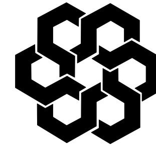

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**International Accounting Standards Board**

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*These notes are based on the staff papers prepared for the IASB. Paragraph numbers correspond to paragraph numbers used in the IASB papers. However, because these notes are less detailed, some paragraph numbers are not used.*

**INFORMATION FOR OBSERVERS**

**Board Meeting:** **23 July 2008, London**

**Project:** **Consolidation**

**Subject:** **An introduction to the staff working draft (Agenda paper 14A)**

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## INTRODUCTION

1 Agenda paper 14C is the staff draft of the proposed IFRS that would replace IAS 27 and SIC-12. It is a working draft. Our intention is to walk through the proposal in the Board meeting. We will use comments to help us revise the draft before we take it to public meetings.

2 The draft has been developed on the premise that IAS 27 and SIC-12 are not fundamentally flawed and the principles underpinning these requirements are sound. Our goals are to:

a improve the comparability of financial statements (by providing clearer (explicit) principles and adequate application guidance than is provided in IAS 27 and SIC-12); and

b to improve the quality of information information that is available to users about the legal entities that, correctly, are not consolidated but which generate some risks for the reporting entity (and are not within the scope of IFRS 7).

3 In developing the draft we have attempted to set out principles that ensure that the group financial statements report the assets, liabilities, equity, revenues and expenses of the parent regardless of how the parent structures its activities. We need to assess whether the principles cast too wide a net or, conversely, do not cause to be consolidated entities which clearly should be consolidated. And if the principles are sound, is there sufficient application guidance to ensure comparability. As a general guide, our assessment is that application of this proposal would mean that most securitisation vehicles will be controlled by the party using the assets that have been securitised. Some managed funds (eg SIVs) would be consolidated but not all. If they are not the disclosures would, in any case, be enhanced.

4 We, of course, would like to think that the staff draft has got it right. But we know that we will need to change aspects of the proposal. We think that we will need to add more guidance, but we would rather add guidance than start off with too much.

5 The purpose of this agenda paper is to summarise the principles underpinning the staff working draft of a proposed revised consolidation standard. This agenda paper:

a states the objective of that standard;

b clarifies its scope;

c defines control and its components; and

d summarises our work on disclosures.

## OBJECTIVE

6 The conceptual framework project investigates the nature and purpose of consolidated financial statements. However, constituents also need guidance on when and how a reporting entity should prepare consolidated financial statements. The purpose of the consolidation project is to provide answers to those questions. We have therefore identified the following objectives of a proposed revised consolidation standard:

a to identify the circumstances in which a reporting entity must consolidate the financial statements of another legal entity with its own financial statements; and

b to set out the accounting and disclosure requirements for consolidated financial statements.

7 IAS 27 *Consolidated and Separate Financial Statements* does not specify its objective. However, we believe that the objective in our working draft is consistent with the thinking underpinning IAS 27.

## SCOPE

8 We have carried over the scope of the proposed revised consolidation standard from IAS 27. This means that the revised standard would apply to the consolidated financial statements for a group of legal entities under the control of a reporting entity.

9 Our working draft defines consolidated financial statements as the financial statements of a group presented as those of a single economic entity. This means that the consolidated financial statements present the assets and liabilities controlled by the parent, whether the reporting entity conducts its activities in a single legal entity or through separate legal entities. Therefore, the consolidated financial statements present the assets and liabilities of a reporting entity and its subsidiaries independent of their legal structure. The legal boundaries of the legal entities controlled by the parent are ignored.

10 Legal entities are those entities that a reporting entity might consolidate. Our working draft contains therefore a description of a legal entity. We describe a legal entity as an entity that can assert legal ownership or title to assets and incur liabilities in their own name. Common examples of legal entities include corporations and partnerships.

11 We do not define the reporting entity that might have control over a legal entity. Also, we do not explain why a reporting entity should prepare consolidated financial statements. Those questions are addressed in the conceptual framework project. The boards have issued recently a discussion paper *Preliminary Views on an improved Conceptual Framework for Financial Reporting: The Reporting Entity* containing a discussion of:

a how to define a reporting entity; and

b whether a reporting entity should prepare consolidated financial statements, separate financial statements or both.

12 Of course a reporting entity as defined in the conceptual framework project is not the same as a legal entity. A reporting entity describes any area of business activity and can either be wider or smaller than a legal entity. For example, a branch of a legal entity or a group of legal entities might meet the definition of a reporting entity. Our working draft deals only with legal entities. It does not address the question how entities other than legal entities should be presented as a single entity. IFRS 8 *Segment Reporting* addresses some aspects of that question.

## CONTROL

13 Having concluded that legal entities are those entities that might be included in consolidated financial statements, we have investigated next on which basis they should be included. The reporting entity discussion paper discusses (a) the controlling entity model; (b) the common control model; and (c) the risk and rewards model to determine the composition of a group reporting entity. The boards' preliminary view is that the controlling entity model is consistent with the objective of financial reporting and should be used as the primary basis for determining the composition of a group. Our working draft bases therefore on the controlling entity model.

14 The current requirements in IAS 27 and SIC 12 *Consolidated Financial Statements: Special Purpose Entities* are only partially consistent with the controlling entity model. IAS 27 applies the controlling entity model to the composition of the group for which consolidated financial statements are prepared. However, we believe that SIC 12 is perceived by many to be based on a risk and rewards model. Our working draft eliminates this inconsistency by applying the same controlling entity model to all legal entities.

15 Using the controlling entity model makes it necessary to define the meaning of control. The reporting entity discussion paper defines control on the conceptual level. Our working draft refines this control definition on a standard level. The conceptual framework team and the consolidation team will inform each other on the progress achieved in our projects and ensure the consistency of the control definition on the framework and standard level.

16 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. In contrast, our working draft defines control over a legal entity as the current power sufficient to use or manage the assets and liabilities of that entity so as to benefit from them as if they are its own.

17 Similar to the definition of control in IAS 27, our revised definition identifies benefits and power as components of control and states that there must be a link between both ("so as to"). However, we no longer require that control has to be achieved by controlling the [strategic] operating and financing policies of a legal entity. In contrast, we believe that a reporting entity can control a legal entity in many ways. The following paragraphs explain first how a reporting entity might have control over a legal entity because it has control over the strategic operating and financing policies. We explain then in a second step why a reporting entity might control a legal entity even though it does not have control over the strategic operating and financing policies. We will then revisit the revised definition of control.

**Control over the strategic operating and financing policies of a legal entity**

18 We continue to believe that a common way to achieve control over a legal entity is by controlling the strategic operating and financing policies of that entity. Control over the strategic operating and financing policies of a legal entity can give the reporting entity the ability to direct the day-to-day activities of that entity, regardless of whether that is achieved by making those decisions directly or by delegating that responsibility to management or others. Therefore, control over the strategic operating and financing policies of a legal entity gives the controlling party the current power to use or manage the assets and liabilities of that entity so as to benefit from them, as if they are its own.

19 Control over the strategic operating and financing policies of a legal entity is often achieved by having a majority of the voting rights of that entity. Our working draft presumes that a reporting entity that controls more than half of the voting rights of a legal entity controls that entity. However, an entity does not need to have the majority of the voting rights to control a legal entity. Our working draft clarifies that a reporting entity can also have control over the strategic operating and financing policies of a legal entity with less than half the voting rights in circumstances in

which there are no other dominant voting interests in the entity. This could include circumstances in which the other owners have not organised their interests in such a way that they actively cooperate when they exercise their votes so as to have more dominant voting power than the holder of the single largest ownership interest. We believe that this clarification will end diversity in practice on how to apply the control definition without a majority of voting rights.

20 IAS 27 states that the existence and effect of potential voting rights that are currently exercisable or convertible should be considered when assessing whether the reporting entity has the power to govern the [strategic] financing and operating policies of a legal entity. The standard clarifies further that the intention of management and the financial ability to exercise or convert those potential voting rights should not affect the assessment.

21 We believe that the requirement in IAS 27 could lead to a reporting entity being deemed to control a legal entity even though it holds potential voting rights that are deeply out of the money. We are concerned that this consequence might create off-balance sheet structuring opportunities. Our working draft emphasises therefore that control must be current. The option to achieve control does not constitute control before the holder exercises that option. However, an option in combination with other factors might provide a reporting entity with control over a legal entity. The following example illustrates the requirement in our working draft:

> A reporting entity holds a currently exercisable option to acquire all outstanding shares of a legal entity at their fair value. Unless the option is exercised, the reporting entity does not have the power to use or manage the assets and liabilities of that entity so as to benefit from them, as if they are its own.
>
> In contrast, an option that is presently exercisable for little or no cash or other consideration is a strong indicator that the reporting entity has control over the legal entity. This is, because the reporting entity can choose at any given time to use or manage the assets and liabilities of the legal entity so as to benefit from them, as if they are its own.

**Control of a legal entity without control over the strategic operating and financing policies**

22 We believe that a reporting entity could have control over a legal entity even though it does not control of what generally be thought of as the strategic operating and

23 The powers available to the legal entity might be limited to the extent that it is not necessary to have a governing body. Or if there is a governing body, its powers are notional and will not be sufficient to affect the performance of a legal entity. Those legal entities are often called special purpose entities and the limitation of the powers of the legal entity is often referred to as predetermining its policies or autopilot. However, our working draft refrains from such language as it intends to develop one single control model for all legal entities regardless of their nature and, thus, to eliminate the need for more or less arbitrary categorisations of legal entities.

**A revised control definition**

24 Control over the strategic operating and financing policies of a legal entity is meaningless when the constituting documents or other contractual arrangements of a legal entity restrict the powers available to the governing body of a legal entity to the extent that the strategic operating and financing policies will not affect the benefits generated by the legal entity.

25 Our working draft contains therefore a broader definition of control. We define control as the current power sufficient to use or manage the assets and liabilities of that entity so as to benefit from them, as if they are its own. That is, our working draft focuses on the control that a reporting entity has over the assets and liabilities of a legal entity, regardless of the means according to which the reporting entity has achieved that control. This means, that a reporting entity accounts for its assets and liabilities the same way, regardless of whether it owns those assets and liabilities directly or whether it controls the legal entity that has legal title to those assets or liabilities.

26 Therefore, when a reporting entity assesses whether it has control over a legal entity, it is often helpful to understand how else it could have structured the transaction and

27 The assessment of control is a continuous process. This means that the reporting entity does not only assess whether it has control over a legal entity when it establishes a relationship to that entity, but that it monitors continuously whether it has achieved control over a legal entity that it has previously not controlled or lost control over a legal entity that it has previously controlled.

28 When assessing control the reporting entity needs to investigate whether its relationship to a legal entity meets all components of the control definition. A reporting entity controls a legal entity if it:

a is exposed to benefits from that entity; and

b has the power to make the decisions that affect the benefits generated by that entity.

29 Those components are related and must be considered together when determining whether one entity controls another. The following example illustrates how the controlling entity model applies to a legal entity whose power has been severely restricted:

> A reporting entity might sell receivables to a separate legal entity. The legal entity finances the acquisition of the receivables by issuing senior bond notes to third party investors and junior bond notes to the reporting entity. The legal entity pays interest on the junior bonds only after it has paid principal and interest to the senior bond holders. To protect the interests of all bond holders, the powers available to the legal entity have been restricted severely. The only powers available to the legal entity are those that allow it to manage the receivables. It is the collection and the default management of those receivables that affects the performance of the legal entity.
>
> In this example the reporting entity is likely to control the legal entity because it benefits from funding through the entity (ie the structure allows it to use the receivables as a source of funding) and it is exposed to variable returns from the junior bond notes. In addition, the reporting entity has the power to manage the receivables and is therefore able to affect the performance of the legal entity so to maximise its benefits and minimise its exposure to variability caused by the receivables.

30 The following paragraphs provide a further analysis of benefits and power as the components of the control definition.

***Benefits from a legal entity***

31 Benefits are the returns to which a reporting entity is entitled from its involvement with a legal entity, which vary with the performance of the legal entity. Our working draft identifies the following characteristics of benefits:

a Benefits must vary:

The financial returns generated by a legal entity are shared among those who invest in the entity. Some investors will receive a contractually agreed return on an investment, such as a fixed return that corresponds with or reflects the risks assumed. Those returns are common to the relationship between a supplier or service provider and its customers and are normally not indicative of a control relationship. However, some investors prefer or accept returns that vary with the performance of the investment. We believe that a reporting entity will only require or accept variable returns if it also has the ability to maximise those returns. Our working draft states therefore that the benefits a reporting entity receives from its control of a legal entity must vary with the financial performance of the legal entity.

b Benefits must have the potential to be favourable:

To benefit from a legal entity, the reporting entity must be exposed to positive and negative variable returns. This requirement addresses a problem that the FASB has been made aware of when reviewing the requirements in FIN 46R *Variable Interest Entities*. The FASB observed that some off-balance sheet structures used loss insurance as means to circumvent the requirements in FIN 46R. This means that a third party guarantees to make up for any lower than expected returns, without any other interest or involvement in the entity. Under FIN 46R that party would be required to consolidate the legal entity. Our working draft clarifies that to control a legal entity the reporting entity must be entitled to both higher and lower than expected returns. A reporting entity that guarantees to make up for lower than expected returns of a legal entity without controlling that entity would not consolidate the entity, but recognise a financial liability for this obligation.

We believe that exposure to the legal entity can include support offered by a reporting entity to the legal entity to protect the reputation of the reporting entity. Offering support to a legal entity is not, in itself, sufficient to give the reporting entity control of the legal entity. If such support exists the reporting entity will need to assess whether it is also able to benefit from the legal entity and what powers it has to manage those benefits. We believe that the reporting entity would need to assess whether the support is such that it meets the denifition of a liability and should be accounted for in accordance with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets.*

c Benefits are not limited to returns of the legal entity:

Our working draft clarifies that to determine the variable returns it receives for a legal entity the investor considers all returns to which it is entitled from its involvement with that entity. Those returns include returns from the performance of the entity itself. However, a reporting entity might also have returns that are not available to other investors. This is the case when it uses the assets of the investee in combination with its other assets, such as combining functions to achieve economies of scale, sourcing scarce products, gaining access to proprietary knowledge or limiting some operations or assets to enhance the value of its other assets.

32 A reporting entity might not control a legal entity even though it receives a variable return from that entity. This is because it is also necessary to consider how all parties that contract with a legal entity share the variable returns from that entity.

***Power over a legal entity***

33 Power is the ability of a reporting entity to participate in the management of the assets and liabilities of a legal entity. When a reporting entity controls a legal entity, the reporting entity will have the ability to manage assets and liabilities as if they are its own and to exclude others from using or managing those assets and liabilities. Our working draft identifies the following characteristics of power:

a Power does not need to be absolute

Power will often be restricted by the rights of other parties that engage with the legal entity. The rights of those parties are often of protective nature and do not hinder the reporting entity from managing the assets and liabilities of a legal entity as if they are its own. We believe that a reporting entity can have power over a legal entity even though other parties have protective rights in that entity. When this draft refers to a reporting entity managing assets and liabilities *as if they are its own* it means that the reporting entity has the same rights as the legal entity. However, our working draft acknowledges that, some contracting parties might have rights in a legal entity that enable their holder to participate in the day-to-day activities of the legal entity, rather than being limited to fundamental changes in the activities of the entity. Those rights are sometimes referred to as participating rights. If other parties hold participating rights in the legal entity, the reporting entity does not have power over it. The following examples illustrate our observation:

*Example 1*: A legal entity is a manufacturing business. The reporting entity holds 75 per cent of the voting rights in the legal entity. This gives the reporting entity the ability to manage the legal entity's assets as if they are its own assets. The reporting entity might use the legal entity's assets independently of the other assets that it controls.

Alternatively, the reporting entity might use the assets of the legal entity in combination with its other assets to create value outside of the legal entity. Therefore, the reporting entity has power over the legal entity. However, to protect the non-controlling interests, the legal entity has policies in place that restrict the reporting entity's power. Those policies prohibit the reporting entity from using its power over the legal entity in a way that decreases the value of the non-controlling interests.

*Example 2*: A franchise agreement might restrict the power to manage the assets and liabilities of a legal entity. Such an agreement might specify for example the location of the franchise business, the goods to be sold or services to be provided as well as the suppliers and the product marketing of the legal entity. In other words, the franchise agreement restricts the franchisee in the way in which it operates its business. However, the restrictions do not give the franchisor the ability to manage the assets and liabilities of the franchisee as if they are its own. They are there to protect the quality of the product or service that is subject to the franchise agreement. The franchise agreement does not give the franchisor control over the franchisee.

Similarly, a legal entity might be economically dependent from a single customer. That customer might have significant rights over the legal entity, i.e. it might have its own staff monitoring the production processes of the legal entity. Those rights are there to protect the quality of the product or service the customer is receiving. They do not give the customer control over the legal entity.

b Power affects the performance of the legal entity

Our working draft assumes that investors require power that is proportionate to their entitlement to the benefits from a legal entity. Accordingly, power must be sufficient to allow them to participate in an entity to ensure that they are compensated for, or benefit from, their investment.

34 A reporting entity can have either directly or indirectly through agents power over a legal entity. An agent is a party that uses its rights in a legal entity on behalf of the reporting entity. Our working draft provides examples of parties that might act as agents of the reporting entity.

***Relation between benefits and power***

35 Benefits and power must not be assessed in isolation. We believe that when assessing control over a legal entity, the reporting entity always needs to investigate both components of control. That is, the reporting entity needs to investigate the benefits that it receives from a legal entity as well as the power it has over that entity. We

believe that a reporting entity requires power that is proportionate to its entitlement to the benefits from a legal entity. Accordingly, it requires power that is sufficient to allow it to participate in an entity to ensure that it is compensated for, or benefits from, its investment. The following example illustrates the relationship between benefits and power:

> The manager of an investment fund decides in which assets the fund should invest and when to disinvest from those assets and receives a fee based on the returns of the investment fund.
>
> The fund manager does not control the investment fund even though he decides into which assets the fund should invest and receives a fee in relation to the performance of the fund. The protective rights of the investors in the fund limit the rights of the fund manager.

## ACCOUNTING REQUIREMENTS

36 The purpose of the consolidation project is to revise the definition of control and the disclosure requirements in IAS 27. Therefore, our working draft carries over the accounting requirements for consolidated financial statements from IAS 27 without further amendments.

## DISCLOSURES

37 In addition to a revision of the control definition, we have been asked to investigate whether a proposed revised consolidation standard should include additional disclosure requirements. We believe that a reporting entity should disclose information that enables users of its financial statement to evaluate:

a the judgements that management has made in the process of applying the reporting entity's accounting policies when reaching decisions to consolidate or not and the financial effects of those judgements.

b the nature and financial effects of restrictions on assets and liabilities resulting from legal entity boundaries that exist within its group.

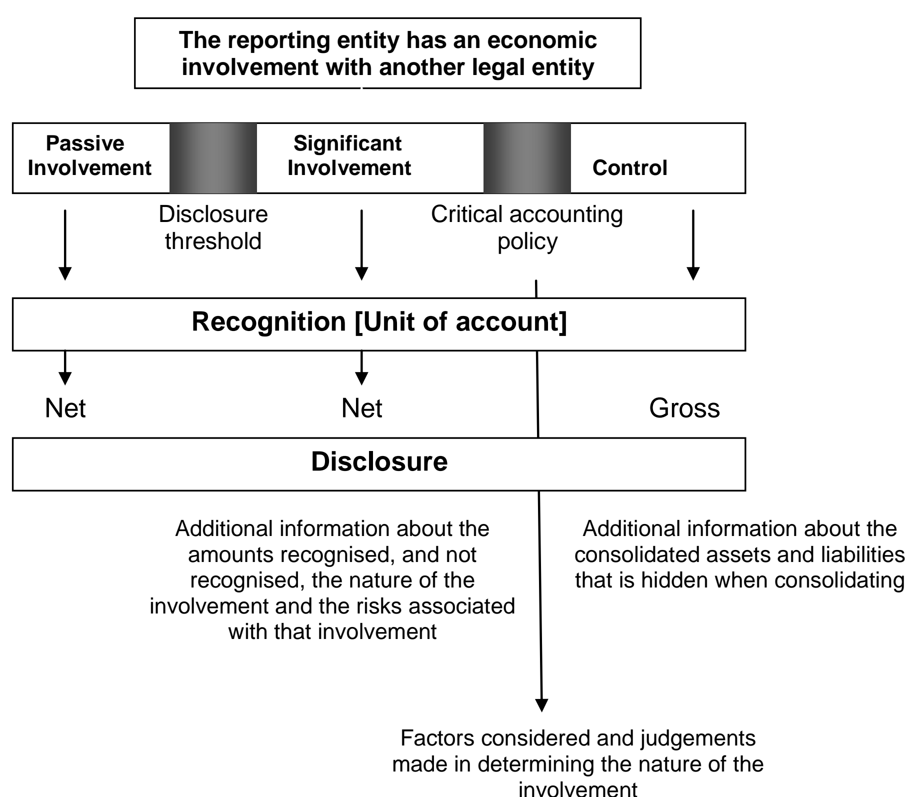
c the financial effects of changes in a parent's ownership interest or the loss of control of a subsidiary.

d the nature of, and risks associated with, its significant involvement with legal entities that it does not control.

38 Our working draft contains application guidance on how to meet each of those disclosure objectives.

**Significant Involvement**

39 We have developed disclosure principles for legal entities that the reporting entity controls as well as for entities in which the reporting entity has significant involvement. The reporting entity consolidates all legal entities that it controls and provides also disclosures for those entities. In contrast, the reporting entity provides disclosures for entities in which it has significant involvement, but does not consolidate those entities. Legal entities that the reporting entity neither controls nor has a significant involvement in are not disclosed. The diagram illustrates this observation:




40 We have defined significant involvement as the ability to participate in the decisions of how to use or manage the assets and liabilities of a legal entity so as to benefit from them that is not sufficient to control that entity. Therefore, assessing whether a reporting entity has significant involvement in a legal entity involves the same decision process as is undertaken in assessing whether the reporting entity controls the legal entity. The difference is that the reporting entity will have concluded that

the powers and related benefits are not sufficient to give it control over the legal entity.

41 Accordingly, a reporting entity can have significant involvement in a legal entity by:

a participating in the governing body of the legal entity such as by having the ability to appoint, or having sufficient voting rights to appoint, directors to the governing body;

b having a contract to service or administer the assets or liabilities, or both, of the entity;

c having the ability to appoint management personnel;

d dominating the major contracts of the legal entity.

42 We believe that to enable users of its financial statements to evaluate the nature of, and risks associated with, its significant involvement with legal entities that it does not control, the reporting entity should disclose information that helps users of the financial statements to assess

a the risks to which the reporting entity is exposed as a result of its involvement with those entities; and

b the conditions or circumstances related to the reporting entity's significant involvement that would cause the reporting entity to have control of the legal entities.

43 In addition to the disclosure requirements in our working draft, the reporting entity would also be required to comply with IFRS 7 *Financial Instruments: Disclosures* in relation to any financial instruments to which it and the entities with which it has significant involvement are a party.

44 Our working draft contains a first draft of the disclosure requirements for legal entities that the reporting entity controls or has a significant involvement in. We will continue to work on those disclosure requirements and provide the Board with a more comprehensive analysis of those requirements at small group meetings in August 2008.