

DE FACTO CONTROL – CONTROL UNDER IAS 27 CONSOLIDATED AND SEPARATE FINANCIAL STATEMENTS

Paper prepared for the Roundtable on Consistent Application of IFRS. This paper sets out the reasons why IFRIC should issue an interpretation or IASB should amend IAS 27.

The Issue

The IASB has confirmed that IAS 27 contemplates circumstances in which one entity can control another without owning more than half of the voting power. This view was set out in the IASB Update of October 2005, as follows:

Control under IAS 27 Consolidated and Separate Financial Statements

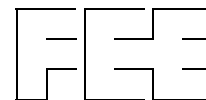
IAS 27 contemplates that there are circumstances in which one entity can control another entity without owning more than half the voting power.

During its deliberations on its control project, the Board confirmed its view that an entity holding a minority interest can control another entity in the absence of any formal arrangements that would give it a majority of the voting rights. For example, control is achievable if the balance of holdings is dispersed and the other shareholders have not organised their interests in such a way that they exercise more votes than the minority holder. This is sometimes referred to as ‘de facto control’.

During those deliberations, the Board has made it clear that, in its view, the control concept in IAS 27 includes de facto control. The Board also acknowledged that professional skill and judgment is required in applying the control concept including determining if de facto control exists. The Board has recently become aware that some who apply IFRSs hold the view that, in the circumstances described, IAS 27 requires an entity to have legal control over a majority of the voting rights to consolidate another entity.

The Board accepts that it would have been helpful if IAS 27 had included guidance to assist preparers in exercising the judgment to apply the control concept. Without that guidance there is a greater risk that two entities faced with the same set of circumstances might reach different conclusions on whether they control another entity. The Board is aware that differences in the application of IAS 27 might also be influenced by the practices followed in jurisdictions before adopting IFRSs.

The Board has made progress on its project on control and it could issue an exposure draft to propose amending IAS 27 by adding guidance on de facto control. However, the Board prefers to address comprehensively issues related to control in any possible proposal to amend or replace IAS 27. The Board acknowledges that this approach means that differences in how IAS 27 is applied might persist until its project on control is completed.



Current Practice

Prior to the Board making the above statement, there were differing views as to whether or not IAS 27 contemplates “de facto control”. Following this statement, there are continuing differences of view over the application of IAS 27 in circumstances where de facto control might be considered to exist. This is a controversial issue in some Member States and there is some evidence of variation in practice across Europe possibly resulting in significant effects on the financial statements. The issue needs to be addressed for reasons of comparability and consistent application of IAS 27 within the EU. A fuller debate on the application of de facto control is needed.

In this regard, one of the reasons why the US FASB did not pursue its 1999 proposals for consolidation based on de facto control was the inability to devise a standard that would result in appropriate and consistent consolidation practice.

Although this issue may be part of the consolidations project, given the complex practical issues to which the issue gives rise and the possible magnitude of the divergence in practice referred to above, the development of guidance cannot await the results of the consolidations project. It is important to have such guidance in place without delay.

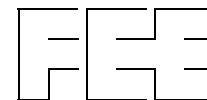
Reasons for IFRIC to address the issue

The IASB, in its statement set out above, has acknowledged that guidance on how to determine if de facto control exists would be helpful. We consider that additional guidance is in fact necessary if inconsistent application is to be avoided. For example, the Board noted that “... control is achievable if the balance of holdings is dispersed and the other shareholders have not organised their interests in such a way that they exercise more votes than the minority holder”. This begs a question of whether the minority holder should consider the likelihood of other shareholders becoming organised if it were to act in a manner prejudicial to their interests.

The key question is whether the fact that the shareholders “have not orchestrated” their interests in a particular way is enough to establish control by the minority holder or whether it is necessary for the shareholders to organise their interests so that they are no longer able to exercise more votes than the minority holder. The point is whether the accounting model is meant by the board to be a “power to control” model or a model based on past actions. It is important to clarify if it is intention or expectation that is relevant, or rather demonstrated ability.

We recommend that guidance should cover:

- How to determine whether de facto control exists in particular circumstances; and
- How to apply IAS 27 when a subsidiary is identified and consolidated on the basis of de facto control.



In the first case, guidance could usefully identify criteria (or indicators) to assist preparers and auditors in assessing whether specific facts and circumstances give rise to a de facto control relationship. Indications of governance criteria as to when control is held as an elaboration of IAS 27 paragraph 13 would be helpful. We are aware of discussions on the following factors:

- The ability to obtain the qualifying majority for proposed votes at the general assembly of shareholders due to the existence of dispersed shareholdings (on the assumption that the likelihood of other shareholders becoming organised is remote);
- Representatives of the dominant shareholder are in a majority at the board of directors (or equivalent governing body). To remove them from this position would take time;
- Demonstration of the ability of the dominant shareholder to pass decisions that are particularly suitable to their activities.

In the second area, guidance may be needed on how to operationalise the Board's view. Specifically, guidance might be needed for companies that change their accounting policy on the basis of the Board's statement. Guidance might also be needed how to first consolidate when de facto control is achieved without an active change in ownership interest and cease consolidation where de facto control is lost without an active change in ownership interest. We recognise that providing guidance that applies in all circumstances may be difficult.

Clarification is also needed on the reasoning behind de facto control to explain why it is not in contradiction with the reasoning behind the consideration of potential voting rights in IAS 27. IAS 27.14 requires consideration of potential voting rights when assessing whether an entity has the power to govern the financial and operating policies of another entity, regardless of the intention one has to exercise the voting rights. The application of IAS 27.14 prevents the consolidation of an entity where the investor company owns the majority of the voting rights but there is a call option presently exercisable in the hands of a third party which, if exercised, would lead to loss of control by the investor over the entity. Before the call option is exercised, it is the investor who is effectively running the company and taking all strategic and operating decisions. Nonetheless it is not consolidated under IAS 27. The guidance on how to operationalise the Board's view would need to explain why this case is different from the de facto control case, where possibly, at any time, dispersed shareholders could get together and take control of the company.

IASB is called on to propose an interpretation by IFRIC or alternatively, an amendment to IAS 27 (subject to the usual due process procedures).