



The concept of CONTROL in financial reporting

YOUR KEY TO THE TAX COMMUNITY

New definition of an “asset”

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- Old: A resource *controlled by* the entity resulting from past events, from which future economic benefits are **expected** to flow to the entity

Today's discussion



- New: A present economic resource controlled by the entity arising from past events



- Present economic resource: A **right** that has the **potential** to produce economic benefits

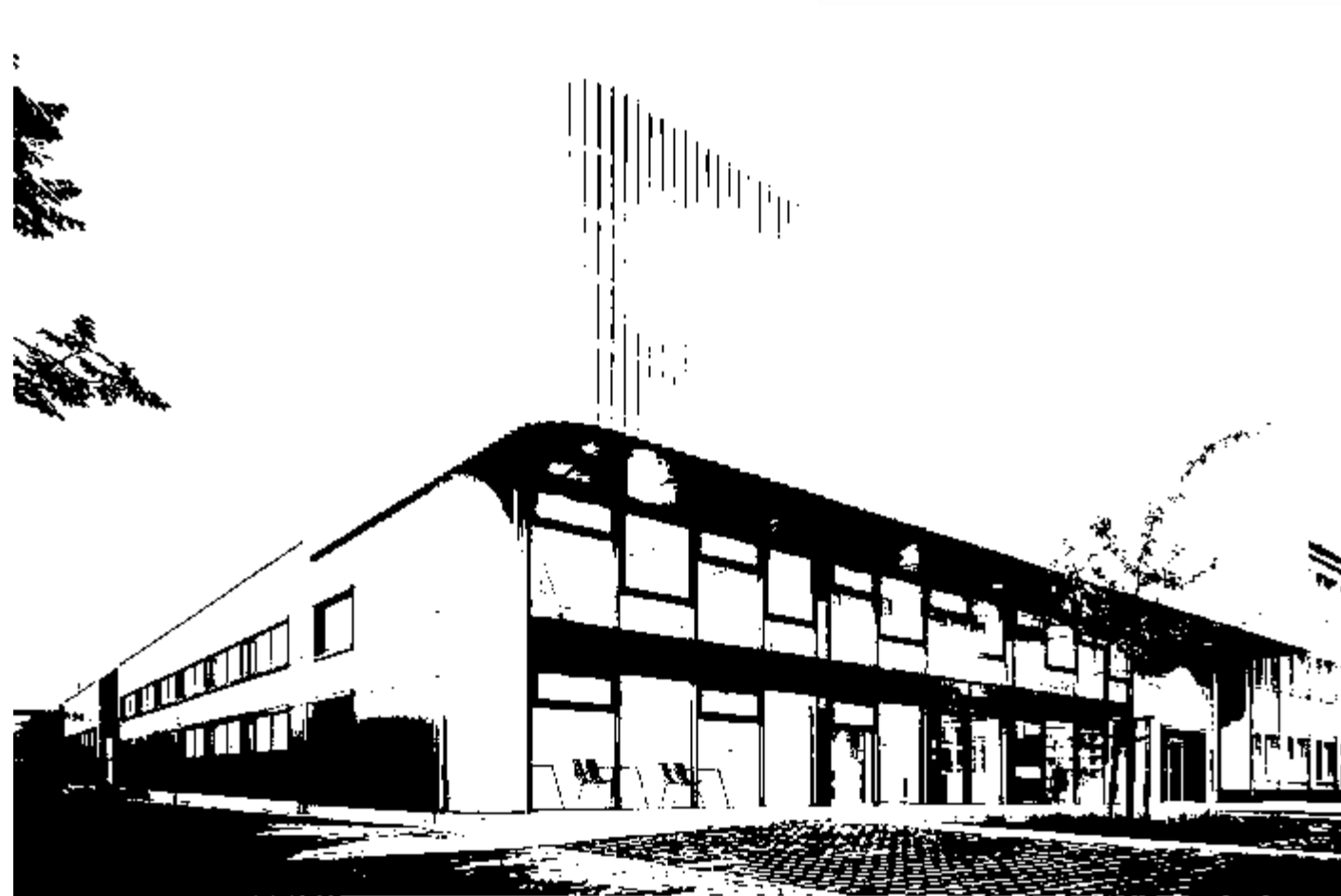
Control

Where does control **impact** financial reporting?

Where does control impact financial reporting?

- Control is present in both the **old** and **new** definitions of an asset
- Two areas of impact need to be considered...

Control over an **asset**



Control by one **entity** over another



Control over an asset

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- NB: Control is not only considered in a physical capacity!
- IAS 38 defines **control** over an asset, in great detail:

An entity controls an asset if

- the entity has the power to obtain the future economic benefits flowing from the underlying resource **and**
- to restrict the access of others to those benefits.

The capacity of an entity to control the future economic benefits from an intangible asset would normally stem from legal rights that are enforceable in a court of law.

In the absence of legal rights, it is more difficult to demonstrate control. However, legal enforceability of a right is not a necessary condition for control because an entity may be able to control the future economic benefits in some other way.

Example 1: Market and technical knowledge may give rise to future economic benefits. An entity controls those benefits if, for example, the knowledge is protected by legal rights such as copyrights, a restraint of trade agreement (where permitted) or by a legal duty on employees to maintain confidentiality.

Example 2: An entity may have **a team of skilled staff** and may be able to identify incremental staff skills leading to future economic benefits from training. The entity may also expect that the staff will continue to make their skills available to the entity. However, an entity usually has insufficient control over the expected future economic benefits arising from a team of skilled staff and from training for these items to meet the definition of an intangible asset. For a similar reason, specific management or technical talent is unlikely to meet the definition of an intangible asset, unless it is protected by legal rights to use it and to obtain the future economic benefits expected from it, and it also meets the other parts of the definition.

Example 3: An entity may have a **portfolio of customers or a market share** and expect that, because of its efforts in building **customer relationships and loyalty**, the customers will continue to trade with the entity. However, in the absence of legal rights to protect, or other ways to control, the relationships with customers or the loyalty of the customers to the entity, the entity usually has insufficient control over the expected economic benefits from customer relationships and loyalty for such items (e.g., portfolio of customers, market shares, customer relationships and customer loyalty) to meet the definition of intangible assets. In the absence of legal rights to protect customer relationships, exchange transactions for the same or similar non-contractual customer relationships (other than as part of a business combination) provide evidence that the entity is nonetheless able to control the expected future economic benefits flowing from the customer relationships. Because such exchange transactions also provide evidence that the customer relationships are separable, those customer relationships meet the definition of an intangible asset.

Control by one entity over another

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- *Old definition of control: The ability of one entity to govern the financial and operating decisions of another so as to obtain benefit from its activities.*
- **Along comes IFRS 10 and changes the entire definition, and provides much more guidance about how control of one entity over another is to be assessed...**
- So, what has changed?

Control – what is it now?

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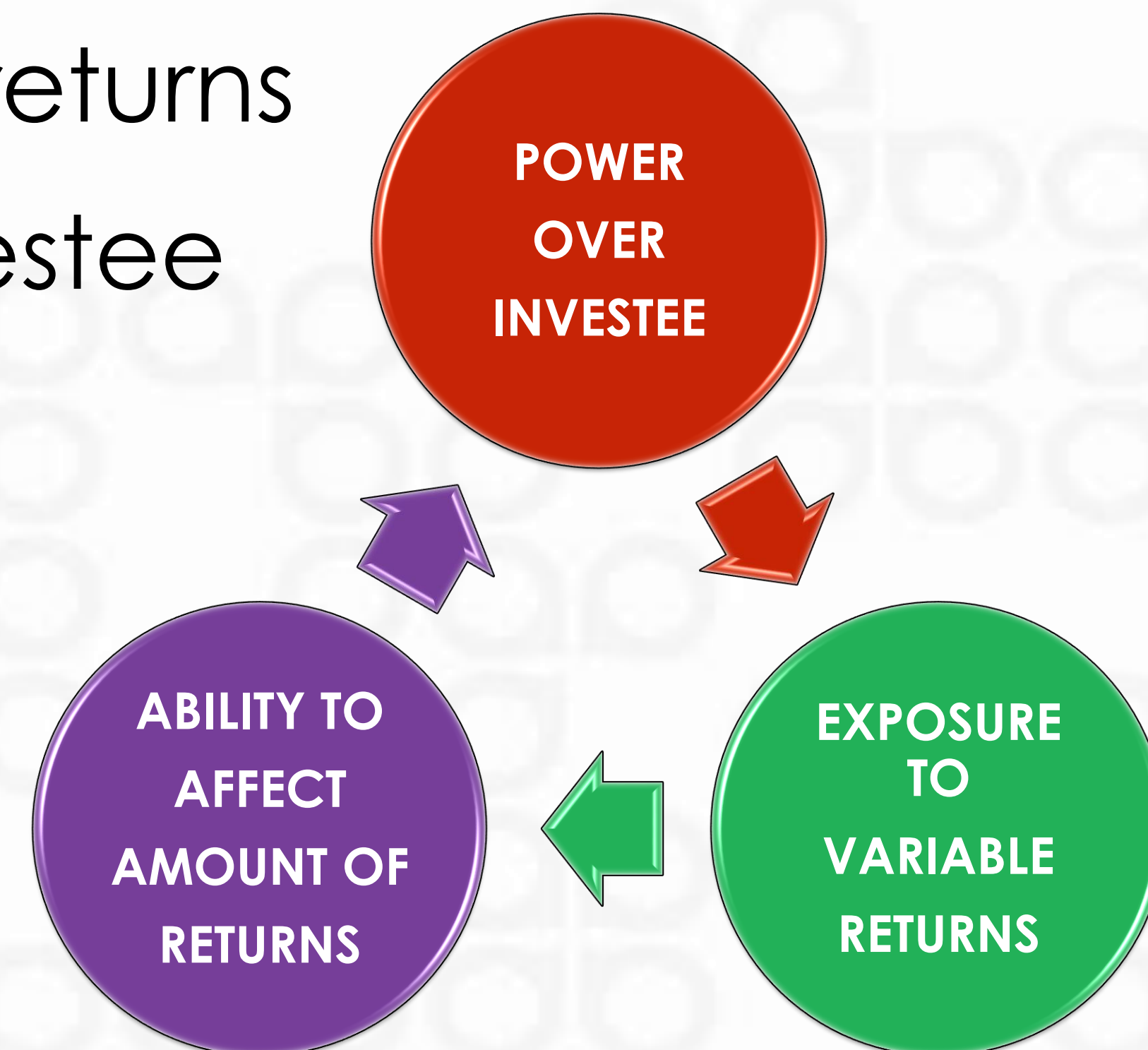


An investor controls an investee when:

- it is **exposed** to (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



POWER
EXPOSURE
ABILITY



Control assessment

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Five questions need to be considered, when thinking about control:

1. What is the **purpose and design** of the investee?
2. What are the **relevant activities** of the investee and **how are decisions made** about those relevant activities?
3. Do the rights that the investor holds, give the investor the **current ability to direct** the relevant activities?
4. Is the investor **exposed**, or does the investor **have rights to, variable returns** from its involvement with the investee?
5. Does the investor have the **ability to use its power** over the investee to **affect the amount** of the investor's returns?

Purpose and design of investee

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What are the RAs? *(example done later)*

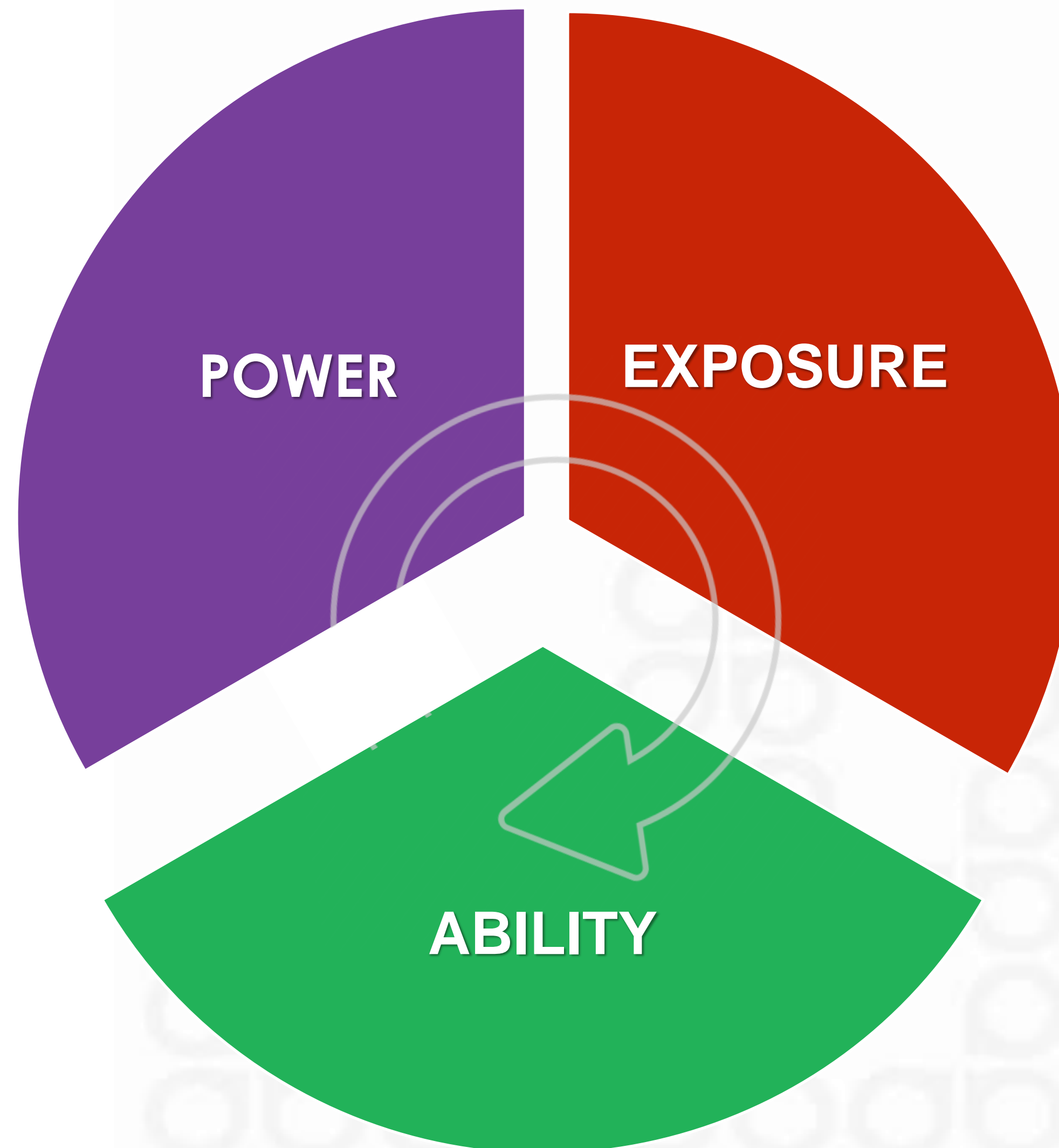
“Activities of the investee that significantly affect the investee’s returns”

Aspects we would want to understand are:

- How are decisions made about the RAs? Board of directors’ meetings? Shareholders’ meetings?
- Who are the key decision-makers?
 - *Decision-maker = an entity with decision-making rights that is either a principal, or an agent for other parties*
- Who has the current ability to direct the RAs?
- Who receives returns from the investee?
- Are there agreements in place that alter decision-making?
- Are voting rights the dominating factor in deciding who controls the entity? E.g. the RAs could be directed by contractual arrangements?
- To which upside and downside risks is the investor exposed due to its involvement with the investee?

So, from here?

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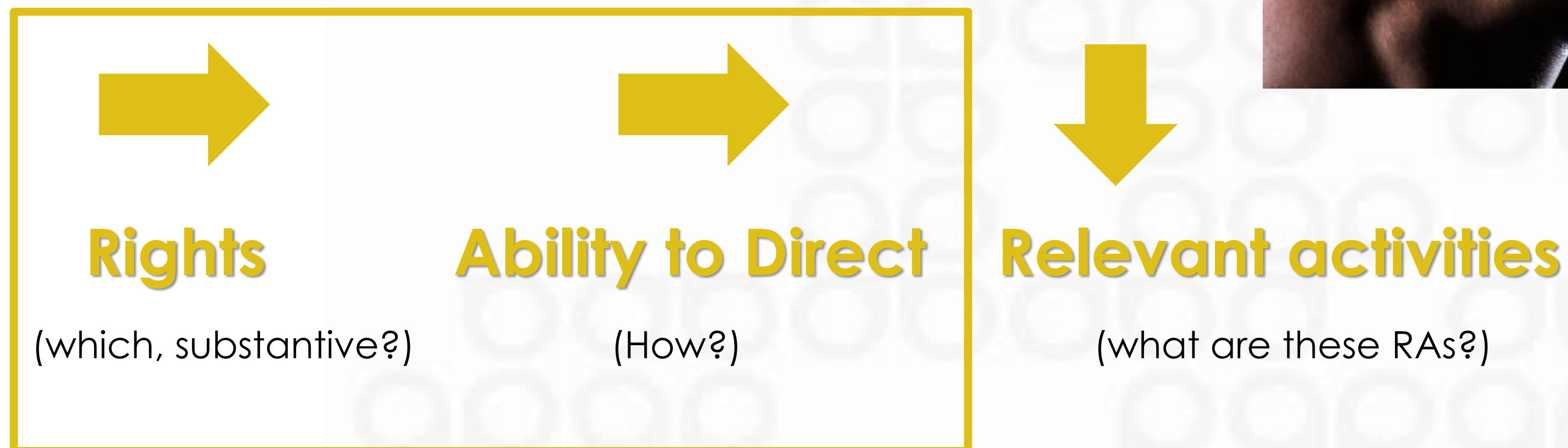


Components of Power

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- An investor has **power** over an investee when the investor has:
 - existing **rights** (power arises from rights),
 - that give it the current (practical) **ability**,
 - to **direct** the **relevant activities (RAs)**



Component 1 of Power: The investor's rights

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- Examples of **rights** that could provide the investor with power:
 - rights in the form of voting rights (or potential voting rights) of an investee
 - rights to appoint, reassign or remove members of an investee's key management personnel who have the ability to direct the relevant activities
 - rights to appoint or remove another entity that directs the relevant activities
 - rights to direct the investee to enter into, or veto any changes to, transactions for the benefit of the investor
 - other rights (such as decision-making rights specified in a management contract) that give the holder the ability to direct the relevant activities

Proving Power: The investor's rights

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How strong must the investor's rights be, to count?

- **Rights of the investor must be substantive, to be considered**
- As an example: Substantive rights exercisable by *other parties* can prevent an investor from controlling the investee to which those rights relate
- Such substantive rights **do not** require the holders to have the ability to initiate decisions, even blocking certain decisions is sufficient
- As long as the rights are not merely *protective*, substantive rights held by other parties may prevent the investor from controlling the investee even if the rights give the holders only the current ability (being practical too) to **approve or block decisions** that relate to the relevant activities

PROTECTIVE



SUBSTANTIVE

Component 2 of Power: The investor's ability to direct RAs

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- **What are relevant activities (RAs)?**



- “Activities of the investee that significantly affect the investee’s returns”
- Examples of **relevant activities** could be:
 - selling and purchasing of goods or services
 - managing financial assets during their life (including upon default)
 - selecting, acquiring or disposing of assets
 - researching and developing new products or processes
 - determining a funding structure or obtaining funding
- Examples of **decisions about** relevant activities could be:
 - establishing operating and capital decisions of the investee, including budgets
 - appointing and remunerating an investee's key management personnel or service providers and terminating their services or employment
- In some situations, activities both **before and after** a particular set of circumstances arises/event occurs, may be *relevant activities* (i.e. multiple relevant activities)
 - When two or more investors have the current ability to direct relevant activities and those activities occur at different times, the investors shall determine which investor is able to direct the activities that **most significantly affect those returns** consistently with the treatment of concurrent decision-making rights. The investors shall reconsider this assessment over time if relevant facts or circumstances change



Example: What are RAs?

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Two investors form an entity to develop and market a medical product.

Investor 1 is responsible for developing and obtaining regulatory approval of the medical product – that responsibility includes having the unilateral ability to make all decisions relating to the development of the product and to obtaining regulatory approval.

Once the regulator has approved the product, **Investor 2** will manufacture and market it – this investor has the unilateral ability to make all decisions about the manufacture and marketing of the product.

What are the relevant activities of the entity?

*(... **relevant activities** are activities of the investee that significantly affect the investee's returns)*

Solution

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- It appears that there are **two groups** of relevant activities (*i.e. multiple relevant activities*)
 - Set 1: Development and regulatory approval of medical product
 - Set 2: Manufacture and marketing of medical product
- Both sets of activities appear to be relevant as they both have the potential to each significantly affect the investee's returns to investors
- **Each investor will therefore have to decide whether Set 1 or Set 2 above is the set of activities that most significantly affects the investee's returns, and whether it is able to direct that set of activities (i.e. power)**
- The investors will decide taking cognizance of:
 - The purpose and design of the investee
 - Factors that determine profit margin, revenue and value of investee, as well as the value of the medical product
 - Each investor's decision-making authority w.r.t. the previous point
 - Each investor's exposure to variability in returns from the investee
 - The uncertainty of (and effort required in) obtaining regulatory approval (consider the investor's record of success in similar set of activities)
 - Which investor controls the medical product once the development phase is successfully completed

Component 2 of Power:

The investor's ability to direct RAs

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- In more complex situations, where power is not merely based on voting rights, the investor is required to determine whether it has the **practical ability** to unilaterally direct the relevant activities of the investee
- The following examples may provide evidence of such **practical ability**:
 - The investor can, without having the contractual right to do so, appoint or approve the investee's key management personnel who have the ability to direct the relevant activities
 - The investor can, without having the contractual right to do so, direct the investee to enter into, or can veto any changes to, significant transactions for the benefit of the investor
 - The investor can dominate either the nominations process for electing members of the investee's governing body or the obtaining of proxies from other holders of voting rights
 - The investee's key management personnel are related parties of the investor (for example, the chief executive officer of the investee and the chief executive officer of the investor are the same person)
 - The majority of the members of the investee's governing body are related parties of the investor

Example 1: Power?

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- Investor A holds 45% of the voting rights of an investee.
- Two other investors each hold 26% of the voting rights of the investee.
- The remaining voting rights are held by three other shareholders, each holding 1%.
- There are no other arrangements that affect decision-making.
- **Substantive rights?** 45% of the voting rights held by the investor
- **Practical ability to direct RAs?** In this case, the size of investor A's voting interest and its size relative to the other shareholdings are sufficient to conclude that investor A does not have power. Only two other investors would need to co-operate to be able to prevent investor A from directing the RAs of the investee.

Example 2: Power?

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- An investor holds 35% of the voting rights of an investee.
- Three other shareholders each hold 5% of the voting rights of the investee.
- The remaining voting rights are held by numerous other shareholders, none individually holding more than 1% of the voting rights.
- None of the shareholders has arrangements to consult any of the others or make collective decisions.
- Decisions about the relevant activities of the investee require the approval of a majority of votes cast at relevant shareholders' meetings — 75% of the voting rights of the investee have been cast at recent relevant shareholders' meetings.
- **Substantive rights?** 35% of the voting rights held by the investor
- **Practical ability to direct RAs?** In this case, the active participation of the other shareholders at recent shareholders' meetings indicates that the investor would not have the practical ability to direct the relevant activities unilaterally, regardless of whether the investor has directed the relevant activities because a sufficient number of other shareholders voted in the same way as the investor.

Example 3: Power?

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- Investor A holds 70% of the voting rights of an investee.
- Investor B has 30% of the voting rights of the investee as well as an option to acquire half of investor A's voting rights.
- The option is exercisable for the next two years at a fixed price that is deeply out of the money (and is expected to remain so for that two-year period).
- Investor A has been exercising its votes and is actively directing the relevant activities of the investee.
- **Substantive rights?** 70% of the voting rights held by the investor
- **Practical ability to direct RAs?** In such a case, investor A is likely to meet the power criterion because it appears to have the current ability to direct the relevant activities. Although investor B has currently exercisable options to purchase additional voting rights (that, if exercised, would give it a majority of the voting rights in the investee), the terms and conditions associated with those options are such that the options are not considered substantive.

Exposure to variable returns

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- Examples of **returns** include:
 - dividends, other distributions of economic benefits from an investee (e.g. interest from debt securities issued by the investee) and changes in the value of the investor's investment in that investee
 - remuneration for servicing an investee's assets or liabilities, fees and exposure to loss from providing credit or liquidity support, residual interests in the investee's assets and liabilities on liquidation of that investee, tax benefits, and access to future liquidity that an investor has from its involvement with an investee
 - returns that are not available to other interest holders. For example, an investor might use its assets in combination with the assets of the investee, such as combining operating functions to achieve economies of scale, cost savings, sourcing scarce products, gaining access to proprietary knowledge or limiting some operations or assets, to enhance the value of the investor's other assets

Make sure to ask: are these returns variable?

The link between power & returns

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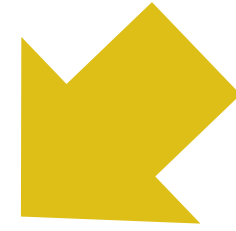
- An important part of assessing whether an investor controls an investee, is to establish whether the investor is a **principal or an agent**
- It is also important to establish whether *another* party with decision-making powers is acting as an agent for the investor
 - An 'agent' is a party primarily engaged to act on behalf and for the benefit of another party or parties (the principal(s)) and therefore does not control the investee when it exercises its decision-making authority
 - This means that the principal has **delegated** its decision-making rights to the agent
- But: a decision-maker does not automatically become an agent because others can benefit from its decision-making

The link between power & returns

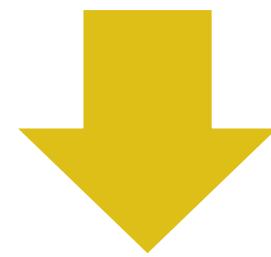
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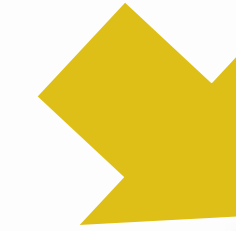
Investor could be:



An agent



Can have decision-making powers (delegated by principal)
Cannot control the investee

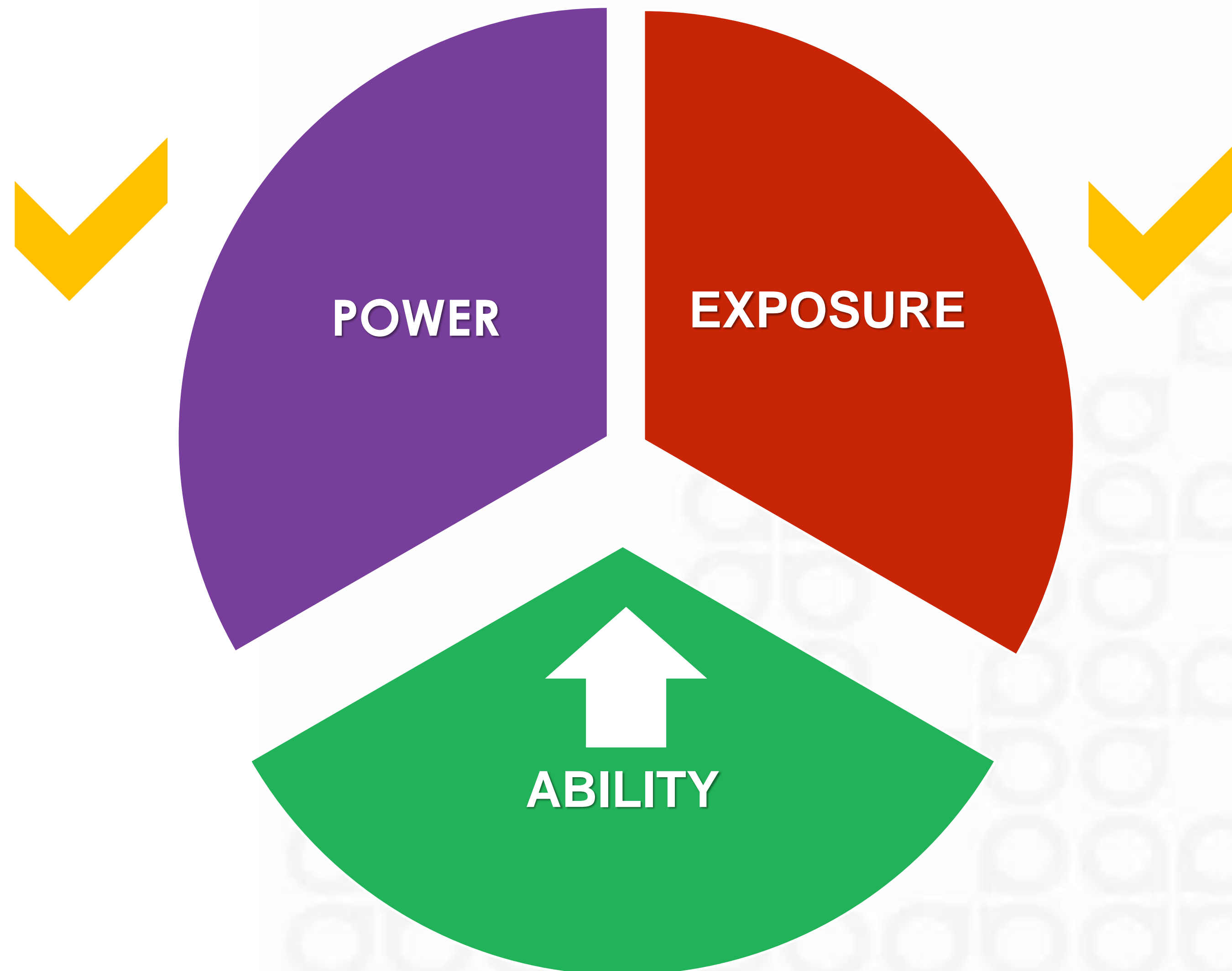


A principal



Considers its own decision-making powers AND those of its agent, to assess if it has control over investee

In conclusion: The ability to influence variable returns?



**Thank you for your
participation**