November 2004

EXTRACTS FROM FRS-37: *CONSOLIDATING INVESTMENTS IN SUBSIDIARIES*

Paragraphs re control

STANDARD

4.13 "Control" by one entity over another entity exists in circumstances where the following parts (a) and (b) are both satisfied:

(a) the first entity has the capacity to determine the financing and operating policies that guide the activities of the second entity, except in the following circumstances where such capacity is not required:
   - **(i) where such policies have been irreversibly predetermined by the first entity or its agent; or**
   - **(ii) where the determination of such policies is unable to materially impact the level of potential ownership benefits that arise from the activities of the second entity.**

(b) the first entity has an entitlement to a significant level of current or future ownership benefits, including the reduction of ownership losses, which arise from the activities of the second entity.

COMMENTARY

Control Requiring Two Elements

4.14 For control to exist for the purposes of this Standard, both parts (a) and (b) of paragraph 4.13 must be satisfied. Part (a) will be satisfied where either the capacity to determine the financing and operating policies as stated in part (a) exists, or one of the exceptions provided in items (i) and (ii) of part (a) exists. Subject to those exceptions, the definition of control requires both a power element (i.e. part (a)) and a benefit element (i.e. part (b)). It is implicit that both the power element and the benefit element are linked because ownership benefits are, by nature, benefits that arise from the determination of the relevant entity's financing and operating policies.

Ownership Form of Control

Limitation to an Ownership Form of Control

4.15 The definition of control represents control of an ownership form. An ownership form of control has been adopted as the criterion for the preparation of consolidated financial statements because owners are the primary users of financial statements and owners primarily rely on financial statements to meet their financial information needs. Other forms of control that exist, but which are outside this definition, include:

- Control of a regulatory form that exists when there is a specific authority under regulation to impose a specified form of compliance on the regulated entity's operation.
- Control of a purchase form that exists when there is a power, held as a consequence of a relationship involving the purchase of goods or services, to compel a provider entity into a certain course of action.
- Control of a lending form that exists when there is a power, held as a consequence of a lending relationship, to compel a borrower into a certain course of action.

In-substance vs Legal Ownership

4.16 Control of an ownership form represents in-substance ownership. It includes in-substance ownership created under any scheme, arrangement, or device and is therefore not restricted to relationships that arise through the legal ownership of equity instruments. It includes all control relationships arising from any mechanism that establishes an ownership relationship between two entities including such a relationship established directly under legislation.

Regulatory vs Ownership Form of Control

4.17 Both ownership and regulatory forms of control can arise under legislation. As with ownership control, regulatory control arising under legislation establishes entitlements to benefits. However, legislation will lead to an ownership form of control only where it establishes, in favour of one entity over another, both the power to determine financing and operating policies and an entitlement to ownership benefits. The critical distinction between ownership and regulatory forms of control established under legislation is that, under the ownership form of control the entitlement to benefit arises from the power to determine financing and operating policies; whereas under the regulatory form of control, the entitlement to benefit instead arises directly from the legislation.

4.18 Regulatory forms of control are not limited to requirements currently in place. They also include the ability to enact regulation to impose future requirements. For the purposes of this Standard, the Crown's sovereign power to enact legislation is to be regarded as a regulatory form of control even though, through this power, the Crown has the capacity to establish ownership relationships as well as regulatory relationships.

Ownership vs Fiduciary Relationships

4.19 Fiduciary relationships, such as those involving trustees and beneficiaries of trusts, might appear to be ownership relationships that satisfy the definition of control in this Standard. However, they can be distinguished in two ways:

- The decision-making power of a trustee does not meet the power element of the definition of control. While a trustee may have the ability to make decisions concerning the financing and operating activities of the trust, this ability is governed by the trustee's fiduciary responsibility at law to act in the best interests of the beneficiaries of the trust.
- A trustee's entitlement to benefits does not meet the benefit element of the definition of control. Any link between the decision-making powers of a trustee and the trustee's entitlement to benefits is different in nature to the link between the power and ownership benefit elements that exist in an ownership relationship giving rise to control. In a fiduciary relationship, the trust deed will specifically preclude a trustee from using its decision-making powers to direct the trust to engage in activities designed to increase its own fees or other benefits. Furthermore, the fee that a trustee receives will be in the nature of recompense for the services it provides as trustee, and is not a benefit attributable to the holding of an ownership interest.

Power Element

Capacity to Exercise Power through Governance

4.20 The power element refers to the capacity to determine the financing and operating policies of another entity. In most cases, with regard to entities in both the private and public sectors, such capacity exists through an ability of one entity to select and terminate those parties responsible for determining the financing and operating policies of the other entity. In the public sector, this ability is often specified by legislative authority. In the private sector, this ability mostly arises from holding a majority interest in the voting rights of the investee. The critical factor is capacity. As a consequence, where the holding of a majority interest in the voting rights of the investee determines the power element and there are favourable unexercised instruments exclusively held by the investor that will give the investor a majority interest when exercised, such interest may need to be determined on the basis that the unexercised instruments have been exercised. In the particular circumstances where such instruments exist and they are currently exercisable, such interest will need to be determined on the basis that the instruments have been exercised.

Unilateral Power

4.21 The decision-making capacity that satisfies the power element of control must be unilateral. The capacity cannot be shared or divided such that it enables power to be exercised jointly by two or more partners or co-owners. The ability to participate with others in making decisions that guide the activities of another entity usually characterises joint venture relationships, which are covered under a separate financial reporting standard. Thus, Entity A will not have a unilateral decision-making capacity with regard to Entity B if Entity A requires the ongoing consent of other parties to set or change the policies or management that guide the activities of Entity B. On the other hand, a unilateral decision-making capacity may still exist despite there being a requirement to consult before a corresponding power can be exercised.

Restrictions on Activities

4.22 While the power element of control cannot be shared, usually it is limited to some degree by law, regulations, fiduciary responsibilities, and contractual rights of other parties. For example, provisions under the Companies Act 1993 restrict the ability of an investor in a less than wholly owned subsidiary to direct its subsidiary to engage in certain specified transactions or activities without the consent of minority shareholders. Also, contractual agreements with lenders may impose limits on an entity's ability to pay dividends. However, these forms of restrictions usually establish protective limits on, rather than participatory rights in, the decision-making capacity of the parent. Such protective limits do not usually give a minority shareholder, regulatory agency or contracting party the ability to make or participate in a parent's decisions that guide the subsidiary's activities. It is only where participatory rights are affected in addition to protective limits being placed on the entity that the power element of control may cease to be satisfied. Rights are participatory if they enable investors (majority and minority owners) to participate in decisions that involve setting and modifying the financing and operating policies that guide the activities of the entity.

Power of Veto

4.23 In some circumstances, the power element of control may appear to be satisfied where there is an ability to restrict others from directing significant policies. However, a power of veto will not of itself satisfy the power element of control unless its effect is that significant policy decisions are taken in accordance with the wishes of the entity holding that power. One entity will not have decision-making capacity with regard to another where there is a third party that has the ability to determine all significant financing and operating policies.

Delegated Power

4.24 The power element rests with the party having the ultimate decision-making capacity, regardless of whether or not the party actively exercises that capacity. The fact that decision-making ability may be delegated by one party to another party such that the second party determines the day-to-day operations of the entity does not undermine the ultimate decision-making capacity of the first party. Delegation of decision-making ability while retaining the ultimate decision-making capacity may occur in several ways, including delegation of such ability within the governance structure of the entity and delegation of such ability to an external party under a contractual arrangement.

4.25 Delegation within the governance structure of the entity includes the appointment or retention by shareholders of directors to exercise decision-making ability on the shareholders' behalf. In such case, the ultimate decision-making capacity of the shareholders continues to exist regardless of whether that capacity is exercised. For example, when a parent obtains control of a subsidiary it may choose to retain the subsidiary's existing policies, directors, officers and other personnel without affecting its ability to change any of that subsidiary's policies or personnel responsible for carrying out those policies. In the public sector, the Crown may exercise power over an entity through legislation which establishes the entity and requires the operation of that entity to have regard to the Government's policies, even though the Crown may not have day-to-day responsibility for the activities of that entity.

4.26 Delegation under a contractual arrangement includes relationships established under management agreements and franchise agreements. Under a typical management agreement, an external party is contracted to manage an entity in return for a management fee. This involves a transfer by the owner of the entity to the external party of a decision-making ability in respect of the entity. However, the ultimate decision-making capacity is retained by the owner of the entity through the ability to terminate the contract and reacquire the decision-making ability previously transferred. In a franchise agreement, the owner of a franchisee might or might not have transferred to the franchisor its decision-making ability over the franchisee. This position depends on whether, by virtue of the terms of the agreement, the franchisor is able to determine all significant financing and operating decisions affecting the franchisee. However, in all cases the ultimate decision-making capacity is retained by the owner of the franchisee through its ability to withdraw from the franchise agreement, reacquire any decision-making ability previously held by the franchisor, and continue operating in business.

Exceptions to Need for Power Element

4.27 Part (a) of paragraph 4.13 identifies two circumstances where the existence of a power element is not necessary to satisfy the definition of control. The first circumstance is where all significant policies concerning an entity have been predetermined and are unable to be modified. In such cases, even although a power element does not exist, a power element is not necessary because the party that stands to gain the ownership benefits will have been irreversibly specified in advance as part of the significant predetermined policies. Control will therefore arise in favour of any party that has established such an entity in circumstances where that party is entitled to a significant or greater level of the entity's ownership benefits. These arrangements are sometimes described as “autopilots”.

4.28 The second circumstance covered by part (a) of paragraph 4.13 is where the determination of significant policies is unable to materially impact the level of potential benefits to be realised. In such cases, a power element is not necessary because, although the policies may not be irreversibly predetermined, the nature of the activities of the entity is such that any exercise of decision-making power will have no material influence on the level of ownership benefits to be realised from those activities. For example, consider the case of a special purpose entity (SPE) established to securitise a mortgage portfolio in circumstances where the activities of the SPE are effectively limited to collecting interest income from mortgagors, paying interest income to the SPE debt holders, and paying insurance premiums to cover the risk of mortgagor default. Any party having decision-making ability concerning the SPE's activities will be unable to materially influence the net surplus or deficit of the SPE. This will instead depend substantially on factors outside the control of the manager, such as prevailing market interest rates and the cost of insurance cover. Control will therefore arise in favour of a party that is entitled to a significant or greater level of the SPE's ownership benefits, irrespective of whether that party has the ultimate decision-making capacity regarding the SPE. Entities having financial assets securitised through an SPE vehicle in this manner will commonly have control over the SPE in terms of this Standard.

Benefit Element

Entitlement to Significant Ownership Benefits

4.29 The benefit element refers to an entitlement to a significant or greater level of ownership benefits. Ownership benefits are benefits equivalent to returns to an investor on or of an investment. Where a capacity to determine the financing and operating policies of another entity exists and is relevant, ownership benefits will be directly attributable to the exercise of decisions concerning the financing and operating policies of that other entity. Types of ownership benefits are discussed in paragraphs 4.32 to 4.35 below.

4.30 A key component of the benefit element is that there be an entitlement to ownership benefits. To hold such an entitlement does not require it to be probable that ownership benefits will arise. The critical factor is that, in the event such benefits do arise, the entitled party has the ability to realise those benefits. However, a substance approach needs to be taken in assessing this factor and such an entitlement will exist only where the entitled party has a realistic ability to obtain those benefits. Entitlements to ownership benefits that are established nominally but that are never able to be obtained do not enable the benefit element to be met.

4.31 Another key component of the benefit element is that the entitlement to ownership benefits must relate to at least a significant level of such benefits. Whether a level of ownership benefits is significant often depends on the type of ownership benefits and the ability of other parties to participate in such benefits. It is not necessarily a question of meeting a predetermined percentage threshold. In cases where percentages are an important determinant, the spread of entitlement percentages is relevant. For example, an entitlement to a level of 20% may be significant where no other parties are each entitled to more than 5%; whereas an entitlement to a level of 40% may be necessary to be significant where one or more other parties are each entitled to 20%.

Benefits from Distributions of Earnings or Net Assets

4.32 An entitlement to ownership benefits will usually arise through a residual interest in an entity that establishes an ability to participate in current or future distributions of earnings or net assets. In identifying residual interests, access to the whole of the benefit inflows arising from gross assets is not a key consideration. A parent will not have access to benefit inflows of an amount equal to those gross assets, as the creditors have a prior claim. For this reason, it is necessary to focus on the benefit flows associated with the net assets of the entity. Often evidence as to who is entitled to these benefits is given by who stands to suffer or gain from the financial performance of the entity.

Receipt of Benefits by Parent Not Required

4.33 A parent's entitlement to distributions of earnings or distributions of net assets is not dependent on whether the parent is the actual recipient of a distribution that has been made. The entitlement depends on a parent's ability to obtain the proceeds of a distribution and apply those proceeds as it determines. Therefore an entitlement to ownership benefits will continue to be held by a parent where distributions are made by a subsidiary to third parties in circumstances where the parent has the ability to claim those resources for its own purposes. Usually such circumstances will arise where the parent has expressly directed, through its capacity to determine the financing and operating policies of the subsidiary, that the transfer be made to third parties.

Other Benefits from Control over Net Assets

4.34 Ownership benefits may also comprise benefits from net assets other than residual distributions. A parent's entitlement to other ownership benefits depends on whether the power element held by the parent has been exercised to ensure that, should such other ownership benefits emerge, the benefits will flow to the parent. For example, a parent will be entitled to any synergistic benefits arising as a result of the parent using its decision-making power to combine certain functions of the parent and the subsidiary to create economies of scale.

Benefits from Complementary Activities

4.35 A parent's entitlement to other ownership benefits may also arise in circumstances where there is a supply of goods or services to a third party by the possible subsidiary, which meets an operating objective of the parent. For example, it is common for special entities such as trusts to be established to provide certain services to support the operating objectives of another entity. In such circumstances, a parent may benefit from complementary activities. Because it can be difficult to identify clearly whether a given circumstance establishes an entitlement to receive the benefits resulting from complementary activities, this Standard takes the position that such entitlement arises when all three of the following conditions apply:

- the supply of goods or services by the possible subsidiary is directly consistent with, and is likely to enhance, the operating objectives of the parent, and
- determination of the nature of the goods or services to be supplied is a direct consequence of the exercise of the parent's decision-making ability over the activities of the possible subsidiary, and
- the parent is relieved, as a result of the activity of the possible subsidiary, of an actual or constructive obligation to provide such supply; or the parent has a right to receive a future service delivery from the possible subsidiary which is not subject to additional funding to be provided by the parent.

Responsibility for loss with or without entitlement to benefit

4.36 The term “ownership benefits” requires that a favourable result can be obtained by a parent from its ability to exercise power over the activities of another entity in order to satisfy the benefit element of control. A favourable result will include reduced deficits, in addition to increased surpluses. An entitlement to ownership benefits may exist where there is both an ability to share in any surplus and a requirement to bear any loss, but such entitlement will not exist where there is only a requirement to bear any loss. A requirement to bear any loss does not in itself diminish its entitlement to benefits from that other entity at some future point. It will only be where the requirement to bear any loss exists on its own, without a corresponding entitlement to share in any gain, that the benefit element of control will not be satisfied. The effect of entitlement to ownership benefits and a requirement to bear any loss on the benefit element of control can be summarised as follows:

(i) entitlement to significant benefits with no exposure to loss = benefit element satisfied

(ii) entitlement to significant benefits with exposure to loss = benefit element satisfied

(iii) exposure to loss but no entitlement to significant benefits = benefit element not satisfied

4.37 The guarantee of liabilities or other obligations of an entity without any other interest or involvement in the entity is an example of a requirement to bear any loss without any entitlement to share in any surplus. The same situation will apply in the case of a securitisation arrangement that exposes the transferor to recourse from the financier with regard to certain financial instruments, while not providing the possibility of a further benefit accruing to the transferor. Although a prior benefit may have accrued to the transferor, once transferred there can be no current or future entitlement to benefits but only a continuing requirement to bear any resulting loss that might occur. While control, and therefore consolidation, will not be applicable in such cases, the obligation to meet any such loss will need to be recognised as a provision or, unless the possibility of such loss is remote, disclosed as a contingent liability, in accordance with FRS-15: *Provisions, Contingent Liabilities and Contingent Assets.*[1]

[1] Extracted from ICANZ Members' Handbook, November 2001, FRS-37.

Assessing the Existence of Control

COMMENTARY

Application of Judgement

5.9 The existence of control as defined in this Standard is a question of fact. The determination of the fact that control exists will, however, often require the application of judgement. This is because control of an entity can be attained in a variety of ways, and the underlying circumstances will vary between differing situations. Paragraph 5.10 sets out a number of rebuttable presumptions, which, in the absence of any evidence to the contrary, will indicate the existence of control. Where a given situation does not apparently match one or more of the rebuttable presumptions, the lists of indicators of both ownership powers and ownership benefits in paragraph 5.11 may still be sufficient to establish the existence of control. The decision tree in Appendix 2 of this Standard indicates how these rebuttable presumptions and indicators are to be applied in determining whether control exists in any given situation.

Rebuttable Presumptions

5.10 The definition of control under this Standard requires, subject to two limited exceptions, that there be both a power element and a benefit element. The circumstances listed in this paragraph establish a rebuttable presumption that control exists. A rebuttable presumption is only rebutted when there is clear evidence of control not being held by the entity in question. This evidence is likely to arise through the existence of other rebuttable presumptions, or indicators listed in paragraph 5.11, being applicable to another entity. All the circumstances listed in this paragraph should be assessed with regard to each situation.

(1) A beneficial ownership of a majority voting interest in an entity.

(2) A unilateral power to obtain a majority voting interest through ownership of securities or other rights that are currently convertible into a majority voting interest at the option of the holder where conversion is favourable to the holder.

(3) A unilateral power to appoint or remove a majority of the members of the governing body of an entity.

(4) A unilateral power, through any form of mechanism, to set or modify the financing and operating policies that guide the activities of an entity.

(5) A unilateral power to extract distributions of economic benefits from an entity.

(6) A right that is directly attributable to the ownership interest in another entity, to a majority of the economic benefits arising from that entity, irrespective of the timing or the mode of distribution of the benefits.

(7) A unilateral power to dissolve an entity and obtain a significant level of the residual economic benefits.

The use of the word "unilateral" in describing the power elements in presumptions (2), (3), (4), (5) and (7), is to be read as a discretion to exercise the particular power in the ordinary operating circumstances of the entity. As explained in paragraph 4.21, a unilateral power arises from a decision-making capacity that cannot be shared or divided. Essentially it refers to a power of a participatory nature rather than a power of a protective nature in the context of the discussion on "restrictions on activities" in paragraph 4.22.

Indicators

5.11 Where a rebuttable presumption is not apparent, the following indicators may still be sufficient to establish the existence of control. In some circumstances any one or more of these may confirm the existence of one of the rebuttable presumptions listed in paragraph 5.10, and control will then be presumed to exist. When this is not the case, an identification of control will require the existence of both a power element indicator from the first group (A) and a benefit element indicator from the second group (B). Ordinarily, for control to be evidenced in such manner, such indicators will be linked. In other words, the benefit element indicator will ordinarily either be established by a power mechanism or result from the exercise of a decision-making power attributable to the substance of a particular power element indicator. In circumstances when both power element and benefit element indicators exist in favour of more than one entity, judgement will be needed, based on all the relevant indicators and other circumstances, as to which entity is the most likely parent or whether control does not exist.

(A) Indicators of Power Element

(1) Ownership of a large minority voting interest and no other entity or organised group of entities has a significant interest.
(2) Retention of a significant minority voting interest after previously holding a majority voting interest.
(3) The holding of direct or indirect title to instruments entitling appointment of a majority of the members of the governing body of an entity.
(4) An ability demonstrated by a recent election to dominate the process of nominating candidates for the governing body of an entity and to cast a majority of the votes cast in an election of members of that governing body.
(5) An ability to cast a majority of the votes usually cast in an election of members of the governing body of an entity.
(6) An ability to use the resources of an entity to dominate the process of nominating members of the governing body of the entity and to solicit proxies from other holders of voting power.
(7) A right to appoint members of the governing body of an entity to fill vacancies until the next election.
(8) A continuing ability to appoint a significant number of the members of the governing body of an entity for which majority appointment or election powers were previously held.
(9) An ability to determine the casting of a majority of the votes cast at a meeting of the governing body.
(10) A direct or indirect ability to determine the revenue-raising, expenditure and resource-allocation policies of another entity, including an ability to modify or approve the entity's budget or an ability to modify or approve rate or fee changes affecting revenues of the entity.
(11) A direct or indirect ability to veto, overrule or modify decisions of the governing body other than for the purpose of protecting existing legal or contractual rights or restrictions.
(12) A direct or indirect ability to appoint, hire, reassign or dismiss key management personnel of the entity.
(13) A unilateral ability to dissolve an entity and redirect the use of its individual assets, subject to claims against those assets, without assuming economic costs in excess of the expected benefits from redirection of the assets.

(B) Indicators of Benefit Element

(1) The holding of direct or indirect title to the net assets of an entity with an ongoing right to access those assets.
(2) Ability under existing regulation or other instrument to access resources of an entity for purposes determined by the entity holding such ability.
(3) A right to a significant level of the net assets of an entity in liquidation or in a distribution other than liquidation.
(4) A right to a significant level of the distributed or undistributed surpluses attributable to holders of an ownership interest.

(5) A right to a significant level of the distributed or undistributed surpluses attributable to holders of an ownership interest that would arise through the exercise of securities or other rights held that may be converted at the option of the holder without assuming risks or obligations in excess of the expected benefits from the conversion.
(6) A right to a significant level of the change in the value of net assets or the rights thereto, excluding contributions and withdrawals of members of that entity, either periodically or cumulatively, and whether received in the form of management fees or distributions.
(7) A right to derive net cash inflows or other economic benefits from an entity under an arrangement which limits that entity to activities consistent with the activities of the entity able to derive the economic benefits.
(8) An ability to derive significant cash inflows, or other economic benefits, through an ability to use the assets of another entity.
(9) An ability to reduce the risk of incurring losses or to limit other risks associated with ownership.
(10) An ability to access cash flow synergies arising from a restructuring of the operations of either entity which occurs as a direct result of the acquisition of an ownership interest in one entity by another entity.
(11) The undertaking, by an entity, of an activity involving the supply of goods or services that is directly consistent with, and is likely to enhance, the investor's operating objectives in circumstances where:
   - determination of the nature of the goods or services to be supplied is a direct consequence of the exercise by the investor of a decision-making ability over the activities of the entity; and
   - the investor is relieved, as a result of the activity of the entity, of an actual or constructive obligation to provide such supply; or the investor has a right to receive a future service delivery from the entity which is not subject to additional funding to be provided by the investor.[2]

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[2] Extracted from ICANZ Members' Handbook, November 2001, FRS-37.

Control Assessment Decision Tree (Appendix 2)