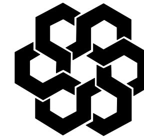

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International Accounting Standards Board

This document is provided as a convenience to observers at IASB meetings, to assist them in following the Board's discussion. It does not represent an official position of the IASB. Board positions are set out in Standards.
These notes are based on the staff papers prepared for the IASB. Paragraph numbers correspond to paragraph numbers used in the IASB papers. However, because these notes are less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

Board Meeting: **12 December 2006, London**

Project: **Consolidations (including SPEs)**

Topic: **Managed Funds and Investment Companies (Agenda Paper 6)**

Introduction

1. The staff has begun drafting a Discussion Paper (DP) outlining a proposal to replace IAS 27 *Consolidated and Separate Financial Statements* and SIC-12 *Consolidation – Special Purpose Entities*.

2. To facilitate the drafting, the staff will bring issues to the Board when the staff thinks that the DP should state a preference for a view that is likely to depart from a tentative decision that the Board has made. The staff will also identify, as early as possible, topics that are controversial or problematic.

3. This paper revisits two issues that the staff thinks are likely to attract significant interest from the investment community—the consolidation of managed funds and the consolidation of investment companies (venture capital organisations). This paper summarises the tentative decisions the Board has made about these topics and outlines the staff's most recent thinking.

4. The staff is seeking feedback from the Board on both topics. In both cases the analysis is in its early stages and the staff will bring more detailed analysis back to the Board in early 2007. The purpose in bringing the analysis in such an early form is to signal to the Board the direction in which the staff is heading.

Managed funds

The problem

5. During the Improvements Project, some respondents to the suggested improvements to IAS 27 stated that private equity entities should not be required to consolidate the investments they control in accordance with the requirements in IAS 27. They argued that they should measure those investments at fair value.

6. Fund managers generally have power over the investments they manage. Some people believe that the managers exercise that power for the benefit of the investors in the fund rather than for their own benefit. In many cases, however, the fund manager is rewarded based on the performance of the fund or has a direct investment in the fund and so benefits in the same way as other investors.

7. IAS 27, and the current proposals, use a control based model for identifying when an entity is a subsidiary of another. Deciding if one entity controls another is based on an assessment of power and benefits. The current definition of control and the newer working definition both, arguably, place more weight on power than on benefits. That is to say, once it has been demonstrated that a fund manager has power then there is a presumption that the manager has control, as long as the manager receives *some* ownership benefits.

8. Practice guidance suggests that materiality thresholds are sometimes applied so that if the level of benefits is not considered to be material then the control definition is not met. In other cases practice guidance suggests that if it can be shown that the investment fund has a narrow purpose then it might be an SPE and control is assessed by asking who has the majority of the risks and rewards.

Summary of tentative decisions of the Board[1]

9. During 2004 the Board decided that a fiduciary relationship exists when one party (the fiduciary) is required to work for the benefit of one or more other parties to whom it owes fiduciary responsibilities under common law, equitable principles, contract, statute or regulation.

10. The Board agreed that the proposed standard should clarify how the control concept should apply to fiduciaries by specifying those aspects of a fiduciary relationship that differentiate the particular circumstances of a fiduciary from those of a controller. In particular, a potential controller should be regarded as failing the control test only when the effect of its (common law, equitable, contractual, statutory or regulatory) obligation to another party or parties is that:

    it has power (ie its role enables it to determine another entity's strategic financing and operating policies) but is explicitly required by agreement or at law to use that power for the benefit of third parties (in other words it is prevented from acting in its own interest to the detriment of the third parties); and

    its ability to benefit from the assets over which it has power is restricted in that it is not able to deal with the assets as if they were its own, and its entitlement to benefits must be agreed between itself and the third parties in whose benefit it must act (or entities representing the third parties' interests), with those benefits in effect limited to a fee for services provided.

11. In the above circumstances, the entity would:

    be unable to meet the second test of control (benefits criterion) on the basis that the benefits the entity receives are not derived from its ability to utilise or deal with the assets of another entity as if they were its own.

    be unable to meet the third test of control (ability to use power so as to increase, maintain or protect the amount of benefits) because its primary obligation is to use any power it has for the benefit of those to whom the obligation is owed. Even if the entity is able to increase, maintain or protect the amount of the benefits it receives as a consequence of using its

[1] This section of the paper is drawn from the summary of Board decisions presented to the Board in July 2005.

power (for example, by receiving a performance-linked fee), it could only do so as a consequence or 'side-effect' of meeting the primary obligation. In contrast, a controller's primary interest is to increase, maintain or protect the amount of benefits it realises for itself. It must then give secondary consideration to its legal or fiduciary obligations (if any) to others (such as minority shareholders).

12. The Board considered how the control definition might be applied if a fiduciary such as a fund manager has power over another entity (the investee) by virtue of a dual role in relation to that investee; that is:

    as a fund manager acting in a fiduciary capacity with power over a fund that has a holding in the investee, but which holding on its own does not give the fund manager power over the investee; and

    as a direct investor (principal) in the investee, but which holding on its own does not give the fund manager power over the investee.

13. The Board concluded initially that there should be a rebuttable presumption that control is assessed in such circumstances by considering the fund manager's two positions collectively. This would be consistent with the tentatively agreed approach to 'de facto agents' generally, whereby there is a rebuttable presumption that an entity's de facto agent's holdings are included in assessing that entity's power (and thus control) unless there is evidence that those holdings are not held as an agent for the entity.

14. However, after considering possible criteria for when the presumption would be rebutted, the Board concluded that no workable criteria could be developed. The Board therefore decided to amend its previous decision and *require* that control be assessed in such circumstances by considering the fund manager's two positions collectively. The proposed standard should include a request for constituents to provide the Board with examples of circumstances in which it could be concluded that the fund manager does not control the investee.

Current thinking

15. The staff understands the reasons the Board reached its tentative decision. The staff would like to revisit that decision, however, because we believe that the more recent thinking on control and consolidations might have provided some grounds for developing criteria.

16. As the staff observed in July, when an entity has rights over an entity that give it strategic power over the investee the controller can benefit from being able to utilise or deal with the assets and liabilities of that entity as if they were its own. The range of possible benefits that a controlling entity could derive comes from its power over those assets and liabilities. Those benefits could include:

    (a) the right to establish policies that result in the controlling entity realising revenue enhancements or cost savings;

    (b) the right to source scarce products;

    (c) the right to proprietary knowledge;

    (d) the right to limit some operations or assets so as to enhance the value of other assets it controls; or

    (e) the right to combine functions to achieve economies of scale.

17. In many cases it is possible that fund managers do not have access to many of the benefits normally associated with ownership power. If the fund manager and the non-controlling interests have access to the same types of benefits—which might be dividends and capital appreciation—this might indicate that the power is not able to be used to access the underlying assets and liabilities. That is to say, we might expect an investor with control to have access to a wider range of benefits than a non-controlling investor.

18. The staff has also started to outline the assumptions underpinning control. For example, the staff assumes that an entity will absorb more of the variability of assets and liabilities as its power over the mean outcomes of those assets and liabilities increases. Expressed differently, entities are expected to contract to guarantee that they have a larger share of the results of their own actions. This does not mean that 'power' and benefits are perfectly correlated. But we might expect the level of benefits to be commensurate with the power that the holder is able to exercise for their benefit. The staff thinks that assessing the level of benefits, in conjunction with the nature of the benefits the fund manager has access to and the nature of the fund manager's power is appropriate.

19. As the staff has emphasised in other aspects of this project, it is likely that indicators would need to be assessed together rather than in isolation. That is to say, both the type and level of benefit would need to be considered together

along with indicators that could suggest limitations on power (such as the nature of fiduciary related constraints).

Question for the Board

20. Does the Board agree that the staff should re-open this topic and try to develop indicators, by focusing on the type and level of benefits as well as the nature of power?

Investment companies

The problem

21. US GAAP has a scope exception that excuses investment companies from the requirement to consolidate investment entities.[2] During the Improvements Project, some respondents to the suggested improvements to IAS 27 stated that investment companies (such as venture capital organisations) should not be required to consolidate the investments they control in accordance with the requirements in IAS 27. The basis of the argument is that these entities manage their investments on a net basis and that presenting the underlying assets and liabilities is misleading and uninformative.

22. The Board rejected that argument. IAS 27 BC22 states:

> The Board concluded that for investments under the control of private equity entities, users' information needs are best served by financial statements in which those investments are consolidated, thus revealing the extent of the operations of the entities they control. The Board noted that a parent can either present information about the fair value of those investments in the notes to the consolidated financial statements or prepare separate financial statements in addition to its consolidated financial statements, presenting those investments at cost or at fair value. By contrast, the Board decided that information needs of users of financial statements would not be well served if those controlling investments were measured only at fair value. This would leave unreported the assets and liabilities of a controlled entity. It is conceivable that an investment in a large, highly geared subsidiary would have only a small fair value. Reporting that value alone would preclude a user from being able to assess the financial position, results and cash flows of the group.

Staff analysis of a scope exclusion

23. Some constituents, including many investment companies, believe that these investments should not be consolidated with the investment company. Instead, they suggest that the investments should be recognised as a net investment and measured at fair value.

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[2] US GAAP provides an scope exclusion for a specified class of investment companies from consolidating some of its investment entities. The FASB has published for comment proposed FSP FIN 46(R)-d that would provide an exception to the scope of FIN-46(R) for investments that continue that exclusion.

24. Those who argue that the investments should not be consolidated appear to suggest that consolidation fails to reflect the intentions of the management of the investing company and that it fails to represent how the business is operated. Although those intentions are relevant and important to users, IFRSs do not normally state that the accounting should reflect the intentions of management. One of the more important roles of IFRSs is to enhance comparability between entities. This requires the development of objective principles for recognising and measuring economic activities.

25. In developing IFRSs the staff assumes that the contractual and economic arrangements entered into by a reporting entity are rational and reflect the intentions of management. The requirements in a standard are then based on accounting for what is observable, rather than management intentions.

26. In the case of consolidations, and the definition of control, if the application of the principles leads to accounting for investments that is less useful to users than would be achieved by applying some other accounting treatment then it might be that there are factors that the standard has missed. That is to say, it might not be a flaw in the concepts underpinning the standard, but a flaw in how those concepts are implemented.

27. In this case, however, the staff thinks that the concept of control is core to how an investment is characterised. If an investment entity is controlled by the investor then that entity is a subsidiary of the investor and, by definition, part of the group. Treating an investment as if it is not part of the group and excluding it from the consolidation model, such as what happens in the US, conflicts with this basic concept.

28. The staff thinks that there is no basis for excluding the investment company from consolidation. The staff has, however, given some thought to the apparent conflict between reporting the assets and liabilities of the investee and the fact that many investment companies focus on the net investee.

A different way of thinking—the unit of account (or aggregation)

29. Once an entity meets the definition of a subsidiary it should be consolidated into the group financial statements. Consolidating the entities requires the elimination of transactions between that entity and the group. One of the

disadvantages of exempting an entity from being consolidated is that the intra-group transactions and balances are not eliminated even though the parent entity has power over both sides of the transactions.

30. If there is any merit in thinking about presenting a venture capital organisation as a 'net investment' the staff thinks that this should be done from within the consolidated financial statements, after all intra-group eliminations have been made. Once those transactions have been eliminated the net activities could be aggregated into a net investment. This would establish as a unit of account, being the net assets and liabilities of the venture capital organisation (adjusted for intra-group transactions). That unit of account could then be measured at fair value, for example.

31. IFRSs already provide guidance about when it is appropriate to aggregate information. Traditionally, the basis for aggregating data is the relative homogeneity of the components. A simple example is property, plant and equipment, which is aggregated into classes. In the case of a venture capital organisation, a case would need to be made for aggregating the underlying assets or assets and liabilities of each venture capital investment on the grounds that they are managed as a net investment.

32. In the proposed FSP FIN 46(R)-d the FASB stated that 'the Board believes that the investment objectives of the parent investment company should determine whether the investment company should consolidate another investment company that it controls.' The FASB therefore sees merit in allowing net presentation and reflecting management intent. IFRSs and US GAAP are not converged on the accounting for investment companies.

33. The staff is not suggesting that this is how the Board should proceed. The point the staff is emphasising is that any consideration of the relative merits of presenting this type of investment in net terms should develop from within the consolidated financial statements. The staff thinks that there is no merit to exempting entities from consolidating other entities that they control.

Summary

34. To summarise, the current staff thinking is that:

(a) there are no grounds for excluding from consolidation an investment company, given the emphasis on a control model;

(b) intra-group transactions and balances should be eliminated on consolidation; and

(c) if it is appropriate for the primary financial statements to present investment companies as a net investment, that decision should be based on principles of aggregation. The staff is not suggesting that aggregating investment company activities is the correct or best accounting treatment.

Question for the Board

35. Does the Board agree that there is unlikely to be any basis for excluding investment companies from the scope of the proposed replacement of IAS 27?