

**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>**



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*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:** March 2006, London  
**Project:** Consolidations (including special purpose entities)  
**Agenda Item:** 14  
**Subject:** Board update and planning

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### **Introduction**

1. This purpose of this paper is to update the Board on the direction the consolidations project is taking. As the technical plan indicates, the next milestone in this project is the agreement of the Board that the control model is robust and can be applied to, so called, special purpose entities. Much work still needs to be done for the staff to be in a position to develop a proposal for replacing IAS 27.
2. This paper is, principally, informational. That is to say, it provides an update to the Board on the project and the direction the staff are taking on some matters. The staff are, however, asking the Board to:
  - (a) agree with the staff recommendation on the target application date for a replacement for IAS 27; and
  - (b) provide feedback on the direction the staff are taking in relation to addressing special purpose entities.

### **Conceptual Framework project.**

3. IASB Agenda Paper 3, at this meeting, includes a discussion of ‘control of an entity.’ That discussion is important to the conceptual framework analysis of a reporting entity, because it is clear that legal and economic entities can be different. The conceptual framework staff are looking at ‘control’ as a, or the, basis for defining the reporting entity.
4. As the staff note in Agenda Paper 3, it is important that the Board provide direction to the staff to clarify the extent that the conceptual framework should discuss control and what should be left for discussion within the standards. Agenda Paper 3 covers topics that the Board has already considered in the consolidations project. That discussion is necessary, because it will help the Board decide whether control is the appropriate basis for defining the reporting entity. It should also be helpful in deciding where the line should be drawn between the conceptual framework discussion and the proposed replacement for IAS 27.
5. The staff believe that it will be important to establish quickly the scope of the conceptual framework. The conceptual framework project is operating on a much longer timetable than the consolidations project. The staff believe that it will be feasible for the Board to approve for publication proposals on the definition of control within the proposed replacement for IAS 27 before the conceptual framework project has been completed. For this to happen, however, there should be sufficient agreement on the direction the conceptual framework project is going so that any work undertaken at the standards level does not end up conflicting with the framework. The staff observe that the higher up it is that the Board draws that line, that is to say, the more of the discussion on control that is placed at the standards level, the less likely it will be that the projects will conflict. Having said that, as Agenda Paper 3 notes, if that line is drawn too high then the conceptual framework might not provide a strong enough foundation, and hence sufficient direction, for the standards.

### **Project timing**

6. The consolidations project has been identified as precedential in the Board’s work programme. In addition, the reactions to the public statement in October

2005 on 'de facto' control have underlined just how important and urgent this project is.

7. The staff believe that the Board should endeavour to align the application date of the proposed replacement of IFRS 3 with the proposed replacement of IAS 27. The Business Combinations II proposals include amendments to IAS 27. It would be unfortunate if IAS 27 was amended as part of Business combinations II and then replaced within a very short time-frame. That is to say, if the application dates can be aligned then it would be better to do so.
8. To be able to align these dates it will be necessary for the staff to accelerate their work on the consolidations project. It will also require that the Board factor the consolidations project into its deliberations on the application date for the replacement IFRS 3. The staff believe that 1 January 2009 is likely to be the earliest achievable common application date for the replacements of IFRS 3 and IAS 27.
9. **Does the Board agree that setting an objective of aligning the application dates for the proposed replacement for IFRS 3 and the amendments to IAS 27 under the current phase of the Business Combinations project with the proposed replacement of IAS 27 under the consolidations project, if this is achievable, is appropriate?**

### **Special purpose entities**

10. Developing a seamless control criteria and a single comprehensive IFRS to replace IAS 27 and SIC-12 for all entities is a primary objective of the project. In this section of the paper the staff outline the next steps they intend to take in addressing special purpose entities.

### **Board education session on the US FIN46R**

11. The staff have arranged for an Education Session on the US FIN46R to be held in the week of the joint IASB-FASB meeting. The purpose of this session is to provide the Board with an overview of the FASB approach to variable interest and qualifying entities. The consolidations project is not a joint project with the FASB. However, it is likely that the FASB will participate more actively in the

project as it develops. Understanding the thinking behind FIN46R should assist the staff and Board in identifying areas where IFRSs and US GAAP are different. It might also help in the development of the proposals.

### **Staff approach to special purpose entities**

12. The term special purpose entity is not defined in IFRSs.<sup>1</sup> One type of special purpose entity is an autopilot, where the operating and financing decisions have been pre-determined. There are varying degrees of ‘auto-pilot’. The staff believe that it is helpful to focus, at least initially, on a special case of autopilot, where the entity is fully auto-piloted to the extent that the entity does not have any operating or financing decisions to be made—a ‘brain-dead’ entity. This special case can then be contrasted with a ‘plain vanilla’ parent-subsidiary relationship where one business owns more than half the voting rights (shares) of another business.<sup>2</sup>
13. These are the base cases. The staff believe that if they cannot develop a model that handles these two cases they are unlikely to develop a solution that will address variants of the cases.<sup>3</sup>
14. The staff believe that an assumption that is implicit in IAS 27 is that the investee is a business. When this assumption holds, controlling the operating and financing decisions of an entity gives the investor the ability to use the assets within the wider group. This might generate synergies for the group as a whole (some of which will be shared with the non-controlling interests and some of which will benefit the parent shareholders.)

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<sup>1</sup> SIC-12 describes some scenarios that could suggest that an entity is a special purpose entity.

<sup>2</sup> In both cases the entity has two ‘owners’, investor A owns 51% of the shares and investor B owns the other 49% of the shares.

<sup>3</sup> The staff believe that the activities within an entity that might be subject to autopilot arrangements are likely to vary. It is arguable, for example, that defined investment strategies for a portfolio manager are a type of autopilot. The point is that the control model needs to be able to generate the ‘correct’ accounting requirements for the two extreme cases as well as those that fall between them.

15. An investor that has a beneficial interest in an entity and has power over its operating and financing policies is assumed to have power over the assets of the entity and to be responsible for that entity's liabilities. In such cases the investor should recognise all of the assets and liabilities of that entity—full consolidation.
16. As the staff indicated in Agenda Paper 7A in October 2005, an entity's control of another entity is a proxy for identifying the assets controlled by the first entity and reporting the combined activities and position as if the entity reporting is a single economic entity. This concept is linked to access to and power over economic benefits, and associated exposure to risks.
17. What if the assumption does not hold, and the entity is not a business? The definition of a business proposed in IFRS 3 is:
- A business is an integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing either:
- (a) a return to investors, or
- (b) dividends, lower costs, or other economic benefits directly and proportionately to owners, members or participants.
18. The staff believe that once the decision making capability of an entity has been decommissioned by an auto-pilot type arrangement, it will be difficult to argue that the entity is 'capable of being conducted and managed...', that is to say, it is unlikely to meet the definition of a business.<sup>4</sup>
19. Control of the operating and financing decisions of an entity gives the investor the *right* to use all of the assets within the wider group.<sup>5</sup> The accounting for those rights, under the consolidation process, is to treat those assets as if they

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<sup>4</sup> If an entity's only activities are on autopilot, and it is 'brain-dead', that entity would not be a business. The setting up or acquisition of such an entity would not meet the definition of a business combination.

<sup>5</sup> This is not strictly true. There are many factors that can limit the ability of an entity to consume an asset outside of the legal entity in which that asset sits. However, the consolidation process generally ignores those constraints.

are controlled by the parent.<sup>6</sup> In the case of an entity that does not have decision-making capability the mechanism that has given the investor a financial interest in that entity will have conveyed rights to the investor. The staff believe that it is likely that those rights will be more limited (restricted) than the rights conveyed to an investor who has control over the operating and financing activities of an entity.

20. The staff therefore believe that it is unlikely that the rights an entity has in another when it controls its operating and financing activities are the same as the rights it has in an entity constrained by an autopilot arrangement. Simplistically, the solution would seem to be to account for those rights (and responsibilities). In the case of a business, a controlled entity is consolidated. When the entity is not a business, the accounting would reflect the contractual rights and responsibilities of the investor. In the base case described here (the entity on full autopilot) investor A might report its 51% interest in the assets and investor B its 49% interest. The staff emphasise that this is not proportionate consolidation. The risks (responsibilities) would also be recognised in by each investor. It might be, as anticipated by FIN 46R that the proportion of risks assumed differs from the proportion of rewards to which the investor is entitled. The investors would recognise the risks and rewards separately.
21. The staff believe that the issues that need to be addressed when considering an interest in an entity are, therefore, whether the entity is a business and what it is that the investor controls. This does not mean that autopilots would fall outside of the scope of a proposed replacement of IAS 27.
22. The staff suspect that many so called special purpose entities will have some elements of a business and some autopiloted activities. If an entity has an interest in another entity that has a business component as well as some activities that have been separated from the business and had their operating policies predetermined, it might be that the investor consolidates the business activities and recognises its interest in the autopiloted activities.

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<sup>6</sup> Agenda Paper 3 provides a discussion of the different ways this reporting is characterised.

23. The staff will use the April education sessions, industry and FASB contacts to establish a library of cases that will be used to identify common characteristics to test the control model the staff have been developing.
24. **Does the Board agree with the general approach the staff are taking in analysing special purpose entities in relation to control?**

### **Other matters**

25. Addressing special purpose entities will be a significant step, but the staff are also working on papers for the Board on the following subjects:
- (a) options over assets versus options over equity instruments;
  - (b) accounting for the attribution of profits or losses in the context of potential voting rights;
  - (c) economic dependence; and
  - (d) disclosure.
26. In addition, the staff intend to address inconsistencies between IAS 27 and the proposed revised IFRS 3 so that the final packages are cohesive.<sup>7</sup>

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<sup>7</sup> For example, the staff propose to ensure that the accounting requirements that relate to activities after an entity has achieved control over a subsidiary are all addressed in the proposed replacement for IAS 27 rather than having some requirements in IFRS 3 and some in IAS 27. In addition, reverse takeovers need to be addressed more clearly in the IAS 27 replacement.