ASSURANCE AND ACCOUNTING

ASPE PRACTICE AID: SECTION 1591, SUBSIDIARIES

New Section 1591, Subsidiaries establishes standards on how to account for subsidiaries in general purpose financial statements. It is applicable for fiscal years beginning on or after January 1, 2016. Therefore, the first annual period impacted by this standard is the year ended December 31, 2016. Early adoption is permitted.

Background

When ASPE was being developed the Accounting Standards Board (AcSB) recognized that the accounting for variable interest entities often required significant effort to determine whether an enterprise had a variable interest in another entity and, if so, whether the enterprise was the primary beneficiary and need to consolidate the entity. However, if the enterprise chose to prepare non-consolidated financial statements it was exempt from the requirements in Accounting Guideline 15 (AcG-15), *Variable Interest Entities*, which allowed the enterprise to avoid this complexity. As a result, the Board decided to retain AcG-15 in the initial version of ASPE and to undertake a project to consider whether private enterprise standards should include similar guidance to that which was being developed for IFRS. The project resulted in:

- New Section 1591, which replaces previous Section 1590 of the same name and AcG-15;
- New guidance on accounting for subsidiaries controlled through rights other than equity interests; and
- Retention of the definition of control, the accounting policy choice to account for subsidiaries using the cost or equity method, and the guidance on entities controlled through voting interests.

Highlights of Section 1591

The chart below summarizes the impact of the new Section 1591. Further details on each topic area can be found by clicking on each heading.

Scope Exemption	New Control Guidance	It's not IFRS 10	Recognition	Transition
Section 1591 does not apply to accounting for contractual arrangements between enterprises under common control.	The definition of control has not changed. Section 1591 provides additional guidance on identifying facts and circumstances other than voting interests that confer control.	Section 1591 and IFRS 10 are not converged standards. For additional guidance, an entity can look to IFRS 10 through the GAAP hierarchy.	There is an accounting policy choice to: • Consolidate; or • Prepared non-consolidated financial statements.	Transitional relief has been provided

Scope Exemption

Significant Change: One significant change in the new standard is that a scope exemption has been included in paragraph 1591.02(f) which states that Section 1591 does not apply to accounting for contractual arrangements between enterprises under common control. Instead, in its consolidated or non-consolidated financial statements each such enterprise reports its rights and obligations related to other enterprises under common control in accordance with other applicable Sections.

Rationale: The AcSB's rationale in providing this exception was that equity interests are the key factor for determining control in most common control scenarios. In these situations, the enterprises within a single control group are controlled from the top and not through relationships lower down in the organization structure. For example, there may be numerous contractual arrangements between enterprises within a single control group that may provide various enterprises in the group with certain powers or influence over other enterprises within the same group. However, the ultimate decision making may still be exercised by the top company.

Impact: We believe this scope exemption will have an impact on many entities. For example, this will scope many previously identified or potential variable interests out of Section 1591 as many of these situations occur as a result of contractual arrangements between enterprises under common control.

Scenario 1 and Scenario 2 included in this publication illustrate the impact of this exemption.

New Control Guidance

No Change: The guidance on determining control through equity interests has been carried forward in Section 1591.

New Guidance: In addition, new guidance has been added that focuses on identifying when the rights of equity interests may not be the dominant factor in determining who controls an enterprise, such as when equity interests do not provide the holder with the continuing power to determine the strategic operating, investing and financing policies of the enterprise. An enterprise needs to consider situations in which it has equity interests in, and contractual arrangements with, another enterprise, as well as situations when it only has contractual arrangements with the other enterprise.

Consider Facts and Circumstances: Section 1591 provides examples of types of contractual arrangements that may give one enterprise control over another, such as supply arrangements, management contracts, lease agreements, license agreements, royalty contracts, other sales contracts and financing arrangements. The new standard reinforces the need to consider all facts and circumstances, and to apply judgment when assessing whether an enterprise is a subsidiary.

Section 1591 and IFRS 10

Section 1591 not Converged with IFRS 10: While the AcSB looked to IFRS 10, *Consolidated Financial Statements*, to seek out concepts and guidance that could be applicable to private enterprises following ASPE, the guidance in Section 1591 and IFRS 10 is not converged. Through the GAAP hierarchy an enterprise can look to IFRS for additional guidance, however, it is not required to do so. If an enterprise does choose to look to IFRS 10 for additional guidance, it must keep in mind that the requirements in ASPE are not converged with IFRS 10 so not all the guidance in IFRS 10 is applicable to private enterprises.

Recognition

Accounting Policy Choice: The recognition guidance in paragraph 1591.24 explains that an enterprise makes an accounting policy choice to either:

a. Consolidate its subsidiaries; or

b. Prepare non-consolidated financial statements and account for subsidiaries that it controls through:

   i. Voting interests, potential voting interests, or a combination thereof, using the equity method or the cost method;

   ii. Contractual arrangements, according to the nature of the contractual arrangements in accordance with the applicable Section of the Handbook, such as a lease (Section 3065), a financial asset or a financial liability (Section 3856); and

      For example, if Entity A and Entity B are arm's length parties to a lease agreement with terms that result in Entity A controlling Entity B, the guidance in Section 3065, *Leases*, would be applied to account for the lease in the non-consolidated financial statements of both Entity A and Entity B.

   iii. Voting interests, potential voting interests, or a combination thereof, in combination with contractual arrangements, in accordance with item (i) for the voting interest, potential voting interest or a combination therefore, and in accordance with item (ii) for the contractual arrangements.

An enterprise must use the same method to account for all of its subsidiaries.

It should be noted that similar to the exemption previously included in AcG-15, when an enterprise choses under paragraph 1591.24(b) to prepare non-consolidated financial statements it is not required to evaluate its contractual arrangements for evidence of control over another enterprise. Instead it accounts for its contractual arrangement in accordance with other applicable Sections of the Handbook depending on the nature of the arrangement.

Related Party Transactions: Paragraph 1591.31 also explains that the requirements in Section 3840, *Related Party Transactions*, do not apply to intercompany transactions between an enterprise and subsidiaries controlled through means other than voting interests, potential voting rights, or a combination thereof, when:

a. The enterprise is preparing non-consolidated financial statements; and

b. Control through means other than voting interests, potential voting interests or a combination thereof, is the only basis of the related party relationship.

This exception is to prevent enterprises preparing non-consolidated financial statements from having to complete a control assessment in order to comply with Section 3840 when a control assessment would not be required to comply with Section 1591. The AcSB believes this exception allows current practice to continue as enterprises preparing non-consolidated financial statements were exempted from applying AcG-15 and identifying enterprises controlled through means other than voting interests.

Transition

Retrospective with Transitional Relief: Section 1591 is required to be applied retrospectively in accordance with Section 1506, *Accounting Changes*, except as permitted by the transition provisions set out in paragraphs 1591.40-.47. An enterprise can only apply the transitional relief set out in paragraphs 1591.42-.47 when preparing its annual financial statements relating to the first fiscal year in which Section 1591 is effective.

When adopting Section 1591, enterprises that prepare consolidated financial statements may identify new subsidiaries that need to be consolidated and some other enterprises that were consolidated previously may no longer qualify as subsidiaries. Based on the information available, this could require extensive work to transition to the new standard. Therefore, the AcSB has provided some transitional relief provisions.

Consolidate a subsidiary that was not consolidated previously:

When an enterprise applies an accounting policy to consolidate its subsidiaries, and the enterprise concludes on the date at which this Section is first effective that it has subsidiaries that were not consolidated previously, the transitional guidance in paragraph 1591.42 provides a choice of two methods to measure the assets, liabilities and non-controlling interests in each of an entities previously unconsolidated enterprise on a subsidiary-by-subsidiary basis:

a. An enterprise is permitted to use the acquisition method in accordance with Section 1582, *Business Combinations*, as if the previously unconsolidated enterprise had been consolidated from the date when the enterprise obtained control, when the information is available; or

b. An enterprise can use the carrying amounts of the assets and liabilities of the previously unconsolidated enterprise.

When applying either of these options, Section 1591 also permits an enterprise to measure any item of property, plant and equipment at fair value.

Some enterprises that choose to prepare consolidated financial statements for the first time when applying the new standard may have subsidiaries that have not prepared financial information in accordance with accounting standards for private enterprises previously (i.e. an entity that prepared notice to reader financial statements in the past) and may lack the information to do so. In those situations, Section 1591 permits the enterprise to measure the assets, liabilities and non-controlling interests by applying the acquisition method in accordance with Section 1582, without the recognition of any goodwill and intangible assets.

No longer consolidate a subsidiary that was previously consolidated:

When an enterprise applies an accounting policy choice to consolidate its subsidiaries and concludes on the date it applies Section 1591 that it will no longer consolidate an enterprise that was previously consolidated, the enterprise determines its interest in the previously consolidated enterprise and measures that interest as the aggregate of the carrying amounts of the assets, liabilities and non-controlling interests that the enterprise had previously consolidated, including any goodwill arising from acquisition and uses this balance as the deemed cost. It also tests the net investment for impairment and accounts for other rights and obligations in accordance with the applicable Section(s).

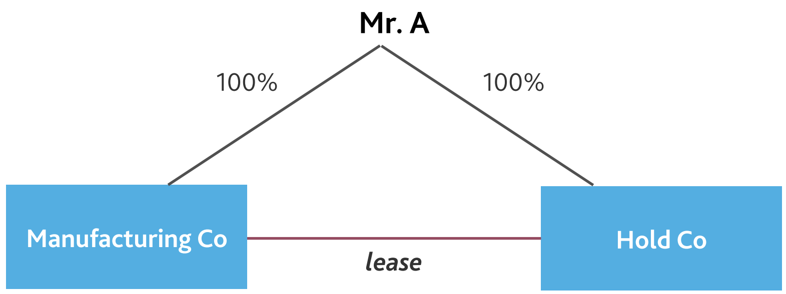
If the aggregate of the previously consolidated assets, liabilities and non-controlling interest results in negative net assets, an enterprise assesses whether it has legal or constructive obligations in relation to the negative net assets and, if so, the enterprise recognizes the corresponding liability. If the enterprise concludes that it does not have legal or constructive obligations in relation to the negative net assets, it does not recognize the corresponding liability but makes an adjustment to retained earnings.

Common Scenarios

Now let's consider the impact Section 1591 could have on some common scenarios.

Scenario 1: Common control, non-consolidated financial statements

Mr. A is the sole shareholder of Manufacturing Co and Hold Co. Manufacturing Co and Hold Co have a contractual arrangement between them in which Manufacturing Co leases the property it uses from Hold Co. Manufacturing Co has a December 31st year end.



Section 1590 and AcG-15 Treatment:

Manufacturing Co previously prepared non-consolidated financial statements each year so that it did not have to assess whether it had a variable interest in Hold Co.

Section 1591 Requirements:

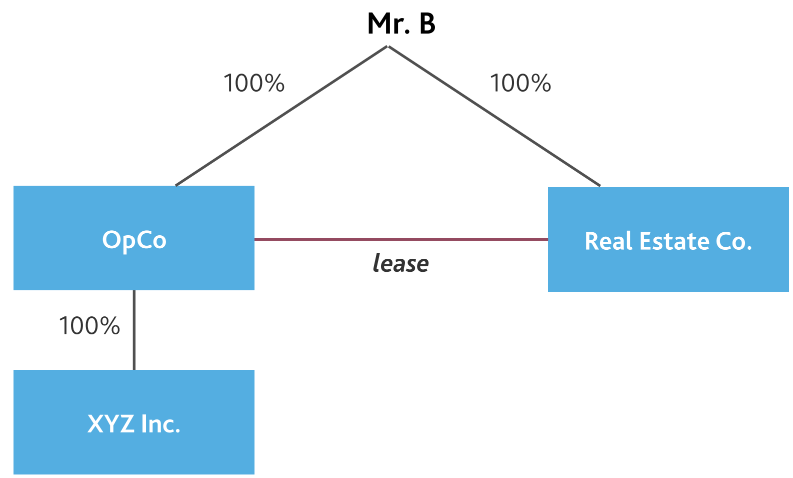
Contractual arrangements between entities under common control are scoped out of Section 1591 by paragraph .02(f). As a result, Manufacturing Co does not have to assess whether it has control of Hold Co via the contractual arrangement.

Transitional Options/Guidance:

Since Manufacturing Co would already be accounting for any rights and obligations it has related to the lease in its financial statements, the only adjustment needed to its December 31, 2016 financial statements is the removal of all non-consolidated references.

Scenario 2: Common control, consolidated financial statements

Mr. B is the sole shareholder of OpCo and Real Estate Co. OpCo also owns 100% of the shares of its subsidiary XYZ Inc. OpCo and Real Estate Co have a contractual arrangement between them in which OpCo leases the building it operates in from Real Estate Co. OpCo has a December 31st year end.



Section 1590 and AcG-15 Treatment:

Based on the guidance in AcG-15, OpCo previously determined that it had a variable interest in Real Estate Co and that it was the primary beneficiary. Since OpCo's accounting policy is to consolidate its subsidiaries, it has prepared consolidated financial statements each year and included Real Estate Co in those statements.

Section 1591 Requirements:

Under paragraph 1591.02(f), contractual arrangements between enterprises under common control are scoped out of Section 1591. As a result, OpCo can no longer consolidate Real Estate Co. Instead, for its December 31, 2016 financial statements, OpCo would account for its rights and obligations related to Real Estate Co due to the contractual arrangement in accordance with Section 3056, *Leases*.

Transitional Options/Guidance:

OpCo would need to retrospectively remove the assets, liabilities and operations of Real Estate Co from its financial statements. Any adjustments OpCo needs to make to account for any rights and obligations it has related to Real Estate Co due to the contractual arrangement must also be applied retrospectively in accordance with Section 1506.

Scenario 3: No common control, non-consolidated financial statements

Mr. C is the sole shareholder of OpCo. Mr. X is the sole shareholder of Property Co. Mr. C and Mr. X are not related. OpCo has a contractual arrangement with Property Co whereby it leases the building it uses from Property Co. OpCo has a December 31st year end.

Section 1590 and AcG-15 Treatment:

Based on the guidance in AcG-15, OpCo previously determined that it had a variable interest in Property Co and that it was the primary beneficiary. OpCo previously prepared non-consolidated financial statements each year so that it did not have to consolidate Property Co.

Section 1591 Requirements:

In this situation, the contractual arrangement between OpCo and Property Co is not scoped out of Section 1591, because they are not entities under common control.However, OpCo has chosen to prepare non-consolidate financial statements and in accordance with paragraph 1591.23A it is not required to evaluate the contractual arrangement for evidence of control. Instead, OpCo must account for the contractual arrangement in accordance with the applicable Section.

Transitional Options/Guidance:

Since OpCo would already be accounting for any rights and obligations it has related to the lease in accordance with Section 3065, Leases, no adjustments to its financial statements would be required.

Scenario 4: No common control, consolidated financial statements

Mr. C is the sole shareholder of OpCo. Mr. X is the sole shareholder of Property Co. Mr. C and Mr. X are not related. OpCo has a contractual arrangement with Property Co whereby it leases the building it uses from Property Co. OpCo has a December 31st year end.

Section 1590 and AcG-15 Treatment:

Based on the guidance in AcG-15, OpCo previously determined that it had a variable interest in Property Co and that it was the primary beneficiary. OpCo previously prepared consolidated financial statements each year which included Property Co.

Section 1591 Requirements:

In this situation, the contractual arrangement between OpCo and Property Co is not scoped out of Section 1591, because they are not entities under common control. As a result, OpCo needs to do an assessment of the control criteria in Section 1591 and determine if it controls Property Co. In most situations it is expected that this analysis would result in the same conclusion as was determined by the analysis done under AcG-15.

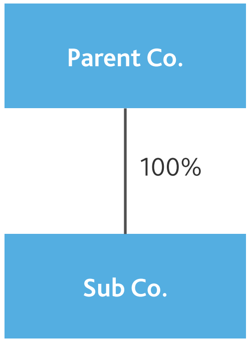
Transitional Options/Guidance:

If it is determined that OpCo <u>does not</u> control Property Co, OpCo would have to retrospectively remove the assets, liabilities and operations of Property Co from its financial statements. If it does have any rights and/or obligations related to Property Co due to the contractual arrangement it would need to account for them retrospectively in accordance with Section 1506.

If it is determined that OpCo still does <u>control</u> Property Co, it has the option to continue to prepare consolidated financial statements (1591.24(a)) which is what we would expect it would do. In this situation, no retrospective adjustments to its previous accounting would be required since it previously consolidated Property Co under Section 1590 and continues to consolidate it under Section 1591.

Scenario 5: Non-consolidated financial statements and planned amalgamation

Parent Co controls Sub Co 100% through equity interests. In 2017, Parent Co plans to amalgamate with Sub Co. Parent Co has a December 31st year end.



Section 1590 and AcG-15 Treatment:

Parent Co has always chosen to prepare non-consolidated financial statements and account for its interest in Sub Co at cost.

Section 1591 Requirements:

In this situation Parent Co can continue to prepare non-consolidated financial statements for its December 31, 2016 year end and account for its interest in Sub Co at cost. There will be no transitional impact on adoption of Section 1591 as per paragraph .40. However, since Parent Co wants to amalgamate with Sub Co in the near future it may want to change its accounting policy and begin consolidating Sub Co upon adoption of Section 1591 to take advantage of the transitional provisions available.

Transitional Options/Guidance:

If Parent Co decides to prepare consolidated financial statements upon adoption of Section 1591, paragraph .42(a) allows Parent Co to use the acquisition method in accordance with Section 1582 to consolidate Sub Co as if Sub Co had always been consolidated from the date control was obtained. However, there using this option results in the same treatment that would be required if no transitional relief provisions had been provided in Section 1591. Instead, it is more likely Parent Co would choose to use the option provided in paragraph .42(b) which would allow Parent Co to use the carrying amounts of the assets and liabilities of Sub Co that are in Sub Co's financial statements at the beginning of the prior year (i.e. January 1, 2015) as the deemed cost. This option provides a simplification to what would normally be required in this situation.

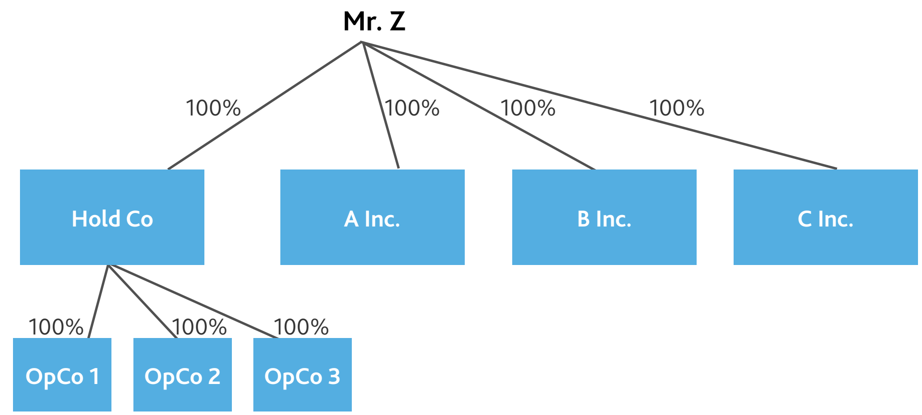
Under either of the options in paragraph 1591.42 in the consolidated financial statements Parent Co may also elect to measure any item of property, plant and equipment of Sub Co at fair value at the beginning of the prior year and this becomes the deemed cost.

Additionally, if Parent Co does not have the information to prepare financial statements of Sub Co in accordance with ASPE, paragraph 1591.44 allows Parent Co to measure (as of January 1, 2015) the assets and liabilities of Sub Co by applying the acquisition method in accordance with Section 1582, except that Parent Co would not recognize any goodwill and intangible assets in Sub Co and would recognize any difference between the net amount added to its balance sheet and the amount of any previously recognized interest in Sub Co as an adjustment to opening retained earnings.

Scenario 6: Non-consolidated financial statements, but user wants consolidated financial statements

Mr. Z is the sole shareholder of Hold Co, A Inc, B Inc and C Inc. Hold Co owns 100% of the shares of OpCo 1, OpCo 2, and OpCo 3. Various contractual arrangements exist between Hold Co and A Inc, B Inc and C Inc. Hold Co has a December 31st year end.

Section 1590 and AcG-15 Treatment:



Hold Co previously prepared non-consolidated financial statements so that it did not have to assess whether it had variable interests in A Inc, B Inc and C Inc. To satisfy the bank, Hold Co also prepared combined financial statements of OpCo 1, OpCo 2, and OpCo 3. However, the bank would prefer to see consolidated financial statements that include Hold Co since it is the company the holds the debt.

Section 1591 Requirements:

Contractual arrangements between entities under common control are scoped out of Section 1591 by paragraph .02(f). As a result, Hold Co does not have to assess whether it has control of A Inc, B Inc or C Inc.

For its December 31, 2016 financial statements Hold Co could prepare consolidated financial statements (i.e. would include Hold Co, OpCo 1, OpCo 2, and OpCo 3), which would satisfy the bank's request. It would also need to determine what rights and obligations it does have related to A Inc, B Inc and C Inc due to the contractual arrangements and account for them in accordance with the applicable Handbook Sections, if it is not already doing so.

Transitional Options/Guidance:

If Hold Co decides to prepare consolidated financial statements upon adoption of Section 1591. As previously discussed, paragraph .42(a) allows Hold Co to use the acquisition method in accordance with Section 1582 to consolidate any or all of its subsidiaries (OpCo 1, OpCo 2, OpCo 3) as if they had always been consolidated from the date control was obtained. However, using this option results in the same treatment that would be required if no transitional relief provisions had been provided in Section 1591. Instead, it is more likely Hold Co would choose to use the option provided in paragraph .42(b) where for any or all of its subsidiaries, Hold Co could use the carrying amounts of the assets and liabilities that are in the subsidiaries financial statements at the beginning of the prior year (i.e. January 1, 2015) as the deemed cost. This option provides a simplification to what would normally be required in this situation.

Under either of the options in paragraph 1591.42 in the consolidated financial statements Hold Co may also elect to measure any item of property, plant and equipment of the subsidiaries at fair value at the beginning of the prior year and this becomes the deemed cost.

Additionally, if Hold Co does not have the information to prepare financial statements of one or all of the subsidiaries in accordance with ASPE, paragraph 1591.44 allows Hold Co to measure (as of January 1, 2015) the assets and liabilities of the subsidiaries by applying the acquisition method in accordance with Section 1582, except that Hold Co would not recognize any goodwill and intangible assets in the subsidiaries and would recognize any difference between the net amount added to its balance sheet and the amount of any previously recognized interest in the subsidiaries as an adjustment to opening retained earnings.

Conclusion

Please contact your BDO advisor for further information or if you have any questions about the impact of Section 1591 on your entity.