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Project	<b>Consolidation</b>
Topic	<b>Involvement in the design of a structured entity</b>

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## Introduction

1. Paragraph 32 of ED 10 *Consolidated Financial Statements* (the ED) states that understanding the purpose and design of a structured entity helps assess how the activities of that entity are directed and how returns are shared among its parties. This agenda paper investigates whether involvement in the design of a structured entity is, in isolation, sufficient to conclude that a reporting entity controls another entity.
2. The agenda paper:
  - (a) explains how involvement in the design of a structured entity would affect a reporting entity's control assessment according to the ED;
  - (b) provides an overview of respondents' comments; and
  - (c) analyses whether in light of those comments the Board should amend its proposals.

## Proposed requirements in the ED

3. Paragraph 36 of the ED states that sometimes some activities of a structured entity are directed by means of predetermined strategic operating and financing policies that specify the actions that must be taken in response to anticipated events or circumstances. Such predetermined policies can give a reporting entity the power to direct those activities.

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

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4. Many respondents believed that this requirement was ambiguous and asked the Board to clarify when and how the predetermination of the strategic operating and financing policies would give the reporting entity power.
5. What we had in mind in developing the wording in the ED was that the parties involved in the design of a structured entity would usually predetermine some activities of the structured entity and allocate the direction of other activities among the parties involved with that entity. For a reporting entity to have the power to direct the activities of a structured entity, it must have the decision-making authority to direct the activities that matter. That decision-making authority is usually agreed to by all parties when an entity is established.
6. Understanding the purpose and design of the structured entity helps understand which parties can direct which activities, whether those activities are significant and how the returns from the structured entity are shared among the parties. The parties that have decision-making authority are also often involved in the design of a structured entity. Therefore, identifying the parties involved in the design can help identify those parties that have the ability to direct some or all of the activities of an entity. However, involvement in the design of a structured entity is not, in isolation, sufficient to conclude that a reporting entity controls the structured entity.
7. Paragraph 32 of the ED expressed this as follows:

Understanding the purpose and design of a structured entity helps assess how the activities of that entity are directed and how returns are shared among its participants. For example, a reporting entity is likely to control a structured entity that has been created to undertake activities that are part of the reporting entity's ongoing activities (eg the entity might have been created to hold legal title to an asset that the reporting entity uses in its own activities, providing a source of financing for the reporting entity). The reporting entity is unlikely to surrender power to direct such a structured entity's activities because of the importance of those activities to the reporting entity's activities.

**Respondents' comments**

8. Respondents had mixed views on whether involvement in the design of a structured entity would be sufficient to indicate control. Some respondents and

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most round table participants agreed that the reporting entity's involvement in the design of the structured entity makes it likely, but does not guarantee, that the reporting entity has the power to direct the activities of the structured entity to generate returns for the reporting entity.

9. In contrast, many respondents disagreed with the proposal because they did not share the Board's assumption that the parties involved with the design of a structured entity are unlikely to predetermine all activities of the structured entity. Rather, they believed that the parties involved in the design of a structured entity would often predetermine all significant activities and would leave only administrative tasks open to the decision of particular parties. Therefore, those respondents were concerned that the ED would base the control assessment on power over insignificant activities that could easily be outsourced to avoid consolidation.
10. Those respondents believed that, similar to the requirements in SIC-12 *Consolidation—Special Purpose Entities*, involvement in the design of a structured entity should be a conclusive indicator of control. In their view, a reporting entity can have power to direct the activities of an entity by different means, including:
  - (a) current rights (ie voting rights or currently exercisable options);
  - (b) rights to act in the future (discussed in agenda paper 3C *Protective and participating rights*); and
  - (c) past actions (ie the pre-determination of policies of a structured entity).
11. Therefore, they argued that a reporting entity does not lose its ability to direct the activities of another entity when it predetermines those activities. Rather, the predetermination of those activities ensures that the entity acts according to the wishes of the reporting entity.

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**Staff Analysis**

12. To meet the power element of the control definition, we believe that a reporting entity must have the ability to make decisions about the activities of an entity that significantly affect the returns. Past decisions affect the control assessment only to the extent that they give a party decision-making authority over those activities.
13. In our view, the reporting entity's involvement in the design of an entity makes it likely that the direction of some activities of the entity has been allocated to the reporting entity. The entity may have been designed to ensure that a reporting entity has decision-making authority over the activities that significantly affect the returns at the only time that such decision-making is required—in this case, the reporting entity has the current ability to direct those activities.
14. However, involvement in the design of a structured entity does not necessarily imply that the reporting entity controls the structured entity because the decision-making authority over some or all of the activities that significantly affect the returns of the entity might have been allocated to other parties.
15. 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 the entity could cease as soon as the vehicle is established. Thus, a control indicator based on a party's involvement in the design of a structured entity would no longer be applicable when the parties involved with that entity change. As a consequence, if we were to conclude that involvement in the design of an entity indicates control, we would need to develop additional guidance as to when involvement in the design of a structured entity should be used as an indicator and when not.
16. In addition, several parties are often involved in the design of an entity and the design reflects the interests of all of those parties including, for example, the transferor, the investors, a sponsor, rating agencies and other parties involved in

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the transaction. As a consequence, it will not always be possible to clearly attribute the design of an entity to one party only. Thus, if we were to conclude that involvement in the design of an entity indicates control, the final standard would need to contain additional guidance as to how to assess control when more than one party was involved in the design of an entity.

17. Having said that, we do think that considering the purpose and design of an entity is important when assessing control. Understanding the purpose and design helps identify the activities of an entity that significantly affect the returns, who has the decision-making authority to direct those activities and who benefits from that direction.
18. Therefore, we recommend that the Board affirms in the final consolidation standard that understanding the purpose and design of an entity is an important factor to consider when assessing control of an entity. However, it is not, in isolation, sufficient to conclude that the reporting entity controls another entity.

**Consistency with the requirements of SFAS 167**

19. The staff recommendation is consistent with the requirements in SFAS 167 *Amendments to FIN 46(R) Consolidation of Variable Interest Entities*.

Paragraph 14F of SFAS 167 states the following:

Although an enterprise may be significantly involved with the design of an entity, that involvement does not, in isolation, establish that enterprise as the enterprise with the power to direct the activities that most significantly impact the economic performance of the entity. However, that involvement may indicate that the enterprise had the opportunity and the incentive to establish arrangements that result in the enterprise being the variable interest holder with that power.

**Question for the Board**

Does the Board agree with the staff recommendation to clarify that:

- (a) understanding the purpose and design of an entity is an important factor to consider when assessing control of that entity, and
- (b) involvement in the design of an entity is not, in isolation, sufficient to conclude that the reporting entity controls that entity?

If not, what do you propose and why?