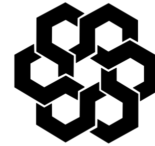

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International Accounting Standards Board

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: **17 April 2008, London**

Project: **Consolidation**

Subject: **Consolidation (Agenda paper 8A)**

Introduction

1. The Board has asked the staff to develop an IFRS to replace IAS 27 *Consolidated and Separate Financial Statements* and SIC-12 *Consolidation—Special Purpose Entities*.

2. The consolidation project has become increasingly important because of the current credit crisis. Regulators, among others, are questioning whether the current accounting for securitisation transactions and the type of vehicle sometimes used to facilitate these transactions is appropriate. Specifically, are the derecognition requirements in IAS 39 and the consolidation requirements in IAS 27 and SIC-12 generating financial statements that reflect the assets and liabilities of the reporting entity? We are also being asked to assess whether the disclosure requirements related to securitisations, guarantees, special purpose entities and structured investment vehicles are adequate.

3. Over the last few months the consolidations team has been analysing financial statements, meeting with representatives from investment banks and accountancy firms and assessing statements from regulators about what they perceive to be 'good practice and good disclosure'. One of the difficulties our review has highlighted is the misunderstanding of the role of some of the problematic entity types, particularly SIVs.

4. The purpose of the session at the April Board meeting is to provide the Board with an overview of this analysis and to describe how we expect this to translate into new proposals to replace IAS 27 and SIC-12. This paper provides some of the seeds for that process. We will not be asking the Board to make decisions at the April session. We want the Board to be aware, however, that when we do return we expect to present a complete package of proposals.

Background

5. The objective of general purpose external financial reporting is to provide information that is useful to present to potential investors, creditors and others in making investment, credit, and similar resource allocation decisions.[1]

6. When a reporting entity has an investment in, or relationship with, another legal entity, the instrument of the relationship will be an asset, or a liability, of the reporting entity.

7. There are circumstances in which the relationship the reporting entity has with the legal entity gives it rights sufficient to be able to use or manage the assets and liabilities of that legal entity as if they are its own. In such cases, it is more meaningful to ignore the legal boundaries of the other entity and report the combined resources and activities of the entities as if they are conducted by a single economic entity (the group). These are the consolidated financial statements. The consolidated financial statements should provide a user with insights into the amounts, timing and uncertainty of the group's future cash flows.

Developing a control model

8. From the outset, consolidation of an entity has been based on whether one entity controls another. In simple terms, if a reporting entity controls a second entity, the first entity is a parent and the second entity is a subsidiary.

9. In early standards, control of an entity was assessed on whether one entity had more than half of the voting rights in the second entity. Having more than half the votes would give that party the ability to control the governing body. That simple test has proven to be inadequate. There are other ways to control a governing body, by agreement for example, and many arrangements have developed whereby an entity clearly controls another entity without having a majority of the voting rights.

10. IFRSs have evolved by developing a wider test of control. IAS 27 defines control as *the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities*. Control is often discussed with

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[1] **Preliminary Views on an improved Conceptual Framework for Financial Reporting:** The Objective of Financial Reporting and Qualitative Characteristics of Decision-useful Financial Reporting

reference to operating and financing policies and decision making. We refer to this as the traditional control model.

11. There are, however, arrangements that are difficult to assess using the traditional control model. Some arrangements have developed in practice whereby the financing and operating decisions have been predetermined. Others have evolved whereby the majority of the voting rights are allocated to a party but not the other economic characteristics that go with ownership.

12. The IASB developed SIC-12 to help apply the control model to cases where the financing and operating policies have been predetermined. The model we are developing is not a complete rethink of IAS 27 and SIC-12. In fact, it builds on the principles underlying those IFRSs, and is intended to provide one cohesive approach to the consolidation of all entities.

Consolidation

13. The consequences of deciding that one entity controls another are clear. The parent combines the financial statements of the subsidiary with its own, after making adjustments for transactions between the parent and its subsidiary (because they are intra-group transactions).

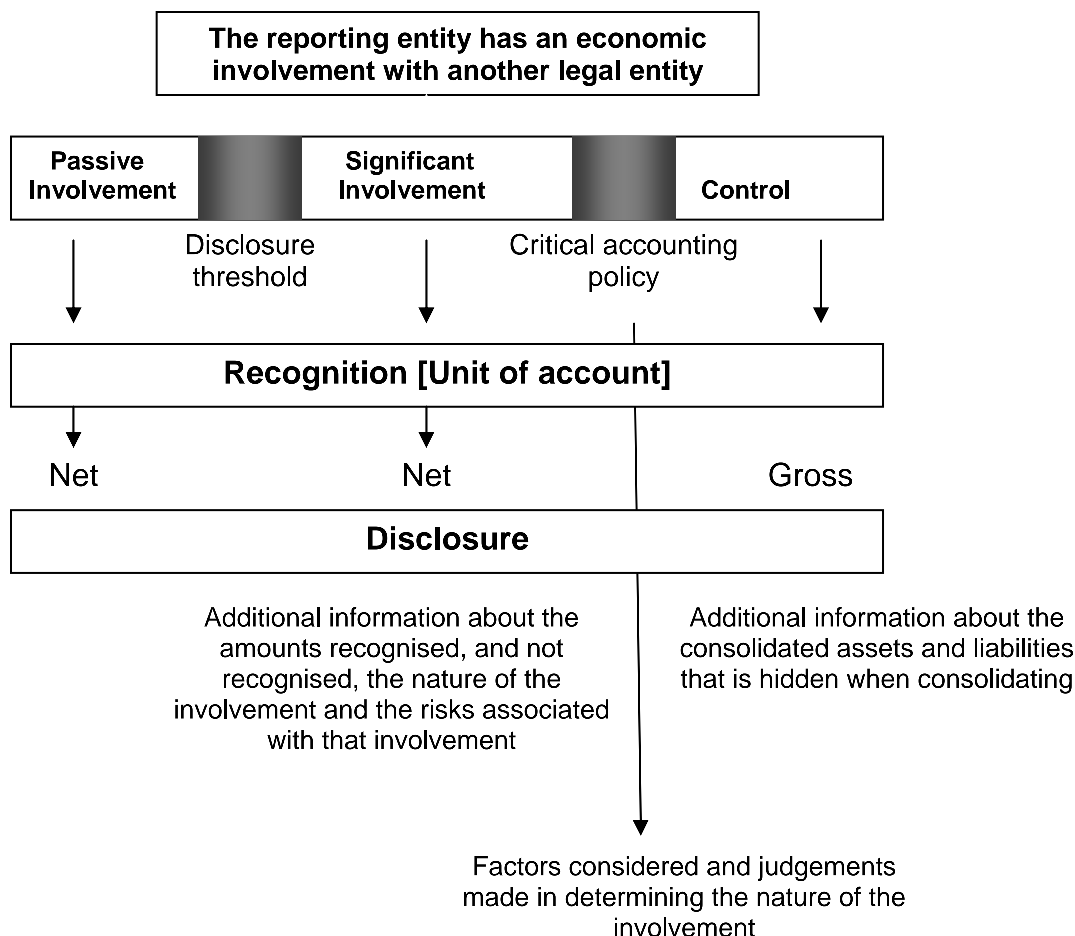
14. The consequences of deciding that one entity does not control another are, often, also clear. That second entity is outside of the group and, particularly for structured financing and investing vehicles, little additional information is reported in the financial statements of the first entity. That paucity of information can belie the importance of the economic relationship between the entities and the significance of the assessment of control. We therefore think it is just as important to consider what information would be helpful to users when difficulties occur with assessing the nature of the relationship between two entities and when the relationship is significant but not sufficient to give one entity control over the other.

15. The message here is that there are a lot of pressure points in the project. If we do not get the right recognition (control) criteria in place, the loss of information can be significant. The following diagram highlights where we see the pressure points. It also suggests that we see disclosure as being particularly helpful when an entity has off-balance sheet interests (that it does not control) and to help explain the judgements that might be necessary in assessing a reporting entity's involvement with another entity.

16. We are not suggesting that disclosure be viewed as a substitute for developing the right control model. First and foremost, we need to get the recognition principles right. We simply believe that disclosures can provide enhanced information for users to support both consolidated assets and liabilities, and

those that are not consolidated. Paragraphs 34 to 45 of this paper discuss the approach to disclosure in more detail.

17. The diagram is not designed to provide answers. Its purpose is to provide a framework for the questions and issues we are resolving.



Control, significant involvement and passive involvement

18. We are developing guidance about what types of involvement might constitute control, significant involvement and passive involvement—the types of involvement that an entity has in another entity that should drive its decision as to whether it controls or not. That is not to say that we want to create lists of involvement under each of the three captions, effectively creating boxes and rules for determining control. For example, an equity investment in an entity could result in control, significant involvement or passive involvement, depending on the extent of the involvement and the reporting entity's rights associated with that equity investment.

19. We think that there is a continuum of involvement, starting at one end of the scale by, for example, owning one share in a large multinational entity, to the other end of the scale, when a reporting entity might have unanimous power to

determine how an entity operates by owning 100% of all debt and equity of the entity.

20. It is our job to provide *guidance* to help entities make the control decision, not to make that decision for management and in the process create bright lines in standards. However, there are, and will be, grey areas between passive and significant involvement, and significant involvement and control. The decision as to whether one entity controls another might be very difficult—if that is the case, we are proposing that the entity would provide enough supporting information to users about the judgements applied in, and the consequences of, making that decision.

21. We want to bridge the gap between deciding whether an entity is 'on or off balance sheet'. If the control decision is difficult, but management has reached a decision that it does not control another entity, then it would be incorrect to consolidate that entity. But, the reporting entity should be required to provide extra disclosure about how it made the difficult decision, and about its significant involvement.

Control of an entity versus significant involvement

Control

22. We are using the following working definition of control:

> A reporting entity controls another entity when it has sufficient rights that it has the power to be able to use or manage the assets and liabilities of that entity as if they are its own. That power must give the reporting entity the ability to affect the financial variability of the entity and the benefits from, or exposure to, that financial variability.

23. The working definition is consistent with the current definition in IAS 27 in that it includes a power element *and* a benefit element. Control is achieved only when both elements exist. The definition differs somewhat from IAS 27, however, in that it does not describe the power element solely as the ability to govern the financial and operating policies of an entity. That is not to say that we think that such ability would not meet the power element. We agree that it would. However, we do not think that the *only* way to meet the power element is to have the ability to govern the financial and operating policies of an entity. This change is intended to address the difficulty in applying the current definition to entities that do not have, or have only limited, financial and operating policies.

24. Control is also based on the following working principles:

    a. Only one party can control an entity. The party that controls an entity is able to exclude others from using or managing the assets and liabilities of that entity and from the related benefits.

b. Assessing whether a reporting entity controls another entity is a continuous process. A reporting entity begins consolidating the financial statements of another entity with its own financial statements when it achieves control and ceases consolidation when it loses control.

c. Control refers to the ‘present ability’ to control another entity; it is not based on whether the reporting entity controlled yesterday or might control tomorrow.

25. Some of the consequences of those principles are as follows:

a. One entity holding sufficient voting rights to exclude others from the strategic decision making process constitutes control—this is usually derived from having the majority of voting rights. However, the holding of a minority of the voting rights of another entity constitutes control if all other voting rights are dispersed and the other shareholders have not organised their interests in such a way that they exercise more votes than the minority holder.

b. Joint or shared control is not sufficient for consolidation.

c. Consolidation is not excluded if control is intended to be temporary.

d. A passive controller controls an entity, irrespective of whether that control is exercised or not. For example, an investment company that controls an investee should consolidate irrespective of whether it participates actively in the investee’s activities on an ongoing basis or manages its participation as an investment.

e. A reporting entity does not control another entity if action must be taken for it to gain control. For example, holding an option or convertible instruments that would give the holder control if exercised is *not* the same as having control after exercise.

f. An entity acting as an agent does not control another entity—it will fail either the power or benefits element of the definition. For example, an entity acting primarily as a fiduciary or fund manager, for the benefit of others, would not control the entity that it manages.

g. One entity’s ability to terminate the activities of another entity for its own benefit (perhaps by having the right to acquire all assets of the entity at any time) is likely to constitute control.

h. One entity’s ability to set or change the activities of the entity for its own benefit (and exclude others from making changes) constitutes control. (For example, by having the ability to change the eligibility criteria for assets or change the financing of the entity.)

i. The standard will not identify 'reconsideration events'—specific events that require an entity to reconsider whether it controls another entity. The requirement to reconsider control on a continuous basis is built into the principles.

26. We intend the control model to apply consistently to traditional operating entities and structured entities (such as securitisations, SIVs and conduits). For example, we are of the view that a reporting entity, which holds less than 50% of the voting rights and has rights to less than 50% of the benefits of an operating entity, can control that entity in particular situations. It follows then that an entity, which is not controlled by voting rights but by predetermination at the time of establishment, could be controlled by a reporting entity that is entitled to less than 50% of the benefits of that entity in particular situations.

Significant involvement

27. If an investor does not control the investee, and therefore the investee's assets and liabilities are not the assets and liabilities of the group, the appropriate unit of account is the net investment.

28. We will need to add guidance on what would constitute significant involvement. At this stage, we have described 'significant involvement' as a reporting entity's involvement in ways that does not constitute control but that could have a material effect on the reporting entity's financial statements.

29. Some types of involvement that we envisage could constitute significant involvement (assuming that those types of involvement do not constitute control) are as follows:

    a. Significant involvement of an operating nature

        i. Joint control

        ii. Significant influence

    b. Significant involvement of an investing or financing nature (most commonly associated with structured vehicles)

        i. Investor in senior or subordinated interests of an entity

        ii. Provider of liquidity support

        iii. Provider of credit enhancement

        iv. Servicer or manager of assets and liabilities

        v. Sponsor or arranger of a structured vehicle

        vi. Purchased or retained interests in assets transferred to another entity.

Passive involvement

30. We think it unnecessary to define passive involvement. It is involvement with an entity that does not constitute significant involvement or control. Passive involvement with another entity would include, as examples, the holding of small equity interests, the provision of financing by an unrelated third party (for example, a bank), and a typical supplier or customer relationship. We have no intention of introducing requirements that would result in entities investigating and disclosing every relationship or involvement that it has with other entities as part of its consolidation process.

Recognition, measurement and disclosure

31. The unit of account for passive involvement is the net instrument (eg shares in an entity, guarantee etc.)

32. The current requirement is, generally, that an interest in an entity is a financial instrument and is therefore measured at fair value. We say generally because the involvement might not cause the reporting entity to recognise a financial asset (or liability).

33. We see no basis for changing this requirement or for changing the disclosure requirements.

Disclosure

34. The following paragraphs give an overview of our initial thinking regarding disclosure. This thinking is largely based on reviewing the financial statements of large reporting entities and identifying what we think is missing or could be improved.

Objectives of the disclosure proposals

35. Our objectives in developing disclosure proposals for consolidated and non-consolidated entities are as follows.

    To disclosure information that enables users of financial statement to evaluate:

    a. the judgements made by management in applying the reporting entity's accounting policies when reaching decisions to consolidate or not.
    b. the nature and financial effect of restrictions on assets and liabilities resulting from legal entity boundaries that exist within the reporting group.
    c. the nature of, and risks associated with, the reporting entity's significant involvement with legal entities that it does not control.

36. There are a number of principles or guidelines that underlie our thinking in developing the disclosure proposals:

a. A reporting entity should provide more information when decision-making is difficult, and vice versa. For example, the more difficult the decision regarding whether or not to consolidate, the more information should be provided about how management reached its decision that it controls or does not control an entity. Put another way, the more judgement that management has applied, the more information should be provided about how that judgement was applied and the effect on the financial statements if a different conclusion had been reached.

b. A reporting entity should locate information about its involvement with consolidated or non-consolidated entities in a way that provides a complete picture, rather than scattered through notes.

c. A reporting entity should provide quantitative information in tables that are supported by narrative descriptions of the amounts included in the tables. That is, unlike other IFRSs, we would prescribe particular formats of reporting. For example, when appropriate, we would require particular information to be presented in tables; the amounts included in those tables should reconcile to other parts of the financial statements; users of financial statements should be able to reconcile the narrative information to the amounts included in the tables; the narrative should explain all material amounts included in the tables, rather than selected or partial amounts only.

The decision

37. IAS 1 already requires an entity disclose information about the judgements that management has made in the process of applying the entity's accounting policies and that have the most significant effect on the amounts recognised in the financial statements.

38. When the decision to consolidate or not is difficult, we think that this is the type of judgement that IAS 1 had in mind. Yet, our assessment is that little is ever disclosed explaining why an entity has not been disclosed even if that decision has been difficult.

39. We would include a requirement in the proposed standard that an entity explain why it has assessed that it has a significant involvement in an entity but does not control that entity. We will need to take care to ensure that we avoid boilerplate replies. The disclosure should also be limited to those decisions requiring judgement.

40. If the decision to consolidate or not is difficult, the reporting entity should disclose information that allows users to assess the effect of the consolidation decision. There seems little point in telling users that the decision required judgement without also explaining the effect of that decision.

Consolidated entities

41. We are considering the following types of disclosures for consolidated entities, ie subsidiaries, to allow users to assess the legal complexity and structure of the operations of the group:

    a. For each individually material subsidiary, the main activity, region of operations, total assets and proportionate of ownership interest held.

    b. Similar information would be required in aggregate for individually immaterial subsidiaries, but the information might also include some descriptive statistics such as the number, mean and median size of assets, etc.

    c. Information about consolidated entities that is hidden when consolidating, eg

        i. information about the activities carried out by, and the entity's involvement with, particular legal entities in which assets and liabilities are isolated from other parts of the group (eg securitisations);

        ii. restrictions on a reporting entity's ability to use or access consolidated assets—this would include restrictions on transferring cash, restrictions due to assets being pledged, restrictions in using or accessing cash flows generated from assets;

        iii. information about non-controlling interests—including, for material NCI, percentage holding of NCI, nature of the activities of the entity which has NCI, share of group profit and cash flows attributable to NCI, protective rights of NCI;

        iv. information about financing on a non-recourse basis;

        v. information about dividends paid by and to group entities and the tax consequences.

42. We do not intend to replicate information about the core activities or operations of the reporting entity that would be provided as segment information.

Non-consolidated entities (in which the reporting entity has significant involvement)

43. Different types of significant involvement will lead to the need for different types of information (disclosure). For example, significant involvement of an operating nature (such as joint control and significant influence) would warrant different disclosures than involvement that is of a financing or investing nature. In addition, for example, asset and liability maturity information might be very useful when an entity provides liquidity support, but not useful when an entity's only involvement is to manage the assets of the entity.

44. Many of the disclosures relating to a reporting entity's significant involvement in non-consolidated entities would become part of IFRS 7 because the type of

involvement would be a financial instrument of the reporting entity. For example, if the reporting entity's involvement is an investment in debt or equity instruments, the provision of credit enhancement or the provision of liquidity support (either contractual or implicit), any disclosures supporting the amounts recognised would be part of IFRS 7. Accordingly, disclosure requirements relating to such involvement would amend IFRS 7, rather than being included in a consolidation standard.

45. Disclosures relating to other types of significant involvement are also likely to be within the scope of other IFRSs. For example:

    a. Joint control—IAS 31

    b. Significant influence—IAS 28

    c. Commitments or guarantees—perhaps IAS 37 as well as IFRS 7

    d. Additional information about fair value, if necessary—IFRS 7.

Next steps

46. We plan to bring the control model, as one complete package, to the Board in the coming months. The package would include:

    a. The control model principles, as they would appear in a due process document.

    b. Application guidance supporting the control model principles.

    c. Illustrative examples.

    d. A summary Basis for Conclusions.

    We are of the view that it will be more efficient and effective to bring the model as a complete package to the Board for decision making, rather than discussing individual topics in isolation.

47. The Board made a number of tentative decisions on the consolidation project in 2002 and 2003—for example, in relation to power with less than a majority of the voting rights, investment companies, veto rights, etc. Given the changed composition of the Board since those decisions were made and to reflect the development of a cohesive control model that will apply to all entities, all previous decisions made by the Board will be revisited as part of the control model that we will bring to the Board in the coming months.

48. We are working with the financial instruments and fair value teams in developing proposed disclosures relating to involvement in non-consolidated entities.