

1 Introduction

1.1 Overview of IAS 23

IAS 23 *Borrowing Costs* requires that borrowing costs directly attributable to the acquisition, construction or production of a 'qualifying asset' (one that necessarily takes a substantial period of time to get ready for its intended use or sale) are included in the cost of the asset. Other borrowing costs are recognised as an expense.

1.2 Amendments to IAS 23 since the last edition of this manual

IAS 23 was most recently amended in January 2016 by consequential amendments arising from IFRS 16 *Leases* (effective for annual periods beginning on or after 1 January 2019, with earlier application permitted). The amendments update the definition of borrowing costs to reflect the requirements of IFRS 16 (see 2.2).

2 Core principle and scope

2.1 Core principle

The core principle of IAS 23 is that borrowing costs directly attributable to the acquisition, construction or production of a qualifying asset form part of the cost of that asset. Other borrowing costs are recognised as an expense. [IAS 23:1]

2.2 Borrowing costs – definition

Borrowing costs are defined as interest and other costs that an entity incurs in connection with the borrowing of funds. [IAS 23:5]

Borrowing costs may include:

[IAS 23:6]

- interest expense calculated using the effective interest method as described in IFRS 9 *Financial Instruments* (or, for entities that have not yet adopted IFRS 9, IAS 39 *Financial Instruments: Recognition and Measurement*). See 4.1 in **chapter B6** (or, for entities that have not yet adopted IFRS 9, 4.1 in **chapter C6**) for further discussion;
- for entities that have adopted IFRS 16 *Leases*, interest in respect of liabilities recognised in accordance with that Standard;
- for entities that have not yet adopted IFRS 16, finance charges in respect of finance leases recognised in accordance with IAS 17 *Leases*; and

- exchange differences arising from foreign currency borrowings to the extent that they are regarded as an adjustment to interest costs (see 2.4).

2.3 Scope – exemptions

An entity is not required to apply IAS 23 to borrowing costs directly attributable to the acquisition, construction or production of:

[IAS 23:4]

- a qualifying asset (as defined in 3.2.1) measured at fair value (e.g. a biological asset within the scope of IAS 41 *Agriculture* or an investment property under construction measured at fair value); or
- inventories that are manufactured, or otherwise produced, in large quantities on a repetitive basis.

IAS 23:4 was amended in June 2014 by *Agriculture: Bearer Plants (Amendments to IAS 16 and IAS 41)* to clarify that the biological assets referred to in that paragraph are those that fall within the scope of IAS 41 *Agriculture*. Also as part of the June 2014 consequential amendments to IAS 23, a specific reference to 'bearer plants' has been added to the list of assets that, depending on the circumstances, may be qualifying assets (see 3.2.1).

The exemption for assets measured at fair value in IAS 23:4 recognises that the measurement of such assets is not affected by the amount of borrowing costs incurred during their construction or production period. The exemption for inventories manufactured in large quantities on a repetitive basis acknowledges the difficulty both in allocating borrowing costs to such inventories and monitoring those borrowing costs until the inventories are sold. The IASB concluded that it should not require entities to capitalise borrowing costs on such inventories because the costs of capitalisation were likely to exceed the potential benefits.

These exemptions are optional rather than mandatory. Accordingly, an entity can choose, as a matter of accounting policy, whether to apply the requirements of IAS 23 to borrowing costs that relate to assets measured at fair value and/or inventories produced in large quantities on a repetitive basis.

2.4 Exchange differences to be included in borrowing costs

2.4.1 Exchange differences to be included in borrowing costs – general

IAS 23 includes no further clarification as to what is meant by the inclusion of exchange differences 'to the extent that they are regarded as an adjustment to interest costs'. The question has been addressed by the IFRIC (now the IFRS Interpretations Committee) – see January 2008 *IFRIC Update*. The IFRIC reaffirmed that how an entity applies IAS 23 to foreign currency borrowings is a matter of accounting policy requiring the exercise of judgement. When the accounting policy adopted is relevant to an understanding of the financial statements, it should be disclosed as required by IAS 1 *Presentation of Financial Statements*.

It is clear that not all exchange differences arising from foreign currency borrowings can be regarded as an adjustment to interest costs; otherwise, there would be no requirement for the qualifying terminology used in IAS 23:6(e). The extent to which exchange differences can be so considered depends on the terms and conditions of the foreign currency borrowing.

Qualifying interest costs denominated in the foreign currency, translated at the actual exchange rate on the date on which the expense is incurred, should be classified as borrowing costs. Although exchange rate fluctuations may mean that this amount is substantially higher or lower than the interest costs contemplated when the original financing decision was made, the full amount is appropriately treated as borrowing costs.

Some exchange differences relating to the principal may be regarded as an adjustment to interest costs (and, therefore, taken into account in determining the amount of borrowing costs capitalised) but only to the extent that the adjustment does not decrease or increase the interest costs to an amount below or above a notional borrowing cost based on commercial interest rates prevailing in the functional currency at the date of initial recognition of the borrowing. In other words, the amount of borrowing costs that may be capitalised should lie between the following two amounts:

- (1) actual interest costs denominated in the foreign currency, translated at the actual exchange rate on the date on which the expense is incurred; and
- (2) notional borrowing costs based on commercial interest rates prevailing in the functional currency at the date of initial recognition of the borrowing.

Whether any adjustments for exchange differences are made to the amount determined under (1) above is an accounting policy choice and should be applied consistently.

The extent to which foreign exchange differences can be regarded as borrowing costs is illustrated in **example 2.4.2** and **example 2.4.3**.

2.4.2 Exchange differences that increase borrowing costs

Example 2.4.2

Exchange differences that increase borrowing costs

Entity X, which prepares its financial statements in its functional currency of Thailand Baht (THB), enters into a borrowing arrangement with terms and conditions as set out below.

| | |
|---|-----------------------|
| Amount borrowed (in the foreign currency) | US\$100 million |
| Date of initial recognition of the borrowing | 1 January 20X1 |
| Exchange rate at the date of initial recognition of the borrowing | THB25:US\$1 |
| Interest rate on foreign borrowings (in US\$) | 6% per annum (fixed) |
| Interest rate on similar borrowing in THB at the date of initial recognition of the borrowing | 12% per annum (fixed) |
| Average exchange rate for 20X1 | THB36:US\$1 |
| Closing exchange rate for 20X1 | THB47:US\$1 |

The following interest payments were made in 20X1.

| | |
|--|----------------|
| Interest payments (6% × US\$100 million) | US\$6 million |
| Translated at average rate | THB216 million |

Entity X should capitalise THB216 million, being the qualifying interest costs denominated in the foreign currency, translated at the actual exchange rate on the date on which the expense is incurred.

In addition, Entity X may choose as its accounting policy to regard exchange differences as an adjustment to interest costs. If it does so, in order to determine the maximum potential adjustment to interest costs for exchange differences, Entity X should determine the borrowing costs that would have been incurred in the 20X1 reporting period if the funds had been borrowed in THB. The calculation is set out below.

| | |
|---|------------------|
| THB equivalent of US\$100 million at 1 January 20X1 | THB2,500 million |
| Annual interest expense based on THB interest rates (12%) | THB300 million |

In the above scenario, the notional borrowing cost in the entity's functional currency of THB300 million is the 'cap' on the amount to be classified as borrowing costs. Consequently, when it has made the relevant accounting policy choice, Entity X should capitalise an amount of borrowing costs between THB216 million and THB300 million.

The foreign exchange loss incurred on the retranslation of the principal amount of the US\$100 million borrowings at the end of the 20X1 reporting period is calculated as follows.

| | |
|---|-------------------------|
| THB equivalent at opening rate of THB25:US\$1 | THB2,500 million |
| THB equivalent at closing rate of THB47:US\$1 | THB4,700 million |
| Foreign exchange loss | <u>THB2,200 million</u> |

As calculated above, the cap on the amount to be classified as borrowing costs in the 20X1 accounting period is THB300 million. The difference of THB84 million between this amount and THB216 million (being the qualifying interest costs denominated in the foreign currency, translated at the actual exchange rate on the date on which the expense is incurred) is the amount of foreign exchange losses on the principal eligible for capitalisation. The remaining exchange loss on the principal (THB2,116 million) is recognised in profit or loss in the year.

If the retranslation of the US\$100 million at the end of the 20X1 reporting period gave rise to a foreign exchange gain, the entire gain should be recognised in profit or loss. The amount of capitalised borrowing costs would be THB216 million (interest costs denominated in the foreign currency, translated at the actual exchange rate on the date on which the expense is incurred). No adjustment to interest costs for exchange differences should be made, because any such adjustment would result in an amount of borrowing costs outside the acceptable range.

2.4.3 Exchange differences that decrease borrowing costs

Example 2.4.3

Exchange differences that decrease borrowing costs

Entity Y, which prepares its financial statements in its functional currency of Thailand Baht (THB), enters into a borrowing arrangement with terms and conditions as set out below.

| | |
|--|----------------------|
| Amount borrowed (in the foreign currency) | US\$100 million |
| Date of initial recognition of the borrowing | 1 January 20X1 |
| Exchange rate at the date of initial recognition of the borrowing | THB25:US\$1 |
| Interest rate on foreign borrowings (in US\$) | 6% per annum (fixed) |
| Interest rate on similar borrowing in THB as at the date of initial recognition of the borrowing | 8% per annum (fixed) |

| | |
|--------------------------------|-------------|
| Average exchange rate for 20X1 | THB36:US\$1 |
| Closing exchange rate for 20X1 | THB22:US\$1 |

The following interest payments were made in 20X1.

| | |
|--|----------------|
| Interest payments (6% × US\$100 million) | US\$6 million |
| Translated at average rate | THB216 million |

Entity Y should capitalise THB216 million, being the qualifying interest costs denominated in the foreign currency, translated at the actual exchange rate on the date on which the expense is incurred.

In addition, Entity Y may choose as its accounting policy to regard exchange differences as an adjustment to interest costs. If it does so, in order to determine the maximum potential adjustment to interest costs for exchange differences, Entity Y should determine the borrowing costs that would have been incurred in the 20X1 reporting period if the funds had been borrowed in THB. The calculation is set out below.

| | |
|--|------------------|
| THB equivalent of US\$100 million at 1 January 20X1 | THB2,500 million |
| Annual interest expense based on THB interest rates (8%) | THB200 million |

In the circumstances described, the notional borrowing cost in the entity's functional currency of THB200 million is the 'floor' on the amount to be classified as borrowing costs. Consequently, when it has made the relevant accounting policy choice, Entity Y should capitalise an amount of borrowing costs between THB200 million and THB216 million.

The foreign exchange gain incurred on the retranslation of the principal amount of the US\$100 million borrowings at the end of the 20X1 reporting period is calculated as follows.

| | |
|---|-----------------------|
| THB equivalent at opening rate of THB25:US\$1 | THB2,500 million |
| THB equivalent at closing rate of THB22:US\$1 | THB2,200 million |
| Foreign exchange gain | <u>THB300 million</u> |

As calculated above, the floor on the amount to be classified as borrowing costs in the 20X1 accounting period is THB200 million. The difference of THB16 million between this amount and THB216 million (being the qualifying interest costs denominated in the foreign currency, translated at the actual exchange rate on the date on which the expense is incurred) is the amount of the foreign exchange gain on the principal to be offset in borrowing costs. The remaining exchange gain on the principal (THB284 million) is recognised in profit or loss in the year.

If the retranslation of the US\$100 million at the end of the 20X1 reporting period gave rise to a foreign exchange loss, the entire loss should be recognised in profit or loss. The amount of capitalised borrowing costs would be THB216 million (interest costs denominated in the foreign currency, translated at the

actual exchange rate on the date on which the expense is incurred). No adjustment to interest costs for exchange differences should be made, as any such adjustment would result in an amount of borrowing costs outside the acceptable range of amounts.

2.5 Costs associated with shares and similar instruments classified as financial liabilities

IAS 23 does not deal with the actual or imputed cost of equity, including preferred capital not classified as a liability. [IAS 23:3]

By implication, IAS 23 does apply to costs associated with shares and similar financial instruments that are classified as liabilities, in accordance with the requirements of IAS 32 *Financial Instruments: Presentation*. Under IAS 32:35, the dividends paid on such instruments are recognised in profit or loss as an expense. IAS 32:36 states that "dividend payments on shares wholly recognised as liabilities are recognised as expenses in the same way as interest on a bond".

Although the definition of borrowing costs in IAS 23:5 (see 2.2) does not define what is meant by 'the borrowing of funds', the classification of shares and similar instruments as liabilities means that they should be considered to represent such borrowings. As a result, the costs of servicing those shares (e.g. dividends) fall within the definition of borrowing costs.

2.6 Imputed interest on convertible debt instruments

In accordance with IAS 32, the liability component of a convertible debt instrument is presented on an amortised cost basis using the coupon rate for an equivalent non-convertible debt. The imputed interest is recognised in profit or loss using the effective interest method. Therefore, it is appropriate for the imputed interest expense in relation to the liability component of the convertible debt instrument to be included in borrowing costs eligible for capitalisation.

2.7 Refinancing gains and losses

An entity may be required to recognise 'refinancing' gains or losses relating to borrowings for a number of reasons; for example, such gains or losses might arise in the context of:

- a substantial modification of the terms of borrowings (see 4.1 in chapter B8 or, for entities that have not yet adopted IFRS 9 *Financial Instruments*, 4.1 in chapter C8); or

- early repayment (i.e. extinguishment) of borrowings (see **section 4 of chapter B8** or, for entities that have not yet adopted IFRS 9, **section 4 of chapter C8**).

Such gains and losses do not qualify as part of borrowing costs that are eligible for capitalisation under IAS 23. IFRS 9 (or, prior to the adoption of IFRS 9, IAS 39) is clear that 'refinancing' gains and losses should be recognised in profit or loss when they arise.

3 Recognition of borrowing costs

3.1 Recognition of borrowing costs – general

Borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset are capitalised as part of the cost of the qualifying asset. Other borrowing costs are recognised as an expense in the period in which they are incurred. [IAS 23:8 & 9]

Note that IAS 23 does not permit an accounting policy of expensing all borrowing costs.

When an entity applies IAS 29 *Financial Reporting in Hyperinflationary Economies*, it recognises as an expense the part of borrowing costs that compensates for inflation during the same period in accordance with IAS 29:21 (see **5.1.5 in chapter A37**). [IAS 23:9]

3.2 Qualifying assets

3.2.1 Qualifying assets – definition

A qualifying asset is defined as an asset that necessarily takes a substantial period of time to get ready for its intended use or sale. [IAS 23:5]

IAS 23 does not provide any guidance on what constitutes a 'substantial period of time'. The specific facts and circumstances should be considered in each case. For example, it is likely that a period of twelve months or more might be considered 'substantial'.

Depending on the circumstances, any of the following may be qualifying assets:

[IAS 23:7]

- inventories;
- manufacturing plants;

- power generation facilities;
- intangible assets;
- investment properties; and
- bearer plants.

IAS 23:7 was amended in June 2014 by *Agriculture: Bearer Plants (Amendments to IAS 16 and IAS 41)* to clarify that, depending on the circumstances, bearer plants (accounted for under IAS 16 *Property, Plant and Equipment* following the June 2014 amendments) may be qualifying assets.

The following are *not* qualifying assets:

[IAS 23:7]

- assets that are ready for their intended use or sale when acquired;
- financial assets; and
- inventories that are manufactured, or otherwise produced, over a short period of time.

3.2.2 Assets with an extended delivery period

IAS 16 *Property, Plant and Equipment* identifies delivery and handling costs as part of the cost of an item of property, plant and equipment. It includes such activities as part of the process of preparing the asset for its intended use. The shipping of an asset is therefore part of its acquisition and, consequently, borrowing costs attributable to the shipping period can be considered to be borrowing costs directly attributable to the acquisition of the asset as required by IAS 23.

For example, an entity orders and pays for a large piece of equipment from overseas that will take six months (in this example judged to be a 'substantial' period of time for the purposes of IAS 23) to arrive. A loan is raised to finance the acquisition. The equipment is already manufactured and available for shipment. Therefore, the period between payment for the equipment and its installation is only caused by shipping time. The asset is recognised by the entity on the date of shipping by the supplier because (in this example) that is the date on which control passes to the entity. Borrowing costs incurred on the loan raised to finance the acquisition will be capitalised as part of the cost of the equipment up to the date that the asset arrives at its destination, is installed and is ready for its intended use.

3.2.3 Investments accounted for using the equity method

Investments accounted for using the equity method are not qualifying assets because they are financial assets, and IAS 23:7 states that financial assets are not qualifying assets.

It is sometimes argued, when a vehicle is established for the purpose of constructing a qualifying asset, that the substance of the arrangement is that the investment is itself a qualifying asset for the investor. The logic is most appealing in the case of projects organised by a limited number of investors to pool resources in developing production facilities or properties. It is argued that, from the investor's perspective, the amount of borrowing costs capitalised should not be different simply because construction of the qualifying asset is through a separate investee vehicle, rather than by the investing entity itself.

However, the accounting for the investor's interest in the vehicle will determine whether or not there is a qualifying asset. If the vehicle is an associate or a joint venture accounted for using the equity method under IAS 28 *Investments in Associates and Joint Ventures*, the interest is a financial asset, and capitalisation of borrowing costs is not permitted by IAS 23.

Example 3.2.3

Investments accounted for using the equity method

Company X invests in construction contracts via participating interests in single-purpose entities. The entities are associates, and are accounted for using the equity method of accounting.

If Company X borrows funds for the purpose of funding the construction activities in these vehicles, should it capitalise borrowing costs as part of the carrying amount of the investments?

No. Borrowing costs should not be capitalised in these circumstances. Investments in associates are financial assets. IAS 23:7 states that financial assets are not qualifying assets.

3.2.4 Joint operations

In contrast to the prohibition on capitalisation of borrowing costs in respect of investments accounted for using the equity method (as described in 3.2.3), when a joint arrangement meets the definition of a joint operation under IFRS 11 *Joint Arrangements*, the entity will instead recognise its share of the assets and liabilities of the joint operation, and capitalisation of borrowing costs will be required to the extent that any of the assets are qualifying assets (see 3.2.1).

The investor's share of the qualifying assets of a joint operation are accounted for as qualifying assets of the investor and, therefore, capitalisation of borrowing costs incurred to fund the construction of those qualifying assets is required, provided that all of the conditions of IAS 23 are met.

3.3 Borrowing costs

3.3.1 Borrowing costs eligible for capitalisation – general

See 2.2 for IAS 23's definition of borrowing costs.

The borrowing costs that are eligible for capitalisation are those borrowing costs that would have been avoided if the expenditure on the qualifying asset had not been made. [IAS 23:10]

Paragraph 8 of IFRIC 1 *Changes in Existing Decommissioning, Restoration and Similar Liabilities* makes clear that capitalisation is not permitted for the periodic unwinding of the discount in relation to changes in obligations to dismantle, remove and restore items of property, plant and equipment. Instead, the periodic unwinding of the discount is recognised in profit or loss as a finance cost as it occurs.

3.3.2 Specific borrowing costs

When funds are borrowed specifically for the purpose of acquiring or constructing a qualifying asset, the amount of borrowing costs eligible for capitalisation is the actual borrowing costs incurred on those funds during the period. [IAS 23:12]

The financing arrangements may result in the specific borrowings being drawn down prior to some or all of the funds being utilised to finance the qualifying asset. In such circumstances, any investment income earned on the temporary investment of the funds, pending their expenditure on the qualifying asset, should be deducted from the actual borrowing costs incurred to arrive at the borrowing costs eligible for capitalisation. [IAS 23:13]

Example 3.3.2

Specific borrowing costs offset by investment income on excess funds

An entity borrows CU20 million to finance the construction of a factory. The funds are to be drawn down on a monthly basis in four equal amounts. Payment of construction costs occurs throughout each month, rather than coinciding with the draw-downs. During each month, the entity invests any excess funds drawn down in accordance with the financing arrangements in short-term bank deposits.

- defines an investment entity and sets out an exception to consolidating particular subsidiaries of an investment entity.

3 Scope of IFRS 10

3.1 General requirement to present consolidated financial statements

IFRS 10 requires that a parent (i.e. an entity that controls one or more entities) should present consolidated financial statements. [IFRS 10:4] Consolidated financial statements are defined as “[t]he financial statements of a group in which the assets, liabilities, equity, income, expenses and cash flows of the parent and its subsidiaries are presented as those of a single economic entity”. [IFRS 10:Appendix A]

IFRS 10 does not deal with the accounting requirements for business combinations and their effect on consolidation, including goodwill arising from business combinations. [IFRS 10:3] The accounting requirements for business combinations are discussed in **chapter A25**.

3.2 Employee benefit plans excluded from the scope of IFRS 10

IFRS 10 does not apply to post-employment benefit plans or other long-term employee benefit plans to which IAS 19 *Employee Benefits* applies. [IFRS 10:4A]

The wording of the scope exclusion in IFRS 10:4A is confusing. At first glance, it appears to say that IFRS 10 does not apply to financial statements presented by post-employment benefit plans or other long-term employee benefit plans. But IFRS 10 does not apply to the financial statements of such plans; rather, they are within the scope of IAS 26 *Accounting and Reporting by Retirement Benefit Plans* (see **chapter A41**).

Instead, employers are required to apply IAS 19 in accounting for employee benefit plans, and it appears that the exclusion in IFRS 10:4A is intended to apply to such employers and to exempt them from having to consider whether benefit plans of the nature described meet the definition of a subsidiary (which would result in a requirement to consolidate them). Without this exemption, it seems possible that some benefit plans might have been required to be consolidated as structured entities.

3.3 Exemption from presenting consolidated financial statements for a parent that is itself a subsidiary

An entity that has subsidiaries need not present consolidated financial statements if it meets all of the following conditions:

[IFRS 10:4(a)]

- the entity is itself either (1) a wholly-owned subsidiary, or (2) a partially-owned subsidiary and all its other owners (including those not otherwise entitled to vote) have been informed about, and do not object to, the entity not presenting consolidated financial statements;
- the entity’s debt or equity instruments are not traded in a public market (i.e. a domestic or foreign stock exchange or an over-the-counter market, including local and regional markets);
- the entity did not file, nor is it in the process of filing, its financial statements with a securities commission or other regulatory organisation for the purpose of issuing any class of instruments in a public market; and
- the ultimate or any intermediate parent of the entity produces financial statements available for public use that comply with IFRSs, in which subsidiaries are consolidated or are measured at fair value through profit or loss in accordance with IFRS 10.

The criteria in IFRS 10:4(a) were amended by *Investment Entities: Applying the Consolidation Exemption (Amendments to IFRS 10, IFRS 12 and IAS 28)*, issued in December 2014 and effective for annual periods beginning on or after 1 January 2016, with earlier application permitted. If an entity applies the December 2014 amendments for a period beginning before 1 January 2016, it is required to disclose that fact. [IFRS 10:C1D]

The December 2014 amendments have clarified that the exemption under IFRS 10:4(a) is available to a parent entity that is a subsidiary of an investment entity, even if the investment entity measures all of its subsidiaries at fair value.

The criteria in IFRS 10:4(a) are only met if the ultimate or any intermediate parent produces financial statements available for public use that comply with IFRSs as issued by the IASB in which its subsidiaries are included either by consolidation or by measurement at fair value through profit or loss in accordance with IFRS 10.

Similarly, if the parent complies with the *International Financial Reporting Standard for Small and Medium-sized Entities* (see **appendix A6**), but not full IFRSs, the above criteria are not met.

If the parent complies instead with a modified version of IFRSs (e.g. IFRSs as endorsed for use in a particular jurisdiction), but does not comply with IFRSs as issued by the IASB (because it applies some accounting treatment that is allowed under the modified version of IFRSs but not under IFRSs as issued by the IASB), the above criteria are not met.

3.4 Parent has no subsidiary at the end of the reporting period

IFRS 10:20 (see 10.3) requires that the income and expenses of a subsidiary should be included in the consolidated financial statements until the date on which the parent loses control of the subsidiary. Accordingly, when a parent has had subsidiaries at any time during a reporting period, IFRS 10 requires consolidated financial statements to be presented (unless any of the exemptions in IFRS 10 is available).

3.5 No bases for exclusion of subsidiaries from consolidation (other than for investment entities)

Other than for investment entities (see section 13), when consolidated financial statements are presented, IFRS 10 does not allow any bases for exclusion of subsidiaries from consolidation. Notably:

- a subsidiary is not excluded from consolidation on the basis that control is temporary. If, on acquisition, a subsidiary meets the criteria to be classified as held for sale in accordance with IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*, it is included in the consolidation but is accounted for under that Standard (see chapter A20);
- a subsidiary is not excluded from consolidation on the basis that there are severe long-term restrictions that impair its ability to transfer funds to the parent. The IASB has concluded that a parent, when assessing its ability to control a subsidiary, should consider restrictions on the transfer of funds from the subsidiary to the parent but that, in themselves, such restrictions do not preclude control; and
- a subsidiary is not excluded from consolidation on the grounds that its activities are substantially different from those of the parent and/or the rest of the group. Information regarding the different nature of the activities of a subsidiary can be appropriately disclosed in accordance with IFRS 8 *Operating Segments*.

4 Identification of parents and subsidiaries

4.1 Definitions – parent and subsidiary

A parent is “[a]n entity that controls one or more entities”. [IFRS 10:Appendix A]

A subsidiary is “[a]n entity that is controlled by another entity” (which will be its parent). [IFRS 10:Appendix A]

A group consists of a parent and its subsidiaries. [IFRS 10:Appendix A]

There are two key aspects to the definition of a subsidiary:

- the concept of ‘control’ (which is discussed in detail in section 5); and
- what constitutes an entity (see 4.2).

4.2 Meaning of an ‘entity’

IFRS 10 does not define what is meant by an ‘entity’. The definition of a subsidiary previously included in IAS 27(2008) *Consolidated and Separate Financial Statements* stated explicitly that the term encompassed an unincorporated entity. Although this clarification has not been carried forward to IFRS 10, it seems clear that a subsidiary need not be a corporate entity (e.g. it can be a partnership or a trust).

In addition, IFRS 10 allows that, in specified circumstances, a portion of an investee (often called a ‘silo’ or ‘cell’) may be accounted for as a ‘deemed separate entity’ (see 4.3).

4.3 Determining whether a portion of an investee is a deemed separate entity

In some situations, an investor may have interests in a particular set of assets and liabilities of an investee (a portion of an investee) by virtue of legal or contractual arrangements, rather than in the entire legal entity. In addition, in some jurisdictions, legal entities are divided into separate parts (often referred to as ‘silos’ or ‘cells’).

In such circumstances, the question arises as to whether it is possible to consider only an individual silo or a portion of an investee (rather than the entire legal entity) as a separate entity for the purposes of the consolidation assessment.

IFRS 10 requires an investor to treat a portion of an investee as a deemed separate entity if, and only if, the following conditions are met:

[IFRS 10:B77]

- specified assets of the investee (and related credit enhancements, if any) are the only source of payment for specified liabilities of, or specified other interests in, the investee;
- parties other than those with the specified liability do not have rights or obligations related to the specified assets or to residual cash flows from those assets; and

An investee is a subsidiary if, and only if, it is a separate entity for the purposes of the consolidation assessment.

- in substance, none of the returns from the specified assets can be used by the remaining investee and none of the liabilities of the deemed separate entity are payable from the assets of the remaining investee.

Therefore, the key to determining whether a portion of an entity is a deemed separate entity under IFRS 10 is whether the portion of the investee is, in substance, 'ring-fenced' from the overall investee.

When the conditions in IFRS 10:B77 are met, the investor should determine whether it has control of the deemed separate entity using IFRS 10's general definition of control (see **section 5**). In particular, the investor should:

[IFRS 10:B78]

- identify the activities that significantly affect the returns of the deemed separate entity and how those activities are directed in order to assess whether it has power over that portion of the investee;
- consider whether it has exposure or rights to variable returns from its involvement with the deemed separate entity; and
- consider whether it has the ability to use its power over that portion of the investee to affect the amount of the investor's returns.

If an investor controls a deemed separate entity, the investor should consolidate that deemed separate entity. In such circumstances, other parties should exclude that portion of the investee when assessing control of, and in consolidating, the investee. [IFRS 10:B79]

4.4 Horizontal groups

Consolidated financial statements are not required for a 'horizontal group', i.e. when two or more reporting entities are controlled by a common shareholding, such as that held by a private individual. IFRS 10 requires the presentation of consolidated financial statements when an *entity* controls one or more other entities. To the extent that entities are controlled by the same *individual*, there is no requirement in IFRSs that consolidated financial statements be presented.

The existence of a controlling individual, and transactions between entities that are under common control and other related parties, are required to be disclosed under IAS 24 *Related Party Disclosures* (see **chapter A23**).

5 Assessment of control

5.1 Control – definition

An investor controls an investee when the investor "is exposed, or has rights, to variable returns from its involvement with the investee and has the ability to affect those returns through its power over the investee". [IFRS 10:6 & Appendix A]

Specifically, an investor controls an investee if and only if the investor has all of the following elements:

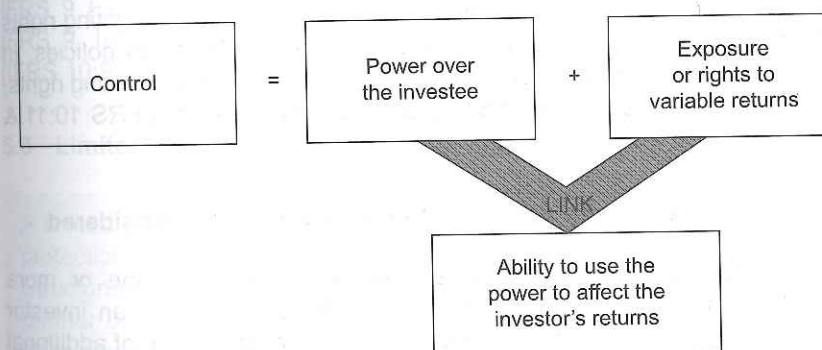
[IFRS 10:7 & B2]

- power over the investee;
- exposure, or rights, to variable returns from its involvement with the investee; and
- the ability to use its power over the investee to affect the amount of the investor's returns.

Power is defined as "existing rights that give the current ability to direct the relevant activities" (see **section 6**). [IFRS 10:Appendix A]

An investor must possess all three elements to conclude that it controls an investee.

The diagram below depicts the three elements of control and the relationship between them.



An investor is required to consider all facts and circumstances in assessing whether it controls an investee. [IFRS 10:8] In practice, the determination as to who controls an investee can be complex.

5.2 Requirement for an investor to assess whether it has control

An investor, regardless of the nature of its involvement with an entity (the investee), is required to determine whether it is a parent by assessing whether it controls the investee. [IFRS 10:5]

Although IFRS 10 refers to an 'investor' having control, it does not define the term 'investor'. IFRS 10:5 states that an investor may have control of an investee "regardless of the nature of its involvement". As a specific example, IFRS 10:B15 states that control may be achieved through a management contract if the contract gives the holder the ability to direct the relevant activities (see 8.2). Therefore, there is no requirement for the investor's interest in the investee to be in the form of debt or equity instruments.

An investor is required to reassess whether it controls an investee if facts and circumstances indicate that there are changes to one or more of the three elements of control listed in 5.1 (see section 9). [IFRS 10:8]

5.3 Assessment of control – purpose and design of the investee

When assessing control, the investor should first consider the purpose and design of the investee in order to identify (1) the relevant activities (i.e. the activities of the investee that significantly affect the investee's returns), (2) how decisions about the relevant activities are made, (3) who has the current ability to direct those activities, and (4) who receives returns from those activities. [IFRS 10:B5]

Sometimes, this assessment will be very straightforward; it may be clear that control over the investee is exercised directly and solely by means of equity instruments (e.g. ordinary shares) that give the holder proportionate voting rights. In such circumstances, unless more complex arrangements have been put in place that alter decision-making, the assessment of control should focus on which party, if any, is able to exercise voting rights sufficient to determine the investee's operating and financing policies. In clear-cut situations, the investor that holds a majority of those voting rights, in the absence of any other factors, controls the investee. [IFRS 10:11 & B6]

5.4 Assessment of control – additional factors to be considered

In more complex cases (e.g. when power results from one or more contractual arrangements), the determination as to whether an investor controls an investee may require more rigorous consideration of additional factors, including some or all of the following:

[IFRS 10:11, B3 & B7]

- whether the investor has power over the investee, i.e.:
 - what the relevant activities are (see 6.2);
 - how decisions about those activities are made (see 6.3); and

- whether the rights of the investor give it the current ability to direct the relevant activities (see 6.4);
- whether the investor is exposed, or has rights, to variable returns from its involvement with the investee (see section 7); and
- whether the investor has the ability to use its power over the investee to affect the amount of the investor's returns (see section 8).

5.5 Only one party can control an investee

The Basis for Conclusions on IFRS 10 states that:

[IFRS 10:BC69 & BC70]

- only one party (if any) can control an investee; and
- the fact that other entities have protective rights relating to the activities of an investee (see 6.4.5) does not prevent an investor from having control of an investee.

Therefore, when two or more investors collectively control an investee (i.e. the investors must act together to direct the relevant activities of the investee), no investor can direct the activities without the co-operation of the others and, consequently, no investor individually controls the investee. In such cases, each investor should account for its interest in the investee in accordance with the applicable IFRSs, as appropriate (e.g. IFRS 11 *Joint Arrangements*, IAS 28 *Investments in Associates and Joint Ventures*, IFRS 9 *Financial Instruments* or, for entities that have not yet adopted IFRS 9, IAS 39 *Financial Instruments: Recognition and Measurement*). [IFRS 10:9]

5.6 Limited partnerships

A limited partnership is typically a form of partnership that offers the protection of limited liability to some of its partners (the 'limited partners'). Structures for limited partnerships and the functions of a general partner of a limited partnership vary widely between jurisdictions and from partnership to partnership. A limited partnership generally must meet specified legal and tax criteria to qualify as a limited partnership; therefore, the structure is often form-driven. The rights and obligations of general partners in limited partnerships are usually different from those of limited partners. Often, the limited partners are not permitted to take part in the management of the limited partnership, which is solely the responsibility of the general partner(s). Some general partners perform a function designed solely to satisfy the criteria to qualify the entity as a limited partnership.

The determination as to whether an investor has control of a limited partnership will always need to take account of the specific partnership structure and any relevant jurisdictional factors. In general, in applying the three elements of the definition of control in IFRS 10 (i.e. having power over the investee, exposure or rights to variable returns from the investee, and the ability to use power to affect returns):

- a partnership in which the general partner has no beneficial interest in the partnership net assets or net income is unlikely to meet the definition of a subsidiary of the general partner (but it is important to ensure that all returns to the general partner have been identified and considered);
- it is possible for a limited partner to have a majority economic interest in a partnership without having power over the relevant activities; this might occur when it can be demonstrated that another partner has control and does not act as agent for the limited partner; but
- a limited partner who is also the sole general partner, or who has power to remove the sole general partner, may exercise control such that the partnership meets the definition of a subsidiary of the limited partner.

The determination as to whether any of the partners controls the partnership is a matter requiring careful judgement based on the relevant facts and circumstances.

5.7 Employee share trusts

Employee share trusts (sometimes established in conjunction with employee share ownership plans (ESOPs) or employee share plans) are designed to acquire an entity's shares and distribute the shares to employees under remuneration schemes. The detailed structure of such trusts varies, but often includes the following:

- the trust holds shares in the sponsoring entity (or another group entity) to be sold or transferred to employees under the terms of a share-based payment plan;
- the trust acquires shares either directly from the sponsoring entity or by purchasing them in the market. These acquisitions may be financed by a cash contribution or loan from the sponsoring entity or by a third-party loan (often guaranteed by the sponsoring entity); and
- the activities of the trust are narrowly defined, typically in a trust deed.

See **section 9 of chapter A16** for a discussion of the factors that should be considered when determining whether a sponsoring entity

applying IFRS 10 controls a trust established as part of an employee remuneration scheme.

6 Power over an investee

6.1 Power over an investee – definition

An investor has power over an investee when the investor has existing rights that give it the current ability to direct the relevant activities. [IFRS 10:10]

Key steps in the determination as to whether an entity has power over an investee are:

- identifying the relevant activities (see 6.2);
- understanding how decisions about relevant activities are made (see 6.3); and
- determining whether the investor's rights give it the current ability to direct the relevant activities (see 6.4).

6.2 Identifying the relevant activities

6.2.1 Relevant activities – general

Relevant activities are defined as “activities of the investee that significantly affect the investee's returns”. [IFRS 10:Appendix A]

It could be difficult to determine the relevant activities of an investee in certain scenarios. In these situations, it is important for an investor to understand the purpose and design of an investee (see 5.3).

IFRS 10 requires an investor to focus on the activities that significantly affect the returns of an investee.

- When the investee is directed through voting or similar rights (see 6.4.6), power often relates to governing the strategic operating and financing policies of an investee. However, as explained in the Basis for Conclusions on IFRS 10, that is only one of the ways in which power to direct the activities of an investee can be achieved. In the IASB's view, referring to the power to govern the financial and operating policies of an investee is not necessarily appropriate for investees that are not directed through voting or similar rights. [IFRS 10:BC42]
- It is important to focus on activities that have a *significant* effect on the investee's returns rather than on administrative activities that have little or no effect on the investee's returns. This focus

the securitisation vehicle that significantly affect the returns of the transaction (even before the default of the receivables).

Note that it is expected to be extremely rare for a structured entity to have no relevant activities (i.e. it operates on full 'autopilot' and the only decisions to be made after formation of the structured entity relate to administrative activities that will not significantly affect the investee's returns). Such a determination should be made only after a thorough analysis of both the expected activities of the structured entity and decisions to be taken in response to contingent events (see 6.2.3 for additional guidance for those rare circumstances when such a determination is made).

6.2.3 Relevant activities – involvement in the design of a structured entity operating on autopilot

It is common for a structured entity to operate in a way so that seemingly no decisions are made in conducting the entity's ongoing activities after its formation (i.e. the entity effectively operates on 'autopilot'). A thorough understanding of (1) the purpose and design of the structured entity, and (2) any decisions to be made after its formation, is critical in assessing who has power.

As discussed in 6.2.2, virtually all structured entities that operate in a largely predetermined way have relevant activities. However, there may be extremely rare situations when, after careful assessment of the purpose and design of a structured entity, the only decisions to be made after formation of the entity relate to administrative activities that will not significantly affect the investee's returns. If this is the case, there are no decisions to be made on relevant activities of the structured entity subsequent to its formation and the only decisions that significantly affect the returns of the structured entity are the decisions taken at the formation stage.

In those extremely rare situations when there are no decisions to be made on relevant activities after formation of a structured entity, an investor can have power over the structured entity as a result of the investor's decisions and involvement in the design and creation of the structured entity. Specifically, the initial design of the entity may be the relevant activity that significantly affects the returns of the structured entity. Consequently, in determining whether an investor has power over the structured entity, the activities performed and decisions made as part of the entity's design at formation should be assessed carefully.

Nevertheless, the fact that an investor is involved in the design of an investee does not necessarily mean that the investor has decision-making rights to direct the relevant activities of the investee. Often,

several parties are involved in the design of an investee and the final structure of the investee includes whatever is agreed to by all those parties (see IFRS 10:BC77). Consequently, an investor's involvement in establishing an investee would not, in isolation, be sufficient evidence to determine that the investor has power over the entity.

In making this assessment, an investor should consider the significance of its interest in the investee and its involvement in the design of the investee (including an assessment of the scope of its decision-making authority during the design process). The more significant an investor's (1) interest, and (2) involvement in the design of the investee, the more indicative it is that the investor had the ability and incentive to make decisions for its own benefit and, therefore, that it has power over the investee.

6.3 How decisions about relevant activities are made

6.3.1 Decisions about relevant activities

Having identified the relevant activities of an investee, the next key step in understanding who has power over an investee is to understand the mechanisms for making decisions about those relevant activities.

Examples of decisions about relevant activities include, but are not limited to:

[IFRS 10:B12]

- establishing operating and capital decisions of the investee, including budgets; and
- appointing and remunerating an investee's key management personnel or service providers and terminating their services or employment.

Accordingly, it will often be appropriate to focus on the purpose and design of the investee and how decisions are made in relation to, for example:

- changes of strategic direction, including acquisitions and disposals of subsidiaries;
- major capital purchases and disposals;
- appointment and remuneration of directors and other key management personnel;
- approval of the annual plan and budget; and
- dividend policy (see also the discussion in section 7).

of principal and interest payments of the assets. The transaction is marketed to the debt investor as an investment with minimal exposure to the credit risk associated with the possible default of the assets in the portfolio because of the nature of these assets and because the equity tranche is designed to absorb the first losses of the investee. The returns of the investee are significantly affected by the management of the investee's asset portfolio, which includes decisions about the selection, acquisition and disposal of the assets within portfolio guidelines and the management upon default of any portfolio assets. All those activities are managed by the asset manager until defaults reach a specified proportion of the portfolio value (ie when the value of the portfolio is such that the equity tranche of the investee has been consumed). From that time, a third-party trustee manages the assets according to the instructions of the debt investor. Managing the investee's asset portfolio is the relevant activity of the investee. The asset manager has the ability to direct the relevant activities until defaulted assets reach the specified proportion of the portfolio value; the debt investor has the ability to direct the relevant activities when the value of defaulted assets surpasses that specified proportion of the portfolio value. The asset manager and the debt investor each need to determine whether they are able to direct the activities that *most* significantly affect the investee's returns, including considering the purpose and design of the investee as well as each party's exposure to variability of returns.

6.3.2.3 Entity has more than one governing body

In practice, entities will have a variety of governance structures, frequently determined by the regulatory requirements in relevant jurisdictions and/or agreements between their shareholders. A clear understanding of the governance structure of an investee is essential in order to identify how decisions about relevant activities are made.

In some situations, the direction of the relevant activities of an investee is determined by majority vote at shareholders' meetings. In such cases, an investor that has the ability to cast the majority of votes at shareholders' meetings generally has power over the investee.

When an investee has more than one governing body, it is important to understand the rights and obligations of each governing body. It should not be assumed merely because one body has oversight of another that the former is necessarily the body that makes decisions about the relevant activities of the entity. In all cases, the assessment of control should be based on a careful analysis of all relevant facts and circumstances.

6.3.2.4 Majority of directors are independent

In many jurisdictions, best practice or mandatory corporate governance codes require that an entity appoint directors who are independent. The term 'independent director' has a variety of meanings in different

jurisdictions, but it is generally taken to describe a director who does not represent a specific shareholder.

If the majority of an entity's directors are independent, it should not be automatically assumed that none of the shareholders has power over decisions made by the directors.

In assessing whether a particular shareholder controls an entity, all relevant facts and circumstances should be considered. [IFRS 10:8] As discussed at 6.3.2.3, a clear understanding of the governance structure of an investee is essential in order to identify how decisions about relevant activities are made and, consequently, who has power over the investee. In the circumstances under consideration, this would involve analysing both the process for decision making at a director level and the extent to which decisions over relevant activities are taken by the directors rather than via a shareholder vote.

In the context of an entity with independent directors, it is necessary to consider the role of those directors in making decisions regarding relevant activities. It may be that their role is limited to ensuring that proper governance procedures are followed (through, for example, membership of an audit or nominations committee); this may involve challenging the basis for decisions made by the non-independent directors (in, for example, a committee of which the independent directors are not members) but not active involvement in the decision-making process.

In circumstances such as these, it may be that an investor can exercise power over decisions made by an entity's directors through power over a majority of an entity's non-independent directors. As for other decision makers (see 8.2.6), powers to appoint and remove independent directors should also be considered.

6.4 Whether the investor's rights give it the current ability to direct the relevant activities

6.4.1 Focus on the 'ability to direct' rather than the actual exercise of power

Power arises from rights. To have power over an investee, an investor must have existing rights that give the investor the current ability to direct the relevant activities. [IFRS 10:11 & B14] Therefore, the assessment of power is based on the investor's *ability* to direct the relevant activities of the investee; specifically, IFRS 10 does not require the investor to have actually exercised its power. An investor with the current ability to direct the relevant activities of an investee has power over the investee even if its rights to direct have yet to be exercised. Conversely, evidence that the investor has been directing the relevant activities of the investee can help

determine whether the investor has power, but such evidence is not, in itself, conclusive in determining whether the investor has power over the investee. [IFRS 10:12]

An investor can have power over an investee even if other entities have existing rights that give them the current ability to participate in the direction of the relevant activities (e.g. when another entity has significant influence). [IFRS 10:14]

6.4.2 Rights that give an investor power over an investee

The rights that give an investor power can differ between investees. [IFRS 10:B14] Different types of rights that, either individually or in combination, can give an investor power over an investee include, but are not limited to:

[IFRS 10:B15]

- rights in the form of voting rights (or potential voting rights) of an investee (see 6.4.6);
- 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; and
- other rights (such as decision-making rights specified in a management contract) that give the holder the ability to direct the relevant activities.

The specific factors that apply when voting or similar rights do not have a significant effect on the investee's returns are considered in 6.4.7.

6.4.3 Evidence to be considered when it is difficult to determine whether the investor's rights are sufficient to give it power

When it is difficult to determine whether an investor's rights are sufficient to give it power over an investee, to enable the assessment of power to be made, the investor should consider evidence regarding whether it has the practical ability to direct the relevant activities unilaterally. Consideration is given, but is not limited, to whether:

[IFRS 10:B18]

- 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 (e.g. the chief executive officer of the investee and the chief executive officer of the investor are the same person); and/or
- the majority of the members of the investee's governing body are related parties of the investor.

When considered together with the investor's rights and the indicators in IFRS 10:B19 and B20 (see below), the factors listed in IFRS 10:B18 may provide evidence that the investor's rights are sufficient to give it power over the investee.

Sometimes there will be indications that the investor has a special relationship with the investee, which suggests that the investor has more than a passive interest in the investee. The existence of any individual indicator, or a particular combination of indicators, does not necessarily mean that the power criterion is met. However, having more than a passive interest in the investee may indicate that the investor has other related rights sufficient to give it power or provide evidence of existing power over an investee. For example, the following suggests that the investor has more than a passive interest in the investee and, in combination with other rights, may indicate that the investor has power over the investee:

[IFRS 10:B19]

- the investee's key management personnel who have the ability to direct the relevant activities are current or previous employees of the investor;
- the investee's operations are dependent on the investor, such as in the following situations:
 - the investee depends on the investor to fund a significant portion of its operations;
 - the investor guarantees a significant portion of the investee's obligations;
 - the investee depends on the investor for critical services, technology, supplies or raw materials;
 - the investor controls assets such as licences or trademarks that are critical to the investee's operations; and/or
 - the investee depends on the investor for key management personnel, such as when the investor's personnel have specialised knowledge of the investee's operations;