THE BOTTOM LINE

Issue 7

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Accountants | Auditors | Business Advisers

Welcome to the latest edition of our financial reporting publication that aims to keep you in the loop with all the latest accounting and financial reporting developments, and the potential impact they may have on your business.

In our last issue for the year, we consider why it is important to pay close attention when assessing whether holding a significant minority equates to control. With the end of SPFS looming for certain entities, we look at the transitional relief available to entities required to change from special purpose to general purpose financial statements, and why there may be merit in doing so early. For not-for-profits, we highlight the recent AASB Staff FAQ relating to concessionary loan accounting. And finally, we provide an update on recent AASB activity, including other Staff FAQs that may be helpful to readers.

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AASB 10

Be wary of significant minorities

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While the control model contained in AASB 10 *Consolidated Financial Statements* has been around for a number of years, I was recently reminded of the potential complexities that could be encountered in applying it, and thought it a good time to remind readers that owning a majority of the voting rights is not always necessary to have control.

Assessing if one entity controls another entity is critical to the preparation of consolidated general purpose financial statements as it determines which entities are included in a parent's financial statements, and therefore has an impact on a group's financial position, performance and cash flows.

When an entity (parent) determines that it controls an investee (subsidiary), the parent consolidates the investee into the financial statements prepared by the parent. The parent consolidates the subsidiary from the date on which it first obtains control of the subsidiary (i.e. the date of acquisition as defined in AASB 3 *Business Combinations*) and continues consolidating the subsidiary until the date on which control is lost.

Control assessments involving majority ownership of the voting rights are relatively straightforward, however, more analysis and judgement will be required when an investor holds a significant minority of the voting rights.

The control model in AASB 10

AASB 10's control model is underpinned by three elements. When all three of these elements of control are present, an investor is considered to control an investee and consolidation of the investee is required using the principles in AASB 10. When one or more of the control elements is missing, no consolidation is required. Instead, the investor will have to determine the nature of its relationship with the investee and account for the investee accordingly (for example, as an associate or joint venture in accordance with AASB 128 *Investments in Associates and Joint Ventures*).

The three elements of control are:

- power over the investee
- exposure or rights to variable returns; and
- ability to use power to affect returns.

As already mentioned, all three elements must be present for control to exist, however the remainder of this article will focus on the first element, being power over an investee, as this will often be the criterion that requires the most analysis in significant minority situations.

Power over an investee

Under AASB 10, power stems from rights. Rights confer power when they are sufficient to give the investor the current ability to direct the relevant activities of the investee unilaterally.

'Relevant activities' are activities of the investee that significantly affect the investee's returns. For many investees, returns depend on a wide range of financial and operating activities. Examples of relevant activities include, but are not limited to:

- selling and purchasing goods and/or services
- managing financial assets during their life (including on default)
- selecting, acquiring or disposing of assets
- researching and developing new products or processes
- obtaining funding or determining a funding structure
- determining or changing operating or financial policies (which may include the items above).

Once the relevant activities have been identified, the next step is to determine which investor, if any, has the current ability to direct those activities (i.e. who has the power). In this context, 'current ability' does not necessarily require the rights to be exercisable immediately. Rather, the key factor is whether the rights can be exercised before decisions about relevant activities need to be taken. Rights that are non-substantive, or are purely protective, must be ignored in determining whether an investor has power.

While control assessments involving a majority ownership of voting rights are relatively simple, AASB 10 requires more analysis where the investor holds a significant minority. This is because, under AASB 10, it is not all about the percentage of voting rights held, but whether or not the investor has the practical ability to unilaterally direct an investee's relevant activities. Accordingly, an investor may have power over an investee even when it has less than a majority of the voting rights. This is commonly referred to as '*de facto* control'.

AASB 10's approach to *de facto* control

AASB 10 provides explicit guidance regarding situations where an investor that holds less than 50 percent of the voting rights has rights that are sufficient to give it power. In such a situation, the focus of any control assessment should be on rights that could give the investor power. These rights might arise from:

- the investor's voting rights;
- contractual arrangements with other vote holders;
- other contractual arrangements;
- potential voting rights; or
- a combination of the above.

Careful attention should be paid where an investor has a significant minority interest in determining whether its voting rights (either alone or in combination with other rights) are sufficient to give it power. When assessing whether an investor's voting rights are sufficient to give it power, an investor considers all facts and circumstances, including:

- the size of its holding of voting rights relative to the size and dispersion of other vote holders (see illustration 1);
- potential voting rights held by the investor and others; and
- rights arising from other contractual arrangements.

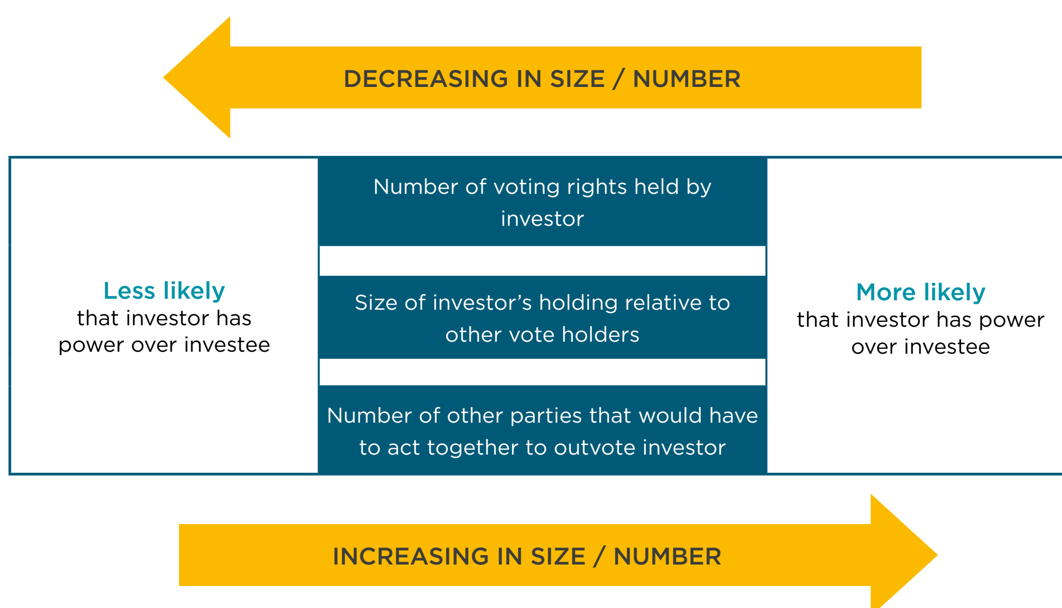


Illustration 1: The effect of voting rights on power

When the investor holds significantly more voting rights than any other vote holder (or organised group of vote holders) and the other shareholdings are widely dispersed, it may be clear after considering the factors listed above that the investor has power over the investee. When the factors above are not clear in determining whether power exists, additional facts and circumstances must be considered, such as:

- voting patterns at previous shareholder meetings (which indicates how passive or active other shareholders are at meetings);
- indicators that the investor has the practical ability to unilaterally direct the relevant activities (for example, the non-contractual ability to appoint the investee's key management personnel);
- indicators that the investor has a special relationship with the investee (for example, the investee depending on the investor to fund a significant part of its operations);
- indicators that the investor's exposure to variable returns is disproportionately greater than its voting or similar rights (which may indicate an incentive for the investor to obtain rights sufficient to give it power).

The fewer the voting rights the investor holds, and the fewer the parties that would need to act in concert to outvote the investor, the more reliance would be placed on the additional facts and circumstances above to assess whether the investor's rights are sufficient to give it power.

Let's consider some scenarios (which are based on similar examples included in AASB 10) to illustrate the principles outlined so far in this article.

Example 1

Company A owns 45% of the ordinary shares in company B, with the remaining 55% owned by other third party investors. There are no potential voting rights, other contractual rights or other relevant facts and circumstances to consider.

Scenario 1:

Assume the other 55% interest is held by two other investors each holding 26%, with the remaining 3% held by three other shareholders, each holding 1%.

In this case, the absolute size of Company A's voting interest and its size relative to the other shareholdings are sufficient to conclude that Company A does not have power over Company B. Only two other investors would need to act together to be able to prevent Company A from directing the relevant activities of Company B.

Scenario 2:

Assume the other 55% of the ordinary shares in Company B is widely held by thousands of shareholders, none of which holds more than a 1% interest.

In this case, Company A has power over Company B. This is because Company A has a dominant voting interest based on the absolute size of its holding and relative to other shareholders. A large number of shareholders would need to act collectively to outvote Company A.

Scenario 3:

Assume the other 55% is held by 11 other shareholders, each holding 5% of the voting rights.

Based on the guidance in AASB 10, the size of Company A's holding and the dispersion of the other shareholders are inconclusive in determining whether Company A has power over Company B. Other relevant facts and circumstances (such as those discussed above) would need to be considered.

Example 2

Company X holds 35% of the voting rights in Company Y. Three other shareholders each hold 5% of the voting rights while the remaining 50% of the voting rights are held by numerous other shareholders, none of which holds more than 1%. None of the shareholders has arrangements to consult with any of the others or make collective decisions. Decisions about the relevant activities are directed by a simple majority of the votes cast at shareholders' meetings. At recent meetings, 75% of the total voting rights were cast, including Company X's votes.

In this case, Company X does not have power over Company Y. The active participation by the other shareholders at recent shareholder meetings indicates that the investor would not have the practical ability to direct the relevant activities of Company Y unilaterally. Put another way, since 75% of the shareholders exercised their voting rights at recent meetings, Company X would need a minimum of 37.5% to have power in this scenario.

The fact that other shareholders may have voted in the same way as Company X, resulting in Company X's desired outcomes being achieved, does not change this conclusion.

AASB 10 does not provide any bright lines or thresholds when it comes to assessing *de facto* control. This inevitably means that significant judgement will be required. Considerations may include:

- How large does an investor's interest need to be relative to other shareholdings? Would, say, 40% of the voting rights be enough to confer power?
- How widely dispersed are the other shareholdings? Could, for example, four shareholders easily act together?
- Are there other relevant agreements between shareholders that need to be considered?
- Are past voting patterns expected to be suggestive of future voting patterns? How far back should an investor look to make an assessment?

Unfortunately, there is no single right answer to these questions. Rather, the particular facts and circumstances need to be evaluated and judgement exercised. The key question for an investor with a significant minority is whether, based on the best information available, it reasonably expects to have the practical ability to direct the relevant activities of the investee unilaterally going forward.

Another thing to bear in mind is that an investor could find itself in control of an investee purely because of circumstances that exist at a point in time, rather than because of deliberate action. This is not expected to be a common occurrence; however, entities should be mindful of the need to gather and analyse information in real-time so control assessments can be made on a timely basis (as this affects consolidation). This would include monitoring the changes in the composition of the share register as it could mean the investor has gained or lost power over an investee as a result of such changes.

SPFS

The merits of transitioning to GPFS early

Very soon, certain for-profit private sector entities will no longer be able to prepare special purpose financial statements (SPFS), but will have to prepare some form of general purpose financial statements (GPFS). Affected entities have been given an additional year to get their GPFS house in order, however this comes at a cost in terms of certain transitional relief.

In this article we look at the optional short-term exemptions offered under the changes that aim to simplify the changeover from SPFS to GPFS. Importantly, the exemptions an entity can take advantage of will depend on when it decides to transition to GPFS.

Background

In The Bottom Line issue 6, we outlined the changes that had been recently mandated by the Australian Accounting Standards Board (AASB) relating to the scrapping of SPFS for certain for-profit entities.

As a reminder, the new requirements will only apply to for-profit private sector entities that are required by:

- legislation to prepare financial statements that comply with either Australian Accounting Standards (AAS) or 'accounting standards'; or
- their constituting document (or another document, such as a lending agreement) to prepare financial statements that comply with AAS, provided such relevant document was created or amended on or after 1 July 2021.

Entities that are affected by the changes will be required to replace their SPFS with Tier 2 GPFS that comply with all the recognition and measurement (R&M) requirements of AAS, including consolidation and equity accounting.

Currently, reporting under Tier 2 of the Australian differential reporting framework entails preparing GPFS with reduced disclosures (called 'Reduced Disclosure Requirements', or 'RDR'). However, under the changes, the existing RDR will be withdrawn and replaced by 'Simplified Disclosures' which are contained in a stand-alone standard, namely AASB 1060 *General Purpose Financial Statements – Simplified Disclosures for For-Profit and Not-for-Profit Tier 2 Entities*. While the recognition and measurement requirements for Tier 2 will remain unchanged, disclosures will be different going forward.

The changes described briefly above are mandatorily applicable for financial reporting periods beginning on or after 1 July 2021. This is one year later than what was initially proposed. Consequently, some of the transitional relief available will depend on whether an entity chooses to apply the requirements early (i.e. to periods beginning before 1 July 2021, such as the financial year ended 30 June 2021), or only from the mandatory effective date of 1 July 2021 (i.e. for the first time in the 30 June 2022 financial year).

Transitional relief explained

AASB 1053 *Application of Tiers of Australian Accounting Standards* has been amended to include three optional short-term exemptions which are available to entities making the move from SPFS to Tier 2 (Simplified Disclosures) GPFS. Importantly, two of these exemptions are only available on early adoption of AASB 1060, as explained in the table below and by the narrative thereafter:

Optional short-term exemption	First applied in reporting periods beginning before 1 July 2021	First applied in reporting periods beginning before 1 July 2022
Treatment of prior period errors	✓	✓
Comparative information not previously disclosed in notes	✓	-
Restatement of comparative information	✓	-

Treatment of prior period errors

For entities applying Tier 2 (Simplified Disclosures) GPFS for the first time, there is no need to differentiate between the correction of errors and adjustments arising on changes in accounting policies where the entity becomes aware of errors made in its most recent SPFS. This exemption can be applied even if AASB 1060 is not adopted early.

The effect of this exemption is that errors in an entity's previous SPFS do not need to be separately disclosed in the first Tier 2 (Simplified Disclosures) GPFS, but can be included in the adjustments arising from changes in accounting policies as a result of moving from SPFS to GPFS. This may be beneficial where an entity is not currently applying all the recognition and measurement requirements of AAS.

Comparative information not previously disclosed in notes

For entities currently preparing SPFS, disclosures will most likely need to be elevated quite significantly on transition to Tier 2 (Simplified Disclosures) GPFS which may involve a fair amount of effort. In order to encourage entities to fast track their transition to GPFS, this optional exemption was included, allowing early adopters to not present comparative information in the notes where such comparative information was not disclosed in the most recent previous SPFS.

Restatement of comparative information

Entities that transition from SPFS to GPFS earlier than the mandatory effective date will not have to restate comparative information in the year of transition.

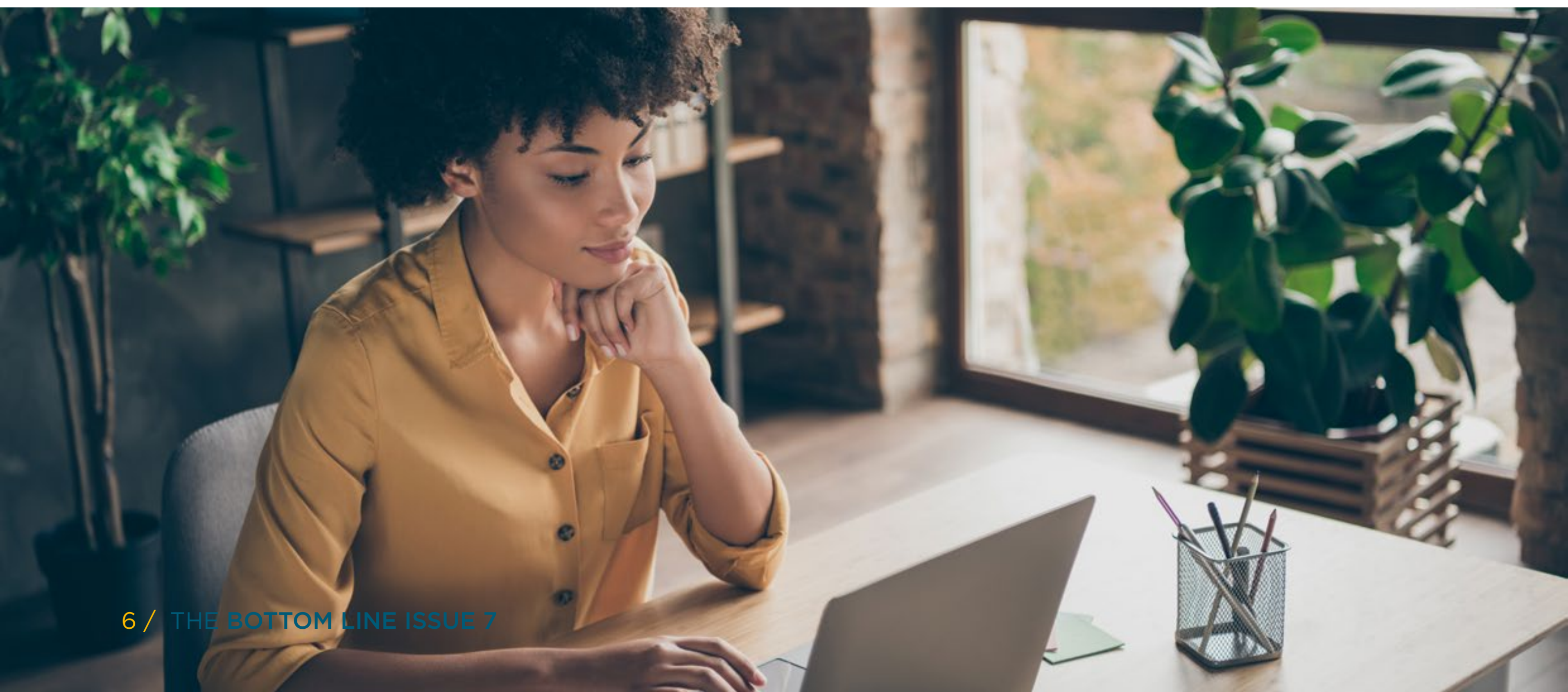
Where this relief is applied, the date of transition changes to the beginning of the reporting period rather than the beginning of the earliest comparative presented. This means that the comparatives presented in the first Tier 2 (Simplified Disclosures) GPFS will be those amounts presented in the most recent previous SPFS.

In the year of transition, entities making use of this optional exemption must:

- disclose a reconciliation of its closing equity in its most recent previous SPFS and the opening equity at the date of transition
- disclose a description of the main adjustments that would have been necessary to make the comparative Statement of Profit or Loss and Other Comprehensive Income AAS-compliant (note that adjustments do not need to be quantified)
- prominently label comparative information that is not AAS-compliant as such.

Start thinking about your transition journey

It has been a challenging six months to say the least, and entities captured by the upcoming changes to SPFS can be forgiven for not yet thinking about the financial reporting implications and what it means for them. However, directors and management are encouraged to start thinking about and planning their transition journey, especially considering the time and effort that could be saved by accessing the optional short-term exemptions that are available when transitioning earlier from SPFS to GPFS.



AASB Staff FAQ: Accounting for concessionary loans

Not-for-profit (NFP) entities may be granted long-term loans that have below-market interest rates or other concessions attached to them. These concessionary loans fall within the scope of AASB 9 *Financial Instruments* and, if they are provided to a NFP entity primarily to allow it to further its objectives, AASB 1058 *Income of Not-for-Profit Entities*. This gives rise to the question: Which standard do you apply first when accounting for these loans?

To address this question, the AASB Staff has recently issued FAQ 12 which explains that it does not matter as the accounting outcome will be the same irrespective of which standard is applied first. This is illustrated below using examples taken from the Staff FAQ.

Example – Interest-free loan to assist NFP to further its objectives

NFP is granted an interest-free loan of $100,000 that is repayable at the end of 5 years. The loan is provided to NFP principally to assist it to further its objectives.

NFP has not previously had borrowings and estimates the prevailing market rate of interest for a loan with a similar term, repayment profile, borrower credit risk and currency to be 5% per annum.

At initial recognition, the transaction price of the financial liability for the loan is $78,353, calculated as the present value of the future principal repayment, discounted at 5%.

The fair value of the loan is assumed to equal its transaction price.

Approach 1 – AASB 9 applied first

The loan arrangement includes two components – a financial liability (for the loan) and a beneficial element (since the loan is interest-free, the fair value of the financial liability ($78,353) is significantly lower than the loan proceeds received ($100,000), and the loan was granted mainly to assist the NFP in furthering its objectives).

Applying AASB 9.B5.1.1, the loan component is recognised as follows on receipt of the loan proceeds:

	Debit	Credit
Cash (financial asset)	$78,353	
Loan payable (financial liability)		$78,353

The beneficial component is immediately recognised as income in profit or loss, in the absence of any other (credit) amount as follows:

	Debit	Credit
Cash (financial asset)	$21,647	
Income		$21,647

Approach 2 – AASB 1058 applied first

Under this approach, the NFP would determine that the fair value of the loan is significantly less than the total loan proceeds received, and therefore apply AASB 1058 (paragraphs 8 to 10) as follows:

	Debit	Credit
Cash (financial asset)	$100,000	
Loan payable (financial liability)		$78,353
Income		$21,647

Conclusion

As can be seen from the above entries, both approaches achieve the same outcome on initial recognition:

	Debit	Credit
Cash (financial asset)	$100,000	
Loan payable (financial liability)		$78,353
Income		$21,647

Deferral of amendments to classification of liabilities

In issue 5 of The Bottom Line, we explained the narrow-scope amendments to AASB 101 *Presentation of Financial Statements* that had recently been issued by the AASB. In short, the amendments clarify the requirements for the presentation of liabilities as current or non-current.

As stated in that article, the effective date of the amendments was originally 1 January 2022. To assist preparers grappling with the effects of the pandemic, the effective date has been deferred by one year, to 1 January 2023, via amending standard AASB 2020-6 *Amendments to Australian Accounting Standards – Classification of Liabilities as Current or Non-current – Deferral of Effective Date*.

Despite the one-year deferral of the effective date of the amendments, entities can still apply them earlier.

AASB 2020-6 applies to annual periods beginning on or after 1 January 2022, which was the original mandatory effective date of the amendments to AASB 101.

Tier 2 disclosures for COVID-19-related rent concessions

The AASB has issued AASB 2020-7 *Amendments to Australian Accounting Standards – COVID-19-Related Rent Concessions: Tier 2 Disclosures* which amends the new Simplified Disclosures standard (AASB 1060) to ensure that entities applying AASB 1060 continue to have all their disclosure requirements in one place.

As a result, those entities that report under Tier 2 (Simplified Disclosures) will have to make the same disclosures relating to COVID-19-related rent concessions as entities complying with the disclosure requirements contained in AASB 16 *Leases*.

Entities applying Tier 2 RDR to prepare financial statements are required to comply with the rent concession disclosures in AASB 16 subject to the disclosure relief also added to AASB 16 by AASB 2020-4 *Amendments to Australian Accounting Standards – Covid-19-Related Rent Concessions*.

AASB 2020-7 applies to annual periods beginning on or after 1 July 2021. Earlier application is required if the entity is applying AASB 1060 and AASB 2020-4 to the period.

New AASB Staff FAQs

The AASB staff have in recent months issued a number of FAQs (including the FAQ discussed earlier in this publication) which provide non-authoritative guidance on current accounting matters that directors, preparers and auditors may find useful. Below is a summary of these Staff FAQs:

TOPIC	OVERVIEW
Impairment of non-financial assets	Reminds entities of the guidance contained in accounting standards when testing a non-financial asset for impairment.
Remuneration underpayments	Provides guidance on the accounting treatment of underpayments of wages that addresses what period the correction of underpayments should be recorded in, how to determine whether prior year payments are material and what the required disclosures are.
Accounting for concessionary loans	Provides guidance on the interaction between AASB 1058 *Income of Not-for-Profit Entities* and AASB 9 *Financial Instruments* when accounting for concessionary loans. The FAQ highlights that irrespective of which standard is applied first, the same accounting outcome is achieved. See our article on *page 7* for more details on this FAQ.
Events after the reporting period	Reminds entities of the requirements of the relevant accounting standards when assessing how post-balance date events affect financial statements not yet authorised for issue in a COVID-19 environment.

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