



Project **Consolidation**

Introduction

1. ED10 *Consolidated Financial Statements* was published in December 2008 as part of the Board's **Consolidation** project. The objectives of the project are to:
 - (a) provide clearer and more consistent requirements for identifying whether a reporting entity (a parent) controls another entity (a subsidiary) than we currently have in IFRS; and
 - (b) improve the information available to investors about the risks a reporting entity has from its involvement with entities that it does not control (such as securitisation and investment vehicles).
2. To achieve these objectives, the Board proposes replacing IAS 27 *Consolidated and Separate Financial Statements* and SIC-12 *Consolidation-Special Purpose Entities* with a new IFRS. ED 10 proposes a revised definition of control and introduces related application guidance so that one control model can be applied to all entities, replacing the two models in IAS 27 and SIC-12. ED 10 also proposes new disclosure requirements in relation to consolidated and unconsolidated entities. The comment period for ED 10 ended on 20 March 2009.
3. The staff presented a summary of comments received to the Board at its May meeting—that summary is available on the IASB website at <http://go.iasb.org/Consolidation+comment+letter+analysis>.
4. We have used the comments received from respondents to focus the discussion at the round table sessions. We will incorporate your input into the Board papers that will be presented to the Board when it deliberates each of the topics.

This paper has been prepared by the technical staff of the IASB for the purposes of discussion at a public round table meeting of the IASB.

The views expressed in this paper are those of the staff preparing the paper and do not purport to represent the views of any individual members of the Board or the IASB.

The meeting at which this paper is discussed is a public meeting but it is not a decision-making meeting of the Board. Official pronouncements of the IASB are published only after the Board has completed its full due process, including appropriate public consultation and formal voting procedures.

5. This paper was prepared by the staff and does not necessarily reflect the views of the Board—the Board will commence deliberations of ED10 on the basis of comments received in July 2009.
6. This paper has four sections, reflecting the main concerns respondents expressed in their comment letters:
 - (a) The control model
 - (b) Assessing control of an entity
 - (c) Agents
 - (d) Disclosure

The control model

7. ED10 proposes that control should be the only basis for consolidation, in line with the Board's preliminary views on the conceptual framework project. A reporting entity presents financial statements that consolidate its assets, liabilities, equity, income, expenses and cash flows with those of the entities that it controls (ie its subsidiaries).
8. Paragraph 4 of ED10 defines control of an entity as follows:

A reporting entity controls another entity when the reporting entity has the power to direct the activities of that other entity to generate returns for the reporting entity.
9. The vast majority of respondents supported control as the basis for consolidation. However, some respondents suggested that the Board should address *why* consolidated financial statements are prepared in determining the basis for consolidation—why should a reporting entity present the assets and liabilities that underlie its investment in another entity as if they were its own, and thus, when does it provide better information to do so?
10. ED 10 was developed on the premise that consolidated financial statements should present the assets and liabilities that a reporting entity has the power to direct, and can benefit from that power.

11. In contrast, although they expressed a preference for a control model, many respondents appeared to support the idea that consolidated financial statements should present the assets and liabilities that underlie a reporting entity's exposure to risks and rewards, irrespective of whether the reporting entity has the power to direct those assets and liabilities.
12. Control of an entity does not necessarily mean that a parent controls each asset or has an obligation for each liability of its subsidiaries. Rather, a parent has control at an entity level—power to direct the activities of the subsidiary so as to benefit from having that power. The control definition in IAS 27 and ED10 implies that power must be seen—ie a reporting entity controls another entity if it has the power to direct the activities of that other entity to generate returns for itself, and that power is evident through the existence of decision making power (eg substantive voting rights or rights within other contractual arrangements).
13. SIC-12 *Consolidation—Special Purpose Entities* is an interpretation of IAS 27 and, accordingly, states that a special purpose entity (SPE) is consolidated when the substance of the relationship between a reporting entity and the SPE indicates that the reporting entity controls the SPE. However, SIC-12 includes four indicators of control, two of which refer to the majority of risks and rewards, and two of which focus on the purpose of the SPE and the decision-making powers in the context of who benefits from the activities of the SPE. Because many of the decision making powers are predetermined in a SPE, it appears that SIC-12 is applied in practice with a strong emphasis on risks and rewards.
14. We agree that presenting information about a reporting entity's exposure to risks provides useful information. ED10 proposes however that the only basis for consolidation should be control (which requires both power and returns) and that information about the risks and rewards to which a reporting entity is exposed (without having any means of managing or influencing that exposure through decision making) is disclosed in the notes to the financial statements. Identifying which assets are controlled is itself an important part of understanding the risks an entity faces. ED10 would not combine assets and liabilities of another entity together with those of a reporting entity and imply

that the reporting entity controls those assets and liabilities, and thus has the ability to manage its exposure to risks and rewards, when it does not.

Risks and rewards within the control model

15. Even though ED 10 is based on control, risks and rewards are integral to a control model and how control is assessed.
16. Respondents to ED10 did not think that the importance of risks and rewards was expressed clearly enough, and suggested different ways to make the role of risks and rewards more explicit. Alternative views are:
 - (a) Risks and rewards are integral to the control model. The benefits/returns criterion requires a reporting entity to be exposed to variability of returns—put another way, a reporting entity must be exposed to risks and rewards in order to control another entity. In addition, a reporting entity will meet the power criterion only if its power gives it the ability to direct the activities of an entity to generate returns for itself—ie a reporting entity must have the ability to affect or influence its exposure to risks and rewards.
 - (b) Exposure to risks and rewards is an indicator of control. A reporting entity's exposure to risks and rewards alone does not meet the definition of control. However the more a reporting entity is exposed to risks and rewards, the more likely it is that that reporting entity also has power to direct the activities of that entity.
 - (c) Exposure to the majority of the risks and rewards, or another specified level of exposure, leads to a presumption of control unless the reporting entity can demonstrate otherwise.
 - (d) Exposure to the majority of the risks and rewards, or another specified level of exposure, should be included as a 'fall back' test for control. Therefore if one party is not identified as having the power to direct the activities of an entity (and power is not shared/divided), the party exposed to the majority of the risks and rewards, or another specified level of exposure, controls the entity.
17. ED10 incorporates alternatives (a) and (b) noted above in paragraph 16. SIC-12 is focused mainly on alternative (b)—exposure to the majority of risks or rewards is applied as a strong indicator of control and, in some situations, can constitute control of an entity in and of itself.

ED10 proposes that the only basis for consolidation should be control—control is defined as requiring both a power and a returns element. Do you agree that power must be seen irrespective of the nature of the entity?

Paragraph 16 sets out four alternatives as to how to integrate risks and rewards into the control model. Currently ED10 proposes that risks and rewards are included as described in paragraph 16(a) and (b). Which alternative(s) do you prefer and why, noting whether your preferred alternative should apply to all entities or to a particular subset of entities?

Assessing control of an entity

18. ED10 proposes that **control of an entity** be defined as:

A reporting entity controls another entity when the reporting entity has the power to direct the activities of that other entity to generate returns for the reporting entity

Separate guidance for structured entities

19. The ED proposes that the definition be used to assess the relationship between a reporting entity and its related entities, whether those related entities house operating activities (such as a branch that is managed within a separate legal structure) or financing or investing type vehicles such as securitisation vehicles or investment funds. The ED does, however, include separate guidance for what it calls structured entities (entities whose activities are restricted to the extent that those activities are not directed as described in paragraphs 23-29 of ED10).
20. Almost all respondents to ED10 recommended having one combined section on assessing control, noting that the guidance for structured entities was largely applicable to all entities.
21. We agree and are encouraged by these comments. Our early drafts took that approach, but early feedback suggested that it would be better to provide special application guidance for what ED10 calls structured entities. We will propose to the Board having one combined section on assessing control in the final standard.

Involvement in the design of an entity

22. Many respondents believe that a reporting entity's involvement in the design of an entity (with restricted activities) is a strong indicator of control, and indeed,

in some situations, would conclude that involvement in the design alone is sufficient to meet the power criterion of the control definition. SIC-12 includes this notion as one of its indicators of control and states the following in its basis for conclusions:

SPEs frequently operate in a predetermined way so that no entity has explicit decision-making authority over the SPE's ongoing activities after its formation (ie they operate on 'autopilot'). Virtually all rights, obligations, and aspects of activities that could be controlled are predefined and limited by contractual provisions specified or scheduled at inception. In these circumstances, control may exist for the sponsoring party or others with a beneficial interest, even though it may be particularly difficult to assess, because virtually all activities are predetermined. However the predetermination of the activities of the SPE through an 'autopilot' mechanism often provides evidence that the ability to control has been exercised by the party making the predetermination for its own benefit at the formation of the SPE and is being perpetuated. (emphasis added)

23. When we developed the exposure draft, we decided that being involved in setting up an entity was not, in and of itself, sufficient to indicate control. Being involved in the design does not mean that a reporting entity will have the ability to direct the activities of the entity. In addition, several parties are often involved in the design of an entity and the final structure of the entity includes whatever is agreed to by all those parties (including investors, rating agencies, the sponsor of the structure, the transferor(s), and other parties involved in the deal).
24. Although the success of, for example, a securitisation will depend on the assets that are transferred to the securitisation entity the transferor might not have any further involvement with the securitisation entity. The benefits from being involved in setting up a vehicle could cease as soon as the vehicle is established. This does not seem to be an appropriate basis for consolidation.
25. Having said that, we do think that considering the purpose and design of an entity can be important when assessing control. Understanding the purpose and design helps identify the activities that cause the returns of the entity to vary, who has power to direct those activities and who benefits from that direction.

How important is a reporting entity's involvement in the design of an entity when assessing control? Do you think that, in and of itself, a reporting entity's involvement in the design of an entity is sufficient to meet the power criterion? How should involvement in the design be weighed against any ongoing decision making powers when assessing power to direct the activities of an entity?

Rights that are available only when specified circumstances arise or events happen

26. Paragraph 34 of ED10 states (within the section on assessing control of a structured entity):

A reporting entity identifies what activities cause the returns to vary and assesses whether it has power to direct those activities. A reporting entity's ability to act when circumstances arise or events happen constitutes power if that ability relates to the activities that cause the reporting entity's returns to vary.

The exposure draft illustrates this guidance with an asset securitisation example that notes that the power to direct how any defaulting receivables are managed would constitute the power criterion of the control definition if managing any defaulting receivables is the only activity that causes the returns to vary.

27. Many respondents disagreed with the guidance, commenting that the ability to act, or having rights that can be exercised, ***only*** in the future and upon the occurrence of events outside the control of the holder of those rights is not current power. Rather, it is contingent power.
28. We agree that having the ability to act in the future is contingent power, but only if those rights are protective. A bank that has the ability to seize assets if a borrower fails to meet specified repayment conditions would not normally control those assets until after the borrower defaults and the assets have been seized.
29. What we had in mind in developing the ED 10 wording is those cases where these so-called contingent rights are really the mechanism that ensures that the party with those rights has power over the activities of the entity when those powers are needed. This is no different to an operating entity for which a majority shareholder exercises its power when it needs to.
30. Sometimes those rights will not be given in isolation. There could be a related arrangement under which the activities are managed within very narrow

parameters and the ‘contingent’ rights kick in as soon as the returns of individual assets vary outside defined margins.

31. To illustrate this point, suppose a reporting entity has a policy of taking remedial steps for any receivables that are outstanding for more than 90 days. The reporting entity could apply this policy using internal staff. Alternatively, the reporting entity could transfer the receivables to a separate entity and have an external party (an agent) collect the amounts due according to predetermined procedures that match the reporting entity’s internal policies. That agreement could specify that the reporting entity steps in and takes over managing any receivables of the entity that are outstanding for more than 90 days. We think the economic risks and the associated powers are, essentially, the same and should be accounted for in the same way. The reporting entity has the power when that power is needed.

Issue 3

When assessing current power to direct the activities of an entity, in what situations, if any, do you think that a reporting entity should consider rights that are available only when specified circumstances arise or events happen?

Identifying the activities that cause the returns to vary

32. ED10 states that ‘a reporting entity identifies what activities cause the returns to vary and assesses whether it has power to direct the activities.’
33. Some respondents have suggested adding the word ‘significant’ so that the power criterion is met only when a reporting entity has power to direct the activities that cause the returns to vary significantly, or put another way, power to direct the activities of an entity that significantly affect the returns. Adding the word ‘significant’ would help distinguish those activities that are relevant when assessing control from those that are not.
34. In its amendments to FIN 46(R) *Consolidation—Variable Interest Entities*, the FASB is proposing to say ‘most significantly impacts ...’. Adding the word ‘most’ could help limit avoidance by those who would otherwise argue that either that none of the activities significantly affect the returns, or that more than one party has the power to direct activities that significantly affect the returns of the entity.

Issue 4

Do you think that the final consolidation standard should state that the power criterion relates to having the ability to direct the activities of an entity that significantly affects the returns? Should it go one step further and say that power is the ability to direct the activities of an entity that most significantly affects the returns? Or do you have another suggestion?

***When can power be shared or divided, such that no one party controls an entity?*¹**

35. Many respondents requested more guidance for assessing control when more than one party might appear to have decision making authority over the activities of an entity.
36. Having identified the activities that significantly affect the returns of an entity, how is power assessed when the decisions relating to those activities are made by different parties? The main situations that we need to address are:
- (a) An entity could have different activities that significantly affect the returns. For example, in a beer manufacturing and distribution entity, one party might make all decisions about the brewing of the beer and another makes all decisions about the distribution of the beer; or, in a structured investment vehicle, one party makes all decisions relating to managing the assets and another makes all decisions about the funding of the vehicle.
 - (b) Multiple parties have unilateral power to direct portions of the activities of an entity. For example, several, unrelated, parties have the power to direct how different bundles of assets are managed (eg a multi-seller securitisation).
37. In situations described in paragraph 36(a), by stating that power is the ability to direct the activities that most significantly impact the entity's economic performance, the amendments to FIN 46(R) would require the parties involved to identify which of those activities most significantly affects the returns of the entity—the party with power to direct that activity would meet the power criterion.

¹ Joint control, as defined in IAS 31 *Interests in Joint Ventures*, is not addressed in this paper. Nevertheless, power is shared in entities that meet the definition of a joint venture in IAS 31 (ie the parties have joint control).

38. In situations described in paragraph 36(b), the amendments to FIN 46(R) deal with this in two ways. If a portion (but not all) of a variable interest entity is controlled by one party, FIN 46(R) requires consolidation of that portion—a portion is described as specified assets (and related credit enhancements, if any) together with specified liabilities or specified other interests that are essentially the only source of payment for the specified assets. Such portions are sometimes referred to as silos—this concept was referred to in ED10.
39. If the entity does not include silos, but the activity that most significantly impacts the entity’s economic performance is directed by multiple unrelated parties, the amendments to FIN 46(R) conclude that the party, if any, with the power over the majority of that activity meets the power criterion.
40. In our view, we could either:
- (a) address situations described in paragraph 36(b) in a similar manner to the FASB;
 - (b) explore expanding the application of the concept of a silo (for example, to entities in which there are separate pools of assets within the entity but only one pool of beneficial interest holders who receive economic benefits from all assets of the entity); or
 - (c) not address the situation in paragraph 36(b) because it is unlikely to occur in practice.

Issue 5

In situations described in paragraph 36(a) and (b), do you think that power could be shared or should the parties involved be required to identify the party with most power as the party that meets the power criterion when assessing control?

Agents

41. Paragraphs B3-B8 of ED10 provide application guidance to assess whether a reporting entity acts as an agent. An agent is a party engaged to act on behalf of another party or parties that uses any decision-making ability delegated to it to generate returns primarily for the other party or parties.
42. Most respondents supported including application guidance on the characteristics of agents in the revised consolidation standard.

Removal rights

43. One of the indicators of an agency relationship included in ED10 is the existence of removal rights. Although such rights are indicative they are not required to be able to conclude that a party acts as an agent.
44. Some respondents asked the Board to provide additional guidance. In particular, they asked the Board to clarify whether removal rights need to be held by one party only and whether that party needs to be able to exercise those removal rights without cause.
45. ED10 states that removal rights can be an indicator of an agency relationship, but implies that all facts and circumstances should be considered without specifying requirements with respect to the contractual terms of the removal rights. This implies that the removal right must be without cause, but can be held by more than one party. We note that this conflicts with the amended FIN 46(R) (which will state that a removal right affects the assessment of power only when one party has the unilateral ability to exercise those removal rights).

Issue 6

Are you aware of circumstances in which the guidance proposed in ED10 regarding removal rights would lead to inappropriate consolidation answers? If so, what approach would you suggest and why?

Disclosures

46. ED10 carries over some disclosure requirements from IAS 27, but proposes also that an entity should disclose information that enables users of its financial statements to evaluate:
- (a) the basis of control and the related accounting consequences;
 - (b) the interest that the non-controlling interests have in the group's activities;
 - (c) the nature and financial effect of restrictions that are a consequence of assets and liabilities being held by subsidiaries; and
 - (d) the nature of, and risks associated with, the reporting entity's involvement with structured entities that the reporting entity does not control

All disclosure requirements are supplemented by extensive application guidance in Appendix B to ED10.

47. Most respondents were generally supportive of the Board addressing additional disclosures to meet the needs of users in light of the financial crisis. However, many of those voiced concerns that the proposed disclosure requirements are too prescriptive and so voluminous they have the potential to obscure key information.
48. Respondents' comments focused mainly on the requirements for structured entities that a reporting entity does not control (paragraph 46(d) of this paper).

Off-balance sheet risk (paragraphs B38-B47 of ED10)

49. ED10 requires disclosure of the reporting entity's involvement with structured entities that the reporting entity does not control. ED10 describes involvement with a structured entity to include both contractual and non-contractual involvement that exposes the reporting entity to variability of returns of the structured entity. A structured entity is an entity whose activities are restricted to the extent that those activities are not directed as described in paragraphs 23 – 29 of ED10 (in effect, the activities are not directed through decision making or voting rights).

Principle

50. Some respondents agreed with the underpinning principle of the proposed disclosure requirements because they thought that to obtain a better understanding of the risk associated with a reporting entity's involvement with unconsolidated structured entities a user would need information about the activities, the assets and, if relevant, liabilities of the structured entity that affect the reporting entity's risk exposure. In addition a user would need information about the contractual terms of the reporting entity's involvement with the structured entity (eg triggers for providing financial support; ranking in terms of absorbing losses).
51. Other respondents disagreed with this view and argued that the counterparty should not matter for the analysis of the reporting entity's risk exposure. Those respondents believe that a risk analysis should focus on the instruments that create risk, regardless of whether the risk is associated with a reporting entity's involvement with a structured entity or a traditional entity. They believe that instead of expanding the disclosure requirements in the consolidation standard, the Board should focus on improving the requirements in IFRS 7.

Scope

52. Most respondents also expressed concerns about the scope of the proposed disclosure requirements because:
- (a) the term "involvement" has a wide meaning and captures any relationship with a structured entity, including arm's length service provider relationships. Some respondents argued therefore that the proposed requirements should apply only to significant involvement.
 - (b) the disclosure requirement asks an entity to apply the definition of a structured entity to entities that the reporting entity does not control. They state that this is likely to prove difficult because the reporting entity will have limited access only to information (for example, the reporting entity would have to assess the importance of voting rights for a structured entity that it does not control).

Content

53. ED10 proposes requiring a reporting entity to disclose:
- (a) the nature and extent of the reporting entity's involvement with structured entities that it does not control; and
 - (b) the nature and extent of, and changes in, the market risk, credit risk and liquidity risk from the reporting entity's involvement with structured entities that it does not control.
54. To meet the latter requirement ED10 proposes, among others, that an entity should disclose both the assets and liabilities of the reporting entity that relate to its involvement in the structured entity and the assets of the structured entity. In addition, the reporting entity should disclose its maximum exposure to a loss from its involvement with the structured entity.
55. Many respondents commented on technical aspects of this and other disclosure requirements. For example, they questioned how a reporting entity should:
- (a) aggregate its risk exposure to structured entities into meaningful categories;
 - (b) obtain information about the assets and liabilities of a structured entity that it does not control, particularly if the structured entity did not prepare financial statements in accordance with IFRSs;
 - (c) determine the maximum exposure to a loss and how it should apply this requirement to derivatives that have theoretically an exposure to unlimited losses.

Alternatives

56. We have identified the following alternatives that the Board could pursue further regarding the proposed disclosure requirements for off balance sheet risk:
- (a) Affirm the proposed disclosure requirements in paragraphs B38-B47 of ED10.
 - (b) Amend the proposed disclosure requirements in ED10 to clarify that it applies only to **significant** involvement with structured entities and address the issues identified in paragraph 55 of the paper and similar issues.

IASB Staff paper

- (c) Amend the proposed disclosure requirements in ED10 to apply to significant involvement with **all** entities and address the issues identified in paragraph 55 of the paper and similar issues.
- (d) Remove the proposed disclosure requirements from ED10 and amend IFRS 7/IAS 37 to require, in addition to the disclosures about the assets and liabilities that are exposed to risk, disclosures about the activities and assets (and/or liabilities) of the counterparty as well as the contractual terms of the reporting entity's involvement with that counterparty (where relevant to an assessment of risk).

Issue 7

The disclosures about unconsolidated entities in ED10 were on the basis of the principle in paragraph 50, ie that off balance sheet disclosures should be limited to involvement with structured entities. Should we retain the notion of a structured entity for disclosure purposes or do you think that we should provide more general risk disclosure requirements that would apply to all entities? Where should those disclosures be located, ie in the consolidation standard or a revised IFRS 7?