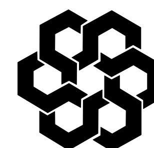

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International Accounting Standards Board

This document is provided as a convenience to observers at the round table discussion on Consolidation, to assist them in following the discussions. It does not represent an official position of the IASB. Board positions are set out in Standards.

Note: These notes are based on the staff papers prepared for the round table discussion on Consolidation.

INFORMATION FOR OBSERVERS

Consolidation round table: September 2008, London

Title: **Discussion points for roundtable meeting**

ED IFRS X *Consolidated Financial Statements*

Discussion points for roundtable meetings
17 September 2008

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Context

The project on consolidation was added to our agenda in June 2003. The objective of the 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.* The project is intended to revise the definition of control to allow the same control criteria to be applied to all entities and to require enhanced disclosure about consolidated and non-consolidated entities.

In November 2007, in response to the recent economic turmoil and the recommendations of the Financial Stability Forum, the Board decided to prioritise the consolidation project and go straight to the publication of an Exposure Draft (ED) rather than a Discussion Paper.

In July 2008, the staff presented a draft ED to the Board, written on the basis of the tentative decisions made over the period the Board has been debating the issues. This was designed to demonstrate to the Board how a more general model could be developed. The staff revised that draft to reflect feedback from individual Board members. A revised draft was then circulated to selected members of the IFRS community, including people at investment banks, accounting firms and standard setters. Feedback from those people has been incorporated in this, the third, draft.

You are participating in a public roundtable to discuss this staff draft. Your input will help the Board decide if the proposal is operational and is likely to improve financial reporting. If this is the conclusion the Board reaches, we expect to continue to develop and improve the proposal so that we can publish an ED in the fourth quarter of 2008.

Because this is a staff draft of a proposal, 'we' and 'our' refer to the staff of the IASB within this document, rather than the Board.

US GAAP convergence

Because of conflicting short-term commitments, the consolidation project is not currently a joint project with the FASB. The FASB is planning to issue on 15 September proposed amendments to FIN 46 (R) *Consolidation of Variable Interest Entities* and Statement No.140 *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities.* The draft amendments will remove the concept of a qualifying SPE from Statement 140 and remove the scope exception for qualifying SPEs from Interpretation 46(R). The revised FIN 46(R) will provide guidance on reconsidering if an entity is a variable interest entity. It will also include guidance on reconsidering which enterprise, if any, consolidates the entity (the primary beneficiary), the process for determining which enterprise is the primary beneficiary in a variable interest entity and disclosures.

The FASB has also decided to issue separately a FASB Staff Position (FSP) that will require additional disclosures. The purpose of the disclosure-only FSP is to meet financial

statement user needs for greater transparency for off-balance sheet transactions as well as to permit preparers, regulators, auditors, and users with adequate time to consider and implement the other proposed amendments to Statement 140 and Interpretation 46(R).

Although we have worked independently of the FASB on the Consolidation project we have shared information as the related projects have progressed. The intention is that this will become a joint project with the FASB as soon as is practicable.

Overview

The Board thinks that the principles included in the existing standards, IAS 27 and SIC-12 are not fundamentally flawed. However we are told that there is variation in their application in practise. IAS 27 is a controlling entity model whereas SIC 12 is perceived as having greater emphasis on risks and rewards. The result is that the two standards can, in some circumstances, be perceived to conflict. For example, a party that has control by 'traditional means' such as holding greater than 50 per cent of voting rights, does not necessarily receive the majority of the benefits associated with a controlling voting interest.

In practise, this also means that the guidance applied to decide if there is control or not varies according to the type of entity. This leads to greater variation in application and reduces the comparability of financial statements. The aim of the project is to develop an IFRS that states more clearly the principles implicit in IAS 27 and SIC-12.

The project is also designed to enhance the disclosures required for both consolidated and non-consolidated entities. The recent economic turmoil has highlighted a widely held perception that current accounting and disclosure requirements do not give sufficient information to users of the financial statements to allow them to understand the risks an entity has exposure to—particularly for off-balance sheet entities.

The draft has been developed to improve financial reporting for those applying IFRSs by:

- revising the control definition to allow the same control criteria to be applied to all entities; and
- suggesting improved disclosure requirements for consolidated and non-consolidated entities. The additional disclosures will give users of the financial statements a greater understanding of the risks to which an entity is exposed.

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 it does not consolidate, the disclosures would, in any case, be enhanced.

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. Some of the sections in the application guidance also include explanations that will eventually be moved to the basis for conclusions.

Control

Consolidated financial statements present the assets and liabilities controlled by the parent and its subsidiaries independent of their legal structure. One of the key areas is identifying the circumstances in which a party must consolidate the financial statements of another entity with its own financial statements.

IAS 27 requires an entity to include in its consolidated financial statements all entities that it controls. IAS 27 provides guidance on what constitutes control but was not perceived to work well for entities that do not have typical governance structures. SIC-12, an interpretation of IAS 27, was issued to clarify the circumstances under which an entity should consolidate such entities.

In some circumstances the current requirements in IAS 27 and SIC-12 are perceived to conflict, as although IAS 27 is a controlling entity model SIC-12 is perceived as having a risks and benefits emphasis. This tension between the two pieces of consolidation guidance leads to a lack of consistency in practise which decreases the comparability of financial statements.

We think that one of the limitations of the guidance in SIC-12 is that it does not define risks and benefits. It is also unclear whether risks or benefits are more important when assessing whether an SPE should be consolidated. This lack of clarity has contributed to diversity in practise.

The Board's preliminary view (as reflected in the *Reporting Entity* DP) is that the controlling entity model is consistent with the objective of financial reporting and therefore should be used as the primary basis for determining the composition of the group.

The aim of this draft ED is to produce a single IFRS on consolidation that provides principle based guidance on when an entity should consolidate another entity. The guidance will be based on the controlling entity model and will be applicable to all entities including those with a narrow and well-defined objective.

Control of an entity

The definition of control of an entity proposed in the draft ED is:

> A party controls an entity when it currently has power sufficient to enable it to manage the economic activities of that entity for its benefit by generating returns from those activities.

The control model in the draft ED applies to the whole spectrum of entities through which an entity can conduct its business. This is a significant improvement from the previous guidance where there was a risk that entities 'fell through the gap' if it did not fit into either the traditional control model, as in IAS 27, or the risks and benefits emphasis given in SIC-

12. As the draft ED introduces a universal control model, it is not necessary to use the term ‘SPE’, or an equivalent, in the draft ED. The control model articulated in the draft ED should capture both traditional corporate entities and more complex business structures.

The guidance in the draft ED is based on the assumption that the greater the variability of returns a party exposes itself to (benefits) the greater the expected ability of that party to affect the performance of the assets (power). The proposals give a wide meaning to the term ‘benefits’. Benefits must have the potential to be favourable and they are not limited to returns from the entity controlled but could include benefits in the form of increased returns in the controlling entity itself.

The new control definition in the draft ED also represents a move away from the concept of an entity operating on ‘autopilot’ because of predetermined policies. Instead, the focus is on power. Some entities have substantially all powers taken from it so there is no need for a corporate governance structure such as a board. In these circumstances all that matters are the powers that the entity has left. Looking at the restriction of power is a more helpful concept than focusing on what has been predetermined.

The draft ED deliberately moves away from the notion that control is only achieved through the power to govern the operating and financial policies of an entity. This is one way in which control can be achieved, but it is not the only way. For example entities with very detailed and defined founding documents or operating within a strict legal framework might only be able to perform a limited range of activities/ transactions. They could be limited so severely that there is no need for a governing body or the governing body’s powers are notional and insufficient to affect performance. In this context control over the financial and operating policies is meaningless as the powers of the entity and its governing body are restricted to such an extent that the financial and operating policy choices, if any, available to it will not impact the returns generated.

The ability to dominate the governing body is a principle in IAS 27. However the draft ED gives more guidance on what might indicate the ability to dominate the governing body. The other indicators included in the draft ED are the ability to participate in management of an entity and access to the residual assets of an entity. These indicators are wider in scope than just looking at the governing body.

Reputational risk

We considered whether an implicit commitment to support an entity to protect its exposure to reputational risk should be a basis for consolidation.

If a party provides such support it will need to assess whether it has current control or whether it will need to do something to get control. The party would, in any case, need to assess whether the commitment is such that it meets the definition of a liability and should

be accounted for in accordance with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets.*

Our conclusion is that reputational risk is not sufficient to indicate that a party should consolidate another entity because the existence of such a risk does not give the party exposed to that risk current control.

Continuous assessment

The assessment of control is continuous process. An entity should determine whether it controls another entity based on current conditions. However an entity should monitor continuously whether those conditions change and if this triggers a change in control. The draft ED proposes that variability of returns in itself will not lead to a reassessment of control. The requirement for continuous assessment should therefore not lead to entities falling in or out of scope for consolidation on a regular basis because of changes in market conditions.

QUESTIONS:

1. Do you think that the revised control defintion could be applied to traditional control arrangements and those entities set up with a narrow and well-defined purpose? If not, where do you think the definition falls down?

2. Is the general control principle likely to lead to the right entities being consolidated?

3. Do you agree that the continuous assessment of control should not lead to entities ‘flipping in and out’ of consolidation?

4. Do you agree with the presumption that the greater the variability of returns that a party exposes themselves to the greater the *expected* ability of that party to affect the performance of the assets of that entity? if not, why not?

5. We envisage that there will be some circumstances when an entity is not controlled by any party. Do you agree? If not, why not?

Control with less than half of the voting rights

IAS 27 requires an entity to consolidate all entities that it controls. In October 2005, the Board issued a statement in which it confirmed its view that control is achievable by a party holding less than half of the voting rights. In that statement, the Board acknowledged that the lack of explicit guidance in IAS 27 on how to apply the control principle in these circumstances has led to diversity in practise.

The draft ED clarifies that a party holding the single largest ownership interest in another entity can control that entity, even if this represents less than half of the voting power. This could include circumstances when the other shareholders 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. This type of situation is commonly referred to as *de facto* control however we have deliberately chosen not to use this term in the draft ED because its use implies that it is not the same as control. Our view is that control is control and it can be achieved in different ways.

QUESTIONS:

6. Do you agree that a party can have control over an entity even if they hold less than half the voting rights? If not, why not?

7. Are the indicators provided in the draft ED sufficient to capture the entities that should be consolidated and to ensure consistent application?

Potential voting rights

Potential voting rights exist when a party owns share warrants, options or equity or debt instruments that can be converted into shares that, if exercised, would give the party voting power over another entity.

The draft ED proposals include amending the treatment of potential voting rights. IAS 27 states that when an entity has potential voting rights that are currently exercisable or convertible they are considered when assessing whether an entity has control. IAS 27 provides guidance on the treatment of options on shares, however the treatment of options held directly over other assets follow the requirements of IAS 39. The treatment in the two standards is inconsistent and can lead to different accounting treatment if an option is held over a corporate shell containing one asset rather than the option being held directly over the asset itself. We believe that this is inappropriate.

The requirements in IAS 27 can be interpreted as stating that the holding of an option is the same as holding the underlying resource and treating the exercise of the option as inconsequential. In fact an option only gives the holder a choice over whether to hold the underlying resource. Currently, a party is required to consider currently exercisable/ convertible options when assessing control irrespective of management intention and financial ability to exercise or convert the option over potential voting rights.

The Implementation Guidance for IAS 27 refers to options which lack economic substance not giving a party the ability to exercise power, however, it is not clear how this interacts with the guidance on ignoring financial ability to exercise the option and management's intention. The current guidance may create off-balance sheet structuring opportunities where an option is significantly out of the money but is currently exercisable.

The general principle introduced in the draft ED is that the existence of an option on its own would not be sufficient to conclude that the entity holding the option has control. However, an option could indicate the existence of control because an option might have been put in place in conjunction with other arrangements. The terms and conditions of the option must be considered as part of this assessment as must any associated arrangements.

There can be circumstances when the terms and conditions of the option are notional. We propose that voting rights covered by an option should be taken into account when determining control if there is little or no cash outflow associated with the exercise of the option and/or any actions that are required to be taken to exercise the option are notional.

QUESTION:

8. Do you agree that the existence of an option on its own is not enough to give a party control over an entity? If not, why not?

Significant involvement

Even if a party does not have control over another entity it could be exposed to risks associated with that entity. The disclosure requirements in IAS 27 do not provide any information on potential risks that a party is exposed to in relation to entities that are not controlled. IFRS 7 provides some risk disclosures however, the disclosures are focused on financial instruments. We think that the current disclosure requirements exclude information that would give a user of the financial statements a full understanding of the risks to which an entity is exposed. Of course, the term 'off balance sheet' is not helpful because it could be defined to be *any* entity or transaction not controlled by an entity.

The draft ED introduces the term 'significant involvement'. Significant involvement is defined as 'the current ability to participate in the decisions on how to manage or use the assets and liabilities of that entity so as to benefit from them, but does not have sufficient power to control that entity'.

The definition is intended to capture all business structures that give an entity the ability to participate in decisions on how to manage or use assets and liabilities in those structures. The definition incorporates associates, joint ventures, trusts and structured investment vehicles. In particular, for structured vehicles we would anticipate that sponsors and those entities providing liquidity support or credit enhancement would fall into this definition.

Once an entity determines that it has significant involvement with another entity, it will need to make additional disclosures to allow users of the financial statements to understand the nature of their relationship with, and the risks associated with, those entities. Entities in which a party has signficant involvement will not be consolidated. For more detail on the required disclosures for non-consolidated entities see the separate section on disclosure.

QUESTION:

9. Do you agree that the definition of significant involvement will capture the right entities about which you want further information or do you think it is casting too wide a net? What entities are being captured that you believe should not be, and vice versa?

Disclosure

Following the recent economic turmoil, analysts and regulators have criticised the current disclosure requirements in relation to 'off balance sheet entities' and said that financial statements do not give adequate information to allow them to understand an entity's risk exposure relating to these entities.

The adoption of IFRS 7 *Financial Instruments: Disclosures* addressed some of the issues with regard to risk disclosures. However, IFRS 7 focuses on financial instruments. There are risks associated with structured entities that IFRS 7 will not capture. The focus on financial instruments in IFRS 7 means that if a party has no financial instrument associated with a structured entity then it is not caught by the risk disclosure requirements in IFRS 7.

The aim of the draft ED is to close the gap between existing disclosure requirements and the information that users of the financial statements require to understand the risks to which an entity is exposed. The financial statements should contain sufficient disclosure to give users a complete understanding of the risks associated with entities.

Non-controlling interests

Consolidated financial statements include the assets and liabilities of subsidiaries. There is some disclosure of restrictions on a subsidiary's ability to transfer cash funds. However, many analysts have asked us to require more disclosure about any restrictions on assets and liabilities held in subsidiaries—particularly as those restrictions relate to non-controlling interests.

A common method of valuing a parent's business is to value the whole business and then value the non-controlling interest (and subtracting this value from the total value). The current disclosures surrounding non-controlling interests are limited to stating its share of the profit or loss and of the net assets. This does not provide adequate information for users to value the non-controlling interest.

For consolidated entities, the draft ED proposes that for those entities with a non-controlling interest disclosure is made, in aggregate, of the assets, liabilities, dividends paid and cash flows (split into investing, operating and financing) in these entities. The purpose of this is to provide adequate information for users to assess the competing claims on the assets and liabilities recorded in the group balance sheet.

Judgement

The draft ED proposes that significant judgements made on whether to consolidate an entity or not, which have had a material impact on the financial statements, are disclosed.

Non-consolidated entities

The disclosures we are proposing for non-consolidated entities will be required when a party has significant involvement with an entity. The recent credit crisis highlighted the need for this information. In April 2008, the Financial Stability Forum recommended that financial institutions make robust risk disclosures in their mid-year reports to enhance the transparency of financial statements. They also recommended that the current accounting and disclosure standard for off-balance sheet entities be improved.

Significant involvement

For non-consolidated entities in which a party has significant involvement, we propose that the financial statements give the assets and liabilities of these entities so that a user can assess the relative scale of on and off balance sheet activity. We anticipate that the information about these entities would involve a high level of aggregation.

This requirement has been described by some as a 'parallel balance sheet'. Such a requirement would only be required if significant involvement is material.

Having established the extent of significant involvement, the draft ED proposes requiring an explanation of the circumstances that would lead to a party having control over entities in which they currently have significant involvement.

QUESTIONS:

10. Do you support a requirement to disclose additional information in those circumstances in which the consolidation decision was not straight-forward?

11. Do you support the proposal to require the disclosure of more information about the claims of non-controlling interests?

12. Do you support the suggested disclosures in relation to significant involvement?

13. Would you, as a preparer of financial statements, be able to produce the additional information required to be disclosed under the draft ED?

Other issues

Agency arrangements (including fund managers)

See draft ED B33-B42

IAS 27 and SIC-12 do not contain requirements for the treatment of interests held in another entity via an agent. By introducing principles that address the principal-agency relationship we expect to reduce diversity in practise.

An agent is a party that is required under an agreement or law to act in the best interests of a principal. An agent is unlikely to be able to establish or change any of the key strategic policies of an entity. An agent will receive reward for its services that is in proportion to the services provided. The reward could be structured so that it is an incentive to act in the best interests of the principal.

An agent will fail the control test because, even though it has some powers, the agent is required by agreement or law to use that power for the benefit of the parties for which it is acting. The ability of an agent to benefit from the assets over which it has power is restricted and its entitlement to benefits must be agreed between it and its principals.

The draft ED proposes that the holdings of agents should be considered as part of a party's interest when they are assessing control as power does not need to be held directly. The types of holding that should be considered will include those held by senior management of the party, legal entities with the same board, close business relationships, parties who cannot sell, transfer or encumber their holding without permission of the controlling party, those parties who need the financial support of the controlling party and related parties (as defined in IAS 24 *Related Parties*).

Agents will include those parties who are acting in a fiduciary capacity. However, where an entity has a dual role, for example a fund manager may act in a fiduciary capacity and have a direct investment in the fund it is managing, we propose including in the draft ED a requirement that control is assessed by considering the two positions collectively—see paragraph B42 .

QUESTION:

14. Do you agree that where a fund manager has dual role - it acts in a fiduciary capacity and hold a direct investment in the investee- the fund manager should consider the two positions collectively when determining whether it has control? If not, why not?

    Please provide examples for which you believe that in spite of the dual role performed by the fund manager you believe it is appropriate for the fund manager not to consolidate the entity.

Investment companies (including venture capital and private equity)

The draft ED does not propose exempting parent entities that are venture capital organisations, mutual fund, unit trust or similar organisations from having to apply the full consolidation procedures to any entity it controls. This is consistent with IAS 27.

There is an alternative view that requiring an investment entity to consolidate does not reflect management intentions or the way the investment is managed. Supporters of this view argue that these types of entities manage their investments on a net basis and therefore presenting the underlying assets and liabilities is misleading and uninformative.

The basic principle in IFRS is that the consolidated financial statements should show the entities that are under control of the reporting entity. We have concluded that an exemption for investment companies in IFRS is not justified.

The Board's reasoning , as given in IAS 27 BC22 still holds:

> "*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*."

QUESTION:

15. Do you agree that investment companies should be required to consolidate any entities it controls? If not, why not?