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International
Accounting Standards
Board

INFORMATION FOR OBSERVERS

Board Meeting:	**23 July 2008, London**
Project:	**Consolidation**
Subject:	**Illustrative case 5 (Agenda paper 14B(5))**

Case title

Development centre

FACT PATTERN

Centre

1. A biotechnological company (Biotech) established a separate legal entity (Centre) to develop new products. Biotech believes that the prospective products will be highly profitable if they prove to be successful but the likelihood of a positive outcome is low. Therefore, Biotech decided to finance the activities through a risk-sharing arrangement with outside investors.

Shareholders

2. Centre issued two types of shares: class A and B. The activities of Centre are financed through an initial public offering of 5 million class A shares to various external investors. Centre received proceeds from IPO of CU5 million. Biotech holds all 100 of Centre's class B shares that have nominal amount and it does not own any class A shares.

3. Biotech has an option to purchase all, but not less than all, of the issued Centre’s class A shares at any time within a period of 5 years and at a predetermined price, that increases after each year by 35%.

4. The class A shares of Centre are sold to investors together with a warrant to purchase two shares of Biotech, exercisable within a period of 5 years. The estimated total value of the warrants at the day of issuance is CU1 million. Warrants to purchase shares of Biotech are granted to investors by Biotech in exchange for the fair value of Biotech’s purchase option on class A shares.

Directors

5. The Board of directors of Centre is composed of 4 directors. Biotech has rights to select 1 director, CEO, and the remaining 3 directors are selected by the majority of the holders of class A shares. The CEO holds a senior management position in Biotech and is the only director affiliated with Biotech. The directors receive a management fee at market rates.

Biotech’s agreements with Centre

6. Biotech and Centre enter into an agreement, whereby Biotech conducts all product development and related activities on behalf of Centre (development agreement) for which Biotech receives a monthly fee.

7. Centre will develop the products using Biotech’s proprietary processes by way of a technology licence (technology licence agreement). Biotech receives a fee from Centre for the licence.

8. Biotech provides Centre with administrative services where Centre reimburses Biotech all of the costs (service agreement).

9. All proceeds from the IPO are spent on servicing, development and technology licence fees and other administrative expenses. The funds should be sufficient to cover all expenses during the period of the purchase option. After 5 years, the IPO proceeds are expected to be exhausted and Centre will need to obtain new funds to continue its operations if the option is not exercised.

Centre’s activities

10. Biotech team proposes products to be developed by Centre, the work plan of the development activities and cost estimates to the directors of Centre that must be approved by all four directors. At each stage of

works, the directors determine whether to continue development and decide on the amount of funding to be allocated.

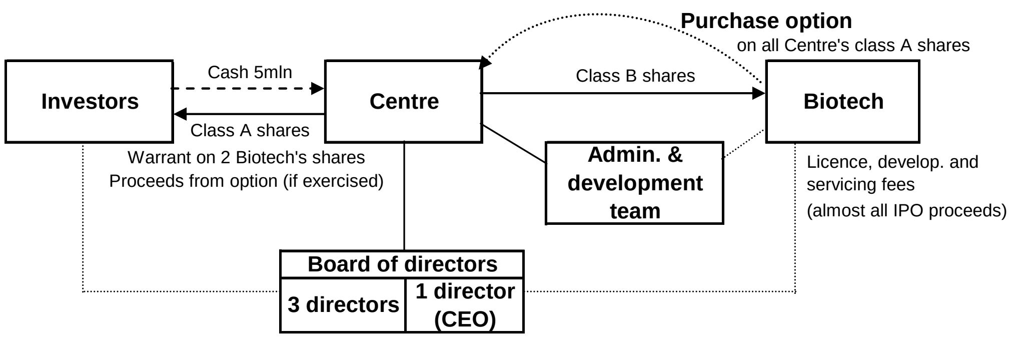
11. Any product not approved for further development by the directors, remains the property of Centre and cannot be sold to third parties until the option on the shares expires. Biotech, however, has an option to purchase products discontinued by the directors at market price and can then continue development outside Centre's operations. [It cannot purchase specific products that are finalised or being developed.] The proceeds received from the purchase of discontinued products would be paid out to investors and would not be used to fund development activates.

12. During the period of the purchase option agreement Centre is not allowed to take actions that would alter Biotech rights under the purchase option. That is, Centre cannot, without Biotech's approval, issue additional shares, pay dividends, borrow funds above specified level, merge or liquidate, amend transaction documents or dispose of any substantial assets. Centre cannot hold other material assets than IPO proceeds and contractual rights.

Activities after the option expires

13. Biotech is not obliged to provide any funds to investors or to continue financing of Centre's activities if the option is not exercised. After Biotech's purchase option expires, the investors would be able to select all four directors and will have full decision making rights regarding Centre's activities. The investors would have to decide whether to sell their shares or Centre's assets on the market or provide new funds to continue Centre's activities.

14. The structure of the transaction and flow of resources is summarised in the diagram:



ANALYSIS IN ACCORDANCE WITH THE PROPOSED EDX

Directors

15. Directors acts as agents on behalf of investors and Biotech. Their rights are limited and constrained by the transaction documents. They can be removed by investors and Biotech and receive a market fee for their services.

Investors

16. The investors finance Centre's activates and assume the related risks. If Centre's operations are unsuccessful, Biotech will not purchase the shares. The investors would have to contribute additional funds to continue Centre's activities or find new investors in order to avoid losses. Their benefits are the warrants to purchase Biotech's shares at a fixed price and the potential proceeds from the option exercised by Biotech on Centre's class A shares or discontinued products.

17. Although the investors can direct decisions of the majority of the directors, their rights are not sufficient to exclusively direct the activities of Centre. During the period of the option, the investors do not have rights to change Centre's investment or financing activities or obtain benefits from the products other than through option proceeds.

18. The investors do not control Centre's activities, but are providers of risky capital that enable Biotech to conduct its product development activities and transfer the risks related with those activities.

Biotech

Benefits

19. Biotech is the main beneficiary of Centre activities. All proceeds from IPO are spent on fees paid to Biotech for its services and the right to use its technology licence. Additionally, Biotech has exclusive access to benefits from Centre's products—during the period of the option, Centre's developed and discontinued products cannot be sold or used by other parties.

20. Biotech structured Centre to transfer risks related with financing the product development activities to investors. In exchange, it incurs the cost of warrants and is exposed to increases in price of Centre's class A shares.

Power

21. Biotech determined the policies of Centre and restricted the ability of investors and other parties to change those policies. It directs the activities that affect Centre's performance (ie initiate and carry the development activities with the use of its licence). Biotech cannot direct the decisions of directors that oversee the development activities. However, the power of directors is very limited; they cannot change the investing and financing policies unless Biotech agrees or initiate new activities. The directors can only veto Biotech's proposals on product and budget. Consent of all directors is required to approve budges and activities, and because Biotech can appoint one director (CEO), it can influence or veto decisions of the Board. The extent of power given to directors selected by investors indicates that investors' rights are protective rather than participating.

Conclusion

22. The existence of independent directors does not preclude Biotech from conducting product development activities for its business purpose and benefit. The activities carried by Centre are part of Biotech's operations and Biotech benefits from the IPO proceeds and Centre's products. The existence of the option to purchase class A shares of Centre *itself* does not lead to the conclusion that Biotech controls Centre. The present rights of Biotech resulting from the option agreement lead to the conclusion that Biotech controls Centre and would be required to consolidate its financial statements.

23. After the option expires, Biotech's rights would change and should be re-assessed to determine whether they are sufficient to continue control over Centre.

ANALYSIS IN ACCORDANCE WITH CURRENT GAAPs

[Paragraphs 24-33 omitted from observer note.]