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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:** 18 September 2006, London

**Project:** Consolidations (including special purpose entities)  
[Education Session]

**Subject:** Education Session: Application of the Proposed  
Consolidations Framework to Entities that are within the  
Scope of SIC-12 (Agenda Paper 7B)

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## **Introduction**

1. The Board has asked the staff to develop consistent control criteria and a single comprehensive IFRS (to replace IAS 27 and SIC-12) for all entities, including those commonly referred to as special purpose entities (SPE). The purpose of this paper is to provide the Board with an update on the direction the staff is taking on matters related to accounting for interests in transactions structured as securitisations, pass-through arrangements, synthetic leases and other arrangements commonly referred to as SPEs. These entities and arrangements are currently within the scope of SIC-12.
2. The staff is not asking the Board to make any tentative decisions in relation to the issues raised in this paper. Rather, the paper is designed to be informative. The staff is seeking feedback from the Board about the underlying principles for assessing the rights one entity has in another. In particular, is the framework likely to be helpful in identifying when one entity should recognise all of the assets and liabilities of an entity (ie, consolidate) as opposed to recognising only those assets and liabilities in which it has a direct interest?

3. The staff notes the importance of keeping in mind that one of the primary purposes of this project is to ensure that users of financial statements have information that is relevant in making decisions (ie, the amount, timing, and uncertainty of future cash flows of the combined entity) and that an entity should recognise its (and only its) assets and liabilities. In the case of securitisations and similar arrangements, it is important that the consolidated financial statements provide such information.<sup>1</sup> It is necessary that the accounting treatment results in equal treatment for all entities: it should not ‘punish the innocent’ or ‘help the abusers’. We must ask whether full consolidation provides users with meaningful information, or perhaps it would be better for the reporting entity to record only its investment in such an arrangement.<sup>2</sup> There is little disagreement amongst users, however, about whether investments in these arrangements should be reflected in the financial statements. The question to be answered is how they should be reflected.
4. Appendix A outlines the Board decisions (including tentative decisions) made to date relating to entities within the scope of SIC-12.
5. Paper 7C provides examples of typical transaction structures. These transactions will be used by the staff to illustrate how the proposals in this paper will affect the accounting for such transactions.

## Scope

6. At the July Board meeting the Board tentatively agreed that a parent 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. In such cases, when presenting group financial statements, the first entity consolidates **all** of the assets and liabilities of the second entity and recognises any rights that other parties might have in those assets and liabilities (ie, non-controlling interests). We refer to this, for simplicity, as the ‘traditional’ control model.

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<sup>1</sup> The effect of consolidating an SPE has an impact outside of financial reporting, particularly in the event of bankruptcy of one of the parties. One of the criteria that a bankruptcy court will look at when deciding whether to ‘substantially consolidate’ separate but related entities is whether they have consolidated accounts. Of course, this is only one of several factors that would be considered in the bankruptcy proceedings, but consolidation could influence the court’s view of the party to which the assets belong.

<sup>2</sup> Note that the staff is not recommending that companies record only their net investment, such as an investment in the shares of the entity (similar to equity accounting). It is possible that companies would then set up these arrangements such that their net investment is zero in order to, in effect, derecognise their investment.

7. This paper focuses on those arrangements for which it is more difficult to conclude that one entity controls **all** of the assets and liabilities of another entity through strategic control either because the policies have been predetermined or the holders of the voting rights are not the real absorbers of the variability of the cash flows related to the assets and liabilities of the entity. Although this type of arrangement is often labelled as a 'special purpose entity', the staff has already noted its preference for avoiding labels that imply discrete types of entities.
8. Instead, the staff will describe the characteristics associated with so-called SPE arrangements such as pass-through arrangements, securitisations and synthetic leases. By doing so, the staff will highlight the common characteristics associated with these arrangements, and the differences, and how the model we are proposing would be used to assess the rights and responsibilities of the parties.
9. The staff will introduce other common transaction types in future papers. Our expectation is that even as the type of transaction we introduce becomes more complex, the model will, by then, be sufficiently well-defined to allow us to assess rights and responsibilities without significant modification.
10. In the US GAAP model entities are classified as either voting interest entities (and fall within the scope of ARB 51), variable interest entities (within the scope of FIN 46(R)) or qualifying special purpose entities (within the scope of FAS 140). In contrast, the model the staff is developing does not create classes of entities, such as operating subsidiaries and SPEs. Instead, the proposed model assesses the rights and responsibilities that one entity has in the assets and liabilities of another entity. The staff believes that this approach accommodates better a model that assesses a range of contractual or other arrangements. That is to say, it avoids creating silos or boxes that, almost inevitably, are separated by bright lines.
11. A review by the staff of professional advice about IAS 27 and SIC-12 suggests that they are viewed by many as discrete (or alternative) models. Given that SIC-12 is an interpretation of IAS 27 this characterisation is a concern.

## **Terminology**

12. One of the difficulties in any discussion of so called SPEs is that people use a variety of terms interchangeably. In this section of the paper we describe the terminology that we use here and expect to use in the Education Session. We also specify some simple assumptions that we do not intend addressing at the

Education Session. They should be taken as given. The list is by no means exhaustive.

13. The legal rights and responsibilities are less important than the economic rights and responsibilities. It is not sufficient merely to consider the transaction's legal form because the legal form might not adequately express the economic rights associated with the arrangement.<sup>3</sup>
14. For the purpose of this paper, a 'business' is defined in the proposed definition in the Exposure Draft to IFRS 3 *Business Combinations* as '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'.
15. Control and management are not synonymous. Management is the ability to direct the use of an item that generates the benefits. That is to say, the manager has been delegated the right to make day-to-day decisions about the use of the assets and liabilities. Although the two often go together, there is no requirement that they do so.
16. An interest in an entity can take the form of an equity, debt, hybrid or other instrument.
17. The following terms are used synonymously in this paper:

Term	Meaning
Investor Originator* Transferor Servicer Creator Participant Potential Controller Interested Party	The party with a contractual or equitable interest in an asset or all of the assets or a liability or all of the liabilities of another entity or arrangement.
Investee Issuer Transferee Originator*	

\* The term originator can apply to both the entity and the party with an interest in the entity. For example, an entity can be the primary lender on a transaction when it is not buying securities in the secondary market.

<sup>3</sup> Having said that, the staff recognises that the legal form is important because it can affect the economic form. The economic rights over an asset are not constant and they rely on continued efforts at protection of the legal rights over the asset. The structuring of a securitisation or pass-through arrangement is a good example of this. See paragraphs 31-34.

## **The Foundations**

18. The proposals build on two very important presumptions, which have their roots in basic finance theory and economic property rights theory. The first is the assumed relationship between risks and rewards and the second is the assumed relationship between rights and benefits. In this section of the paper we provide a brief introduction to these presumptions.
19. The staff notes that in this paper references to **benefits** (or rewards) are intended to be neutral (covering an asset or a liability). We also use the term **variability** in relation to who bears the risks or receive the rewards. In this way, an entity that absorbs the variability of an asset is the party the benefits from the asset. For example, the (legal and beneficial) owner of an asset will absorb the variability of that asset. As the value of that asset changes the (legal and beneficial) owner is better or worse off.

### **Risks and rewards**

20. Fundamental to the ideas we are developing is the presumption that each party to the transaction will act in accordance with their respective economic interests. This means that the party that expects to benefit is presumed to have exposure to commensurate risk, and an entity that is exposed to risks is presumed to expect commensurate benefits. This is the presumption in the accounting standards of many jurisdictions (see paragraphs 64-67).
21. Risks and rewards have two sides. An entity might invest in an activity with an expectation of a return on that investment. Conversely, an entity might receive a payment in exchange for assuming a risk (such as accepting responsibility for a liability).

### **Rights and benefits**

22. Economic property rights theory tells us that the more a party is able to affect the variability of an asset the more of that variability it is expected to absorb. It follows that the more variability a party is expected to absorb the more control the party will want to have over the assets causing the variability. That is to say, parties exposed to an entity's residual risks usually require some level of control of that entity to protect their risk position.
23. Of course it is possible to design an entity such that the parties stated as being the residual risk holders are the 'owners' of that residual risk by name, but that ownership is notional. For example, the level of residual risk that these parties absorb could be very small relative to the total variability of the assets and liabilities of the entity. So small, in fact, that the residual benefits or risks are

insignificant or immaterial relative to the entity as a whole. In such cases, the level of control those parties would be expected to exercise over the entity would also be immaterial. This is one of the ideas underpinning US FIN 46(R). And that is why FIN 46(R) follows the variability in an attempt to identify the controller.

24. The approach the staff is suggesting is consistent with US FIN 46(R), with one important difference. The party absorbing (or exposed to) the majority of the variability of an entity might, in fact, be absorbing all of the variability of some of the assets of the entity and none of the variability of other assets of the entity. A requirement for that party to consolidate all of the assets of the entity could result in it reporting assets that it does not control and for which it does not absorb variability. Conversely, the party that absorbs all of the variability of those other assets (and presumably has some power over them) does not report those assets.
25. The key will be identifying what rights each party has (and the variability they are absorbing). Does it have rights to the whole entity, some of the entity, some of the assets, all of the assets or responsibility for the net or some or all of the obligations?
26. The staff intends to use feedback from this education session as input when the staff establishes guidelines for assessing the rights and responsibilities an entity has in the assets and liabilities of another entity. The principles should assist in developing consistent accounting in cases for which assessing who controls the entity as a whole or where the underlying elements of control are less obvious (ie, it cannot be analysed using the ‘traditional control model’). They should also help in assessing the rights a particular entity has in another entity when the assets are controlled by more than one party (ie, when one party has rights to a particular portion of the assets, such as the interest payments, and another party has rights to another portion, such as the principal payments). That is to say, when the variability of an entity’s assets has been contractually allocated to more than one party and, perhaps, the unallocated (or residual) variability is economically insignificant.
27. The staff emphasises that a rules-based approach will be avoided because that approach provides a basis for those who wish to arrange their affairs to avoid recognition of an interest in such an arrangement.

## **Creation and Purpose**

28. To help develop these concepts it might be helpful to look at some examples of arrangements commonly found in practice.
29. Securitisations, pass-through arrangements, synthetic leases or similar arrangements are generally created for valid business reasons in order to reduce the cost of borrowing, shift risk to other parties and allow investors to obtain tax benefits. They are often structured to isolate credit risk and provide bankruptcy remoteness such that the assets of the entity are removed from the creator's and investors' balance sheets (ie, non-consolidation). However, due to their private nature, these arrangements can also be used to deceive investors by concealing assets and liabilities that have a negative impact on balance sheet and earnings quality. It is the latter circumstances that have received the most attention in recent years and these entities now have the reputation of being created to conceal a company's true financial position.
30. Whatever the reason for their creation, these arrangements often function not on their own account but rather to support the activities of another entity or entities. The motivations to establish some arrangements (including securitisations and conduits) relate to trying to distance specific assets and liabilities from the reporting entity while keeping as much of the ability to direct those items, and benefit from that direction, as possible.

## **Securitisations**

31. In a securitisation, an entity is created to facilitate a transaction and generally involves transferring assets in two steps by means of a 'true sale' to a 'bankruptcy remote' entity. A 'true sale' securitisation involves the isolation of an asset or set of assets from the originator. This ensures that the holders of the securitised assets can continue to benefit from the cash generated by such assets if the originator becomes insolvent. Generally, the entity's objects and powers are restricted as closely as possible to the bare activities necessary. The purpose of doing this is to reduce the risk of the entity in which the assets have been placed from becoming insolvent as a consequence of claims created by activities unrelated to the securitised assets and the issuance of the securities. (It is this limited or narrow purpose that has led to such entities being called 'special purpose'.)
32. The restricted activities of the entity holding the securitised assets often mean that the entity does not have any 'effective' strategic power. And, accordingly,

assessing who has exclusive rights over that strategic power is not a relevant question.

### **Pass-through arrangements**

33. Pass-through arrangements are, perhaps, the most passive of these types of entities. They generally hold only financial assets and liabilities and act as a conduit to the investors, distributing the cash flows of invested funds. Although pass-through arrangements are often set up through an SPE, they do not need to be. These entities buy interests in pools of assets from one or more sellers and fund such purchases by selling commercial paper notes or other debt, primarily to institutional investors.
34. The base of assets is divided into varying classes of securities backed by assets with different characteristics. The assets are generally long-term assets that are 'matched' with liabilities of the same duration. Most conduits are sponsored and administered by large commercial or investment banks. The sponsor collects the monthly payments from the sellers, and, after deducting a fee, remits or passes them through to the holders of the pass-through security. The sponsor typically does not own an equity interest in the entity, although it might hold subordinated debt.

### **Synthetic leases**

35. In a synthetic lease transaction, a bank or other third party provides funding for the construction or acquisition of equipment to be utilised by and leased to the entity. At the end of the lease, the entity is obligated to buy the asset (or make arrangements for it to be purchased by a third party) at a fixed price (effectively guaranteeing the value of the asset). In this type of arrangement, there is more flexibility in financing than in traditional conventional methods. There are a number of funding sources available, including commercial paper, private placement, bank debt or other funding sources. Synthetic leases are often used with commercial properties (including offices and factories), but can also be used for other assets, such as aircraft and other major equipment.
36. In a typical synthetic lease transaction, the lessee would have two options at the expiration of the lease term: One is to purchase the property from the lessor (or owner) for the balance due. Because this amount cannot be a bargain purchase, an appraisal is required at the lease inception stating that the amount is not a bargain price. The other option is to sell the property on the last day of the lease term to a buyer unaffiliated with the lessee and guarantee the lessor any deficiency in the sale proceeds up to a specified amount (with any excess payable to the lessee). Through a fixed price purchase option available at any



time, the lessee might benefit from any appreciation in the underlying value of the leased asset even though such assets are not 'owned' for accounting purposes.

37. Because of the nature of the lease, this liability is not included on the balance sheet. However, because the transaction places the legal title of the asset with the lessee, the lessee is regarded as the owner of the property for tax purposes and is eligible for the depreciation and interest deductions contained in the lease payments. The guaranteed purchase price at the end of the lease means that the lessee is at risk for any decline in the value of the asset. In other words, the lessee absorbs the variability of the assets.

### **Underlying Characteristics**

38. The term 'special purpose entity' is often used synonymously with securitisations, pass-through arrangements/conduits, synthetic leases and others. In many cases, these transactions actually do not involve an SPE (which, as described above, is established through a true sale to a bankruptcy remote entity). But because the term SPE is so commonly used it is simpler for most people to describe them as such. Although this generalisation is simple and understood by most practitioners, it does not portray the true characteristics of many arrangements. In fact, it can be limiting when interpreting the IFRSs and GAAP on this issue.
39. The term SPE potentially can be taken literally in order to structure transactions that do not involve SPEs and therefore do not have to follow the related accounting requirements. For this reason, US FIN 46(R) has not defined SPE, but calls them (and other entities with similar characteristics) 'variable interest entities'. However, the use of the term 'variable interest entity' has its own interpretation issues.
40. Many reporting entities can structure transactions in such a way that the arrangement will not be considered a variable interest entity (and therefore will not be subject to the related accounting requirements). As noted above, the staff's preference is to exclude any references to specific classes of entities so as to avoid these problems.

### **Definitions and descriptions in IFRSs and other GAAP**

41. Despite the staff's preference for excluding the term 'special purpose entity' from the revised IFRS, it is relevant in this analysis to consider the underlying characteristics of these entities in the various definitions and descriptions that have arisen over time and across jurisdictions. These descriptions might help us

identify the characteristics and indicators that suggest that the interest in an entity is more likely to be in some of the assets or some of the liabilities, or both, than in the entity as a whole.

42. At the December 2003 Board meeting, an SPE was defined as an entity whose policies were in substance so extensively (and immutably) predetermined, that any remaining policy choices could not be described as that entity's 'strategic operating and financing policies'. This definition covers only a subset of entities commonly considered to be SPEs.
43. SIC-12 defines an SPE as an entity that is set up to accomplish a narrow and well-defined objective (such as to effect a lease, research and development activities, or securitisation of financial assets).
44. In US FIN 46(R) an SPE is not defined. However, the FASB staff has identified the following characteristics that are typically found in SPEs:
  - (a) Its activities and purpose effectively are limited.
  - (b) Most of its activities and operating decisions are effectively specified in or governed by the entity's formation or governance documents or by financing, operating, and investor agreements such that some or all decisions are predetermined.
  - (c) No independent party has a substantive equity investment that is at risk and its capital structure has significant leverage.
  - (d) It does not meet the definition of a business.

The existence or absence of any or all of the above characteristics is not a bright line for determining whether or not an entity is an SPE or a variable interest entity, and that the ultimate determination will be based on judgement. The critical determining factor in FIN 46(R) is whether an entity supports the activities of a 'primary beneficiary'.

45. The French Code of Commerce defines an SPE as 'a separate legal structure, created specifically to manage a transaction or group of similar transactions on behalf of an enterprise. The SPE is structured and organised in such a way that its activity is performed, in fact, only on behalf of this enterprise, by making assets available or by providing goods, services, or funds.'
46. UK GAAP calls an SPE a 'quasi-subsidiary' and defines it as 'a company, trust, partnership or other vehicle that, though not fulfilling the definition of a subsidiary, is directly or indirectly controlled by the reporting entity and gives

rise to benefits for that entity that are in substance no different from those that would arise were the vehicle a subsidiary’.

### **Common features of these definitions**

47. The characteristics that standard setters have indicated are common to entities that are used for securitisations, pass-through arrangements and synthetic leases (and other types of activities which the staff will introduce in later papers) are:
- (a) a narrow purpose;
  - (b) predetermined strategic policies; and
  - (c) insufficient equity.
48. One way to think about these characteristics is that they seem more closely associated with an asset than with a business. (Please note that these characteristics are illustrative only and are not meant to be a checklist of items that would indicate that such an arrangement should follow a particular accounting treatment.) US FIN 46(R), correctly in the staffs opinion, characterises these as indicators. And these indicators are not unrelated.

### **Narrow purpose**

49. Most of the definitions and descriptions consider the narrow, special purpose nature of these entities.
50. Having a narrow purpose makes them easier to establish without any explicit, ongoing power to direct them (ie, they are able to operate with predetermined policies).
51. The existence of a narrow purpose is an indicator that the traditional control model might not be an appropriate basis for identifying which parties have rights over the assets of the entity or responsibility for its liabilities. However, having a narrow purpose is not a necessary or sufficient characteristic for concluding that the power over the strategic policies of an entity will be unhelpful in assessing rights.
52. In many cases, the fact that the entity has a narrow purpose can help distinguish it from an entity that has operations that resemble a business that must be actively managed—but not all. We are not suggesting or implying that there is a ‘point’ at which an entity’s purpose changes from narrow to broad. However, the more narrow the purpose, the more likely we are to find less variability in the types of activities undertaken (and the types of assets it holds) and the more likely it will be that the arrangement can have predetermined strategic policies.

### **Predetermined strategic policies (referred to by SIC-12 as ‘autopilot’)**

53. Many of these arrangements are able to operate with predetermined policies. It is clear that finding that the policies have been predetermined implies that assessing who has power over the strategic policies of an entity is less likely to be helpful in assessing rights.<sup>4</sup> However, it is likely that the party for which the policies have been predetermined to benefit is the principal absorber of the variability of the entity and its assets. That is to say, an entity with predetermined policies can still have one party that has rights over the entity as a whole.
54. Many arrangements have elements requiring both the exercise of strategic decisions and activities for which policies have been predetermined. Consider an arrangement that has been created to undertake specific activities for the benefit of the creator and/or the investors, such as performing research and development activities or to start up a new product or business. An arrangement also might have some business activities since they are managed on a day-to-day basis with regard to the purchase and sale of assets, the issuance and settlement of liabilities, and the distribution of income to investors.<sup>5</sup>
55. As stated previously, the more variability there is in the types of activities undertaken by these types of arrangements, the less likely it will be that the arrangement will be able to have completely predetermined policies. This does not mean that all entities that undertake some business activities should be considered to be operating businesses. However, the more variability there is in the types of activities undertaken, the less likely it will be that the arrangement can have predetermined policies.

### **Insufficient equity**

56. Although having sufficient equity capital, on its face, gives the appearance that an entity can be assessed using the ‘traditional’ control model, this is not to say that all thinly-capitalised, highly leveraged entities can not.
57. If the entity does not have the ability to fund or finance its operations without assistance from, or reliance on, another party, the equity is not sufficient to absorb the variability of its assets and liabilities (ie, profits and losses). In cases for which the investors have a guaranteed return such that they do not participate in the entity’s losses, it is likely that the entity is not an operating business.

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<sup>4</sup> In fact, external parties, such as credit rating agencies and regulators, will often stipulate some of these policies, effectively giving the participants less power.

<sup>5</sup> This is similar to the ‘indirect interest’ proposed for joint venture arrangements as discussed at the July Board meeting.

### Illustration - features of a securitisation

58. Consider, for example, these characteristics as they apply to a securitisation. In a securitisation arrangement, an entity that holds the assets does not generally have characteristics that fit the ‘traditional’ control model and cannot be analysed in the way we would for an operating business.

<b>Generic operating subsidiary</b>	<b>Securitisation*</b>
Operates as a business	Does not have qualities of a business
Significant variability in activities undertaken	No variability in activities and has a very narrow purpose
Very few, if any, predetermined policies	All policies are predetermined
Has sufficient independent equity	Does not have sufficient independent equity

\*This continuum can also be applied more generally to other types of arrangements.

59. The staff believes that a typical securitisation has characteristics that place it to the right-hand side of the continuum. This means that assessing the rights over the strategic policies of the entity is not likely to be an appropriate basis for assessing whether the interested party controls all of the assets and liabilities of the entity, only some of them, or none. Instead, it will be necessary to look at other indicators.
60. The staff believes that, in some cases, such as a qualifying SPE (within US GAAP) or a ‘pass-through arrangement’ (within IAS 39), it is clear that assessing the rights over strategic power is not appropriate. Not all arrangements and activities place the interests clearly to the left or right of that decision node. As power over the assets increases (ie, moves toward the left side of the continuum), the evidence of that power should become more apparent because the rights should become better defined. This would signify a typical parent-subsidiary relationship. Between these two extremes is a grey area in which at some point the entity will have some characteristics of both and a decision will need to be made as to how to account for the rights and obligations of the investors.

### Absence of Strategic Power

61. As stated previously, under the traditional control model, the benefits realised by an investor are generally proportionate to the power held (usually in the form of voting rights). In such cases is easy to observe who is making the strategic

policy decisions. In the case of a securitisation or similar arrangement, however, there are two issues:

- (a) Rights over the **entity** are not always held by the investors in such an arrangement.
  - (b) If the investor does have stated rights over the entity those rights might have notional rather than real value.
62. That is to say, the entity holding the majority of the voting rights in such an arrangement might not control the entity particularly if the operating and financial policies have been predetermined. It can be argued that participants in these types of arrangements implicitly have accepted the predetermined policies of the entity and are therefore unable to control the entity's assets or the associated future economic benefits. Presumably, they do not care to do so.

### **IFRSs and other GAAP**

63. The Board has tentatively decided that the level of ownership is relevant only as one aspect of evidence in applying the control criterion. When discussing the type of entity that we have described some standards suggest that it is 'difficult' to analyse these entities using a 'traditional' control perspective (since no party appears to have control). In response to this issue, many IFRSs and GAAP emphasise the importance of benefits and risks when evidence of control is not available.

#### **IFRSs**

64. In the IFRSs SPEs, securitisations and similar arrangements are covered by SIC-12 *Consolidation – Special Purpose Entities* and IAS 39 *Financial Instruments: Recognition and Measurement*.
- (a) SIC-12 looks to the substance of the relationship between an enterprise and an SPE to determine whether the entity is controlled by that enterprise. In essence, when power is not evident, the party that benefits most will be likely have control.<sup>6</sup> The following factors should be considered:
    - (i) The activities of the arrangement are being conducted on behalf of the enterprise according to its specific business needs so that the enterprise obtains benefits from the entity's operation;
    - (ii) The enterprise has the decision-making powers to obtain the majority of the benefits of the activities of the arrangement or, by setting up an 'autopilot' mechanism, the enterprise has delegated these decision making powers;

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<sup>6</sup> The criteria in SIC-12 is in contrast to the criteria in FIN 46(R) in that SIC-12 gives more weight to benefits, while FIN 46(R) gives more weight to losses.

- (iii) The enterprise has rights to the majority of the benefits of the arrangement and therefore may be exposed to risks incident to the activities of the entity; or
  - (iv) The enterprise retains the majority of the residual or ownership risks related to the arrangement or its assets in order to obtain benefits from its activities.
- (b) IAS 39 provides guidance on pass-through arrangements, which might or might not be set up through SPEs. The purpose of IAS 39 is to determine whether the assets and liabilities transferred to a pass-through arrangement qualify for derecognition (SIC-12, on the other hand, considers when another entity should consolidate the assets and liabilities of the arrangement). The derecognition tests for IAS 39 look both to risks and rewards and to control, with more emphasis being placed on risks and rewards (ie, control is the determining factor only in cases where it is not obvious that a transfer of ownership has taken place, see paragraphs 20(c) and 23 of IAS 39).<sup>7</sup>

#### **New Zealand GAAP**

65. New Zealand Financial Reporting Standard No. 37 *Consolidating Investments in Subsidiaries* contains an exemption to the need for a power element, stating that:

‘Any party having decision-making ability concerning the SPE’s activities will be unable to materially influence the net surplus or deficit of the SPE because this will depend on circumstances outside the direct influence of the manager, such as prevailing market interest rates and the cost of insurance cover. Control will therefore arise in favour of a party that is entitled to a significant or greater level of the SPE’s ownership benefits, irrespective of whether that party has the ultimate decision-making capacity regarding the SPE. Entities having financial assets securitised through an SPE vehicle in this manner will commonly have control over the SPE...’ (paragraph 4.28)

#### **UK GAAP**

66. Financial Reporting Standard 5 *Reporting the Substance of Transactions* was developed with off-balance sheet financing and securitisation arrangements in mind. FRS 5 notes that, in some cases, arrangements are made for allocating the benefits arising from the activities of an entity such that active exercise of control is not necessary. When the day-to-day direction of financial and operating policies has been predetermined, control will be exercised indirectly via the arrangements for allocating the benefits and it will be necessary to look

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<sup>7</sup> In IAS 39, the basis for control is whether the transferee can sell the transferred asset without restriction. See paragraph 23 of IAS 39.

at the effects of those arrangements to establish which party has control. The ability to prevent others from directing policies and from enjoying the benefits arising from the net assets is an indication of control. The party possessing control will be the one that gains the benefits arising from the net assets of the entity. Evidence of which party gains these benefits is given by which party is exposed to the risks inherent in them.

#### **US GAAP**

67. In US GAAP, SPEs are accounted for under FIN 46(R) *Consolidation of Variable-Interest Entities* and FAS 140 *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*.
- (a) US FIN 46(R) assumes that the primary beneficiary of a variable interest entity (such as an SPE, but it also relates to other types of entities) has to the majority of risks and benefits, with the emphasis being on exposure to potential losses. The primary beneficiary is the party that holds a significant amount of the variable interests in an SPE. Where different types of variable interests exist, the interest that has exposure to loss before other variable interests is considered to be the interest with the greatest level of variability. A variable interest is considered 'significant' when it is greater than the variable interests held by the other individual entities that hold variable interests.
  - (b) US FAS 140 relates to very passive arrangements (referred to as 'qualifying SPEs'), such as those that hold only financial assets and liabilities and which function only to receive and distribute proceeds to investors, and relates only to the transferee of the arrangement. Investors in qualifying SPEs cannot exercise control over the entity since all activities are predetermined and the entity effectively is 'brain dead'.<sup>8</sup> The level of risks and rewards is hardly relevant in this case as qualifying SPEs are not subject to consolidation as long as specific criteria are met.

#### **Practical Issues with SIC-12 and US FIN 46(R)**

68. The switch from a control model to a risk and/or rewards model does not resolve the issues of when, whether and what to consolidate. Even with guidelines in place, it is not always clear which party ultimately receives the majority of the benefits from the assets of the entity or which party has assumed the majority of the risks. In fact, in practice, 'control' can sometimes pass

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<sup>8</sup> A 'brain dead' entity can be considered as one which requires no active management, with only an administrator who manages the day-to-day activities of the entity within predefined parameters.



between different investors solely due to changing market conditions, when nothing has changed in the substance of the relationship between the investors and the entity. Another practical problem with SIC-12 is that it can lead to more than one party being identified as the parent of an entity, contrary to the unilateral control-based consolidation model.

69. There are also interpretation difficulties with SIC-12. Although SIC-12 is based on the principle of control, reference is also made to benefits (ie, risks and rewards), making it difficult to determine which factors need to be considered. This therefore leads to a conflict between the control model and the risk and rewards model (ie, the party who has control by traditional means does not receive a majority of the rights associated with holding a controlling voting interest). The models should not conflict. The staff believes that the focus on 'the entity as a whole', rather than the assets and liabilities of the entity, is at the root of this conflict.
70. Determining whether an entity controls (ie, meets the power and benefits criteria) an SPE continues to cause confusion in practice. In April and May 2006, the IFRIC addressed, amongst other issues, whether there are any indicators of control that play a dominant role in determining whether an entity should be consolidated under IAS 27 and SIC-12. At both meetings, the IFRIC decided that there is no single indicator and that all factors relevant to the determination should be considered.
71. In a world of continuous financial engineering, it is not surprising that reporting entities have created instruments that will help them to get around the requirements of US FIN 46(R) and SIC-12. One of the more common instruments is the 'expected loss note'. By issuing expected loss notes to a third party (who often is in the business of doing this), an entity is able to show that control lies not with the reporting entity but with that third party. In accordance with the terms of the note, the third party will be exposed to more than half of the expected losses, is entitled to more than half of the expected residual returns and will take some control over the entity's activities. The existence of the note provides loss protection to the investors and/or debt holders, and effectively absorbs the majority of the expected losses of the entity. The advent of such instruments is useful in analysing these types of arrangements from a consolidation perspective, particularly in relation to the existence of 'straw men' where there is an impression that control of the entity lies with a party other than the one that actually directs the operations of and benefits from the activities of the entity.

72. Even with appropriate guidelines in place, some reporting entities structure transactions in such a way that the arrangements are not subject to consolidation. For example, just prior to the release of US FIN 46(R), Citigroup's 2003 annual report stated:
- ‘The Company is evaluating the impact of applying FIN 46-R to existing VIEs in which it has variable interests and has not yet completed this analysis. We are revising our calculations of expected losses and expected residual returns to reflect the new guidance in FIN 46-R to determine whether any changes to our consolidation decisions under FIN 46 will be needed. Depending on the results of these calculations, we are also **considering restructuring alternatives that would enable certain VIEs to continue to meet the criteria for non-consolidation.**’ [Citigroup 2003 annual report, emphasis added]
73. In fact, they go on to state that the assets and liabilities on their 2003 consolidated balance sheet would have been higher by US\$43 billion (or 25% of total assets of US\$171 billion) had they consolidated these entities. In their 2005 annual report, Citigroup seems to have accomplished their goal:
- ‘SPEs may be Qualifying SPEs (QSPEs) or VIEs or neither. The Company’s credit card receivables and mortgage loan securitizations are organized as QSPEs and are, therefore, not VIEs subject to [FIN 46-R]. When an entity is deemed a variable interest entity (VIE) under FIN 46-R, the entity in question must be consolidated by the primary beneficiary; however, the **Company is not the primary beneficiary of most of these entities and as such does not consolidate most of them.**’ [Citigroup 2005 annual report, emphasis added]
74. The staff has a more fundamental difficulty with a simple shift in focus away from assessing power and onto assessing risks and rewards. Our difficulty is that the assessment is still undertaken with the purpose of identifying who controls the entity **as a whole**. As we have emphasised several times in this paper, it could be that no single party has rights over all the assets of an entity (or any rights of importance).
75. The focus on the entity as a whole also provides financial engineering opportunities. This is because all of the assets and all of the liabilities follow the party deemed to control the entity.

### **What are the Real Rights and Responsibilities?**

76. The correlation between risks and rewards is not always perfect. It is possible that an entity will have power over another entity's strategic financing and

operating policies because the first entity owns the largest single shareholding of the other entity, even though it holds less than a majority of the shares. In such a case, full consolidation would apply because the first entity has control over the assets and liabilities of the other entity. In other words, power is power.

77. The recognition and derecognition of an interest in a business unit or entity is relatively straightforward when the variability of benefits occurs *at that level*. For securitisations of financial assets and liabilities (and other common SPE activities), which are specifically designed to segregate and reallocate benefits and risks relating to the assets and liabilities, the analysis needs to be performed *at a more detailed level*. That is to say, in some circumstances it will be necessary to ‘look through’ the entity in order to identify the assets and liabilities that should be recognised by each of the parties.
78. When there is no real present choice of strategic financing and operating policies, evidence of an entity’s exclusive rights and responsibilities over another entity’s assets and liabilities is provided by taking a wider view of the arrangements because evidence about which party makes the limited present choices becomes less relevant in deciding issues of control. In other words, it might be necessary to consider the rights and responsibilities of the parties in order to assess which assets and liabilities they have control over and responsibility for. It might be the case that this assessment will result in one party consolidating the entity.
79. ‘Taking a wider view’ typically is necessary in the absence of traditional control criteria (ie, based on power and benefits criteria, linked by a requirement that a controlling entity be able to use the power to increase, maintain, or protect benefits) because the party with power and/or the party who benefits will not always be obvious. There is an interrelationship between the traditional control model (ie, having power so as to benefit) and the risk and rewards model (ie, having exposure to the majority of the benefits and risks) because the party that is exposed to the majority of the risks and rewards of an entity will likely demand some form of power over the entity. Both models refer to being able to benefit from the activities of the entity and both models assume that there are risks involved with realising those benefits. However, the risk and rewards model assumes that the traditional indicators of control are not evident and the underlying assumption is that the existence of risks and rewards will point toward the party (or parties) that effectively has control.
80. In fact, the absence of control in the traditional sense does not necessarily mean that the entity’s ‘real’ rights over the assets are not in proportion to its ‘real’

power the assets. In the traditional control model this normally will be indicated by the level of voting rights held, and the rights and power will be evident. In some cases, however, the investors' 'real' rights might not appear to be proportionate to the power held, although in fact they are proportionate.

81. In an operating business, the common equity holders have the right to an entity's residual returns and the obligation to absorb losses. Because they absorb the entity's variability, equity holders will generally require some level of control over the entity, usually in the form of voting rights. That is to say, the equity holders' 'real' rights and 'real' power are proportional.
82. In some cases, however, the equity investors appear to have voting rights that are out of proportion to their risk exposure. The equity holders do not have the typical rights (such as voting rights) associated with an equity investment (ie, the risks and rewards are not correlated with the voting rights) because they do not absorb the variability of the assets and liabilities and therefore are not exposed to the residual risk. However, once one factors in the likelihood of those investors actually absorbing the variability of the assets or considers what decisions those investors have real influence over it is likely, in many cases, that the power and benefits will be shown to be proportional. For example, the equity investors of an SPE might appear to have power because they have voting rights; however, their real power is limited because the voting rights do not provide them with the right to assert power over the entity. In other words, the 'real' rights and 'real' power are, in fact, proportional.
83. In addition, the level of residual risk might be immaterial because the variability of the assets, and liabilities, of the entity has been allocated to other parties. This means that focusing on who absorbs the residual risk does not provide an indication of who is absorbing (substantially all of) the variability of the assets. And, as we have already stated, the parties that do absorb that variability presumably expect to have control over that portion of the assets.

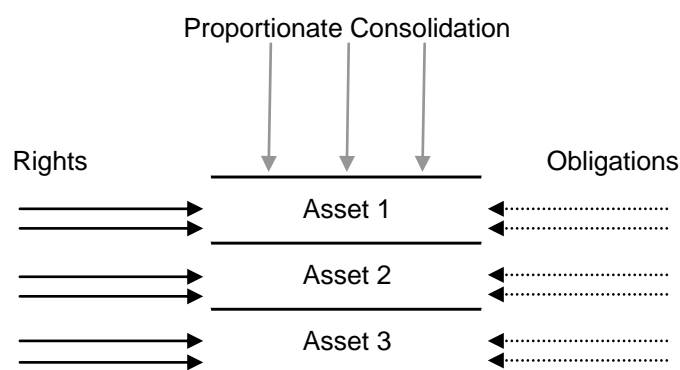
### **Is Consolidation Always Appropriate?**

84. The US FIN 46(R) and SIC-12 reliance on assessing who receives the risks or rewards of ownership creates two fundamental dilemmas:
  - (a) Is it appropriate to account for, on a consolidated basis, the benefits represented by an entity's assets and not simply the direct benefits that the participants control through their investment?

- (b) Is it reasonable that changes in the levels of risks and/or rewards due to outside factors (such as changing market conditions) **when the economic rights and obligations have not changed** should influence which party should consolidate the entity?
85. To avoid practical misunderstandings and uncertainty, the staff therefore is proposing a single control model and not a risk and rewards model. Having said that, as stated in paragraphs 76-83, the identification of risks and rewards might, however, be helpful in the assessment of who has control over the assets and liabilities of the entity.
86. In December 2003, and again in March 2006, the staff asked the Board to consider whether, rather than consolidation, it would be better to look directly at what could be termed the ‘substantive undivided interests’ of an entity’s participants. This would reflect the fact that, in this situation, no party has control over the entity as a whole. Rather, each participant has control over its particular interest in the entity and a portion of its underlying assets and liabilities.<sup>9</sup>
87. In effect, the participants in the arrangement are like joint venturers, each of which is responsible for its portion or interest in the entity. The staff would like to emphasise that this is not proportionate consolidation. In proportionate consolidation, a top-down approach is taken such that all assets and liabilities are recognised in proportion to the investor’s ownership interest. In contrast, the proposed model is similar to a components approach in which the assets and liabilities recognised are based on the rights and obligations of each participant.
88. The ‘components’ are those of the entity, as well as those of the assets. For example, in an asset backed securitisation arrangement some parties having the rights some of the assets of the entity (an entity component), some having the rights to the principal payments and others having the rights to the interest payments (asset components).

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<sup>9</sup> This is not to say that the participant only has control over its share investment in the entity. Arguably, with these types of entities the participants often have not really given up control over either the assets they have transferred upon creation of the entity or during a subsequent investment. Although the participants do not have control over the entity, they do have control over their investment in that entity (by way of either the assets that have been transferred or a subsequent investment that has been made).



89. It might be, as anticipated by US FIN 46(R), that the proportion of risks assumed differs from the proportion of rewards to which the investor is entitled. The investors would recognise the rights and obligations separately. Such an approach would be consistent with the application of a purely control-based consolidation model to entities with predetermined strategic operating and financing policies. This approach would also be consistent with that suggested in UK FRS 5.<sup>10</sup>
90. The staff believes that the accounting treatment should be consistent, regardless of the type of entity in which the asset resides. Consider a simple example of an asset under three circumstances:
- (a) Owned outright,
  - (b) Placed in a wholly-owned subsidiary, or
  - (c) Transferred to a securitisation arrangement.
91. The asset **owned outright** [case (a)] would be recognised by the entity. In this case, it is generally easy to determine that the entity has the risks and rewards of ownership and therefore control over the asset.
92. The **asset placed in a wholly-owned subsidiary** [case (b)] would be recognised if the subsidiary was controlled by the entity owning the subsidiary. Traditional control principles would apply and the asset would be recognised upon consolidation.
93. The **asset transferred to a securitisation arrangement** [case (c)] would require further analysis. If the transferor receives benefits from and is exposed to **the risks of the asset, the asset should be recognised.**<sup>11</sup> It is important to ask

<sup>10</sup> The types of arrangements discussed in this paper would fall under what FRS 5 refers to as ‘special cases’ in its paragraph 23. The treatment of a multi-originator securitisation is covered in paragraph D15 of the Application Notes.

<sup>11</sup> This assumes that the entity holds only assets that have been transferred by the transferor and that the transferor is the only investor in the entity.

‘who owns what’ and to consider what it is that each party receives and gives up in a transaction. The accounting treatment should not be different merely because the asset resides in an SPE or other entity rather than in an operating subsidiary.

94. The decision of whether (and what) to consolidate depends on an entity’s ability to benefit from the assets and liabilities of another entity and the exposure to the risks inherent in those benefits. That is to say, the accounting should reflect the economic rights and obligations of the participants. In the case of an investor controlling the entity as a whole, there should be no practical difference between the recognition of assets and liabilities when an entity is consolidated using the traditional control model and the recognition of the individual assets and liabilities when you ‘look through’ the entity to identify the parties’ benefits and risks. The assets of the entity belong to, and should be recognised by, those to whom cash collections are distributed (ie, the parties that benefit) and who is exposed to the variability of the cash flows (ie, the parties that have the corresponding risks).<sup>12</sup> That is to say, the model needs to work regardless of the structure of the entities involved.
95. As in IAS 39, derecognition of the transferred assets should not be available unless the assets have truly been sold and no significant benefits or risks are retained in the entity or its underlying assets. Derecognition treatment should not be available when there is an insignificant change in economics. Furthermore, investments made in these entities after their creation should not lead to non-recognition of the investors’ interests merely because the rights and obligations are not apparent. It is important that we not get into the situation where assets and liabilities are not recognised, regardless of the passivity of the activities of the arrangement, simply because the ‘traditional’ control criteria are not met.

## **Proposed Accounting Treatment**

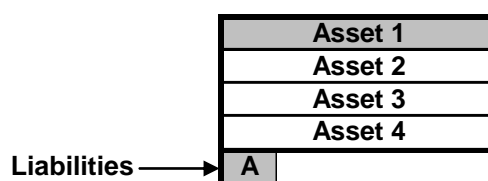
96. In most cases, it will be obvious which party controls an entity and should therefore consolidate it. This will most often – but not always – be the case when an entity has been established to further the objectives of the creator, and the creator has the right over the operating and financing policies of the entity. However, because there are situations in which control over an entity or its assets is not obvious, the solution therefore might be a two-stage model in

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<sup>12</sup> If specific conditions are met, the accounting treatment for pass-through arrangements is determined by the principles of recognition and derecognition under IAS 39 rather than by the principles of consolidation.

which, first, the existence of control is assessed<sup>13</sup> and, second, if control cannot (or should not) be established by ‘traditional’ means, each investor will recognise the respective rights and responsibilities related to their interest in the entity.

97. The existence of risks and rewards can help assess control. It might be that one entity controls the whole entity. Alternatively, it might be that the entity has control over particular assets and liabilities of the entity. When the rights and obligations to the individual assets and liabilities have been clearly identified, then the entity should recognise those rights and obligations for which it has control over, **and not others**.
98. Since the liabilities and losses might not be proportionate to assets and income, these would be accounted for separately. The staff suggests that the assets and liabilities be shown separately and not ‘net’.
99. To illustrate, assume an entity has an investment in a securitisation arrangement. During an assessment of the risks and rewards of each of the investors, it becomes evident that the entity has the rights to Asset 1 and is responsible for Liability A. This can be shown graphically as:



100. To reiterate, the staff is not proposing full consolidation of **all** entities that are within the scope of SIC-12, or that **none** of them be consolidated, but rather accounting for each party’s economic investment in these entities. This is because control is held over the investment in the entity, not the entity itself or its underlying assets. The amounts to be recognised by each investor include:
  - (a) The assets over which rights are held,
  - (b) The obligations and risks assumed,<sup>14</sup> and
  - (c) Any income or losses received.
101. Having said that, it is likely that the definition of control **will** be met in cases in which an entity was created by a party for the purpose of meeting the objectives

<sup>13</sup> The party that has control under the ‘traditional’ control model will consolidate the entity.

<sup>14</sup> Liabilities to be recognised might include guarantees of debts, residual values, and asset values and other obligations incurred as a result of the asset transfer.



of that party. In such cases the party should fully consolidate the assets and liabilities of the **entity**.

## Summary

102. This paper focuses on those arrangements for which it is difficult to conclude that one entity controls another entity using the traditional control criteria, perhaps because the policies have been predetermined or the holders of the voting rights are not the real absorbers of the variability of the assets and liabilities of the entity. It is meant to assist in developing principles for consistent accounting in situations in which the form of the arrangement makes it difficult to assess the rights and obligations of a party with an interest in an entity.
103. The model the staff is developing is consistent with the principles underlying IAS 27, SIC-12 and US FIN 46(R). It does not create classes of entities, but rather it assesses the rights and responsibilities that one entity has in the assets and liabilities of another entity.
104. The main difference between the proposed model and the existing models (particularly US FIN 46(R)) is that the objective of the proposed model is not limited to identifying which party shall consolidate all of the assets and liabilities of an entity. Because the party absorbing the majority of the variability of an entity might, in fact, be absorbing all of the variability of some of the assets of the entity and none of the variability of other assets of the entity, a requirement for that party to consolidate all of the assets of the entity could result in it reporting assets that it does not control and for which it does not absorb variability. Conversely, the party that absorbs all of the variability of those other assets (and presumably has some power over them) does not report those assets. The staff believes that this approach does not show a true economic picture regarding the ‘real’ interests of the parties involved.
105. The staff realises that the principles in this paper will be difficult to operationalise and to draft into a revised IFRS. However, operational difficulties should not get in the way of identifying the best conceptual base from which to develop the Standard. These principles will allow us to assess the rights and responsibilities a party has with regard to interests in entities for which the traditional control criteria do not apply. The staff believes that this approach avoids creating silos or boxes that, almost inevitably, are separated by bright lines and that lead to opportunities to ‘get around the rules’. Most importantly, it attempts to reflect the economic reality of these types of transactions.

106. The staff would like feedback from the Board regarding the proposed approach.  
*In particular, does the Board agree with the underlying principles as they apply to entities that cannot be analysed using the traditional control model?*

## Appendix A

### Summary of Previous Board Decisions (including Tentative Decisions) regarding Entities within the Scope of SIC-12

- A1. **July 2002:** There should be a comprehensive standard covering consolidation of both SPEs and non-SPEs. Consistent criteria should be developed for all entities, whether or not SPEs and whether or not passive, rather than excluding certain categories of entities from the application of the provisions.

When the existence of control is not evident by traditional means, the Board agreed with the FASB that control should be assessed by examining the variable interests of the participants. To determine which entity should consolidate, consideration must be given to the order of loss, the size of the potential loss exposure and the benefits applicable to each party's interests. Application of the principles may result in no entity consolidating an SPE.

It does not follow that derecognition means non-consolidation, but some entities that are controlled may have little in the way of assets because they have been dispersed to other participants. In this light, there does not seem to be a need to exempt entities similar to US qualifying SPEs.

- A2. **October 2002:** Where control cannot be assessed by looking at who has the power to direct financial and operating policies, control should be assessed by other means. Parties who hold the majority of variability of the outcome ('variable interests') related to an SPE are akin to majority equity holders and should consolidate the SPE. Where the variable interest approach does not identify a party in effective control, components held by each party should be recognised.

There should be no specific carve out for particular transaction types (such as the US qualifying SPE classification) due to the resulting complexity.

- A3. **December 2003:** SPEs were defined as entities whose policies were so extensively predetermined that the remaining policies cannot be described as that entity's 'strategic operating and financing policies'. The entity responsible for predetermining an SPE's strategic operating and financing policies satisfies the power criterion and is likely to be the SPE's controller.

An entity involved with an SPE post-policy determination seems unable to satisfy the power criterion. However, an entity ultimately responsible for an SPE's policy determination might use an agent and that an entity that appears to

be involved only with an SPE post-policy determination might have directed that policy determination. These entities would satisfy the power criterion.

Indicators, such as an entity's risk exposure to an SPE and whether the SPE's activities further an entity's business purposes, might assist in identifying the entity ultimately responsible for an SPE's predetermined policies.

A4. **February 2004:** Entities that fall within one or more of the following categories are straw men for an investor:

- (a) The investor's related parties as defined in IAS 24 *Related Party Transactions*;
- (b) An entity that received its interest in the investee as a contribution or loan from the investor;
- (c) An entity that has an agreement that it cannot sell, transfer or encumber its interest in the investee without prior approval of the investor;
- (d) An entity that cannot finance its operations without financial support from the investor;
- (e) Employees of the investor;
- (f) An entity that has a close business relationship with the investor (like that between a professional service provider and one of its significant clients); and
- (g) An entity with the same board of directors as the investor's.

Categories (e) and (f) should include only those entities highly likely to be dominated by the investor. For example, in the case of SPEs, (e) should be restricted to senior management and it should be clarified that (f) is not intended to capture 'standard' business relationships such as that between a customer and its suppliers.

The exposure draft of the revised standard should include a rebuttable presumption that the holdings of straw men, as listed above, should be assumed to be available to an investor in assessing whether that investor meets the power criterion, subject to evidence that those holdings are in fact not effectively held as agent for that investor.

A5. **October 2005:** 'Control' can arise in circumstances in which an investor holds less than half of the voting rights in an entity. This means that an entity might have power over another entity but be entitled to less than half of the benefits.