THE STANDARD STANCE

Decoding ‘Control’ Under Ind AS 110, Consolidated Financial Statements

Volume 10
May 2024

BDO

The objective of Ind AS 110 – Consolidated Financial Statements (Ind AS 110) is to establish principles for the presentation and preparation of consolidated financial statements when an entity controls one or more other entities.

Implementing Ind AS 110 can pose challenges, especially for conglomerates with complex organisational structures and diverse business operations. Through this publication, we will delve into the intricacies of Ind AS 110, exploring the concept of 'control' and the challenges associated with its implementation.

KEY CONSIDERATIONS UNDER IND AS 110

Why is the concept of control so important?

Control is the sole basis for consolidation. The structure of the investee is not relevant. Consequently, the requirements of Ind AS 110 apply to all investor/ investee relationships, including 'structured entities'. Regardless of the nature of its involvement with an investee entity, an investor should determine whether it is a parent by assessing whether it controls the investee. 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.

To put it simply, the control model under Ind AS 110 is based on the existence of three elements of control (as illustrated in the figure below). When all three elements are present, an investor is considered to control an investee and consolidation is required. When one or more of the elements are not present, an investor will not consolidate, but would be required to determine the nature of its relationship with the investee (e.g., significant influence, joint control) and the appropriate accounting under the requisite Ind AS.

Let us look at each of the above elements in brief as well as some of the key complexities involved while assessing the same.

POWER

The first criterion of control relates to power. An investor needs to demonstrate power over an investee to determine control. Power arises when an investor has existing rights that give it the 'current ability' to direct the 'relevant activities' unilaterally. In this context, 'current ability' does not necessarily require the rights to be exercisable immediately. Instead, an investor only needs to have the ability to control relevant activities, and it is not relevant whether the investor exercises this ability.

Therefore, when assessing whether an investor has power, two critical concepts need to be considered:

- What are the 'relevant activities' of the investee; and
- Existing right, i.e., who has the right to direct the relevant activities?

What are the relevant activities of the investee?

Relevant activities are defined as *"activities of the investee that significantly affect the investee's returns."*

The concept of relevant activities is a key part of the analysis required by Ind AS 110. While in many cases these will be straightforward to identify, in others careful consideration will be required. To identify relevant activities, an investor considers the purpose and design of an investee. In other words, relevant activities depend on the business model of an investee and how revenue is generated.

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

- determining or changing operating and financing policies (which might include the items below)
- selling and purchasing goods and/ or services
- selecting, acquiring, or disposing of assets
- researching and developing new products or processes
- determining a funding structure or obtaining funding
- establishing operating and capital decisions of the investee, including budgets
- appointing, remunerating, or terminating the employment of key management personnel

For many investees, this criterion will be straightforward to assess. The assessment may be highly judgmental for entities where multiple investors share the power over an investee's relevant activities or that have predetermined activities.

EXAMPLE:

Two investors, B and C, form an investee that is engaged in the development of a medical product (which will be registered in the name of the investee), and its subsequent manufacture and marketing. B has the unilateral ability to make decisions related to development (including obtaining regulatory approval), and C has the unilateral ability to make decisions about manufacturing and marketing. All these activities are relevant activities that take place within the investee.

In determining which investor has power, the investors would consider:

- the factors that determine the profit margin/ revenue
- the effect of each investor's decision-making authority on the investee's returns
- the uncertainty of, and the effort required to obtain regulatory approval
- which investor controls the medical product if the development phase is successful

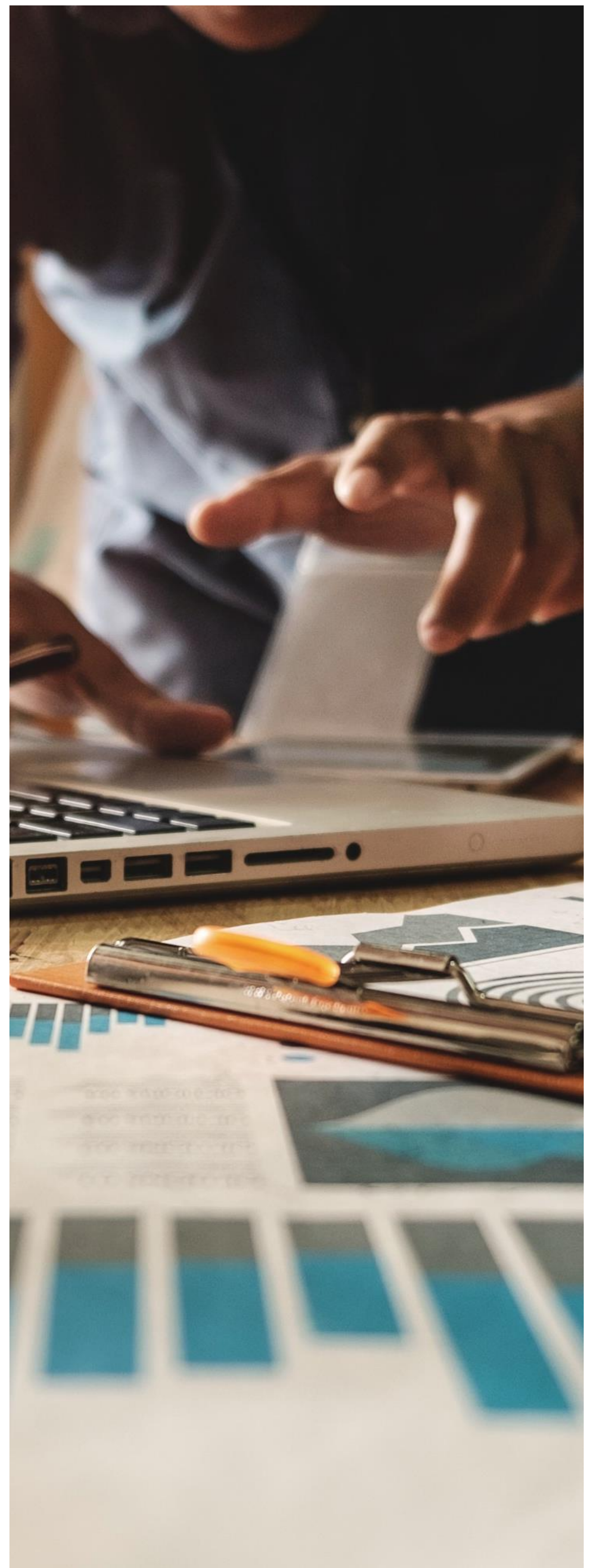
The above example is included in the basis of the conclusion of IFRS 10. In this example, IFRS 10 does not conclude which of the activities is the most relevant activity (i.e., the activity that most significantly affects the investee's returns). If it were concluded that the most relevant activity is:

- developing and obtaining regulatory approval of the medical product – then the investor that has the power to direct that activity would have power from the date of entering the arrangement; or
- manufacturing and marketing the medical product – then the investor that has the power to direct that activity would have power from the date of entering the arrangement.

Who has the existing right to direct the relevant activities?

Once the relevant activities are identified, the next step is to determine which investor, if any, has the current ability to direct those activities. 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. Only substantive rights (see below) are considered, with protective rights being disregarded. Examples of rights that, either individually or in combination, can give an investor power include but are not limited to:

- ability to make decisions through voting rights (including potential voting rights)
- right to appoint a majority of the directors on the board
- remove members of an investee's key management personnel who have the ability to direct the relevant activities
- to direct the investee to enter or veto any changes to transactions for the benefit of the investor
- relevant activities that are directed by means of contractual arrangements



One of the key aspects of control under Ind AS 110 is the fact that an investor can have power even if it holds less than the majority of voting rights. To explain this further, the standard provides specific guidance for the following scenarios:

Voting Rights – Majority Not Held:

Contractual agreements with other vote holders	A contractual arrangement between an investor and other vote holders can give the investor the right to exercise voting rights sufficient to give power. **Example:** Entity E has four shareholders – Entity A, Entity B, Entity C and Entity D. Entity A owns 40% of the ordinary shares of Entity E while each of the other shareholders owns 20%. The relevant activities of Entity E are directed by its board of directors comprised of six directors: three appointed by Entity A, and one each appointed by Entity B, Entity C and Entity D. To avoid deadlock in board deliberations, the shareholders have entered into an agreement to the effect that one of the directors appointed by Entity A acts as the chairman of the board and has an additional casting vote at board meetings. The shareholders' agreement effectively gives Entity A majority of votes at board meetings in relation to the relevant activities. Absent other factors, this provides Entity A with power over Entity E, even though Entity A does not hold a majority of the voting rights in Entity E.
Potential voting rights	Potential voting rights are the rights to obtain voting rights of an investee (e.g., convertible instruments, options, and forward contracts). When assessing whether it has power over an investee, an investor also considers the potential voting rights that it holds. The potential voting rights are considered only if the rights are substantive. **Example:** Company A holds stakes in two entities - S1 and S2, both operating in the same industry sector. Company A holds a controlling interest in S1 and a 35% interest in S2. The remaining 65 % interest in S2 is held by Company B. S1 is much larger than S2 in terms of market share. Its products account for a market share of 40% whereas S2 only accounts for 15%. Company A also holds options to acquire a further 40% interest in S2 from Company B. The options are in the money, but the competition authority has stated that it would only permit Company A to acquire the additional 40% share in S2 if Company A disposes of its controlling interest in S1. In this example, Company B is likely to have control over S2. If Company A exercises its options (potential voting rights), it would be required to sell its wholly-owned subsidiary S1. This would result in a significant negative economic effect. The fact that S1's (that would be required to be disposed of) turnover is nearly treble of S2's turnover is a significant economic barrier to overcome. In the absence of other facts or circumstances, Company A's options are considered to be non-substantive. It would be too disadvantageous for A to exercise its options.
De facto control	Ind AS 110 explicitly includes the concept of 'de facto' control, where an investor with less than a majority of voting rights has power over an investee. The primary focus of the analysis under Ind AS 110 remains on whether an investor has sufficient voting rights to give that investor the practical ability to direct the relevant activities. This involves an assessment of the size of its holding of voting rights relative to the size and dispersion of holdings of the other vote holders. **Example:** An investor acquires 48% of the voting rights of an investee. The remaining voting rights are held by thousands of shareholders, none individually holding more than 1% of the voting rights. None of the shareholders has any arrangements to consult any of the others or make collective decisions. When assessing the proportion of voting rights to acquire, based on the relative size of the other shareholdings, the investor determined that a 48% interest would be sufficient to give it control. In this case, based on the absolute size of its holding and the relative size of the other shareholdings, the investor concludes that it has a sufficiently dominant voting interest to meet the power criterion without the need to consider any other evidence of power.

Substantive vs. Protective Rights

Ind AS 110 clarifies that only substantive rights are considered for control assessment, with protective rights being disregarded. The distinction between substantive and protective rights can be significant in the analysis of which investor (if any) has the unilateral power to control an investee. Protective rights are related to fundamental changes in the activities of an investee or are rights that apply only in exceptional circumstances. As such, they cannot give the holder power or prevent other parties from having power and therefore control over an investee.

Examples of protective rights:

- A lender’s right to restrict the borrower’s activities (if these could change credit risk significantly to the detriment of the lender)
- Approval of capital expenditure greater than the specified threshold
- Veto transactions between the investee and a related party
- Issue of debt or equity instruments requiring approval by non-controlling interest holders
- The sale of a significant portion of the entity’s operating assets

Is a right to veto the budget a ‘protective right’?

Veto rights over budgets are fairly common in shareholders’ agreements and form part of the assessment as to the level of power held by investors. If the budget approval rights held by a shareholder (or other investor) are viewed as substantive, that might indicate that the entity having those rights has power over an investee. However, the right to approve budgets should not automatically be considered substantive but should be based on a careful consideration of the facts and circumstances. Factors to consider in assessing whether budget approval rights are substantive or protective include (but are not limited to):

- the level of detail of the budget that is required to be approved
- the extent to which the budget determines the management’s actions
- the consequences of budgets not being approved
- whether previous budgets have been challenged; and if so, the practical method of resolution
- who appoints the operator and/ or key management personnel of the investee?

EXPOSURE TO VARIABLE RETURNS

The second criterion for assessing whether an investor has control of an investee is determining whether the investor has an exposure, or has rights, to variable returns from its involvement with the investee. An investor is exposed, or has rights, to variable returns from its involvement with the investee when the investor's returns from its involvement have the potential to vary as a result of the investee's performance. Returns can be positive, negative or both.

Although only one investor can control an investee, more than one party can share in the returns of an investee. For example, holders of non-controlling interests can share in the profits or distributions of an investee.

Examples of exposures to variable returns include:

- dividends, fixed interest on debt securities that expose the investor to the credit risk of the issuer
- economies of scale, cost savings, scarce products, proprietary knowledge, synergies, or other exposures to variable returns that are not available to other investors

Simply having an exposure to variable returns from its involvement with an investee does not mean that the investor has control. To control the investee, the investor would also need to have power over the investee, and the ability to use its power over the investee to affect the amount of the investor's returns.

LINK BETWEEN POWER AND VARIABLE RETURNS

The third control criterion requires an investor to have the ability to use its power to affect the investor’s variable returns. This criterion is included in the standard to address principal-agent relationships. If the decision maker (i.e., an investor) has the power to direct the activities of the investee that it manages to generate returns for itself, then it is a principal. On the contrary, if an entity is primarily engaged to act on behalf of and for the benefit of another party, then it is an agent.

In practice, managed funds fall within this category. The key question is whether a fund is required to be consolidated by the fund manager.

EXAMPLE

A fund manager (the decision maker) establishes markets and manages a fund that provides investment opportunities to a number of investors. The fund manager must make decisions in the best interests of all investors and in accordance with the fund’s governing agreements but has wide decision-making discretion. The fees are commensurate with the services provided, wherein the fund manager receives a market-based fee for its services equal to:

- 1% of assets under management, and
- 20% of all the fund’s profits if a specified profit level is achieved.
- The fund manager has a 45% investment in the fund but no obligation to fund losses beyond its 45% investments.

The fund has a board of directors, all of whose members are independent of the fund manager and are appointed by the other investors. The board appoints the fund manager annually.

ANALYSIS

The fund manager is likely to be an agent. Although the fund manager is paid fixed and performance-related fees that are commensurate with the services provided, the combination of the fund manager's 45% investment together with its remuneration creates exposure to variability of returns from the activities of the fund that is of such significance that it indicates that the fund manager is a principal. However, the investors have substantive rights to remove the fund manager. The board of directors provides a mechanism to ensure that the investors can remove the fund manager if they decide to do so.

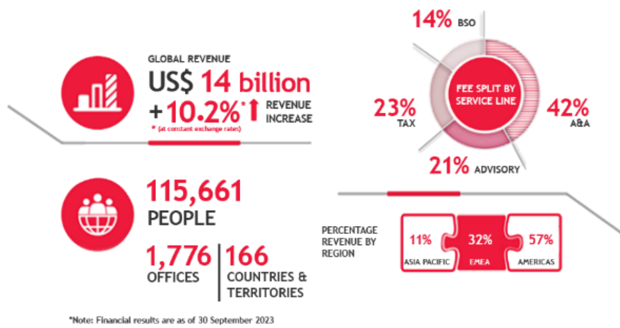
In the analysis, greater weight is given to the substantive removal rights. Thus, although the fund manager has extensive decision-making authority and is exposed to the variability of returns of the fund from its remuneration and investment, the substantive rights held by the other investors indicate that the fund manager is an agent.

CONCLUSION

The concept of control under Ind AS 110 is fundamental to the preparation and presentation of the consolidated financial statements. By understanding the criteria outlined in the standard and applying them judiciously to specific scenarios, entities can accurately assess control relationships and determine the scope of consolidation.

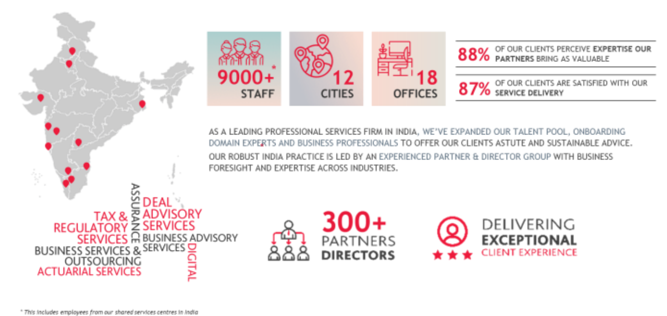
ABOUT BDO GLOBAL

BDO is a leading professional services organisation with a presence in 160+ countries and over 115,600 people working out of more than 1,750 offices. We endeavor to deliver an exceptional client experience through a tailored solutions approach, while partnering with our employees and clients globally.



ABOUT BDO IN INDIA

BDO in India offers Assurance, Tax, Advisory, Business Services & Outsourcing and Digital Services for both domestic and international clients across industries. The team at BDO in India consists of over 9,000 professionals led by more than 300 partners and directors operating out of 18 offices, across 12 key cities.



CONTACT US

For any content related queries, you may write in to accountingadvisory@bdo.in

For any other queries or feedback, kindly write to us at marketing@bdo.in

Ahmedabad | Bengaluru | Chandigarh | Chennai | Coimbatore | Delhi | Goa | Hyderabad | Kochi | Kolkata | Mumbai | Pune

This publication has been carefully prepared, but it has been written in general terms and should be seen as containing broad statements only. This publication should not be used or relied upon to cover specific situations and you should not act, or refrain from acting, upon the information contained in this publication without obtaining specific professional advice. Please contact BDO India LLP to discuss these matters in the context of your particular circumstances. BDO India LLP, its partners, employees and agents do not accept or assume any responsibility or duty of care in respect of any use of or reliance on this publication and will deny any liability for any loss arising from any action taken or not taken or decision made by anyone in reliance on this publication or any part of it. Any use of this publication or reliance on it for any purpose or in any context is therefore at your own risk, without any right of recourse against BDO India LLP or any of its partners, employees or agents.

BDO India LLP, a limited liability partnership, is a member of BDO International Limited, a UK company limited by guarantee, and forms part of the international BDO network of independent member firms.

BDO is the brand name for the BDO network and for each of the BDO Member Firms.

Copyright © 2024 BDO India LLP. All rights reserved. Published in India.

Visit us at www.bdo.in