

BASIS FOR CONCLUSIONS ON EXPOSURE DRAFT

ED 10 Consolidated Financial Statements

Comments to be received by 20 March 2009



International
Accounting Standards
Board®

**Basis for Conclusions on
Exposure Draft
ED 10 CONSOLIDATED FINANCIAL
STATEMENTS**

Comments to be received by 20 March 2009

This Basis for Conclusions accompanies the proposed International Financial Reporting Standard (IFRS) set out in ED 10 *Consolidated Financial Statements* (see separate booklet). Comments on the draft IFRS and its accompanying documents should be submitted in writing so as to be received by **20 March 2009**. Respondents are asked to send their comments electronically to the IASB Website (www.iasb.org), using the 'Open to Comment' page.

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Basis for Conclusions on ED 10 *Consolidated Financial Statements*

This Basis for Conclusions accompanies, but is not part of, the draft IFRS.

Introduction

- BC1 This Basis for Conclusions summarises the International Accounting Standards Board's considerations in developing the proposals in ED 10 *Consolidated Financial Statements*. Individual Board members gave greater weight to some factors than to others.
- BC2 The exposure draft is published by the Board as part of its consolidation project. The Board added the project to its agenda in June 2003.
- BC3 The aim of the exposure draft is to propose an IFRS that improves financial reporting by clarifying the principles that determine when a reporting entity should consolidate another entity. In particular, the Board aims:
- (a) to issue a single IFRS on consolidation to replace the consolidation requirements in IAS 27 *Consolidated and Separate Financial Statements* and SIC-12 *Consolidation—Special Purpose Entities*;
 - (b) to clarify the definition of control of an entity and address application issues; and
 - (c) to require enhanced disclosures about consolidated and unconsolidated entities.
- BC4 The Board did not reconsider all of the requirements in IAS 27. For example, the Board did not reconsider the consolidation procedures or the accounting requirements for the loss of control over an entity. Accordingly, this Basis for Conclusions does not discuss requirements of IAS 27 that the Board did not reconsider. When the Board finalises its Basis for Conclusions on the IFRS arising from this exposure draft, it intends to include relevant paragraphs from the Basis for Conclusions on IAS 27, including the dissenting views on requirements the Board did not reconsider.
- BC5 IAS 27 also contains requirements for the preparation of separate financial statements. The Board does not propose revising the requirements to prepare separate financial statements in IAS 27. The Board decided to retain those requirements in IAS 27 and proposes to rename that standard 'IAS 27 *Separate Financial Statements*'.

- BC6 This Basis for Conclusions discusses the following matters:
- (a) why the Board proposes to revise IAS 27 and withdraw SIC-12;
 - (b) why the Board proposes the revisions set out in the exposure draft;
 - (c) whether the proposals help to achieve convergence with US GAAP; and
 - (d) whether the benefits of the proposals outweigh the costs of implementation.

Why the Board proposes to revise IAS 27 and withdraw SIC-12

Perceived inconsistencies between IAS 27 and SIC-12

- BC7 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. Therefore, control over another entity requires the ability to direct or dominate the other entity's decision-making, regardless of whether this power is actually exercised.
- BC8 Control is often difficult to assess in the context of special purpose entities (SPEs). SIC-12 identifies indicators for when a reporting entity should consolidate an SPE. SIC-12 describes SPEs as entities that are created to accomplish a narrow and well-defined objective. Often SPEs are created with legal arrangements that impose strict and sometimes permanent limits on the decision-making powers of their governing board, trustees or management. Those limits may restrict the operations of the SPE. Therefore, it is often less clear how the control definition in IAS 27 applies to those entities.
- BC9 SIC-12 requires an SPE to be consolidated when the substance of the relationship between an entity and the SPE indicates that the SPE is controlled by that entity. The Interpretation identifies the following indicators for control of an SPE:
- (a) in substance, the activities of the SPE are being conducted on behalf of the entity according to its specific business needs so that the entity obtains benefits from the SPE's operation;
 - (b) in substance, the entity has the decision-making powers to obtain the majority of the benefits of the activities of the SPE or, by setting up an 'autopilot' mechanism, the entity has delegated these decision-making powers;

- (c) in substance, the entity has rights to obtain the majority of the benefits of the SPE and therefore may be exposed to risks incident to the activities of the SPE; or
 - (d) in substance, the entity retains the majority of the residual or ownership risks related to the SPE or its assets in order to obtain benefits from its activities.
- BC10 Many believe that those indicators are based on a risks and rewards model and do not necessarily identify a control relationship. In their view, IAS 27 and SIC-12 are based on different consolidation models. They are concerned that in the absence of SIC-12, IAS 27 might require a reporting entity (a) to consolidate an entity that would not be consolidated in accordance with SIC-12 or (b) not to consolidate an entity that would be consolidated in accordance with SIC-12.
- BC11 This inconsistency is aggravated by the fact that it is not clear which entities are within the scope of IAS 27 and which are within the scope of SIC-12. SIC-12 describes SPEs as entities that are created to accomplish a narrow and well-defined objective, but leaves it to the judgement of the preparer to decide when an entity has a narrow and well-defined objective.
- BC12 Interested parties emphasise that both the differing consolidation concepts in IAS 27 and SIC-12 and the difficulty that some have in determining whether particular entities are within the scope of IAS 27 or SIC-12 have caused diversity in practice and therefore reduced the comparability of financial statements. They are also concerned about the structuring opportunities that those inconsistencies might have created.
- BC13 The exposure draft proposes to address those inconsistencies by proposing a single definition of control that would apply to all entities.

Need to clarify the definition of control and to provide further application guidance

- BC14 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, but does not explain the meaning of the components of this definition. In particular, IAS 27 does not elaborate on the meaning of power and benefits and does not explain how those components have to be linked to constitute control.

- BC15 Many constituents requested guidance on the following aspects of IAS 27:
- (a) whether a reporting entity can control another entity even though it holds less than the majority of voting rights in that entity;
 - (b) how potential voting rights affect the control assessment in IAS 27;
 - (c) when approval or veto rights of other parties prevent a reporting entity from having control of an entity;
 - (d) how to identify agents that act for a reporting entity; and
 - (e) how to assess control when a reporting entity acts simultaneously in the role of a principal and agent.
- BC16 In addition, constituents asked the Board to clarify the meaning of the following terms in SIC-12:
- (a) narrow and well-defined objective;
 - (b) autopilot;
 - (c) risks; and
 - (d) benefits.
- BC17 The Board observed that uncertainty surrounding all of those issues adds to diversity in practice. Some issues will be resolved through the revised definition of control. The Board decided to propose guidance on all remaining issues.

Enhancing disclosure

- BC18 The project also aims to enhance the disclosures required relating to consolidated entities and introduces disclosure requirements relating to unconsolidated entities. Many users of financial statements believe that the current accounting and disclosure requirements do not provide sufficient information to allow them to understand the composition of the reporting entity and to determine the value of a present or future investment in that entity.
- BC19 The recent global financial crisis has also highlighted a need for better disclosure about:
- (a) the basis of control and the related accounting consequences; and
 - (b) the nature of, and risks associated with, the reporting entity's involvement with structured entities that the reporting entity does not control.

- BC20 Therefore the Board has decided to revise the disclosure requirements relating to consolidated and unconsolidated entities.

Proposals

- BC21 The following paragraphs summarise the Board's rationale for (or against) revising:
- (a) the scope of the proposed IFRS (paragraphs BC22–BC27);
 - (b) definition of the group (paragraphs BC28–BC31);
 - (c) control as the basis for consolidation (paragraphs BC32–BC39);
 - (d) the definition of control (paragraphs BC40–BC62);
 - (e) the control assessment (paragraphs BC63–BC97);
 - (f) the treatment of structured entities (paragraphs BC98–BC121);
 - (g) the disclosure requirements (paragraphs BC122–BC145);
 - (h) the effective date and transition (paragraphs BC146–BC152).

Scope

- BC22 The Board decided not to amend the scope of IAS 27 either to expand or to restrict the entities required to prepare consolidated financial statements.
- BC23 Some, including many investment companies, asked the Board to reconsider the scope of the proposed IFRS. They argued that investment companies should not be required to consolidate the investments they control because they manage those investments on a net basis and, in their view, presenting the underlying assets and liabilities of their investments is misleading and uninformative. Instead, they suggest that the investments should be recognised net and measured at fair value. They emphasise that US GAAP has a scope exception that exempts an investment company from consolidating its investments.
- BC24 The Board observed that those who argue that the investments should not be consolidated appear to suggest that consolidation fails to reflect the intentions of the management of the investment company and therefore fails to represent how the business is operated. Although those intentions are relevant and important to users of financial statements, recognition and measurement principles in IFRSs are rarely developed on

the basis of the intentions of management. Rather, they are developed on the basis of reporting what currently exists and, in doing so, aim to enhance comparability between entities.

- BC25 The Board noted that the concept of control is crucial to how an investment is characterised in the financial statements. If an investment entity is controlled by the investor then that entity is a subsidiary of the investor and, by definition, part of the group. In contrast, excluding an investment from consolidation would mean that the investment is treated as if it were not part of the group.
- BC26 The Board observed further that introducing a scope exemption for investment companies would also create practical challenges. Although investment companies are legally defined in the US, there is no comparable international definition. The Board noted that many who asked for a scope exemption would not meet the US definition of an investment company.
- BC27 The Board therefore decided that it should not propose exempting investment companies from the principle that a reporting entity's consolidated financial statements should include all entities that the reporting entity controls. The Board confirmed its reasoning set out in paragraph BC27 in the Basis for Conclusions on IAS 27:

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.

Definition of the group

- BC28 The group for which consolidated financial statements are prepared consists of a parent and its subsidiaries. The exposure draft defines parent and subsidiary in relation to each other. A parent is an entity that has one or more subsidiaries. A subsidiary is an entity that is controlled by a parent.

- BC29 In May 2008 the Board published a discussion paper *Preliminary Views on an improved Conceptual Framework for Financial Reporting: The Reporting Entity* as part of its work on phase D of the conceptual framework project. The project is conducted jointly with the US Financial Accounting Standards Board (FASB). In that discussion paper the Board set out the preliminary view that a group^{*} should not be limited to business activities that are structured as legal entities. Rather, a group should be broadly described as being a circumscribed area of business activity.
- BC30 The consolidation exposure draft implements at standards level this wide understanding of a group. The Board therefore concluded that neither the parent nor its subsidiaries need to be legal entities. Accordingly, a parent or a subsidiary can have the legal form of, for example, a corporation, a partnership or a trust.
- BC31 Sometimes the legal and contractual arrangements of a legal entity give one party control over a particular set of assets and liabilities, whereas another party might have control over another set of assets and liabilities within the same legal entity. Those groups of assets and liabilities are often referred to as silos. The Board noted that when assessing control each silo could be treated as a separate entity.

Control as the basis for consolidation

- BC32 The discussion paper on the reporting entity analyses the following alternative bases for consolidation:
- (a) In the *controlling entity model* the consolidated financial statements comprise the controlling entity and other entities under its control.
 - (b) In the *common control model* the combined financial statements comprise entities under the control of the same controlling entity or body.
 - (c) In the *risks and rewards model* two entities are included in the consolidated financial statements when the activities of one entity affect the wealth of the residual shareholders (or residual claimants) of the other entity.

* Note for the reader of the exposure draft. The discussion paper on the reporting entity refers to a group as a 'group reporting entity'. ED 10 uses the term 'reporting entity' to describe an entity that might have control over another entity.

- BC33 The discussion paper sets out the Board's preliminary view that the controlling entity model should be used as the primary basis for consolidation. It rejects the risks and rewards model as a basis for consolidation on the grounds it is not conceptually robust. However, the Board observed that there are occasions when combined financial statements, and therefore the application of the common control model, would provide useful information to users of financial statements.
- BC34 This exposure draft proposes to implement the Board's preliminary views at the standards level. It proposes that the controlling entity model should be the only basis for consolidation. The exposure draft does not address the preparation of combined financial statements and therefore does not discuss application of the common control model. The Board may return to this issue at the conclusion of phase D of the conceptual framework project.

Reputational risk

- BC35 The Board discussed the basis for consolidation as part of the conceptual framework project and not as part of its project on consolidation. However, in response to questions raised as a result of the global financial crisis, the Board considered whether reputational risk should be a basis for consolidation as part of this project.
- BC36 Reputational risk refers to a reporting entity's implicit commitment to provide support to unconsolidated structured entities without having a contractual or constructive obligation to do so. Some financial institutions have recently acquired financial interests in structured entities to provide funding that those entities could not obtain from third parties because of the lack of liquidity in the market. Those financial institutions had previously acted as sponsors when structuring those entities. They stated that there was no legal obligation for them to acquire the financial interests.
- BC37 Some asked the Board to consider whether reputational risk might be a basis for consolidation. The Board observed that before those transactions the financial institutions that were exposed to reputational risk did not control those structured entities. The Board concluded that the consolidation of structured entities on the basis of reputational risk is inconsistent with the controlling entity model.
- BC38 The Board investigated also whether it should use reputational risk as a separate basis for consolidation in addition to control. However, the Board was concerned about the structuring opportunities that two competing bases for consolidation would create. The Board concluded that

reputational risk is not a sufficient basis for consolidation because it reflects only management's intentions (see also the discussion of management's intentions in paragraph BC24). Instead, the Board decided to propose that an entity should disclose the fact that it has provided support to unconsolidated structured entities without having a contractual or constructive obligation to do so (see paragraphs BC135–BC145).

- BC39 Also, the Board observed that an entity's explicit commitment to support another entity is likely to be a liability that is accounted for in accordance with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*.

Definition of control

- BC40 In the conceptual framework project, the Board noted that if the controlling entity model is used as the basis for consolidation, control should be defined at a conceptual level. Thus, the discussion paper on the reporting entity included a definition of control.
- BC41 The deliberations leading to this exposure draft, which took place after the Board published that discussion paper, refined the Board's view of how it should define control. Those refinements have been included in this exposure draft. The Board will consider in the future how to reflect these refinements in the definition of control in the conceptual framework project.
- BC42 The definition of control includes three components:
- (a) power;
 - (b) returns; and
 - (c) the link between power and returns.

Power

- BC43 IAS 27 refers to the power to govern the financial and operating policies of an entity.
- BC44 The Board noted that governing the strategic operating and financing policies of an entity is in most cases the same as having power to direct the activities of the entity. However, the power to govern the strategic operating and financing policies of an entity is only one way in which power to direct activities can be achieved. A reporting entity can have the power to direct the activities of another entity by means of contractual arrangement—through its involvement in establishing the activities of the entity, or in the ongoing decision-making that affects the activities of the entity.

- BC45 For example, some entities have detailed and defined founding documents or operate within a legal framework that permits only a limited range of activities or transactions. Such entities may have no need for a governing board or other corporate governance structure because it is unlikely that strategic operating and financing policy decisions would need to be made on an ongoing basis to direct the activities of the entity.
- BC46 The Board believes that it would improve clarity and consistent application of the control concept if the Board widened the concept of control to reflect the power to direct another entity's activities, rather than restricting it to the notion that control can be achieved only through the power to govern the financial and operating policies of an entity to generate returns.

Power to direct the activities

- BC47 Control of an entity requires that a reporting entity must have the power to direct the activities of an entity. This does not mean that a controlling entity must actively direct the activities. Rather, a controlling entity needs to have the power or ability to direct the activities—exercise of that power is not necessary for control.
- BC48 Some are concerned that, in developing the proposals in the exposure draft, the Board might not have applied the control definition consistently. In their view, some of the proposals in the exposure draft require a demonstration of the ability to direct the activities (eg the conclusions on options or convertible instruments) whereas others require a controlling entity only to have the power without any need to demonstrate that power (eg a passive dominant shareholder or control of some structured entities). They point to the following proposals:
- (a) A reporting entity controls another entity if it has the power to direct the activities of that entity to generate returns for the reporting entity even if it chooses not to use its power (a passive dominant shareholder with voting rights that does not vote).
 - (b) In contrast, a reporting entity can have the power to direct the activities of another entity even though it holds less than the majority of the voting rights in that entity, as long as the other shareholders choose not to organise themselves to prevent the reporting entity from directing the activities of the entity.
 - (c) Options and convertible instruments can give the reporting entity the ability to direct the activities of an entity even before the

reporting entity chooses to exercise or convert those instruments (see paragraphs BC74–BC87). Some view an option holder with currently exercisable options as being in the same position as a passive dominant shareholder because, like a passive shareholder that can choose to direct the activities by voting, the option holder can choose to direct the activities by exercising the options.

- (d) Lastly, a reporting entity can have the power to direct the activities of a structured entity even though it has the ability to direct the activities of that entity only if particular circumstances occur that are not within the control of the reporting entity; for example, an entity that has the power to direct how receivables of a structured entity are managed on default. The proposals mean that a reporting entity can control a structured entity even though it neither has the current ability to direct the activities of that entity nor can choose in the future to obtain that ability. It might never exercise its power to direct the activities if the receivables do not default (see paragraphs BC110–BC121).

BC49 The Board acknowledged those concerns, but does not believe that the proposals in the exposure draft are inconsistent. The Board believes that the fact patterns in (a) and (b) above are different because the passive shareholder in (a) has power by having the ability to vote and can choose at any time to direct the activities of the entity that it controls by exercising its voting rights. In contrast, the other shareholders in (b) would first need to take action and organise themselves to stop the reporting entity from directing the activities of the entity. The reporting entity has power because it directs the activities and other parties cannot take that power away without further action.

BC50 The dominant shareholder in (a) above has power by having the ability to vote; the option holder in (c) does not have that ability to vote before it exercises its options and therefore it does not have power by that means. If the option holder has power, it is likely to arise because as a consequence of holding the options it is able to influence the shareholders or governing body of the entity to the extent that the strategic operating and financing policies of the entity are determined according to the wishes of the option holder. Therefore the Board concluded that in these situations the option holder has the power to direct the activities of the entity, like a passive shareholder (see paragraphs BC74–BC87).

- BC51 Lastly, the Board noted that in (d) above, the reporting entity does not need to direct the activities of the structured entity before the receivables default, if the structured entity operates according to predetermined policies. The reporting entity has the power to direct the activities of the structured entity by having the power to direct the only activities of the entity that cause the returns of the entity to vary (managing the receivables on default), and therefore the only activities that can generate returns for the reporting entity. Like the passive shareholder, the reporting entity need not exercise its power, eg the receivables may never be in default (see paragraphs BC110–BC121).

Returns

- BC52 The revised definition of control retains the concept that control conveys the right to obtain benefits from another entity. The reason for including the ability to benefit, rather than simply defining control as a synonym of power, is to exclude situations in which an entity might have power over another entity but only as a trustee or agent. However, the draft IFRS uses the term ‘returns’ rather than ‘benefits’ (as used in IAS 27, which the proposed IFRS will amend). The Board decided to replace the term because many interpret ‘benefits’ to imply only positive returns. The Board believes that ‘returns’ makes more explicit that the reporting entity may obtain positive or negative returns.
- BC53 The exposure draft provides guidance to explain that the returns accruing to a controlling entity must vary according to the activities of the controlled entity. In most cases, the right to returns is associated with the power to direct the activities that generate those returns. The Board believes that an entity’s ability to affect the performance of the assets of another entity is correlated with its willingness to be exposed to the variability of returns from its involvement with that other entity. Thus, the Board’s assumption is that the entity that receives the greatest returns from another entity is likely to have the greatest power over that entity.
- BC54 Such returns differ from fees paid in exchange for services. In the Board’s view, returns commensurate with the service provided are fees, regardless of how they are structured. Returns that are not commensurate with the service provided may indicate control.

Link between power and returns

- BC55 Control entails an entity using its power for its own benefit. Thus, power and returns must be linked. This is consistent with the Board's preliminary view from the discussion paper on the reporting entity that control should not be based on power alone, but should also include the ability to benefit from that power (or to reduce the incidence of losses). If one entity has power over another entity, but not the ability to benefit from that power, it would be unlikely that the two entities represent a circumscribed area of business activity of interest to equity investors, lenders and other capital providers. Without the ability to benefit, the first entity's interests in, or relationships with, the other entity are unlikely to have a significant effect on the first entity's resources, claims on those resources, and the transactions and other events and circumstances that change those resources and claims.
- BC56 The Board also decided to clarify that the proportion of returns accruing to an entity need not be directly correlated with the amount of power to direct activities, nor is the right to receive returns a sufficient condition for control. The Board noted that many parties can have the right to receive variable returns from an entity (eg shareholders, debt providers, agents), but only one party can control an entity. The party controlling the entity is assumed to direct the activities of the entity to maximise the returns it obtains. This ability does not require that it obtains all the returns available.
- BC57 The Board decided not to specify the proportion of voting rights or the proportion of returns needed to obtain control. The Board noted that the proportion of voting rights needed to direct the activities of another entity and the proportion of returns available to an entity with power might vary depending on the circumstances.

Control is not shared

- BC58 In developing the discussion paper on the reporting entity the Board concluded that power is not shared with others. During its deliberations of ED 10 the Board refined its view and concluded that a parent need not have absolute power. Other parties can have rights relating to the activities of an entity. For example, there are often limits on power that are imposed by law or regulations. Similarly, other entities—such as non-controlling interests—may hold protective rights that limit the power of the reporting entity. However, only one party can have power that is sufficient to direct the activities of that entity to generate returns

and, thus, only one party controls an entity. If an entity shares control with other parties, it often has an interest in a joint venture. IAS 31 *Interests in Joint Ventures* provides accounting requirements for those interests.

- BC59 However, when other parties have rights that restrict the power of the reporting entity to an extent that it does not have the ability to direct the activities of an entity to generate returns for itself, the reporting entity does not have power sufficient to control that entity.
- BC60 IAS 27 does not provide guidance to identify when the rights of other parties cause the reporting entity not to control another entity. The Board decided to add application guidance on when a reporting entity controls an entity even though other parties have rights in that entity. The proposed application guidance refers to those rights of other parties as protective rights.
- BC61 Some asked the Board to incorporate guidance similar to that in the US EITF No. 96-16 *Investor's Accounting for an Investee When the Investor Has a Majority of the Voting Interest but the Minority Shareholder or Shareholders Have Certain Approval or Veto Rights*. The Board decided that such an approach was appropriate because the guidance is widely accepted and incorporating it in the proposed IFRS would help with international convergence.
- BC62 During the development of the exposure draft, some expressed concerns that a supplier's economic dependence on a customer could lead to the customer being required to consolidate the supplier's financial statements. For example, it can be difficult to explain why the franchisor in a franchise arrangement or a major customer in some customer relationships does not have power to direct another entity's activities. The Board reasoned that the stipulations a major customer or franchisor imposes are primarily to protect the quality of the goods or services being supplied or the franchise brand. The Board also observed that the customer or franchisor does not normally participate in, nor is exposed to, the variability of returns of the supplier or franchisee. As a consequence, the returns component of the control test is unlikely to be met in such circumstances. However, the Board acknowledged this concern by adding application guidance about power in customer relationships.

Assessing control

- BC63 The following paragraphs discuss how an entity assesses control, specifically:
- (a) continuous assessment of control
 - (b) related arrangements
 - (c) power to direct activities without a majority of the voting rights
 - (d) options and convertible rights
 - (e) agency arrangements.

Continuous assessment of control

- BC64 The Board considered whether a reporting entity should assess control:
- (a) when it gets involved with another entity and subsequently only when particular reconsideration criteria are met; or
 - (b) continuously.
- BC65 The Board noted that the assessment of control requires consideration of all facts and circumstances and that it would be impossible to develop reconsideration criteria that would apply to every situation in which a reporting entity obtains or loses control of another entity. Therefore, the reassessment of control only when particular reconsideration criteria are met would inevitably lead to inappropriate consolidation in some cases and failure to consolidate in others.
- BC66 The Board noted that the continuous reassessment of control would result in a reporting entity consolidating those, and only those, entities that it controls. In the Board's view, IAS 27 requires a reporting entity to assess control continuously even though this is not stated explicitly. Some were concerned that the continuous assessment of control would lead to frequent changes in the decision about whether an entity is controlled and, thus, should be consolidated. In their view, the continuous assessment of control would impose undue costs on preparers of financial statements.
- BC67 However, the Board concluded that it did not expect frequent changes in control as a result of changes in market conditions. This is because the proposals are based on a control model. Although changes in market conditions might affect the returns to the reporting entity, they do not

generally affect a reporting entity's ability to direct the activities of another entity. If the Board had opted for a risks and rewards model, then changes in economic conditions could cause an entity to move in and out of consolidation.

Related arrangements

- BC68 In the amendments to IAS 27 issued in January 2008, the Board added guidance on how to assess whether multiple arrangements are related and should be considered together. However, that guidance was limited to arrangements related to the loss of control.
- BC69 During the development of ED 10 some observed that paragraph 15 of IAS 27 refers to 'other contractual arrangements whether considered individually or in combination'. They said that they assumed IAS 27 had intended such a requirement to apply generally to arrangements but that the current wording was not helpful. The Board therefore decided to amend the related arrangements guidance developed in the business combinations project by generalising the principle so that it applies to obtaining and losing control.

Power to direct activities without a majority of the voting rights

- BC70 In October 2005 the Board stated that, in its opinion, IAS 27 contemplates that there are circumstances in which one entity can control another entity without owning more than half the voting rights. The Board accepted at that time that IAS 27 does not provide clear guidance about the particular circumstances in which this will occur and that, as a consequence, there was likely to be diversity in practice. This is sometimes referred to as de facto control. This is not a term the Board supports because it implies, incorrectly, that obtaining control in such a manner is in some way weaker than other means of obtaining control.
- BC71 The Board decided that the exposure draft should ensure it is clear that a reporting entity can control another entity even if it does not have more than half the voting rights, as long as those voting rights are sufficient to give the reporting entity the ability to determine the strategic operating and financing policies.
- BC72 The Board noted that a reporting entity could have the ability to prevent other parties from controlling another entity even if it does not have more than half the voting rights. This ability is enhanced when the reporting entity's holding is significantly higher than the next highest

holding and if the level of dispersion of the other holdings is high. Such dispersion creates a practical impediment to those other shareholders being able to prevent the major shareholder from controlling the entity.

- BC73 The exposure draft also states that an entity could hold a minority, but the largest, share of the voting rights and control the entity by other means. The Board reasoned that a reporting entity could control another entity through its ability to appoint management or through contractual arrangements. Those arrangements could allow the reporting entity to direct the activities of the other entity. The shareholding, sometimes referred to as a cornerstone shareholding, prevents other parties from changing those other arrangements.

Options and convertible instruments

- BC74 A reporting entity might own options, convertible instruments or other instruments that, if exercised, give the reporting entity voting rights.
- BC75 IAS 27 refers to those instruments as potential voting rights. According to that standard, the existence and effect of potential voting rights that are currently exercisable or convertible are considered when assessing control. If the options or convertible instruments that give a reporting entity potential voting rights are currently exercisable, IAS 27 requires the reporting entity to treat those potential voting rights as if they are current voting rights. According to IAS 27, the reporting entity considers all facts and circumstances except the intentions of management and the financial ability to exercise or convert such rights.
- BC76 Because of the revised definition of control of an entity, the Board reconsidered options and convertible instruments to obtain voting rights as part of this project.

Control

- BC77 The definition of control of an entity requires the reporting entity to have the power to direct the activities of the entity to generate returns for the reporting entity.
- BC78 The questions for the Board to consider were:
- (a) do options or convertible instruments to obtain voting rights give the holder the power to direct the activities of the entity to which those options or instruments relate? And, if so,
 - (b) in what situations do those options or convertible instruments give the holder the power to direct the activities of that entity?

- BC79 The Board noted that when the activities of an entity are directed by means of strategic operating and financing policies, the shareholders ultimately have the power to direct the activities by having the ability to appoint the members of the governing body.
- BC80 An option holder does not have the ability to appoint the members of the governing body of another entity before exercising its options. Therefore, some might argue that an option holder would never have the power to direct the activities of an entity before exercising its options. However, this view assumes that the only way to obtain power to direct the activities of an entity was by having the ability to appoint the members of the governing body. The Board has concluded that this is one way, but not the only way, to have the power to direct the activities of another entity.
- BC81 In considering options and convertible instruments, the Board concluded that power to direct the activities does not arise from the ability to exercise or convert the instruments and thus obtain voting rights in the future. But the holding of options or convertible instruments could lead to the holder controlling an entity without having to exercise or convert the instruments when a reporting entity considers all facts and circumstances. For example, the option holder could have power indirectly if the shareholder that is the counterparty to the option agreement uses its voting power to act on behalf of the option holder, or if the strategic operating and financing policies are determined according to the wishes of the option holder. In addition, there may be situations in which there are particular rights attached to the option or convertible instrument that enable the holder to participate in the strategic operating and financing policy decision-making to the extent that the option holder controls the entity.
- BC82 The Board observed that options and convertible instruments can give the holder the power to direct the activities of an entity. Concluding that such instruments always or never give the holder control would be likely to cause inappropriate consolidation in some cases and failure to consolidate in others.
- BC83 The Board concluded that the general guidance in the exposure draft that addresses control should apply to options and convertible instruments, ie when assessing control, an entity should consider all facts and circumstances including its power from holding options or convertible instruments to obtain voting rights.

- BC84 The Board also noted that, when considering options, what is important is the relationship between the option holder and the shareholder that is the counterparty to the option agreement. The option holder might not have a direct relationship with the entity to which the voting interests relate. Accordingly, whether an option holder controls an entity will often depend on whether the option holder is able to direct the shareholder that is the counterparty to the option agreement to act as instructed by the option holder. If this is the case, then the option holder controls the entity because of the relationship between the option holder, the shareholder with voting rights and the entity.
- BC85 In the Board's view, a reporting entity that is required to transfer little, or no, consideration to exercise an option over shares is likely to have control of those shares. In those circumstances, the option holder is likely to have acquired a controlling interest at the time it acquired the options and the reporting entity is in the same position as a passive majority voting shareholder. This view is consistent with the requirements in IAS 39 *Financial Instruments: Recognition and Measurement* and IAS 33 *Earnings per Share*.
- BC86 The Board observed that if an option to acquire shares in an entity is exercisable at a price that equals the fair value of those shares, the option holder does not obtain a return from those shares until that option is exercised. It is only once the option holder has obtained the shares that it has access to the returns. The Board concluded that in such circumstances the option fails the second part of the control definition.

Currently exercisable

- BC87 The Board noted that its conclusions about the effect of options and convertible instruments when assessing control mean that being currently exercisable is not a mandatory criterion for control, as it is in IAS 27. 'Currently exercisable' would be a criterion for control only if the Board had concluded that an option holder's power to direct the activities of an entity was dependent on its ability to exercise the options at any time. Rather, the Board concluded that an option holder that controls another entity has power to direct the activities irrespective of whether the options are exercised. Although the holder of options that are exercisable today is more likely to have control than the holder of options that are not exercisable until some point in the future, it should not matter if the party can exercise the options today as long as the option holder has the current power to direct the activities of the entity.

Agency arrangements

- BC88 IAS 27 and SIC-12 do not contain requirements for the treatment of interests held in another entity via an agent. The lack of guidance has created divergence in practice. The Board decided to introduce principles that address the principal-agency relationship in order to reduce diversity in practice.
- BC89 An agent is a party that is required under an agreement or law to act in the best interests of a principal or principals. An agent will receive remuneration for its services that is commensurate with the services provided. The remuneration could be structured so that it is an incentive to act in the best interests of the principal.
- BC90 The Board concluded that:
- (a) any powers assigned to an agent are restricted to use only for the benefit of the parties for which the agent is acting. In other words, the ability of an agent to benefit from the assets over which it has power is restricted and its entitlement to remuneration must be agreed between it and its principals. Thus, an agent will fail the control test.
 - (b) an entity can exercise its power to direct the entity's activities by removing the agent. The agent has only delegated power.
- BC91 In some cases, the line between principal and agent is blurred. An agent may have 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.
- BC92 The Board considered whether it should require the reporting entity to assess its power in aggregate when it has a dual role and conclude that it uses the powers available to it in its role as agent for its own benefit and not for the benefit of other parties. Conversely, the Board considered whether it should require the reporting entity to assess its power excluding its influence arising from being a fiduciary. Thus, the reporting entity would always conclude that it uses the powers available to it in its role as agent for the benefit of other parties.
- BC93 However, the Board concluded that both approaches would create structuring opportunities, and might cause a reporting entity to consolidate entities that it does not control and not consolidate entities that it controls.

- BC94 The Board noted that this issue was wider than simply relating to dual role situations. Accordingly, the Board decided to provide principles and guidance that distinguish between:
- (a) reporting entities that are directing activities of entities as agents of other parties; and
 - (b) reporting entities that have been given power by other parties sufficient to have power to direct the activities of that other entity.
- BC95 When the reporting entity acts in a dual role and the voting rights it has from both roles are sufficient to have power to direct the activities of another entity, the question is whether the reporting entity can use that power for its own benefit or for the benefit of others. Because the reporting entity has the power sufficient to direct the entity's activities, the Board decided to place the onus on the reporting entity to demonstrate that it does not use the power it has as an agent for its own benefit, rather than the opposite. Accordingly, in situations in which it is difficult to identify whether the reporting entity is acting for its own benefit or for the benefit of others, the Board decided that when assessing control, a reporting entity would exclude from its assessment the voting rights it holds as an agent only if it could demonstrate that it uses those voting rights to act on behalf of others.

Intermediate parent

- BC96 The Board considered an example in which parent A has a subsidiary B and B has two subsidiaries C and D. The Board noted that the guidance relating to agency relationships might be interpreted to imply that B acts as an agent for A and therefore does not control C and D. The Board does not believe that the guidance on agency relationships in the exposure draft would prevent an intermediate parent from preparing consolidated financial statements, and the Board has no intentions of doing so in proposing the guidance.
- BC97 The Board also observed that this issue exists in IAS 27 and SIC-12 because both, although not stated explicitly, require that only one party controls another party. Therefore, any intermediate parent could be considered not to control its subsidiaries because those subsidiaries are controlled ultimately by the intermediate parent's parent.

Structured entities

- BC98 The exposure draft introduces the term *structured entity*. Identifying this class of entities is important because many of the disclosure requirements in the exposure draft relate to structured entities with which the reporting entity is, or was, involved. The exposure draft also provides guidance for identifying the controlling party for structured entities because they often do not have typical governance structures.
- BC99 The type of entity that the Board envisages being characterised as a structured entity is unlikely to differ significantly from an entity that SIC-12 describes as a special purpose entity (SPE). SIC-12 describes an SPE as an entity created to accomplish a narrow and well-defined objective and lists as examples entities established to effect a lease, research and development activities or a securitisation of financial assets. SIC-12 also states that an SPE can take the form of a corporation, trust, partnership or unincorporated entity.
- BC100 One of the objectives of the project was to integrate the guidance in SIC-12 with the principles in IAS 27 so it is clear that consolidation is determined on the basis of control. The Board was concerned that because an SPE is associated with SIC-12, the term 'special purpose entity' would carry connotations of a risk and rewards model and therefore decided to use the new term 'structured entity' to break that connection.

Predetermined strategic policies

- BC101 The Board decided that SIC-12 confuses two notions. SIC-12 does not describe with clarity the distinction between limiting the activities in which an SPE is permitted to engage and predetermining the actions of the governing board, trustee or management over the activities of the SPE. The former is reflected in the SIC-12 characterisation of an SPE as having a narrow and well-defined objective. The latter is described by SIC-12 as an SPE 'operating on so-called autopilot'.
- BC102 The exposure draft makes a distinction between these concepts. The activities of an entity are limited when the entity is prevented, by agreement or in its documents of incorporation, from undertaking specified activities. For example, an entity might have its activities limited to investing in AA-rated residential mortgages. Expressed the other way, the entity is not able to invest in any assets that are not AA-rated residential mortgages.

- BC103 In contrast, predetermined strategic operating and financing policies specify the actions that must be taken in response to anticipated or specified events. For example, a predetermined policy could specify that the entity must take specified actions against any mortgagee whose payments are more than 60 days in arrears.
- BC104 During the development of the exposure draft it became apparent that the concept of an autopilot means different things to different people. Some think of an entity on autopilot as being equivalent to the US GAAP notion of a qualifying special purpose entity, with all strategic operating and financing policies and actions of the entity being predetermined. They think of it as an entity that requires no important decision-making. Others think of it more as a general term to describe entities for which decision-making is limited in some way (rather than non-existent). The Board decided not to use the term autopilot in the exposure draft because that term potentially confuses restricting the activities of an entity with predetermining the actions relating to those activities that must be taken in response to anticipated events or circumstances.

Strategic operating and financing policies

- BC105 In developing the exposure draft, it became clear that some interested parties think of a structured entity (or SPE) as having no strategic operating or financing policies. Instead, such entities have straightforward administrative or operating activities that do not require a governing body or any party to have wide decision-making powers. In many cases, how the entity responds to particular circumstances is predetermined. Others told the Board they believe that because these decisions are the only decisions that cause the returns of the entity to vary, they are the strategic decisions of the entity. The Board was indifferent about how the exposure draft characterised the decisions in a structured entity as long as the concepts were clear and would be understood by those using and applying the exposure draft. The Board decided to characterise those decisions using the latter approach (ie as strategic) because this is more consistent with how predetermined policies are described in SIC-12.

Definition of a structured entity

- BC106 The Board considered defining a structured entity using a particular attribute or attributes that distinguish structured entities from all other entities. However, the Board concluded that it should define a structured entity as one for which control could not be assessed in a typical manner such as by assessing voting rights or control of the entity's governing

body. The Board decided to take this approach because it could not identify a single attribute, or set of attributes, that satisfactorily isolated the types of entities the Board had in mind. Structured entities tend to have a narrow well-defined purpose, a limited range of activities in which they are permitted to engage, predetermined strategic policies and own assets with well-defined cash flows (such as financial assets with contractual cash flows)—but so too do many businesses that have normal governance structures.

- BC107 Some also suggested that the Board should define a structured entity as one whose activities do not meet the definition of a business, noting that many SPEs are used to house a group of assets, such as financial assets in a securitisation, or a single asset, such as an item of specialised equipment. IFRS 3 *Business Combinations* defines a business as:

An integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing a return in the form of dividends, lower costs or other economic benefits directly to investors or other owners, members or participants.

- BC108 The Board concluded that this definition of a business was unlikely to be an appropriate basis for distinguishing between assets housed in an entity and a business. This is because the words ‘capable of being conducted’ mean that even a single asset might meet the definition of a business if it is capable of being managed for the purpose of providing a return.
- BC109 The Board observed that whether a reporting entity concludes that an entity in which it has an interest is a structured entity should not affect the control assessment and, thus, consolidation. This is because the exposure draft uses consistent control criteria based on power and returns to assess whether one entity is controlled by another. This contrasts with the existing relationship between IAS 27 and SIC-12 for which the decision about control can depend on whether a reporting entity concludes that an entity is within the scope of IAS 27 or SIC-12.

Control of a structured entity

- BC110 The proposed definition of control of an entity requires consideration of both power and returns.
- BC111 Power can be more difficult to assess when the activities of an entity are not directed by strategic operating and financing policies on an ongoing basis—such as when an entity’s activities are restricted by contractual arrangement, including predetermining how a party must respond to

anticipated circumstances arising in the entity. Indeed, some think that power should be ignored when assessing control of a structured entity. Their view is that power cannot be assessed if there is no demonstration of power on an ongoing basis because ongoing decision-making is not required when the strategic operating and financing policies are predetermined. Therefore, they would propose control criteria for structured entities based on returns alone, similar to the US requirements in FIN 46(R) *Consolidation of Variable Interest Entities*.*

- BC112 Others believe in a control model that requires both power and returns but are concerned that, without a requirement to consolidate on the basis of a particular level of returns, it will be too easy to disguise power, creating structuring opportunities to avoid consolidation. They note, for example, that power can be divided among different parties, or that strategic operating and financing policies can be partially or fully predetermined or predetermined conditionally. They would suggest including a risks and rewards 'fall back' test in situations in which it is not possible to determine power to direct the activities of a structured entity. That would mean including a requirement to consolidate when a reporting entity is exposed to a particular level of variability of returns, irrespective of whether that reporting entity has the power to direct the activities of the structured entity.
- BC113 In developing ED 10, the Board has been clear that it does not want to publish a document with bright-line requirements, like those in FIN 46(R), ie requirements that mean a reporting entity must consolidate another entity when it receives a particular level of the expected returns of that entity, regardless of whether it has power to direct the activities of the entity. In practice, FIN 46(R) created structuring opportunities, such as the creation of expected loss notes, that can result in a reporting entity consolidating another entity when it does not control that entity, and not consolidating when it does.
- BC114 The FASB published an exposure draft of amendments to FIN 46(R) in September 2008. The main change proposed in the exposure draft relating to control is that the assessment of control is no longer solely on the basis of a quantitative analysis of the majority of expected returns. Rather, the exposure draft proposes that control is assessed qualitatively by determining the party that:
- (a) has power to direct matters that most significantly impact the activities of a variable interest entity, and

* 'Variable interest entities' as defined in FIN 46(R) captures a set of entities similar to those envisaged as structured entities in the exposure draft.

- (b) has the right to receive returns from the variable interest entity that could potentially be significant.*

If the qualitative assessment is inconclusive, a reporting entity performs a quantitative analysis of expected returns.

- BC115 That proposed change reflects problems that the FASB and its constituents identified when applying FIN 46(R)—the main problems arising because the determination of consolidation ignores power, and is assessed solely on the basis of a calculation of expected returns. The proposed change also indicates that the FASB thinks that an assessment of control of a variable interest entity can be made using power and returns. It is not necessary to create a test that ignores power.
- BC116 The Board came to conclusions similar to those of the FASB regarding the assessment of control of a structured entity. The Board noted that how a structured entity is controlled will reflect the particular facts and circumstances of that entity, such as how the returns of the entity are shared and how decisions, if any, are made about the activities that affect those returns. Unlike entities that are controlled through a governing body, there is no single, simple test that the Board could identify for assessing control of a structured entity. Rather, it is necessary for a reporting entity to assess those specific facts and circumstances.
- BC117 The Board noted the concerns regarding assessing the power to direct the activities of a structured entity but concluded that a reporting entity should be able to reach a decision on whether it controls a structured entity by applying the definition of control of an entity, ie by assessing both power and returns. A structured entity is rarely, if ever, set up with activities that are entirely predetermined. There are often ways of exerting power over the activities by having, for example, the ability to change the restrictions under which the structured entity operates, or having other related arrangements with the structured entity that ensures power over the activities or assets of the entity.
- BC118 In addition, the Board noted that predetermination of how the activities of an entity are directed does not preclude that entity from being controlled. Predetermination ensures that any anticipated actions relating to the activities of the entity are taken when required. A reporting entity can have the power to direct the activities of an entity as a result of predetermined strategic operating and financing policies

* The exposure draft of amendments to FIN 46(R) uses the words 'benefits' and 'losses' to describe returns.

that enable the reporting entity to have the power to direct or manage the activities, or assets and liabilities, of the entity when events happen such that the activities of the entity need to be directed (for example, when receivables of a structured entity are in default).

- BC119 In reaching its view, the Board considered whether (and decided not) to include a rebuttable presumption of control of a structured entity when a reporting entity has rights to a particular level of returns. The Board believes that structured entities should not be treated differently from other entities when applying the definition of control of an entity, and a quantitative analysis would inevitably create structuring opportunities and problems in terms of calculating returns.
- BC120 Such a requirement to consolidate without having the power to direct the activities of an entity might simply create new opportunities for structuring. Because structured entities would be consolidated on a different basis from other entities, those wishing to avoid consolidation, if that is their objective, might focus on ensuring that the entities do not meet the definition of a structured entity, or might transfer exposure to the variability of returns to another party (like expected loss notes that were created in response to FIN 46(R)).
- BC121 If a reporting entity has no means of directing or managing the activities, or assets and liabilities, of an entity, it does not have any ability to affect its returns from its involvement with that entity. In that situation, the reporting entity does not have the power to direct the activities and would not control the entity, even though it might be exposed to risks associated with the structured entity. The Board concluded that in such a situation, it is more appropriate for the reporting entity to account for and disclose its exposure to those risks, rather than include in its statement of financial position assets and liabilities that the reporting entity has no ability to direct or manage.

Disclosure

- BC122 The Board proposes requiring disclosures that enable users of 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;

- (d) the nature of, and risks associated with, the reporting entity's involvement with structured entities that the reporting entity does not control;
- (e) the accounting consequences of changes in the reporting entity's ownership interest in a subsidiary without loss of control; and
- (f) the accounting consequences when the reporting entity loses control of a subsidiary during the reporting period.

BC123 The following paragraphs explain the Board's rationale for the proposed disclosure requirements in paragraph BC122(a)–(d). The disclosure requirements in paragraph BC122(e) and (f) have been carried over from IAS 27. Paragraphs BC67–BC71 of the Basis for Conclusions on IAS 27 set out the Board's reasoning for those disclosure requirements.

Basis of control

BC124 The decision whether the reporting entity controls another entity requires judgement. Paragraph 122 of IAS 1 *Presentation of Financial Statements* (as revised in 2007) requires an entity to disclose the judgements that management has made in the process of applying the entity's accounting policies and that have the most significant effect on the amount recognised in the financial statements. IAS 27 applies this requirement to consolidated financial statements and requires a reporting entity to disclose:

- (a) the nature of the relationship between the parent and a subsidiary when the parent does not own, directly or indirectly through subsidiaries, more than half of the voting power; and
- (b) the reasons why the ownership, directly or indirectly through subsidiaries, of more than half of the voting or potential voting power of an investee does not constitute control.

BC125 SIC-12 does not require the disclosure of information about why the reporting entity concluded that it must (or must not) consolidate an SPE.

BC126 Investors who use financial statements argue that the current disclosure requirements do not meet their information needs because:

- (a) the disclosure requirements in IAS 27 are often addressed by reference to the consolidation requirements in IAS 27 only, without further explanation of how those requirements apply to a particular set of facts and circumstances;

- (b) the disclosure requirements in IAS 27 fail to provide information about the accounting consequences of the decision whether the reporting entity controls another entity; and
 - (c) there are no explicit disclosure requirements for SPEs.
- BC127 The Board proposes addressing the information needs of users of financial statements by requiring a reporting entity:
- (a) to describe the basis for its assessment that it controls another entity, or not, and any significant assumptions or judgement applied;
 - (b) to disclose information that is necessary for users to evaluate the accounting consequences of its decision that it controls another; and
 - (c) to provide these disclosures also for structured entities from which the reporting entity receives returns that are potentially significant to the structured entity.
- BC128 Some constituents expressed concerns that the proposed disclosures might encourage users of financial statements to reassess the judgement of management and therefore to replace it with their own. The Board acknowledges those concerns, but observes that consideration of different scenarios is a common practice in the analysis of financial statements and does not necessarily mean that the judgement of management is replaced by that of other parties. The Board observed that the disclosure requirements require the reporting entity to explain the basis for its assessment of whether it controls an entity, or not. The Board believes that this requirement would reduce the incentive for users of financial statements to replace management's judgement with their own.
- BC129 The proposals in the exposure draft would require a reporting entity to disclose information about the financial effect of not consolidating entities in which the reporting entity is the dominant shareholder with voting rights and the financial effect of consolidating entities in which the reporting entity holds less than half the voting rights. Some expressed concerns that this requirement would be burdensome. However, the Board decided to propose these disclosure requirements because it thinks that the information will be useful to investors and others in evaluating the composition of the group. The Board also concluded that the requirement should not be burdensome. The Board is not requiring detailed information about each entity within this category. Rather, the disclosures are intended to provide investors with information that alerts them about general effects of control assessments

that are less than straightforward. The reporting entity should also have access to the information in all cases. For those entities that it controls, it should have the information. For those entities that it does not control the reporting entity almost always has an involvement that exposes it to risks. The information a reporting entity uses to assess its risk exposure should enable the reporting entity to have the information necessary for the disclosures proposed in the exposure draft.

- BC130 The Board did not include a requirement to disclose the accounting consequences of an assessment that it controls a structured entity. The Board thinks that the risk disclosures for structured entities are sufficient to meet the needs of users in this respect.

Non-controlling interests

- BC131 The consolidated financial statements present the assets, liabilities, equity, income, expenses and cash flows of the parent with those of its subsidiaries as a single entity. Users of financial statements agree that consolidated financial statements provide decision-useful information. However, many users stated that further information about the interest that the non-controlling interests have in the group's activities would assist their analysis of consolidated financial statements.
- BC132 Users stated that it would, for example, affect their analysis whether an asset that is of particular importance for the reporting entity is held in a wholly-owned subsidiary or in a subsidiary with a large non-controlling interest. Users have requested information about the interest that the non-controlling interests have in the activities of the group at segment or business activity level. In addition, users believe that information about the performance, cash flows and net assets of the group that are attributable to non-controlling interest would provide valuable inputs in their valuation of the reporting entity.

Restrictions on assets and liabilities

- BC133 IAS 27 requires disclosures about the nature and extent of significant restrictions on the ability of subsidiaries to transfer funds to the parent. Users of financial statements note that, in addition to legal requirements, the existence of non-controlling interests in a subsidiary might restrict the subsidiary's ability to transfer funds to the parent or any of its other subsidiaries. However, non-controlling interests are not referred to explicitly in the disclosure requirement in IAS 27. Therefore, users have asked for additional disclosure requirements about non-controlling interests.

BC134 In response, the Board decided to clarify the disclosure requirement in IAS 27 and to propose requiring the disclosure of all restrictions that are a consequence of assets and liabilities being held by subsidiaries, including the extent to which non-controlling interests can restrict the activities of subsidiaries, such as restricting cash flows or investment and financing decisions.

Structured entities that the reporting entity does not control

BC135 IAS 27 does not require disclosures about the nature of the relationship and risks associated with unconsolidated entities. However, the Board was asked by the Financial Stability Forum and others to review the disclosure requirements for what are often described as 'off balance sheet' activities.

BC136 In developing those disclosures the Board had to decide:

- (a) which types of involvement with unconsolidated entities a reporting entity should disclose; and
- (b) what information a reporting entity should disclose about those relationships.

BC137 The Board observed that disclosure of every involvement with unconsolidated entities would not be feasible or meaningful. The disclosure requirements should help investors and other users to assess the market, liquidity and credit risks to which a reporting entity is exposed as a consequence of its involvement with structured entities. With this in mind, the Board decided to limit its disclosure requirements to involvements with structured entities that expose the reporting entity to variability of returns of the structured entities. Those involvements include the holding of equity or debt instruments, as well as other forms of involvement such as the provision of funding, liquidity support, credit enhancements, guarantees and asset management services. The definition of involvement is not intended to capture mere supplier or customer relationships.

BC138 The Board believes that those restrictions limit the disclosure requirements to those relationships with unconsolidated entities that are at the heart of the current financial crisis and would avoid unduly burdensome disclosures for other types of involvements with unconsolidated entities.

- BC139 Some constituents expressed concerns that the proposed definition of involvement is too wide because virtually every involvement with another entity would expose the reporting entity to variability of returns. Other constituents were concerned that the proposed disclosure requirements would create incentives to structure entities in a way that they would not meet the definition of a structured entity and therefore would not require disclosures.
- BC140 The Board acknowledged those concerns, but believed that in order to ensure the feasibility of the disclosure requirement it is necessary to limit its scope. The Board concluded that the exposure draft provides sufficiently robust definitions of the terms 'structured entity' and 'involvement' to reduce structuring opportunities to a minimum. The Board observed also that, in comparison with IAS 27 and SIC-12, it has significantly reduced structuring incentives by requiring the same control criteria for structured entities and other entities. Therefore, under the proposals structuring incentives are limited to the disclosure requirements.
- BC141 The Board concluded that for users to assess their exposure to variability of returns from the reporting entity's involvement with a structured entity the reporting entity should disclose:
- (a) the nature and extent of its 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.
- BC142 The Board observed that IFRS 7 *Financial Instruments: Disclosures* requires similar risk disclosures. However, IFRS 7 focuses on risk disclosures about financial instruments and may not apply to all assets held by subsidiaries or structured entities. Therefore, users of financial statements asked the Board to propose in this project disclosures about a reporting entity's risks from its involvement with unconsolidated structured entities.
- BC143 The Board has decided to require tabular disclosures to the extent that other presentation formats, for example narrative disclosures, are not more appropriate. In addition, the proposals contain in paragraph B46 a list of risk disclosures that a reporting entity should provide, but only if such disclosure is relevant to an assessment of the risk to which the reporting entity is exposed.

- BC144 In requiring those disclosures, the Board observed that a reporting entity might be exposed to risk from contractual and non-contractual commitments and from past and present activities. For example, a reporting entity can be exposed to reputational risk from its involvement with an unconsolidated structured entity. Reputational risk refers to a reporting entity's implicit commitment to provide support to unconsolidated structured entities without having a contractual or constructive obligation to do so. The Board decided to require a reporting entity to provide disclosure when it has provided such support to an unconsolidated structured entity.
- BC145 The Board decided against requiring disclosures of a reporting entity's intention to provide future support to an unconsolidated structured entity without having a contractual or constructive obligation to do so. Although the Board acknowledged that such a disclosure would be of interest for users of financial statements, the Board questioned its feasibility. The Board observed that the legal implications of a forward-looking disclosure about reputational risk might cause many reporting entities to provide only rather general statements about reputational risk. The Board did not think that such disclosure would provide benefit to users of financial statements.

Effective date and transition

- BC146 The Board will set the effective date for the proposed requirements when it approves the IFRS. The Board recognises that many countries require time for translations and implementation of new standards into practice and, where IFRSs are legally binding, into law. To accommodate the time required, the Board intends to allow a minimum of one year between the date when wholly new IFRSs or major amendments to IFRSs are issued and the date when implementation is required.
- BC147 However, the exposure draft proposes permitting earlier application of the IFRS to allow a reporting entity to benefit from the enhanced consolidation guidance.
- BC148 The Board observed that the exposure draft might result in an entity consolidating entities that were not previously consolidated or not consolidating entities that were previously consolidated. Therefore, the Board considered how the transition requirements might reduce the costs of implementation to be proportionate to the benefit obtained from implementing the proposals.

- BC149 The Board believes that, in general, retrospective application would result in the most useful information for users. An entity should be required to present its financial statements as if the new definition of control had always been in place. As a result, the information presented for all periods would be fully comparable.
- BC150 However, the Board also observed that retrospective application might prove extremely difficult, if not impossible. If a reporting entity concludes that according to the revised control definition it controls an entity that it did not control according to the requirements in IAS 27 or SIC-12, retrospective application would generally require that entity to apply the acquisition method in IFRS 3 *Business Combinations* when the reporting entity obtained control of the entity. In its project on business combinations the Board concluded that retrospective application of the acquisition method would not be feasible.
- BC151 Similarly, if a reporting entity concludes that according to the revised control definition it does not control an entity that it has consolidated according to IAS 27 and SIC-12, it would need to derecognise the assets and liabilities of that entity from the day it lost control over that entity. In its project on business combinations, the Board concluded that it should not require retrospective application of its requirements for the loss of control of an entity because of the implementation difficulties and costs associated with applying those requirements.
- BC152 Therefore, the Board decided to require prospective application of the proposed IFRS. Thus, an entity would begin or end consolidation when it applies the proposed IFRS for the first time. The effect would be the same as if the entity had obtained or lost control on that date.

Convergence with US GAAP

- BC153 The FASB is currently reviewing its consolidation requirements. That work includes:
- (a) 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* (SFAS 140), issued on 15 September 2008. The proposed amendments remove the concept of a qualifying SPE from SFAS 140 and remove the scope exception for qualifying SPEs from Interpretation 46(R). Further proposed amendments to Interpretation 46(R) aim to shift the consolidation criteria for variable interest entities from a risk and

rewards-based model to a control-based model. The proposal would also amend the disclosure requirements for consolidated variable interest entities.

- (b) a FASB Staff Position that will require additional disclosures about consolidated and unconsolidated variable interest entities until the FASB's deliberations to amend SFAS 140 and Interpretation 46(R) have been finalised.

BC154 Although the IASB and FASB have not conducted their work jointly, the boards have shared information as the related projects have progressed. Both boards propose introducing similar control-based consolidation requirements and disclosures for structured entities (variable interest entities). However, in contrast to the FASB's proposals, the proposed IFRS would apply to all entities.

BC155 The boards plan to investigate ways to conduct their consolidation projects as a joint project in the future.

Benefits and costs

BC156 The objective of financial statements is to provide information about the financial position, performance and changes in financial position of an entity that is useful to a wide range of users in making economic decisions. The benefits derived from information should exceed the cost of providing it. The evaluation of benefits and costs is a matter of judgement. Furthermore, the costs are not necessarily borne by those who enjoy the benefits. For these reasons, it is difficult to apply a cost-benefit test in any particular case. In making its judgement, the Board considers:

- (a) the costs incurred by preparers of financial statements;
- (b) the costs incurred by users of financial statements when information is not available;
- (c) the advantage that preparers have in developing information, when compared with the costs that users would incur to develop surrogate information; and
- (d) the benefit of better economic decision-making as a result of improved financial reporting.

- BC157 The Board believes that the proposals to introduce control as a single criterion for consolidation of all entities, as well as the clarification of the control definition and related application guidance in the exposure draft, would benefit both users and preparers of financial statements by providing clearer and simpler consolidation requirements.
- BC158 The Board observed that the proposals would result in more consistent application of the consolidation requirements and therefore benefit users of financial statements by providing more comparable consolidated financial statements. Users of financial statements would also benefit from the proposed improved disclosure requirements, many of which the Board proposed in response to direct requests by users.
- BC159 The Board acknowledged that the proposed amendments will impose (a) one-off transition costs and (b) ongoing costs for preparers of financial statements. The Board has sought to reduce transition costs by proposing the transition guidance described in paragraphs 52 and 53.
- BC160 The Board observed that the proposed requirements will not necessarily lead to the consolidation of more entities than would IAS 27 and SIC-12. Rather, some entities will be consolidated in accordance with the proposals that are not consolidated in accordance with current IFRSs and some entities will no longer be consolidated in accordance with the proposals that have been consolidated in accordance with current IFRSs. Therefore, the Board cannot assess whether the revised control definition will result in higher costs for preparers attributable to consolidation of more entities.
- BC161 However, the Board acknowledged that the improved disclosure requirements impose additional costs for preparers of financial statements. The Board believes that those costs will be more than offset by the benefits to users of financial statements from those disclosures.

Alternative views on ED 10

Alternative views of Robert P Garnett, James J Leisenring and John T Smith

- AV1 Messrs Garnett, Leisenring and Smith voted against publication of ED 10, for the reasons set out below.

The definition of control

- AV2 Messrs Garnett, Leisenring and Smith believe that the document does not explicitly conclude whether an entity should consolidate another when it in fact controls the other entity or when it has the ability to be in control of the entity.
- AV3 Paragraph 24 concludes that an entity with a majority of the votes necessary to elect the governing body is in control. Paragraph 8 concludes that an entity need not have exercised its power to direct activities of an entity in order to control that entity. That means that an entity with a majority of the votes necessary to elect the governing body is always in control even if it never exercises its rights to vote. However, an entity that holds an option or other ability to acquire a majority of voting rights is not necessarily considered to be in control. If the rights are currently exercisable, both parties have the ability to control but both may choose not to exercise their respective rights. However, the option holder is deemed to be in control of the entity only if 'other relevant facts and circumstances' give it the power necessary to be in control—what facts and circumstances are necessary is not suggested.
- AV4 Messrs Garnett, Leisenring and Smith believe that holding exercisable options or other rights that if exercised would represent power to control should always be considered as being in control if the cost of conversion is at a fixed price. A fair value option or other conversion right would fail to meet the returns requirement of the control definition and should not result in consolidation as indicated in paragraph BC86.
- AV5 The conclusion in paragraph BC84 between whether an option writer is or is not a shareholder is not persuasive. Why any distinction would be made for the holder of an option based on the counterparty is not clear.
- AV6 These inconsistent conclusions suggest that the Board has not resolved whether the principle for consolidation is in fact being in control or having the ability to be in control.

- AV7 This inconsistency may result from confusion about what power means. In the definition of control, power to direct the activities of the entity is critical. Later in the draft IFRS (paragraph 22) power is to be assessed by considering whether the 'strategic operating and financing policies' can be determined. Determining strategic operating and financing policies and directing activities are not the same thing. This document uses these two terms as though they were synonymous.

Control of structured entities

- AV8 Messrs Garnett, Leisenring and Smith believe this proposed IFRS will be less operational than IAS 27 and SIC-12. The focus on power inherent in this proposal rather than the variance in returns will result in more structuring opportunities than are permitted at present and presumptively fewer entities will be consolidated because power is more easily disguised. In that regard the application of the IFRS will be contrary to the observation in paragraph 13 and repeated in paragraph 33.

Control of a structured entity

- AV9 Mr Smith understands the weaknesses of relying on a bright line test on the basis of an entity having the majority of risks and rewards and the difficulty of assessing returns when they have been divided up and do not rest with a single entity. However, he is concerned that by eliminating that test, an entity that clearly and obviously has the majority of the risks and rewards of a structured entity can easily avoid consolidation by circumventing the power criterion.
- AV10 Mr Smith believes that the guidance in the section of the exposure draft dealing with structured entities is insufficient because it relies primarily on the supposition that power will be retained in situations in which the reporting entity has significant exposure to the variability of returns of a structured entity or has been involved in setting up the structured entity for its benefit. He believes the exposure draft fails to give consideration to the incentive being created to purposefully predetermine and disperse the strategic operating and financing policies to avoid consolidation.
- AV11 Mr Smith is concerned that power can be difficult to assess particularly when it is divided among different parties, or when strategic operating and financing policies have been partially or fully predetermined or predetermined conditionally. Therefore, he believes that additional guidance is needed to address the difficulty in assessing power to direct the activities of a structured entity.

- AV12 In the absence of additional guidance, Mr Smith would propose including a risks and rewards 'fall back' test in situations in which it is not possible to determine the power to direct the activities of a structured entity. That would mean including a requirement to consolidate when a reporting entity is exposed to a particular level of variability of returns, without a requirement to assess power.