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International
Accounting Standards
Board

This document is provided as a convenience to observers at the World Standard Setters meeting, 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 WSS meeting. Paragraph numbers correspond to paragraph numbers used in the WSS agenda paper.

INFORMATION FOR OBSERVERS

WSS Meeting: **September 2008, London**

Project: **Consolidation - an introduction to the staff working draft**
Agenda paper 1

INTRODUCTION

1 The most recent version of the staff draft of the proposed IFRS that would replace IAS 27 and SIC-12 is attached. It is a working draft. An earlier version was discussed by the Board at its meeting in July. The version you have reflects comments received from the Board as well as comments received from our consultations with outside parties.

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 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 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 principles are also preceded by explanations that will eventually be moved to the basis for conclusions.

5 At the WSS meeting we will summarise the principles underpinning the staff working draft of a proposed revised consolidation standard and work through some key points. We will also describe the consultations we are undertaking. These include a public round-table in London in the week following the WSS meeting.

6 At the WSS meeting we have break-out sessions which will give you the opportunity to provide feedback on the proposals. We are particularly interested in your feedback on:

(a) the overall direction of the package;

(b) the definition of control; and

(c) the emphasis on identifying what power is important rather than asking whether an entity is on auto-pilot.

7 We will be posting regular updates with revised versions on the consolidations project page on the IASB Website.

OBJECTIVE

8 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.

9 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

10 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 entities under the control of the reporting entity.

11 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 entity or through separate 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 entities controlled by the parent are ignored.

12 We do not define the entity that might have control over another. Also, we do not explain why an 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.

CONTROL

13 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 an entity as follows:

> A party controls an entity when it currently has power sufficient to enable it to manage the individual assets and liabilities of that entity so as to benefit by generating returns from them.

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 an entity. In contrast, we believe that a party can control an entity in many ways. The following paragraphs explain first how a party might have control over an entity because it has control over the strategic operating and financing policies. We explain then in a second step why a party might control an 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 an entity

18 We continue to believe that a common way to achieve control over an entity is by controlling its strategic operating and financing policies. Control over the strategic operating and financing policies of an entity can give a party 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 an entity gives the controlling party the current power to manage the assets and liabilities of that entity so as to benefit from them.

19 Control over the strategic operating and financing policies of an entity is often achieved by having a majority of the voting rights of that entity. Our working draft presumes that a party that controls more than half of the voting rights of an entity controls that entity. However, a party does not need to have the majority of the voting rights to control an entity. Our working draft clarifies that a party can also have control over the strategic operating and financing policies of an 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 party 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 party with control over an entity. The following example illustrates the requirement in our working draft:

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

Control of an entity without control over its strategic operating and financing policies

22 We believe that a party could have control over an entity even though it does not control of what generally be thought of as its strategic operating and financing policies. The constituting (founding) documents of an entity, and the legal framework in which it operates, might limit the range of transactions and activities in which an entity can engage or define a range of transactions and activities in which it is not permitted to engage. For example, an entity might be prohibited from investing into a new type of business without all of its owners agreeing to such a change.

23 The powers available to an 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 the entity. Those entities are often called special purpose entities and the limitation of the powers of the 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

entities regardless of their nature and, thus, to eliminate the need for more or less arbitrary categorisations of entities.

A revised control definition

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

25 Our working draft contains therefore a broader definition of control. That is, our working draft focuses on the control that a reporting entity has over the assets and liabilities of an entity, regardless of the means according to which a party has achieved that control. This means that an entity reporting accounts for its assets and liabilities the same way, regardless of whether it owns those assets and liabilities directly or whether it controls the entity that has legal title to those assets or liabilities.

26 Therefore, when a party assesses whether it has control over an entity, it is often helpful to understand how else it could have structured the transaction and why the party has chosen a particular legal form. We believe that if the party could have undertaken the business activities or transactions within its own legal structure (ie by the parent) with substantially the same economic effect that is achieved by undertaking the business activities or transactions in separate legal entities, this is an indication that the party controls the entity.

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

28 When assessing control the party needs to investigate whether its relationship to an entity meets all components of the control definition. A party controls a legal entity if it is exposed to benefits from that entity and 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:

> An entity might sell receivables to another entity. The second entity finances the acquisition of the receivables by issuing senior bond notes to third party investors and junior bond notes to the first entity. The second 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 second entity have been restricted severely. The only powers available to the second 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 second entity.
>
> In this example the first entity is likely to control the second 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 first entity has the power to manage the receivables and is therefore able to affect the performance of the second 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 an entity

> Benefits are the returns to which a party is entitled from its involvement with an entity, which vary with the performance of the entity.

ACCOUNTING REQUIREMENTS

31 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

32 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 an entity should disclose information that enables users of its financial statement to evaluate:

(a) the judgements that management has made in applying the [proposed] IFRS 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 a parent's use of subsidiaries to manage its group.

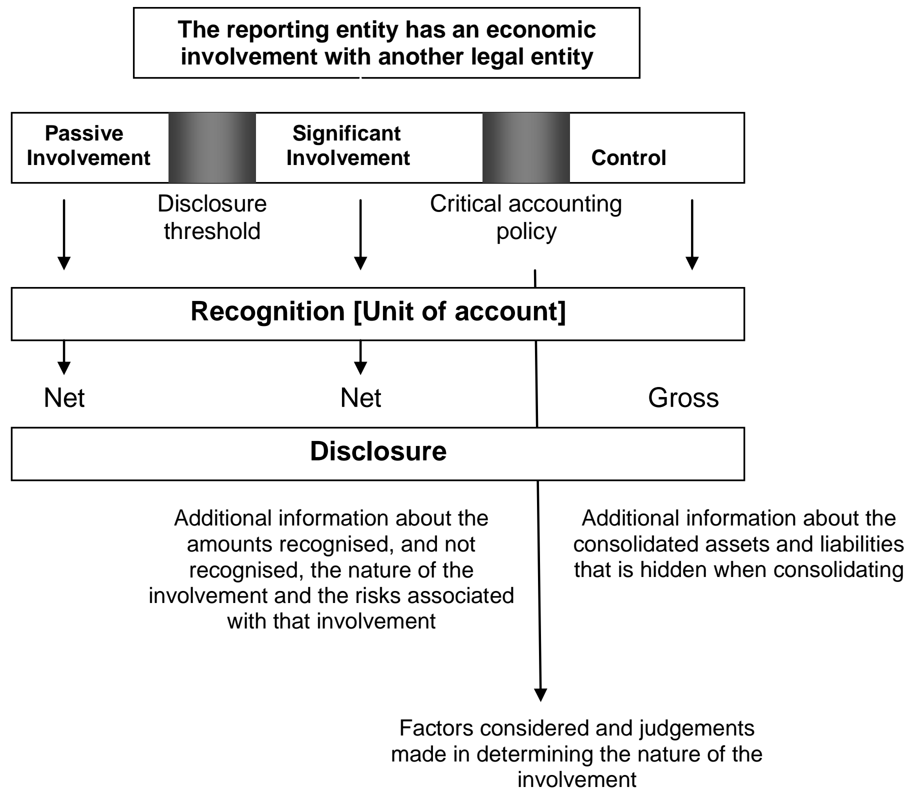
(c) the financial effects of changes in a parent's ownership interest or the loss of control of a subsidiary.

(d) the nature of, and risks and benefits associated with entities that it does not control but with which it has significant involvement.

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

Significant Involvement

34 We have developed disclosure principles for entities that the reporting entity controls as well as for entities in which the reporting entity has significant involvement. The reporting entity consolidates all 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. Entities that the reporting entity neither controls nor has a significant involvement in are not disclosed. The diagram illustrates this observation:


The reporting entity has an economic involvement with another legal entity
Passive Involvement
Significant Involvement
Control
Disclosure threshold
Critical accounting policy
Recognition [Unit of account]
Net
Net
Gross
Disclosure
Additional information about the amounts recognised, and not recognised, the nature of the involvement and the risks associated with that involvement
Additional information about the consolidated assets and liabilities that is hidden when consolidating
Factors considered and judgements made in determining the nature of the involvement