



**30 Cannon Street, London EC4M 6XH, United Kingdom**  
**Phone: +44 (0)20 7246 6410 Fax: +44 (0)20 7246 6411**  
**Email: [iasb@iasb.org](mailto:iasb@iasb.org) Website: <http://www.iasb.org>**

**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**

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| <b>Board Meeting:</b> | <b>20 July 2006, London</b>  |
| <b>Project:</b>       | <b>Consolidations (including SPEs)</b>                             |
| <b>Subject:</b>       | <b>Power and Benefits – building a framework (Agenda Paper 13)</b> |

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### **Introduction**

1. The primary objective of this paper is to describe the basic framework the staff is developing for a proposed revised consolidations standard.
2. The staff emphasises that the framework being described includes some features that are designed with SPEs in mind. We expect to bring back to the Board in September the first of the papers that will discuss SPEs within the context of this framework and we will explain more fully issues that are relevant to securitisations, pass through arrangements and other activities that are generally within the scope of SIC-12 (or FIN 46R in the US).
3. The focus of this paper is on a typical parent-subsidiary relationship, rather than an SPE. The staff asks that the Board keep this in mind when considering the matters identified in this paper.

4. This paper asks the Board for feedback on:
- (a) the informational objective that the staff is using as the basis for the proposals;
  - (b) shifting the focus of control to the assets and liabilities of the entity rather than the entity per se;
  - (c) assessing the existence of control by considering indicators—some indicators are presumptive in their own right whereas some indicators are not sufficient on their own to establish control but when considered with other indicators cumulatively establish that control exists; and
  - (d) some initial thinking on options over an entity.

### **Informational objective**

5. When an entity has an investment in another entity the investment instrument will be an asset, or a liability, of the investor. When an entity reports those assets and liabilities to which it has legal rights and responsibilities it will report its interest in the investment instruments, such as shares.<sup>1</sup> These are the separate financial statements of the investee.
6. There are circumstances when the investment instrument will give its holder sufficient rights to be able to utilise or deal with the assets and liabilities of that investee as if they were its own. In such cases it is more meaningful to present the results of operations and the financial position of the investor and its investee as if the combined entities were a single economic entity. These are the consolidated financial statements.
7. IAS 27 does not state what the *purpose* of consolidated financial statements is, but defines them as ‘the financial statements of a group presented as those of a single economic entity.’<sup>2</sup> The US ARB 51 *Consolidated Financial Statements*

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<sup>1</sup> The investment instrument will not normally give the investor legal rights to the assets of the investee or legal responsibility for its liabilities.

<sup>2</sup> IAS 1.4

states that the purpose of consolidated financial statements is to present the results of operations and the financial position of a parent and all its subsidiaries as if the group were a single economic entity.<sup>3</sup> ARB 51 also states that there is a presumption that consolidated financial statements are more meaningful than separate statements and that they are usually necessary for a fair presentation when one of the companies in the group directly or indirectly has a controlling financial interest in the other companies.

8. The ARB 51 description of the consolidation process also implies that there is a loss of information in separate financial statements because data are aggregated into the net investment in the subsidiaries. The consolidation process is ‘more meaningful’, presumably, because the consolidation process reveals the underlying assets, liabilities and activities.
9. The staff believes that it would be helpful if the proposed standard expressed the informational objective it is designed to achieve. That objective should be for the entity reporting to present information about the assets and liabilities, and the activities related to dealing with those assets and liabilities, for which it holds sufficient rights to be able to utilise or deal with as if they were its own. That is to say, combining the results of the operations and the financial position of the investor and its investee as if the combined entities were a single economic entity notwithstanding its legal form. Users of the financial statements of an entity are assumed to want information about those assets, liabilities and activities.
- 10. Does the Board agree with the informational objective proposed?**
11. The primary purpose of the proposed standard will be to establish the principles for identifying when an investor is required to include the assets, liabilities and activities of an investee in its consolidated financial statements. That is to say, the circumstances when the investor will have sufficient rights to be able to utilise or deal with the assets and liabilities of that investee as if they were its own.

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<sup>3</sup> This wording is based on the amendments proposed as part of Business Combinations II.

12. As the project develops the staff will present proposed principles and requirements for the accounting for assets, liabilities and activities, after initial recognition, that have been brought into the consolidated financial statements including accounting for their derecognition. The project will also consider the requirements for the presentation of separate financial statements.

## **Control**

13. The objective of identifying when an investor is required to include the assets, liabilities and activities of an investee in its consolidated financial statements has centred, for much of the Board's deliberations to date, on what is meant by 'control of an entity'. The Board has tentatively decided that control forms the basis for deciding whether an entity is a subsidiary of another. The working definition of control that the Board has tentatively agreed to is:

Control is the ability to direct the strategic financing and operating policies of an entity so as to access benefits flowing from the entity and increase, maintain or protect the amount of those benefits.

14. The definition contains three tests:
- (a) the ability to direct the strategic financing and operating policies of the entity (the 'Power Criterion');
  - (b) the ability to access the benefits flowing from the entity (the 'Benefits Criterion'); and
  - (c) the ability to use its power so as to increase, maintain or protect the amount of those benefits.
15. Although the staff believe that the basic thinking behind this definition is sound, the staff wish to amend it to focus on the assets and liabilities of the entity rather than the entity per se. The type of wording the staff is considering is:

An entity has a controlling interest in another entity when it has exclusive rights over that entity's assets and liabilities which give it access to the

benefits of those assets and liabilities and the ability to increase, maintain or protect the amount of those benefits.<sup>4</sup>

16. The staff believe that the change is appropriate because use of the assets and liabilities of the entity are, ultimately, what power over the strategic financing and operating policies is intended to capture. This characterisation of control also provides a stronger link with benefits (see below). It also avoids implying that control over assets and liabilities can only be achieved by directing the strategic financing and operating policies of an entity—control might be achieved other than through strategic power. This last point has so-called SPEs in mind.

## **Power**

17. An entity recognises the assets it has rights to and the liabilities for which it is responsible. An entity can have rights to an asset in the possession of another entity through contractual or other arrangements. For example, an entity might have the right to a residual interest in an asset it has leased to another entity. In a similar manner an entity might be responsible for obligations incurred by another entity, such as guaranteeing a liability or making good a fall in the value of an asset.
18. An entity can also have rights that give it the ability to utilise or deal with all of the assets and liabilities of another entity as if they were its own assets and liabilities. For example, power over the assets and liabilities of an entity can be achieved when an investor has the exclusive ability to direct that entity's financing and operating policies. This is referred to here as strategic power.
19. The holder of strategic power has the ability to determine how assets are used, including using them in conjunction with other assets it controls. That is to say, the holder of strategic power can consume the assets directly within its business

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<sup>4</sup> The term 'exclusive' is borrowed from economics which uses the term to explain the difference between a public good and a private good. Its use here is, therefore, economic rather than legal. Exclusivity is explained later in this paper. The draft definition of an asset being developed by the conceptual framework team uses the term 'privileged access'. Although the staff believe that the terms are likely to have qualitatively the same meaning the term 'exclusive' is used in this paper because it is consistent with the terminology in the property rights literature, on which much of the thinking in this paper is based. The definition will be aligned with whatever definition of an asset emerges from the CF project.

or indirectly by having the ability to direct that they be sold. In a similar manner, strategic power gives the holder the ability to commit that entity to borrow additional funds, incur debts and settle existing debts.

20. Power must be exclusive. That is to say, power cannot be shared or divided. Only one entity can control another entity. If an entity must participate with others in directing the policies and decisions that guide the activities of another entity it does not have control over that entity's assets and liabilities.
21. Having exclusive power does not require that the controlling entity possess, for example, all of the voting rights in an entity. To illustrate, the strategic power over an entity often rests with those parties holding voting interests. One party can have exclusive power without holding all of the voting rights. The controlling entity need only hold sufficient voting rights to be able to exclude others from the strategic decision making. In the absence of other factors, a simple majority of votes will be sufficient to give the holder exclusive power. In other cases less than a majority holding will be sufficient to exclude the other voting interests from the strategic decision making.
22. A requirement to consult with others does not prevent an entity having exclusive power. It is not uncommon for strategic power to be constrained by law, regulations, fiduciary responsibilities, and contractual rights of other parties. However, these forms of restrictions usually establish protective limits on, rather than participatory rights in, an entity's ability to direct the strategic financing and operating policies of another entity. In other words, such protective limits do not usually give the other party the ability to make or participate in the decisions that guide an entity's activities.
23. The staff believe that the proposed standard should include principles for assessing whether the power indicators combine to give the holder protective or rather than participatory rights.<sup>5</sup>

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<sup>5</sup> The reference to 'combine' reflects the staff belief that some factors might indicate either protective or participatory rights when considered in isolation. It is when the factors are considered together that it is more likely that a clearer picture of the rights that the investing entity has will emerge. The US literature addresses this in EITF 96-16 *Investor's Accounting for an Investee When the Investor Has a Majority of the Voting Interest but the Minority Shareholder or Shareholders Have Certain Approval or Veto Rights*.

## Benefits

24. An instrument that establishes an equitable interest in another entity will benefit the holder directly through any returns paid on that instrument and indirectly from any proceeds from selling that interest.<sup>6</sup> The value of the equitable instrument will reflect any residual interest in the assets of the entity attributable to, or absorbed by, those instruments.
25. The most common form of equitable interest in an entity is shares that carry voting rights. A shareholder is typically entitled to vote on matters that include appointing members of the governing body. The shareholder will receive returns on the shares in the form of dividends and through changes in the value of the shares that are a result of those shares absorbing the variability of the entity's assets and liabilities.
26. As explained in paragraph 19, 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. The type of benefit is therefore potentially more extensive than just the dividends and interest in the residual of the entity that the instrument that gives the holder strategic power also provides. Those additional 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.

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<sup>6</sup> The terms direct and indirect are also borrowed from economics and relate to direct consumption and indirect consumption. Indirect consumption refers to the sale or disposal of the asset.

27. Benefits do not need to be derived directly from an entity and could arise in combination with other assets. For example, benefits might arise by denying a competitor access to a subsidiary's assets to protect the controlling entity's market share, even if those assets are not otherwise utilised by the controlling entity.
28. **Does the Board have any concerns with the proposed emphasis in the definition of control on the assets and liabilities of the entity, rather than on the entity per se?**

### **Assumptions and presumptions**

29. In developing the proposed standard, the staff intend to make explicit the assumptions and presumptions on which the principles are based. The staff assume 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 their own actions. This assumption underpins the US FIN 46R, which concludes that (for variable interest entities) the party absorbing the majority of the risks of an entity is also likely to have power over that entity.
30. The staff will develop these assumptions more fully for the Board when it begins the discussion of SPEs. For the moment, however, the staff wants to ensure that the Board is aware that the staff believes that the absence of a clear articulation of the assumptions underpinning IAS 27 and SIC-12 has not been helpful.

### **Assessing control**

31. 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.
32. The staff assumes that the contractual and economic arrangements entered into by a reporting entity are rational and reflect the intentions of management. Therefore if management intend to control the assets and liabilities of an entity they will undertake transactions that achieve this. The requirements in a



standard should be based on accounting for what we can observe, rather than what we cannot (management intent).

33. In many cases identifying whether an entity controls another entity is easy, because the rights are clear. This is consistent with the property rights literature which notes that, on the face of it, as the power over assets increases the evidence of that power should also become more apparent, because the rights should become better defined. The staff characterise this type of indicator as being presumptive. A presumptive indicator is one that leads to a general belief, which would normally be based on observed behaviour or some other evidence.
34. In other cases assessing control might require more judgement. The staff believe that in the absence of a presumptive indicator control should be assessed by considering the indicators that evidence the nature of the relationship between the investor and the investee. These indicators would need to be considered collectively, rather than in isolation. That is to say, the staff views these indicators as providing a matrix of variables with the relative weight assessed to each variable depending on the particular circumstances of the case. The staff believe that this will be the most difficult part of the proposed standard to develop.
35. 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 the standard has missed.<sup>7</sup> 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.
36. The general idea can be demonstrated by considering voting rights.

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<sup>7</sup> The staff would be concerned if the definition of control caused assets and liabilities that an entity does not have the right to or responsibility for to be recognised in its consolidated financial statements. Similarly, omitting assets and liabilities that it does have rights to or is responsible for would not meet the information objective.

## Voting rights

37. An obvious presumptive indicator is the right to cast a majority of the votes of an entity, giving the holder the right to appoint that other entity's board of directors or equivalent governing body (and control of the entity is by that board or body).
38. An entity is presumed to have strategic power over another entity when it owns, more than half of the voting interests in another entity. To be able to rebut this presumption the entity holding a majority of the voting rights would need to demonstrate that another entity has rights which give that other entity the strategic power.
39. The Board has already tentatively decided that an entity does not need to have the legal rights to a majority voting interest in an entity to have strategic power over it. It might have power as a consequence of other contracts or arrangements, or because it is the most dominant investor.<sup>8</sup>
40. The staff believe that the holder of less than a majority voting interest in an entity can be **presumed** to control that entity if the holder satisfies any one or more of the following conditions:
  - (a) it has the right to cast sufficient votes to constitute a majority of the votes usually cast at meetings of the entity's governing body.<sup>9</sup>
  - (b) it has exclusive rights to exercise more than half of the entity's voting rights by virtue of an agreement with other investors.
  - (c) it has exclusive rights under a statute or an agreement to determine the entity's strategic operating and financing policies.

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<sup>8</sup> This notion is commonly referred to as 'de facto control'. The absence of this term from the body of this paper is deliberate. The staff believe that the term is unhelpful in that it could imply that de facto control is not the same as having 'real' control. An entity either controls another entity, or it does not. The staff intends to avoid using special labels such as 'de facto control', 'latent control' and 'special purpose entities' in future Board papers and within the proposed standard.

<sup>9</sup> Many of these indicators are taken from papers and discussions the Board has held over the last two years. In those discussions, however, the term 'ability' has, generally, been used. The staff has amended this to 'right'.

- (d) it has exclusive rights to appoint or remove the majority of the members of the entity's board of directors or equivalent governing body and control of the entity is by that board or body.
- 41. A shareholder might also have strategic power with less than half the voting rights in circumstances where there are no other dominant voting interests in the entity. This could include circumstances when the other shareholders have not organised their interests in such a way that they actively cooperate when they exercise their votes so as to have more dominant voting power than the holder of the single largest shareholding. Of course, a single active shareholder would not control an entity if the balance of voting interests are held by a passive shareholder with the right to exercise a more dominant number of votes. Put simply, the passive shareholder would have the most dominant shareholding in terms of the rights held.
- 42. Having a voting right and not exercising it is different to having a voting right and not colluding with the other shareholders. Even if the other shareholders do act together to get control, none of those individual shareholders has control, they have shared control. That is to say, the shareholder with the single largest block of voting rights is the shareholder that is most likely to be in a position to have exclusive control. The question is whether that shareholder has sufficient rights to demonstrate that it does in fact have control.
- 43. Often, although not always, there will be other factors that combine to indicate that a dominant shareholder has strategic power over an entity. The existence of any of the following factors might indicate that the holder of less than a majority voting interest in an entity controls that entity, although each factor taken on its own would not be sufficient to conclude that control exists:
  - (a) the right to use the resources of an entity to dominate the process of nominating members of that entity's governing body and/or solicit proxies from other holders of voting interests;
  - (b) the right to appoint members to fill vacancies of an entity's governing body until the next election;
  - (c) retaining a significant minority voting interest in an entity after previously holding a majority voting interest;
  - (d) the continuing right to appoint or remove a significant number of the members of an entity's governing body after previously holding the power to appoint or remove the majority of the members;

- (e) the right to appoint, hire, reassign or dismiss an entity's key management personnel;
- (f) the right to dissolve an entity and redirect the use of its assets, subject to claims against those assets, without also assuming any costs from redirecting those assets that are in excess of the expected benefits of redirection;
- (g) the right under a statute or an agreement to access or use an entity's resources for purposes determined by the holder of the right;
- (h) the right under a statute or an agreement to amend an entity's constitutional documents;
- (i) the existence of material transactions or sharing of resources between the investor and the investee (supply or administration, common staff, management or Board members etc.).

44. As has been emphasised, these factors must be assessed together, as a matrix of factors. The proposed standard would make it clear that assessing indicators in isolation, or one at a time, is not appropriate. And further, the list presented here is just that—a list. The proposed standard would provide principles, with illustrative examples, that help identify the type of indicator that investors would be required to assess. The staff do not want indicators in the proposed standard being used as a checklist.

**45. Does the Board agree with this general approach to developing indicators?**

### **The framework, next steps**

46. The staff has been developing an approach to the proposed standard that it anticipates will provide a cohesive framework for considering SPEs, investment entities (venture capitalists), protective and participatory rights, options and other 'potential' voting rights. The staff expect to ask the Board to consider some matters related to SPEs at the September meeting. Concurrently, the staff is also working on the remaining outstanding issues. To help that process, the staff would like the Board to consider the matter of options.

### **Options over an entity**

47. One of the tentative decisions that the Board has made is that holding presently exercisable options over rights that, if exercised, would give the holder of those options control over an entity's strategic power is sufficient to meet the definition of control. This creates a perceived anomaly in the timing of

recognition of assets when options are held over an asset compared with when options are held over an entity that holds an asset.

48. The staff on the consolidations project has been developing its thinking on options over an entity at the same time as this issue is being considered by the conceptual framework team. To assist both teams, the staff is seeking feedback from the Board on the analysis that follows.
49. The staff notes that this analysis is not scheduled to be presented to the FASB in this form. However, feedback from the Board might help the staff in its preparation of papers on the conceptual framework currently scheduled to be presented to both Boards in September.

### **What boundaries do we respect, and why?**

50. In presenting the separate financial statements of an investor, the investor sometimes respects the boundaries of an entity and accounts for the net activities of each of the entities (or structures) in which it has an interest. It might be helpful to think about why those boundaries are respected.
51. A parent entity will respect the boundaries of an entity that has its own legal identity. An entity is normally afforded a legal identity through legislation, rather than contract. A simple test might be whether that entity is recognised as being able to have legal title to an asset. For example, a company would normally be able to claim title to an asset in its own right. In contrast, in many jurisdictions a contractual joint venture will not have a legal right. In such cases the venturers might need to register each of their names on the title. One venturer could do so and then use a contract to define the property rights. Or the venturers might set up an entity that does have legal identity and register that entity as the owner and use contracts to define the property rights.
52. What seems to be clear is that the entity will have a form that allows it to assert its rights and be responsible for obligations in its own name. That is to say, a **legal identity**. A legal identity should not be confused with statutory form, such as a company. It is almost certain, however, for an entity to be able to justify respecting the boundaries of a particular form, that the rights and obligations of that form will need to be legally enforceable by and against it in its own right. If an entity has a legal identity the separate financial statements of

the investor respect that form and recognise it as an entity (subsidiary) in the parent rather than as a way of organising activities (such as a branch or division).<sup>10</sup>

53. If an entity has an investment in an entity, the form of which is of the type that is respected in the separate financial statements of an entity, those boundaries will be ignored in presenting the consolidated financial statements of the group when the investor has control over that entity.
54. Ignoring the boundaries can be characterised as ignoring the instrument which gave the investor control. In cases where shares in a company, for example, are the instruments that give the investor control, then consolidation involves ignoring those shares. Put another way, if an ownership instrument gives the holder control of an entity we ignore that ownership instrument and report directly all of the assets and liabilities that the ownership instrument gives the holder the rights to. Appendix A demonstrates this concept algebraically.
55. This characterisation might help us think about options over an entity in a slightly different way to the way it has been presented in earlier Board papers.
56. The basic facts are reproduced from Agenda paper 0509b06, presented to the Board in September 2005:

**Facts**

There are two principal entities; Entity A and Entity B.

Entity B has a parcel of land as its only asset. It has no other contractual rights or obligations and, accordingly, the fair value of Entity B is equal to the fair value of the land.

Entity A owns a controlling interest in a third, ancillary entity, C. Entity A is required to publish consolidated financial statements and chooses to publish separate financial statements.

57. There are two scenarios:

**Scenario 1**

Entity A holds a presently exercisable call option over the land.

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<sup>10</sup> The ability to assert rights and the responsibility for obligations seems to be the compelling characteristic. The characteristic of perpetual life is a poor indicator, because we observe limited life entities.

## Scenario 2

Entity A holds a presently exercisable call option over 100 per cent of the shares in Entity B.

58. The Board has decided that holding a presently exercisable option over 100 per cent of the shares of a company would give control of that company to the holder of the options.
59. Following this decision we get:

|                                   | Scenario 1       | Scenario 2 |
|-----------------------------------|------------------|------------|
| Consolidated financial statements | Option over Land | Land       |

60. We can ask a slightly different question. Rather than asking if an option itself gives control maybe we can ask whether or not the equity instruments should be 'ignored'.
61. The equity instruments give the holder the right to control the assets and liabilities in the entity. In presenting the consolidated financial statements, those equity instruments are ignored. In the current case, ignoring the entity form would lead to the holder of the option reporting an option over the assets and liabilities in the entity rather than over the entity. In the simple case of the land this would give:

|  | Scenario 1       | Scenario 2         |
|--|------------------|--------------------|
| Separate financial statements (Entity A) | Option over Land | Option over Shares |
| Consolidated financial statements        | Option over Land | Option over Land   |

62. The answer is different to the one discussed in September 2005 because we look through the entity form to identify what it is that we have an option over. It is also based on the premise that an option is different to actual ownership. The Board decisions to date assume that options are sufficient to meet the control test. The staff believe that the simple case of land gives an intuitive result. The consolidated reports would show an option over the land. The Appendix demonstrates this algebraically.

63. For this solution to be robust we need to move away from the ‘one asset’ case. Consider the case where Entity B owns land and livestock, which are grazing on the land. Suppose Entity A has an option over the land and livestock under scenario 1 and an option over Entity B under scenario 2. The option in scenario 1 is for both the land and the livestock. That is to say, Entity A must buy both the land and the livestock . If it helps, assume that the option premium is CU5, the exercise price CU95, the fair value of the land CU60 and the fair value of the livestock CU20.
64. The staff believes that the key to deciding how to account for this under scenario 2 is in deciding how to account for it under scenario 1. Presumably, under scenario 1, the option is recognised in aggregate. The staff is not aware of an appropriate basis for bifurcating the option and recording separately an option over land and an option over the livestock. Perhaps there is some basis for bifurcating the option. Moving to the accounting for the option in scenario 2, the answer to scenario 1 should provide the basis. That is to say, we ignore the entity form and recognise the option over the land and livestock (presumably in aggregate).
65. This approach gives us symmetry in the accounting for the option over an entity and the option over the asset. This is because we ignore the entity and the accounting is as if the interest (an option) was in the assets directly.
66. Of course it also highlights why we had a difference in the accounting in the first instance. The Board decisions to date appear to assume that an option is a sufficient basis for determining control. In making that decision the consequence is that the option and the instruments which the option is for are both ignored when the consolidation is performed. In contrast, in accounting for an individual asset the option is not ignored.
67. The staff emphasises that this analysis does not in any way address the matter of whether the rights embedded in an option are the same as the rights associated with ownership. This was not, however, the objective of the analysis. Its purpose was to challenge the assertion that the Board has made that holding presently exercisable options over rights that, if exercised, would give the holder of those options control over the an entity’s strategic power is grounds for ignoring those options when the consolidated financial statements are presented.



68. The staff believes that his analysis suggests that the appropriate focus is on what rights an option gives the holder and when those rights are sufficient to be viewed as equivalent to ownership.
69. **The staff is seeking feedback on the analysis presented in this section of the paper.**

## Appendix

70. The characterisation of consolidation described in the last part of the paper can be demonstrated algebraically.

71. Suppose that the subsidiary, S, has equity,  $E^s$ , comprising two assets,  $A^{s_1}$  and  $A^{s_2}$ , and liabilities,  $L^s$ . The superscript s denotes that they are assets and liabilities of the subsidiary. Viz:

$$E^s = A^{s_1} + A^{s_2} - L^s$$

72. Suppose also that the parent entity owns all of the shares of the subsidiary, as well as other assets and liabilities. Viz:

$$E^p = A^{p_1} + A^{p_2} + A^{p_3} - L^p$$

where  $A^{p_3}$  denotes the interest the parent has in the subsidiary. Now assume that  $A^{p_3} = E^s$ . This means that:

$$A^{p_3} = A^{s_1} + A^{s_2} - L^s$$

Substituting  $A^{p_3}$  with  $A^{s_1} + A^{s_2} - L^s$  gives:

$$E^p = A^{p_1} + A^{p_2} + [A^{s_1} + A^{s_2} - L^s] - L^p$$

73. This simple algebra demonstrates that boundary definition under consolidation can be viewed as substituting the net investment in a subsidiary with the individual assets and liabilities in that subsidiary.<sup>11</sup>

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<sup>11</sup> We can relax the assumption that  $A^{p_3} = E^s$  to reflect the more realistic case of the accounting for the assets and liabilities within the subsidiary being different to the accounting for those assets and liabilities in the consolidated financial statements. Differences can arise because the assets and liabilities are measured in the group using accounting policies or measurements that are not the same as those used to carry the net investment in the separate financial statements of the parent. IAS 27 requires the investment to be measured at cost or fair value. At any given time the cost or fair value might differ from the net equity of the subsidiary. The point is that you cannot **just** ignore the boundaries of an entity when you consolidate the financial statements. By placing the assets and liabilities into an entity it can cause the accounting to be different to the accounting if the assets and liabilities had been owned directly by the parent. The aggregate investment in the subsidiary and its underlying assets and liabilities are fundamentally the same. But ignoring the boundaries also requires the preparer to adjust for measurement and recognition differences caused by putting the boundaries in place.

Now assume that rather than owning the shares  $A^{P_3}$ , the investor has an option over the shares, denoted by  $\lambda$ . Viz:

$$E^P = A^{P_1} + A^{P_2} + \lambda A^{P_3} - L^P$$

If we apply the same approach as before, substituting the assets and liabilities of the investee into the equation, we get:

$$E^P = A^{P_1} + A^{P_2} + \lambda[A^{S_1} + A^{S_2} - L^S] - L^P$$

74. Simply, the investor now has an option over the assets.