



Project	Consolidation
Topic	Structured entities

Introduction

1. The purpose of this paper is to provide the boards with information to determine whether additional guidance specific to structured entities should be provided in the overall consolidation guidance. The purpose of including this guidance, if the boards so choose, would *not* be to propose a separate consolidation model for structured entities. Rather, it would be to define the scope for particular disclosures and, potentially, to emphasise features in analysis pertinent to structured entities within the overall control model.

Statement 167

2. The FASB issued Statement 167, *Amendments to FASB Interpretation No. 146(R)* (now codified in Topic 810, *Consolidations*), in June 2009. The FASB's purpose for issuing this guidance was to improve financial reporting by reporting entities involved with variable interest entities (hereafter referred to as structured entities). The FASB undertook this project to address constituent concerns about the application of FASB Interpretation 46 (revised December 2003) (FIN 46(R), *Consolidation of Variable Interest Entities*), and the elimination of the qualifying special-purpose entity (QSPE) concept, which, among others, exempted QSPEs from consolidation. Specifically, constituents were concerned that (i) the accounting and disclosures under FIN 46(R) did not always provide timely or useful information, and (ii) reporting entities that appeared to control structured entities were not required to consolidate these entities under the guidance.

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

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

Comments made in relation to the application of IFRSs or U.S. GAAP do not purport to be acceptable or unacceptable application of IFRSs or U.S. GAAP.

The tentative decisions made by the FASB or the IASB at public meetings are reported in *FASB Action Alert* or in *IASB Update*. Official pronouncements of the FASB or the IASB are published only after each board has completed its full due process, including appropriate public consultation and formal voting procedures.

Staff paper

3. The FASB was aware that the IASB was reconsidering its consolidation guidance as a separate project under a different timeline at the time that the FASB deliberated and issued consolidation guidance specific to structured entities. The FASB, as a result of the market turmoil before and during its deliberation process and at the suggestion of the March 2008 Policy Statement on Financial Market Developments from the President's Working Group on Financial Markets, concluded that consolidation guidance in US GAAP for structured entities needed to be developed expeditiously. Although the structured entity consolidation guidance within Topic 810 was not developed as part of the IASB's stand-alone consolidation project (now a joint project), both boards worked together (and continue to do so) to issue guidance that yields consistent consolidation results for structured entities.
4. Although it is premature to determine precisely whether the implementation and results of the guidance issued by the FASB are consistent with its expectation, the FASB staff, through reviews of current public filings and discussions with the large accounting firms, are confident that structured entities within the scope of Topic 810 are being consolidated by the reporting entity with power and returns.
5. The FASB issued FASB Staff Position 140-4 and FIN 46(R)-8, "*Disclosures by Public Entities (Enterprises) about Transfers of Financial Assets and Interests in Variable Interest Entities*" in December 2008 that required significantly enhanced disclosures for reporting entities with interests in a what is being referred to within this paper as structured entities, including consolidated structured entities. Substantively, these disclosures are consistent with those required in Topic 810. Based upon discussions with several users of financial statements, these enhanced disclosures were determined to be extremely useful and effective for users in their analyses of a reporting entity's involvement with variable interest entities.

Staff paper

ED 10

6. The IASB issued ED 10 *Consolidated Financial Statements* in December 2008. Paragraphs 32-38 provided consolidation guidance for structured entities and defined a structured entity as “an entity whose activities are restricted to the extent that those activities are not directed as described in paragraphs 23-29.” Paragraphs 23-29 provided consolidation guidance for entities controlled by voting rights.
7. The vast majority of respondents to ED 10 opposed creating a ‘subset’ of entities within the final consolidation guidance. Respondents commented that a specific definition for structured entities creates the same problems that IAS 27 and SIC-12 now create—inconsistent application and potential arbitrage by identifying entity-specific characteristics.
8. Respondents requested that the final consolidation guidance not have separate guidance on structured entities but, rather, a single, cohesive standard for consolidation. Respondents felt that the guidance provided for structured entities could almost always be applied to all entities. Therefore, they suggested that there should be one section that includes combined guidance on assessing control for all entities.
9. Respondents were asked to comment on the definition of a structured entity in paragraph 30 of the ED. The majority of respondents did not agree with the proposed definition of a structured entity in ED 10. Most were against it because, as mentioned above, they did not agree with creating a subset of entities within the document and therefore felt there was no need for a definition. Others disagreed with the definition because it was interpreted as a ‘negative definition’ that did not provide specific guidance about the type of entity to be classified as a structured entity.
10. Respondents commented that if this particular type of entity is going to be defined, it should not just be a residual set of entities that does not fall into the category of traditional operating entities. The definition should give these entities a specific set of characteristics—some preferred the characteristics defined in SIC-12 (a narrow and well-defined purpose) for special purpose entities and questioned why the term special purpose

Staff paper

entity was not retained. They also requested that the final standard make clear that the absence of voting rights does not automatically mean that an entity is a structured entity.

11. Respondents also voiced concerns about defining structured entities for disclosure purposes. With an unclear definition of a structured entity, entities might have greater incentive to structure around the definition and avoid having to comply with the disclosures, which many respondents viewed as onerous.
12. Some respondents supported defining structured entities and thought that these entities needed to be identified separately from voting interest entities. They were in favour of defining structured entities by using broad characteristics (not a negative definition) and stating that the assessment of control for these entities may be more difficult than for operating/voting entities.

Views Regarding Providing Structured Entity Guidance

13. The additional guidance proposed for structured entities (and discussed in this paper) includes the following:
 - (a) a list of examples of interests that a reporting entity might have in a structured entity that could assist when assessing the means by which a reporting entity might control a structured entity (paragraph 2 of Appendix A); and
 - (b) detailed guidance on how to identify both a structured entity and an interest in a structured entity that could be used to define a structured entity for disclosure purposes (paragraphs 1-14 of Appendix A).
14. The guidance within Topic 810 (Statement 167) relating to the assessment of power over a structured entity will be incorporated into the overall control guidance that would apply to all entities (and is not the subject of the discussion in this paper).

Staff paper

View 1 – Provide Separate Guidance for Structured Entities

15. Some staff believe that detailed additional guidance is required to identify whether an entity is a structured entity and whether a reporting entity has an interest in a structured entity. These staff believe that consolidation of structured entities has been a long-standing issue in global accounting and that structured entities simply do not operate in a manner consistent with voting interest entities and, typically, are not directed by interests that are similar in nature to voting interests. Identifying the interests that result in power over a structured entity has proven to be extremely difficult and, thus, structured entities have often remained unconsolidated by the party that has control over the entity.
16. These staff propose that a reporting entity with interests in a structured entity follow the overall control guidance for all entities for determining whether a reporting entity should consolidate another entity. Therefore, these staff do not believe that additional guidance for identifying a structured entity or interests therein represents separate consolidation guidance for determining whether a reporting entity controls another entity. Rather, these staff think that additional guidance for structured entities will make it easier for constituents to determine whether an entity is a structured entity and what reporting entity with an interest in a structured entity controls the structured entity according to the principles set forth in the overall control guidance.
17. There are two main reasons that the staff supporting this view recommend including the additional guidance:
 - (a) Guidance will be included within the consolidation standard that specifically relates to entities that are controlled by voting rights. That guidance will address how to assess control when a reporting entity holds a majority and less than a majority of the voting rights in another entity. The staff supporting this view believe that it is important to include guidance to differentiate a structured entity from entities controlled by voting rights to ensure that a reporting entity cannot apply the voting rights guidance when assessing control of a structured entity. These staff fear that, without such guidance, a reporting entity might be able to argue that it does not control a structured entity by referring to the voting rights

Staff paper

guidance, which could lead to inappropriate consolidation answers. These staff believe that ideally it is desirable to have a single overall control model but, in reality, constituents will be unable to consistently apply the overall model without additional guidance.

- (b) A definition of a structured entity is required for disclosure purposes because both Statement 167 requires and ED10 proposes disclosures specifically relating to a reporting entity's involvement with structured entities. The definition and guidance included in Topic 810, and derived from Statement 167, has worked well in practice. The staff supporting this view would be concerned that removing all of the guidance that currently exists in Topic 810 from the final consolidation standard will inevitably result in practice questioning whether the FASB's intentions and conclusions reached within its guidance have changed. These staff believe that the existing FASB guidance on consolidation of structured entities and the underlying disclosures are both effective and implementable. Consequently, these staff believe that it is unlikely that providing additional guidance will cause confusion in practice in the US.
18. In addition, these staff believe that providing additional guidance for structured entities that is consistent with that in Topic 810 (Statement 167) will give constituents the opportunity to comment on whether the guidance is needed when considering the overall control model, as opposed to not including it and having constituents request additional guidance (which may result in re-exposure). The staff supporting this view believe that specific questions regarding the proposed additional guidance could be included in the exposure draft to determine whether the information is needed and/or effective. Additionally, these staff would propose including a question to determine whether constituents believe that consolidation results under the proposed overall control model and those determined under current US GAAP for structured entities would be consistent and if the disclosures without structured entity guidance would be sufficient.
19. Appendix A sets out the suggested language for the additional guidance related to structured entities. It is consistent with that in Topic 810 but has been amended in a

Staff paper

manner that the staff believes is more understandable, qualitative in determining whether an entity is a structured entity, and replaces 'variable interest entity' with 'structured entity'.

View 2 – Define Structured Entity for Disclosure Purposes only

20. Some staff agree with the respondents to ED 10 that asserted that 'subset' guidance for structured entities should not be provided when assessing control of a structured entity. These staff believe that the overall control definition and guidance will be sufficient for reporting entities to determine situations in which an entity is controlled by other interests and not voting interests. Therefore, they do not believe that the additional guidance is necessary for purposes of analyzing whether the interests held by a reporting entity in a structured entity give the reporting entity power. The main reasons for their view is as follows:

- (a) The additional guidance does not change or provide any additional guidance regarding the assessment of control of a structured entity. All of the guidance regarding the assessment of control included in both the structured entity section of ED10 and in Topic 810 will be included in the overall control guidance.
- (b) The additional guidance would, however, clarify that the voting rights guidance should not be applied when assessing control of a structured entity. The staff supporting this view do not think that this is necessary because:
 - (i) The overall control guidance will include the overriding principle that a reporting entity considers all of the rights that it holds, and assesses whether those rights give it the power to direct the activities that significantly affect the returns. If voting rights do not give a reporting entity the power to direct the activities that matter, then those voting rights (and any guidance relating to voting rights) would not be relevant when assessing control of the entity.
 - (ii) The voting rights guidance would also state that a reporting entity with a majority of the voting rights in an entity (or less than a majority in the entity) would have power only if the strategic

Staff paper

decisions about the activities of the entity are determined through voting rights. If the voting rights have no effect on the strategic decisions about the activities of the entity, then the voting rights guidance would not apply.

21. These staff agree that a definition of a structured entity is required, but only for disclosure purposes. There are two ways that the boards could approach that definition:
- (a) Include the guidance in paragraphs 1-14 of Appendix A to this paper to define a structured entity. The main advantages of this approach is that:
 - (i) it would result in a definition of a structured entity that is aligned with current US GAAP guidance and a similar scope for the disclosure requirements. We understand that definition and the disclosure requirements have worked well to date in the US.
 - (ii) Detailed guidance would be provided to define a structured entity which would reduce the possibility of reporting entities avoiding the disclosure requirements by arguing that they did not have involvement with a structured entity.

This approach would, however, introduce complicated guidance into IFRS solely to define a structured entity for disclosure purposes. Although, staff would not suggest that the current definition of an SPE in SIC-12 *Consolidation—Special Purpose Entities* would be sufficient (ie a SPE is an entity that is created to accomplish a narrow and well-defined objective), moving from a definition of four words to very detailed guidance would be a move from one end of the spectrum to the other in terms of detail. The guidance in paragraphs 1-14 of Appendix A would also define a structured entity in terms of whether it is controlled by voting rights and on the basis of the sufficiency of its equity at risk. Generally, less than 10% equity at risk is identified as being insufficient. However, other qualitative factors are provided to determine whether this presumption could be overcome or whether an entity needs more than 10% equity at risk for equity to be considered sufficient. The equity at risk concept is not one that is used in current IFRS literature or was proposed in ED10.

Staff paper

- (b) Include a brief description of a structured entity, that would describe typical characteristics of a structured entity, along the following lines:

Structured entities have restricted activities because they are established with a narrow and well-defined purpose. That purpose is to create investment opportunities for investors by passing on risks and rewards associated with the assets of the structured entities to investors. Structured entities often issue multiple contractually linked securities to investors that create concentrations of credit risk (tranches).

The activities of structured entities (such as securitization vehicles, asset backed financings, managed investments funds, limited partnerships, and certain operating entities) are typically not directed through voting or similar rights. Additionally, the total equity at risk in a structured entity is often not sufficient to permit the entity to finance its activities without additional subordinated financial support by any parties, including equity holders.

This approach to defining a structured entity would not provide as much detail regarding the identification of such an entity. Some would, therefore, argue that this increases the risk that a reporting entity might avoid providing disclosures requirements by arguing that it does not have involvement with a structured entity. Others, however, might view the detailed guidance in Appendix A as providing a greater opportunity to structure around the guidance by, for example, creating an entity that has more than 10% equity at risk but which is not controlled by voting rights.

This approach might also change the scope of the current disclosure requirements for involvement with a structured entity in US GAAP.

Staff supporting defining a structured entity by describing typical qualitative characteristics of such an entity also believe that it would be beneficial to expose such an approach to US constituents as an alternative. We could seek views from those constituents who are knowledgeable of the current US GAAP guidance regarding structured entities as to whether the approach set out in

Staff paper

paragraph 21(b) (which emerged from comments to ED10) would work in practice.

Questions for the boards

Do the boards believe that separate guidance for determining whether (i) an entity is a structured entity, and (ii) whether a reporting entity holds an interest in a structured entity should be provided in the consolidation standard (view 1)? Alternatively, do the boards believe that guidance for determining whether an entity is a structured entity should be provided for disclosure purposes only (view 2)?

Regarding the definition of a structured entity, do the boards believe that the consolidation standard should include:

- (a) the guidance set out in Appendix A to the paper, or
- (b) a brief definition/description of a structured entity similar to the proposal in paragraph 21(b) of the paper?

Staff paper

APPENDIX A – Proposed Additional Structured Entity Guidance**Structured Entities**

- 1 The activities of structured entities (such as securitization vehicles, asset backed financings, managed investments funds, limited partnerships, and certain operating entities) are typically not directed through voting or similar rights. Additionally, the total equity at risk in a structured entity is not sufficient to permit the entity to finance its activities without additional subordinated financial support by any parties, including equity holders. The consolidation guidance within paragraphs XX-XX shall be applied to determine which reporting entity with an interest in a structured entity controls and, thus, consolidates the structured entity.
- 2 The initial determination of whether an entity is a structured entity shall be made on the date at which a reporting entity becomes involved with the entity. For purposes of the structured entity Subsections, involvement with an entity refers to ownership, contractual, or other pecuniary interests that may be determined to be structured entity interests. That determination shall be based on the circumstances on that date including future changes that are required in existing governing documents and existing contractual arrangements. Interests in structured entities include, but are not limited to:
 - (a) direct investments, such as equity interests and beneficial interests, in the other entity (particularly subordinated interests).
 - (b) decision-making rights and the associated remuneration that result in the reporting entity acting as a principal (see paragraphs XX-XX).
 - (c) obligations to absorb losses of the entity, including explicit or implicit guarantees provided to other interest holders in which the decision maker is a principal.
 - (d) debt instruments.
 - (e) derivative instruments.
 - (f) lease arrangements.

Staff paper

- 3 The design of the entity is important for determining whether an entity is a structured entity. The phrase *by design* refers to entities that meet these conditions because of the way they are structured. For example, an entity under the control of its equity investors that was originally not a structured entity does not become one because of operating losses.
- 4 Specifically, an entity is considered a structured entity, if, by design, all of the following characteristics do not exist:
- (a) the total equity investment (equity investments in an entity are interests that are required to be reported as equity in that entity's financial statements) at risk is sufficient to permit the legal entity to finance its activities without additional subordinated financial support provided by any parties, including equity holders, or
 - (b) The power to direct the activities of an entity that significantly impact the entity's returns are through voting rights or similar rights.
 - (c) As a group, the holders of an equity investment at risk are exposed to the variability associated with the entity's returns.
- 5 A development stage entity does not meet characteristic (a) in the preceding paragraph if the equity investment in the entity is not sufficient to permit the entity to finance its activities it is currently engaged in and provisions in the entity's governing documents and contractual arrangements do not allow for additional equity investments.

Sufficiency of Equity

- 6 The total equity of an entity is considered to be sufficient if the total equity at risk meets all of the following characteristics:
- (a) includes only equity investments in the entity that participate significantly in the entity's returns even if those investments do not carry voting rights
 - (b) does not include equity interests that the entity issued in exchange for subordinated interests in the entity
 - (c) does not include amounts provided to the equity investor directly or indirectly by the entity or by other parties involved with the entity (for example, by fees, charitable

Staff paper

contributions, or other payments), unless the provider is a parent, subsidiary, or affiliate of the investor that is required to be included in the same set of consolidated financial statements as the investor

- (d) does not include amounts financed for the equity investor (for example, by loans or guarantees of loans) directly by the entity or by other parties involved with the entity, unless that party is a parent, subsidiary, or affiliate of the investor that is required to be included in the same set of consolidated financial statements as the investor.
- 7 Generally, an equity investment at risk of less than 10 percent of an entity's total assets shall not be considered sufficient to permit the entity to finance its activities without subordinated financial support in addition to the equity investment unless the equity investment can be demonstrated to be sufficient. The demonstration that equity is sufficient shall be made based on a qualitative analysis and shall consider whether:
- (a) the entity has demonstrated that it can finance its activities without additional subordinated financial support.
 - (b) the entity has at least as much equity invested as other entities that hold only similar assets of similar quality in similar amounts and operate with no additional subordinated financial support.
 - (c) the amount of equity invested in the entity exceeds the estimate of the legal entity's expected losses based on reasonable quantitative evidence.
- 8 Some entities may require an equity investment at risk greater than 10 percent of their assets to finance their activities, especially if they engage in high-risk activities, hold high-risk assets, or have exposure to risks that are not reflected in the reported amounts of the entity's assets or liabilities. The presumption in the preceding paragraph does not relieve a reporting entity of its responsibility to determine whether a particular entity with which the reporting entity is involved needs an equity investment at risk greater than 10 percent of its assets in order to finance its activities without subordinated financial support in addition to the equity investment.

Staff paper

- 9 The design of the entity (for example, its capital structure) and the apparent intentions of the parties that created the entity are important qualitative considerations, as are ratings of its outstanding debt (if any), the interest rates, and other terms of its financing arrangements. Often, no single factor will be conclusive and the determination of the sufficiency of the equity at risk will be based on the preponderance of evidence. For example, if an entity does not have a limited life and tightly constrained activities, if there are no unusual arrangements that appear designed to provide subordinated financial support, if its equity interests do not appear designed to require other subordinated financial support, and if the entity has been able to obtain commercial financing arrangements on customary terms, the equity would be expected to be sufficient. In contrast, if an entity has a very small equity investment relative to other entities with similar activities and has outstanding subordinated debt that obviously is effectively a replacement for an additional equity investment; the equity would not be expected to be sufficient.
- 10 Interests in specified assets of an entity shall not be considered in determining the adequacy of the equity at risk in an entity unless the specified assets constitute a majority of the assets of the entity.

Power

- 11 An entity is not controlled by voting or similar rights in situations in which equity investors, as a group, do not have the power to direct the activities of another entity that significantly impact the other entity's returns through these rights (such as those of a common shareholder in a corporation or a general partner in a partnership). In addition, equity investors do not have power over another entity in situations in which a decision maker is remunerated for directing the entity's activities pursuant to a legal or contractual arrangement and is not an agent (see paragraphs XX-XX). Additionally, the entity is not controlled by voting or similar rights if the equity holders, as a group, are not exposed to variability associated with the returns of an entity.

Staff paper***Reconsideration of Whether an Entity is a Structured Entity***

12 An entity that previously was not subject to this structured entity section shall not become subject to it because of losses in excess of anticipated returns that reduce the equity investment in the entity. The initial determination of whether an entity is a structured entity shall be reconsidered if any of the following occur:

- (a) the entity's governing documents or contractual arrangements are changed in a manner that changes the characteristics or adequacy of the entity's equity investment at risk.
- (b) the equity investment or some part thereof is returned to the equity investors, and other interests become exposed to expected losses of the entity.
- (c) the entity undertakes additional activities or acquires additional assets, beyond those that were anticipated at the later of the inception of the entity or the latest reconsideration event, that increase the entity's exposure to variability of the entity's returns.
- (d) the entity receives an additional equity investment that is at risk, or the entity curtails or modifies its activities in a way that decreases its exposure to variability of the entity's returns.
- (e) changes in facts and circumstances occur such that the holders of the equity investment at risk, as a group, lose the power from voting rights or similar rights of those investments to direct the activities of the entity that significantly impact the entity's returns.

Interests in Specified Assets of a Structured Entity

13 Interests in specified assets of a structured entity (such as a guarantee or subordinated beneficial interest) shall be considered when determining which party controls the structured entity only in situations in which the fair value of the specified assets is more than half of the total fair value of the other entity's assets, or if the interest holder has another interest in the structured entity as a whole (except interests that are insignificant or have little or no exposure to the variability of the other entity's returns).

Staff paper

- 14 A reporting entity with an interest in specified assets of a structured entity shall treat a portion of the structured entity as a separate entity if the specified assets (and related credit enhancements, if any) are essentially the only source of payment for specified liabilities of the structured entities. These portions of structured entities are referred to as silos. If the reporting entity is required to consolidate a discrete portion of a structured entity, other interest holders shall not consider that portion to be part of the larger structured entity.