns be potentially affected by its involvement in the investee. The returns must potentially be variable rather than fixed or in other words the returns from the investee depend upon the investee’s performance (AASB 10.B56). AASB 10’s definition of control adopted the term ‘returns’ rather than the term ‘benefits’ which had been used in the prior version of AASB 127 because it was discovered that some investors were seeking to avoid consolidating loss making subsidiaries by arguing that the losses were not ‘benefits’ to the investor! The term ‘returns’ was adopted because returns can be both positive and negative (AASB 10.B56). Some examples of potential returns from the investee to the investor are provided in AASB 10.B57 and include, but are not limited to, dividends, the ability to obtain resources not available to other parties (e.g., produce distribution channels or access to scarce raw materials), tax benefits, or economies of scale.

**Link between power and returns**

The third component of the control definition is that the investor has to be able to use its power over the investee to impact the amount of return generated by the investee. That is, it is not enough for the investor to be exposed to variable returns from the investee, it must be able to also have the ability to interact with the investee in such a way that it affects how much return the investee makes. This component of the control definition is especially important in the context of our discussion of SPEs in section 1.5.5. It was noted in that section that a bank, for instance, may enter into a securitization arrangement by creating an entity such as a trust that is placed on ‘auto-pilot’. A key component of the auto-pilot arrangement is that the management and decision-making responsibilities for the trust’s relevant activities is given by the bank to an ‘independent’ entity, the trustee. The objective of the arrangement is to allow the bank to meet its securitization needs by transferring power over the trust’s relevant activities to the third party trustee while at the same time avoiding bringing the trust onto the group’s consolidated financial statements. These types of situations are described in AASB 10.18 as ‘principal or agent’ arrangements; that is, it must be determined whether the trustee is the principal investor entity for the trust or whether the trustee is actually only acting as an agent on behalf of the bank (in other words, the bank is the principal and the trustee is the agent). If it is decided that the bank is a principal, then it has not transferred power over the SPE trust to the trustee and it will have to consolidate that SPE trust into the group’s consolidated financial statements.

AASB 10.B58–B75 provide implementation guidance on assessing whether a decision-maker is acting as a principal or as an agent for another investor. Again, it is important to assess each case on its own facts but AASB 10.B60 suggests that factors that should be considered include:

*The scope of the decision-maker’s authority over the investee. If the decision-maker has considerable freedom to make decisions about the relevant activities of the investee, then it is more likely to be a principal;*

*What rights are held by other parties? For example, does another party have substantial and unilateral rights to remove the decision-maker (so-called ‘kick-out’ rights) or must a number of parties be required to act together before the decision-maker can be removed?;*

*How is the remuneration of the decision-maker determined for its involvement in the investee? If, for instance, the decision-maker’s remuneration is largely independent of the returns generated from the investee, then the decision-maker is more likely to be an agent rather than a principal;*

*Does the decision-maker have financial interests other than remuneration in the investee that expose the decision-maker to the variability in returns that would be experienced by a principal? For example, what is the size, if any, of the decision-maker’s holding in the equity of the investee?*

None of these factors in themselves is conclusive in determining whether a decision-maker is a principal or an agent for another investor and it may be that in practice it will be necessary to determine a decision-maker’s status on the balance of a variety of factors.

In summary, the definition of control in AASB 10 requires the facts of each investor–investee relationship to be analysed to determine whether the three components of control have been satisfied; namely, does the investor have power to direct the relevant activities of the investee by having the current ability to exercise substantive rights; is the investor exposed to variable returns from its involvement with the investee; and does the investor have the ability to use its power over the investee to potentially vary the amount of returns generated from the investee. If all three of these components are satisfied, then the investor controls the investee and the investor must prepare consolidated financial statements.

***Q1.12 Determining the power to control (Section 1.7)***

Notes to instructors: The purpose of this question is to demonstrate how to build an argument for or against control. The usual steps involved in this process are:

|  |  |
| --- | --- |
| Item | Technical reference(s) |
| Application of definition of control | AASB 10.5–10.7 |
| Consideration of control without majority ownership | AASB 10.B38 |
| Implications of convertible instruments | AASB 10.B47–B50 |
| Conclusion with supporting reason | Application of the above technical references to the circumstances of each scenario |

1. Target Ltd holds a non-controlling interest shareholding in ABC Pty Ltd but it has five of the seven seats on the board of directors and is responsible for operating and financial policies on a day-to-day basis. This scenario has resulted from an agreement with the majority shareholder (75%) of ABC Ltd, Mr and Mrs M. All of the facts would need to be assessed very carefully here.

Prima facie, Target Ltd is in a position of control because of its ability to control the casting of a majority of votes at a meeting of the board of directors. However, AASB 10.12 indicates that an investor with the current ability to direct the relevant activities of the investee can still have power over the investee even if that power is not being exercised. In this case, Mr and Mrs M are closely monitoring the business and have the existing voting power to override any decision made by Target Ltd. Consequently, Target Ltd does not have power over ABC Ltd and so does not satisfy the control requirement of AASB 10. As the first criterion of the control concept in AASB 10.7 is not satisfied, it is not necessary to address the remaining criteria. Target Ltd does not need to consolidate ABC Ltd. (It is possible that Target Ltd has ‘significant influence’ over ABC Ltd and may, therefore, equity account for its investment in ABC Ltd; see Section 1.4.3 of the chapter.)

1. Default under a loan agreement has given Target Ltd power over the financing decisions and cash payments of HHQ Pty Ltd. To exercise power over HHQ Pty Ltd, Target Ltd must have substantive rights over the relevant activities of HHQ Pty Ltd. In this case, it seems likely that although Target Ltd exercises power over the financing and cash payments, it does not have the ability to direct the other relevant activities of HHQ Pty Ltd. More importantly, given that Target Ltd’s rights have arisen from default on a loan and that its powers are restricted only to financing and cash payments, it is likely that these powers are ‘protective’ rather than substantive (see AASB 10.B26–B28). The powers that Target Ltd is currently exercising have only arisen because of an exceptional circumstance (AASB 10.B26) and are designed to protect the capital sum lent by Target Ltd rather than giving it power over all the relevant activities of HHQ Pty Ltd. AASB 10.B28 gives a lender’s right to restrict a borrower from certain activities as an example of a protective right. Consequently, Target Ltd does not control HHQ Pty Ltd and does not consolidate that entity.
2. As a joint shareholder with Y Pty Ltd, Target Ltd is unlikely to be in a position of unilateral control. Prima facie the position may be one of X Pty Ltd being subject to ‘joint control’ by Target Ltd and X Pty Ltd, although it would be necessary that there is a contractual agreement that all decisions about the relevant activities would need the unanimous consent of Target and Y Pty Ltd (see Section 1.4.2 of this chapter). In this particular case, it would seem that Target Ltd has power over one set of relevant activities of X Pty Ltd (i.e., financing) but Y Pty Ltd has power over the other relevant activities of X Pty Ltd (i.e., management of operations). AASB 10.B13 suggests that when two or more investors have power over different relevant activities, it may become necessary to decide which of the relevant activities most significantly affects the returns of the investee; it might be suggested that as X Pty Ltd is an operating concern, it is likely that the operations are the relevant activity most likely to significantly impact on returns and this would result in Y Pty Ltd having power, not Target Ltd. Based on this analysis, Target Ltd would not consolidate X Pty Ltd.
3. In this situation, it is necessary to determine whether Target Ltd is operating the trust as a principal or as an agent on behalf of the beneficiaries (AASB 10.B58). AASB 10.B60 identifies four factors that are indicative of the decision-maker (i.e., Target Ltd) being an agent rather than a principal. These indicators are: the scope of Target Ltd’s decision-making authority; the rights held by others (e.g., their ability to dismiss Target Ltd as trustee); the remuneration to which Target Ltd is entitled (e.g., is the remuneration comparable to ordinary market conditions); and the extent to which Target Ltd is exposed to variability in returns from other interests it might have in the trust. The facts of the question are silent on some of these factors (which are only indicators anyway) but given that Target Ltd must act in accordance with the instructions of Mr F, it seems likely that it actually has very limited decision-making authority (if any at all). It is also common for a trust deed to allow beneficiaries to remove a trustee that is not acting in their best interests which gives them some so-called ‘kick-out’ rights. Based on the information available, it is concluded that Target Ltd is acting as an agent rather than a principal with regard to its decision making for the King Arthur trust. As such, Target Ltd does not control the King Arthur trust and would not consolidate it.
4. Target Ltd is a passive investor as evidenced by it having no seats on the board of directors of BIJ Pty Ltd. Nonetheless, Target Ltd’s 75% shareholding is likely to convey the power to govern decision making as envisaged in the definition of control (AASB 10.B35). Hence, in these circumstances Target Ltd controls BIJ Ltd and therefore it should consolidate the financial statements of BIJ Pty Ltd. It does not matter that Target Ltd is a passive investor given the other facts (AASB 10.12).
5. The independent directors of HTE Ltd have a fiduciary duty to all the shareholders of HTE Ltd equally (which, of course, does include Target Ltd as a shareholder). As such, Target Ltd has the power only to control the casting of the votes of the four executive directors it has appointed to HTE Ltd through its 40% shareholding.

Prima facie, Target Ltd’s 40% shareholding does not give it the power to dominate the composition of the board of directors and Target Ltd does not have the power to control the casting of a majority of director votes at a board meeting. Furthermore, a shareholding of 40% does not, of itself, give Target Ltd the power to control the casting of a majority of votes at a general meeting of shareholders and under these circumstances Target Ltd would not be required to prepare consolidated financial statements as a business combination has not occurred. AASB 10.B38 gives examples of situations in which *de facto* power might exist where less than a majority of voting power is held but these situations are not evident in the facts provided.

Alternatively, if the remaining 70% of shareholders of HTE Ltd regularly fail to exercise their voting rights at general meetings, it could be argued that Target Ltd does control HTE Ltd. If, for example, only 50% of the shareholders of HTE Ltd are actively involved in voting at meetings, then Arrows’ 40% shareholding would effectively constitute 57.15% (40/70) of votes that are normally exercised at a shareholder meeting. The fact that Target Ltd has nominated ‘four executive directors’ to HTE Ltd (i.e., the directors involved in the day-to-day operations) also suggests that its 40% shareholding is sufficient for control. If this alternative view is accepted then Target Ltd would be required to consolidate.

***Q1.13 Determining the power to control (Section 1.7)***

**Part A**

The question asks whether A Ltd is a subsidiary of B Ltd. To be a subsidiary, A Ltd must be controlled by B Ltd as per AASB 10. Appendix A and paragraph 6 of AASB 10 define control as follows:

*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.*

AASB 10.7 indicates that there are three essential components to this definition of control; namely (1) the investor has power over the investee; (2) the investor has exposure or rights to variable returns from its involvement in the investee; and (3) the investor must be able to use the power it has over the investee to affect the amount of the investor’s returns. It is most important to understand that in any given investor–investee relationship *all* three of these components must be satisfied before ‘control’ can be confirmed and a parent–subsidiary relationship established.

Does B Ltd have power over A Ltd?

AASB 10.10 indicates that to have power, B Ltd must have rights that give it the ability to direct the relevant activities of A Ltd. The facts of the question are largely silent on what are the relevant activities of A Ltd (although they may well include activities such as manufacturing and research and development). B Ltd has rights that would give it input into the relevant activities of A Ltd—these rights come from its voting power (30%) and from its four members of A Ltd’s board of directors (e.g., AASB 10.11). These rights must be current and substantive (see AASB 10.B22–B25) and there is nothing in the facts of the question to suggest that B Ltd’s rights are not substantive. However, the facts suggest that B Ltd’s power is insufficient to allow it to unilaterally direct the relevant activities of A Ltd. This is because D Ltd (through its own direct ownership interests and its indirect interests via its control of C Ltd) has voting rights of effectively 47% and effectively four directors on the board of A Ltd. In the absence of other information, this would suggest that D Ltd can act as an effective counter-veiling power to that of B Ltd. What is unknown is how do the other independent and unrelated shareholders in A Ltd normally vote? If these independent shareholders have normally cast their votes in a way consistent with B Ltd, then this may be an indicator that B Ltd has power over A Ltd as this voting bloc would out-vote D Ltd (similar observations might be made about the behaviour of the independent directors). However, given the available information, it is likely that B Ltd does not have the power to unilaterally direct the relevant activities of A Ltd. Consequently, as B Ltd fails the first criterion of the control concept, B Ltd cannot control A Ltd and so A Ltd is not a subsidiary of B Ltd. (It is unnecessary to address the other control criteria as all three criteria must be satisfied for control to exist.)

**Part B**

The AASB 10 control criteria outlined in Part A need to be reapplied to this new set of facts. The key issue relates to whether the rights that come with the call option are current and substantive. AASB 10.B22 requires that the holder of the right must have the current practical ability to exercise that right. AASB 10.12 states that it is not necessary for the holder of the right to have yet exercised that right for it to be substantive (i.e., in this case, the fact that B Ltd has indicated that it does not intend to exercise the right does not matter to determining whether B Ltd has power over A Ltd). The facts of the case are silent on whether the call option held by B Ltd is currently exercisable—AASB 10.B22–B25 and AASB 10.B47–B50 provide relevant guidance with regard to substantive potential voting rights. In general, this guidance suggests that provided the options held by B Ltd are currently exercisable (e.g., they are not ‘out of the money’), then B Ltd would have power to direct the relevant activities of A Ltd.

B Ltd would have the capacity to control 53% of A Ltd ordinary voting shares, being their current 30% shareholding and the additional 23% shareholding (calculated as 1 – [0.3 + 0.22 + 0.25]) from the currently exercisable options. B Ltd would be able to remove current members and appoint other members to A Ltd Board of Directors. If, however, the options were not currently exercisable, then B Ltd would not appear to have power to direct the relevant activities of A Ltd (as discussed in Part A of this question).

If it is concluded that B Ltd could exercise the options and so then direct the relevant activities of A Ltd, it would be necessary to then also consider the remaining two criteria of the control concept of AASB 10.7.

Is B Ltd exposed to variable returns from its investment in A Ltd?

The answer to this question would be yes. For instance, part of B Ltd’s returns would be dividends and the capital value of the A Ltd investment. In addition, it might be argued that as the raw material produced by A Ltd is so central to the manufacturing activities of B Ltd, this would also impact on B Ltd’s returns.

Can B Ltd use its power over A Ltd to affect the amount of its returns from A Ltd?

The answer would again be yes. As one of the key relevant activities of A Ltd would be manufacturing the rare raw material and B Ltd, through its voting power could make decisions that impact on A Ltd’s manufacturing activities, B Ltd’s use of its power would have a direct impact upon the returns generated from A Ltd’s manufacturing and sales of the raw material.

As all three of the control criteria can be satisfied (based on the assumption that the options are currently exercisable), it can be concluded that in this case, B Ltd controls A Ltd and so A Ltd is a subsidiary of B Ltd.

***Q1.14 Control in the not-for-profit sector (Section 1.7.7)***

Paragraphs 6 and 7 of AASB 10 indicate that an investor has control over 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. To have control, the investor must have:

• Power over the investee; and

• Exposure or rights to variable returns from its involvement in the investee; and

• The ability to use its power over the investee to affect the amount of the investor’s return.

AASB 10.10 indicates that to have ‘power’ over the investee, the investor must have existing rights that allow it to direct the relevant activities of the investee. AASB 10.B15 (b) indicates that the right to appoint, reassign or remove members of an investee’s key management is one example of such a right to direct relevant activities. AASB 10.B26–B28 specify that some rights might be protective rights (which are defined in AASB 10.Appendix A as “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”). AASB 10.B27 is clear that an entity that only possesses protective rights does not have power over another entity in the form specified in AASB 10.6.

Paragraph IG4 of Appendix E indicates that in a not-for-profit context, the principles in AASB 10.5 and 11 remain relevant. The ability to control another entity is not limited only to circumstances in which there is a financial interest by the investor in the investee. Paragraph IG6 notes that power can arise from statutory provisions and IG8 specifically states that “subject to consideration of all the facts and circumstances, a State or Territory government normally would not have power to direct the relevant activities (i.e., the activities that significantly affect the returns) of a local government that determines through the council elected periodically by the local community how to deploy the local government’s resources in the interests of the local community (even though those interests might coincide with or overlap the interests of the State or Territory government)” (although, as noted, this must always be assessed on the basis of the specific facts and circumstances of each case [IG3]).

In the case of local government councils, some indicators of control by the minister would seem to include operations constrained by the requirements of the relevant Act, reliant on some funding from the State Government, and the possibility of dismissal of councillors. On the other hand, the facts above indicate that the minister cannot overturn a lawfully made decision of a council and that the minister can only recommend dismissal of councillors, and that dismissal is only available under exceptional circumstances (e.g., where councillors have committed some fraud or malfeasance). In addition, the appointment of an administrator is clearly temporary and it is the ratepayers who appoint the replacement council. These rights to dismiss a council fit the definition of ‘protective rights’ as they are designed to only operate in situations where there has been substantive misbehaviour by the councillors; that is, they are designed to protect rate payers (para. IG15). On the basis of this analysis, it is concluded that the government does not control the local councils because it does not satisfy the power criterion. If power existed, it is likely that the government could use that power to influence the returns from the councils (i.e., the ability of councils to deliver services) but these questions are hypothetical given that power has not been established.

A good student should have seen the guidance provided in Example IG3 of Appendix E. A long analysis is provided in that example which could have been used to assist in answering this question.

***Q1.15 Investment entities (Section 1.7.6)***

An investment entity is characterised by having a business purpose which is only to invest for capital gains or investment income (such as interest or dividend revenue) or both (AASB 10, paragraph 85B). An investment entity is defined in paragraph 27 and Appendix A of AASB 10 as an entity that:

1. *Obtains funds from one or more investors for the purpose of providing those investor(s) with investment management services;*
2. *Commits to its investor(s) that its business purpose is to invest funds solely for returns from capital appreciation, investment income, or both; and*
3. *Measures and evaluates the performance of substantially all of its investments on a fair value basis.*

Paragraph 31 of AASB 10 states that a parent entity that determines that it is an investment entity does not consolidate its subsidiaries (or apply the requirements of AASB 3 when those subsidiaries were purchased) but rather it must measure its investment in those subsidiaries at fair value through profit or loss following the requirements of AASB 9. One exception to paragraph 31 is contained in paragraph 32 which requires the investment entity parent to consolidate those subsidiaries which provide services to the investment entity’s investment activities.

Based on this information, Reassure cannot be an investment entity because its business purpose is not solely to invest for capital gains or investment income (it is an insurance business). However, FI is an investment entity because its sole purpose is to provide investment management services (that generate capital growth and investment income in the form of interest revenue and dividend revenue) and it measures its funds using fair value (and that information is used for performance measurement).

Consequently, in FI’s own financial statements, it reports its controlled investees at fair value through profit or loss and does *not* consolidate its financial statements with those of Funds A, B and C. However, Parent’s consolidated financial statements will consolidate all of its controlled investees, including FI and FI’s Funds A, B and C.

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