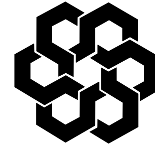

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International Accounting Standards Board

This document is provided as a convenience to observers at the IASB-ASBJ meeting, to assist them in following the 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 meeting. Paragraph numbers correspond to paragraph numbers used in the papers. However, because these notes are less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

IASB-ASBJ Meeting: **September 2007, London**

Project: **Consolidation (Agenda paper 1-2)**

Introduction

1. This paper is structured as follows:

    a. Section 1 summarises the objectives of the Consolidation project and the Board's tentative decisions to date (paragraphs 3-15).

    b. Section 2 explains the Board's view regarding control by an investor with less than a majority of voting rights (paragraphs 16-19).

    c. Section 3 explains an aspect of the project for which IAS 27 *Consolidated and Separate Financial Statements* and US GAAP have different requirements—investment companies (paragraphs 20-34).

2. Sections 2 and 3 include questions for discussion (paragraphs 18-19 and 33-34). The Board and staff value the views of the ASBJ and its staff on those matters.

Section 1: The Consolidation project and tentative decisions to date

The project

3. The goal of the Consolidation project is to publish a single IFRS on consolidation to replace IAS 27 *Consolidated and Separate Financial Statements* and SIC-12 *Consolidation – Special Purpose Entities* such that the control criteria within a single IFRS should be developed for all entities.

4. The next milestone in this project is to issue a discussion paper on consolidation. The discussion paper will address the control criteria and principles. The Board expects to publish the discussion paper in the first quarter of 2008.

5. The Board has been developing the project with the following principles in mind:

   a. Consolidation should be based on the principle of reporting a parent and its subsidiaries as if it were a single economic entity.

   b. Identifying whether an entity is a subsidiary should be based on the notion of control, ie an entity's control of another entity should be used as a proxy for identifying the assets controlled by the first entity. Thus the concept is linked to access to economic benefits, and associated exposure to risks.

   c. Only one entity can control another entity. In other words, control must be unilateral or non-shared.

   d. There should be no exemption from consolidation because a subsidiary's operations are dissimilar to that of its controller's or because an entity adopts measurement models different to those of the controller.

   e. Consistent control criteria and a single comprehensive IFRS (to replace IAS 27 and SIC-12) should be developed for all entities, including SPEs.

Tentative decisions to date

The definition of control

6. The Board has tentatively decided 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. Therefore, to control an entity the potential controller must satisfy three tests:

   a. it must have the ability to direct the strategic financing and operating policies of the entity (the 'Power Criterion');

   b. it must have the ability to access the benefits flowing from the entity (the 'Benefits Criterion'); and

   c. it must be able to use its Power so as to increase, maintain or protect the amount of those benefits.

Power with less than a majority of the voting rights

7. The Board has confirmed its view that an entity holding a minority interest can control another entity in the absence of any formal arrangements that would give it a majority of the voting rights.

Potential voting rights (options over an entity)

8. The Board tentatively decided that when an option holder holds sufficient options that, if exercised, would place it in control of another entity, that is not sufficient, in itself, to establish that the option holder meets the Power criterion. However, there might be situations in which the holding of options, taken in conjunction with other facts and circumstances, indicate that the option holder currently has power over the entity.

9. The Board has also tentatively concluded that whether or not exercise of potential voting rights is economically favourable to the holder of those rights is not relevant to the assessment of whether the Power criterion is satisfied.

Veto rights

10. Parties such as minority shareholders or lenders may have the right to veto decisions or their consent may be a prerequisite to some decisions. The Board has tentatively concluded that veto rights, even if limited to the ability to block actions, may negate control if those rights relate to operating and financing policies. To negate control those veto rights must also relate to decisions in the ordinary course of business—rather than being limited to fundamental changes in the organisation (such as disposals of business units or acquisitions of significant assets).

11. The Board has also tentatively concluded that veto rights may in some circumstances be sufficient to enable holders to exercise control.

Parties acting as agent for another party

12. The Board has tentatively concluded that the holdings of interests of parties effectively acting as agent for another entity should be considered in assessing whether that other entity is a controller.

Applying the control concept to fiduciaries

13. The Board has tentatively decided that the proposals should clarify how the control concept should apply to fiduciaries by specifying those aspects of a

fiduciary relationship that differentiate the particular circumstances of a fiduciary from those of a controller.[1]

Investment companies

14. The Board affirmed that investment companies (such as private equity entities and venture capital organisations) should not be excluded from the scope of the proposed standard. The Board concluded that the information needs of users are best served by financial statements that consolidate investments under the control of the reporting entity.

Temporary control

15. The Board has tentatively concluded that the fact that control of an entity might be temporary does not of itself change the assets controlled by an entity. During the time that control is held and until such time as control ceases, the controlled assets are part of the economic entity and should be recognised as such.

Section 2: Control with a minority of the voting rights

16. During its deliberations on the consolidation project, the Board confirmed its view that an entity holding a minority interest can control another entity in the absence of any formal arrangements that would give it a majority of the voting rights. Professional skill and judgement is required in applying the control concept including determining if control exists. The Board plans to include guidance in the discussion paper to assist preparers in exercising judgement. The discussion paper will suggest the type of indicators and situations in which an entity could control another entity without holding a majority of the voting rights.

17. The following are examples of situations in which the Board is of the view that control exists:

    a. A minority shareholder is able to dominate the voting and the remaining holdings have not organised themselves in a way that prevents the minority from asserting this dominance.

    b. A minority shareholder when it has the majority of voting rights through agents. The discussion paper will include a rebuttable presumption that the following holdings should be assumed to be available to an investor:

[1] A fiduciary relationship exists when one party (the fiduciary) is required to work for the benefit of one or more other parties to whom it owes fiduciary responsibilities under common law, equitable principles, contract, statute or regulation.

i. the investor’s related parties as defined in IAS 24 *Related Party Transactions*;
ii. an entity that received its interest in the investee as a contribution or loan from the investor;
iii. an entity that has an agreement that it cannot sell, transfer or encumber its interest in the investee without the prior approval of the investor;
iv. an entity that cannot finance its operations without financial support from the investor;
v. employees of the investor (that are likely to be dominated by the investor);
vi. an entity that has a close business relationship with the investor (and is likely to be dominated by the investor); and
vii. an entity with the same board of directors as the investor’s.

Questions for discussion

18. Do you agree that it is possible that an entity holding a minority interest can control another entity? If not, why?

19. If you agree, what guidance would be helpful to include in the discussion paper on consolidation?

Section 3: Investment companies

The problem

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

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

> The Board concluded that for investments under the control of private equity entities, users’ information needs are best served by financial statements in which those investments are consolidated, thus revealing the extent of the operations of the entities they control. The Board noted that a parent can either present information about the fair value of those investments in the notes to the

> consolidated financial statements or prepare separate financial statements in addition to its consolidated financial statements, presenting those investments at cost or at fair value. By contrast, the Board decided that information needs of users of financial statements would not be well served if those controlling investments were measured only at fair value. This would leave unreported the assets and liabilities of a controlled entity. It is conceivable that an investment in a large, highly geared subsidiary would have only a small fair value. Reporting that value alone would preclude a user from being able to assess the financial position, results and cash flows of the group.

Staff analysis of a scope exclusion

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

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

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

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

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

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

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

28. Once an entity meets the definition of a subsidiary it should be consolidated into the group financial statements. Consolidating the entities requires the elimination of transactions between that entity and the group. One of the disadvantages of exempting an entity from being consolidated is that the intra-group transactions and balances are not eliminated even though the parent entity has power over both sides of the transactions.

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

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

31. We think that there is no merit to exempting entities from consolidating other entities that they control. Rather, it is a matter of determining whether it is more beneficial to present information in a different way within the boundaries of the consolidated financial statements.

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

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

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

c. if it is appropriate for the primary financial statements to present investment companies as a net investment, that decision should be based on principles of aggregation. That is to say, it might be appropriate for the assets and liabilities of an investment company to be viewed as a ‘class’ and presented as a net investment.

Questions for discussion

33. Do you believe that there are any grounds for excluding from consolidation an investment company that is controlled?

34. If you agree with the staff that an entity should consolidate all entities that it controls, what are your views on presenting an investment company as a net investment within the boundaries of the consolidated financial statements?