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International Accounting Standards Board

This document is provided as a convenience to observers at the Analyst Representative Group meeting, to assist them in following the discussions. It does not represent an official position of the IASB. Board positions are set out in Standards.

Note: These notes are based on the staff papers prepared for the ARG meeting. Paragraph numbers correspond to paragraph numbers used in the ARG agenda paper.

INFORMATION FOR OBSERVERS

ARG Meeting: **November 2007, London**

Project: **Consolidation: Application of a control model to structured arrangements**
(Agenda Paper 2)

Introduction

1. The aim of the consolidation project is to develop consistent control criteria and a single comprehensive IFRS (to replace IAS 27 *Consolidated and Separate Financial Statements* and SIC-12 *Consolidation—Special Purpose Entities*) for all entities, including those commonly referred to as special purpose entities (SPEs). Our initial due process document will be a discussion paper.

2. The purpose of this paper is to provide you with an overview of our approach to consolidation, and in particular to discuss how that approach applies to transactions structured as securitisations, conduits and other arrangements. We seek your input on that approach and whether you think that it would result in financial information that is relevant in making decisions.

3. The overriding principle that we are following in this project (as detailed in paragraph 5 below) is driven by our view that an entity should recognise its (and only its) assets and liabilities. A consequence of recent financial instability in the market appears to be a tendency (at lease, in the financial press) to say that

more is better—everything should be consolidated; if more assets and liabilities are reported in financial statements, that will provide better information to investors and prevent banks and others from 'hiding' risks 'off balance sheet'. We must, however, ask whether consolidation always provides better information. There is little disagreement about whether investments in these arrangements should be reflected in financial statements. The question that we must address is how best to reflect those investments.

4. You should note that views presented in this paper are those of the staff, and *not* of the Board. The Board has yet to discuss the content of this paper—it will do so at its November meeting.

Overview of our approach to consolidation

5. The overriding principle that we are following in the consolidation project is as follows:

> An entity should include in its financial statements the assets that it controls and the obligations for which it is responsible.

This approach is the same as the principle underlying ED 9 *Joint Arrangements* published by the Board in September 2007.

6. There are two ways that an entity can control an asset:

(a) directly, such that the entity has specified rights to some of the benefits of an individual asset and the ability to prevent others from accessing those benefits, or

(b) indirectly, by controlling an entity that controls the asset directly or indirectly.

7. In discussions to date, the Board has tentatively decided that a parent entity has a controlling interest in another entity when it has exclusive rights over that entity's assets and liabilities which give it access to the benefits of those assets and liabilities and the ability to increase, maintain or protect the amount of those benefits. To have a controlling interest in another entity, an entity should:

(c) have the ability to direct the strategic financing and operating policies of the other entity (the *power* criterion).

(d) have the ability to access benefits flowing from the entity (the *benefits* criterion).

(e) be able to use its power so as to increase, maintain or protect the amount of its benefits.

8. If an entity meets all three criteria, it controls the other entity and the first entity should consolidate all of the assets and liabilities of the entity. Through its *strategic power* to direct the policies of the entity, it has the ability to direct the use of *all* of the assets, and can determine when to settle, transfer or increase *all* of the liabilities.

9. Therefore, when the activities of an entity are governed by financing and operating policies, and the entity can be controlled through voting rights, we believe that asking 'who controls the entity?' is an appropriate surrogate for asking 'who controls each of the assets and liabilities of the entity?'. We refer to this as the traditional control model.

10. This paper focuses on those arrangements for which it is more difficult to conclude that one entity controls **all** of the assets and liabilities of another entity through strategic power either because the policies have been predetermined or the holders of the voting rights are not the absorbers of the variability of the cash flows relating to the assets and liabilities of the entity. These arrangements are accounted for in IFRSs and US GAAP today in accordance with SIC-12 *Consolidation—Special Purpose Entities*, and FIN 46(R) *Consolidation of Variable-Interest Entities* or SFAS 140 *Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities*. We will refer to these arrangements generically as structured arrangements.

11. In the US GAAP model, entities are classified as either voting interest entities (and fall within the scope of ARB 51 *Consolidated Financial Statements*), variable interest entities (within the scope of FIN 46(R)) or qualifying special purpose entities (within the scope of FAS 140). In IFRSs, entities are consolidated using either a control model (IAS 27) or what is perceived as a risks and rewards model (SIC-12). In contrast, the model the staff is developing does not create classes of entities. Instead, the proposed model assesses the rights and responsibilities that one entity has in the assets and liabilities of

another entity. We believe that this approach accommodates better a model that helps to avoid creating silos or boxes that, almost inevitably, are separated by bright lines.

12. We are therefore proposing a single control model and not a risk and rewards model. Having said that, the identification of risks and rewards might often, however, be helpful in assessing who has control over the assets and liabilities of an entity.

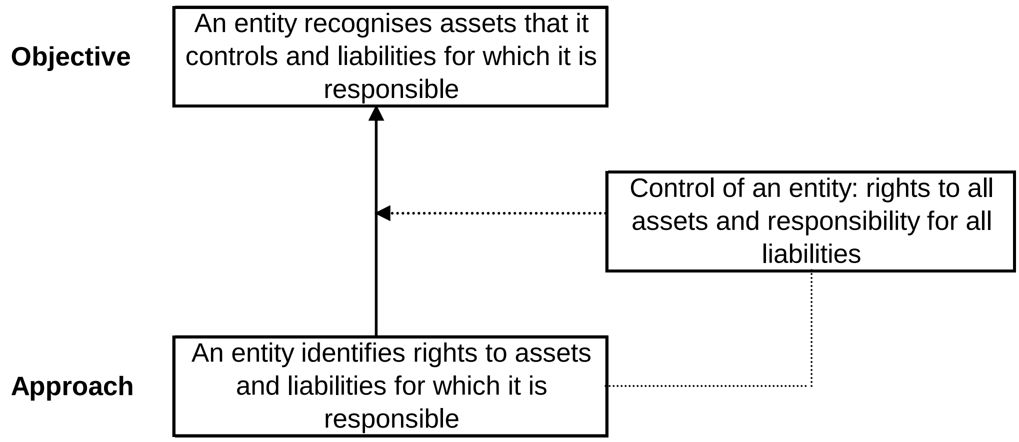
13. The decision of whether (and what) to consolidate depends on an entity's ability to benefit from the assets and liabilities of another entity and the exposure to the risks inherent in those benefits. That is to say, the accounting should reflect the economic rights and obligations of the participants. In the case of an investor controlling the entity as a whole, there should be no practical difference between the recognition of assets and liabilities when an entity is consolidated using the traditional control model and the recognition of the individual assets and liabilities when you 'look through' the entity to identify the parties' rights and obligations.

When is consolidation appropriate?

14. In answering the question 'when is consolidation appropriate?', our answer is 'when it results in an entity recognising assets that it controls and liabilities for which it is responsible'.

15. In most cases, it will be obvious which party controls an entity and should therefore consolidate it. This will most often – but not always – be the case when an entity has been established or is being operated to further the objectives of another entity, such that the other entity has power over the operating and financing policies of the entity. However, because there are situations in which control over an entity is not obvious, the solution therefore might be a model in which, first, the existence of control is assessed[1] and, second, if control of the entity cannot (or should not) be established, each investor will recognise their respective rights and responsibilities related to their interest in the entity.

[1] The party that has control will consolidate the entity.



16. In some arrangements such as structured investment vehicles (SIVs), the arrangement operates more like an operating finance company with structured finance characteristics. It is similar to the treasury function of a bank, with assets, liabilities, liquidity and administration functions that must be managed. There is often continuous reinvestment of assets and management not only of credit risk but also of interest rate, foreign currency and liquidity risk. In this situation, it is very likely that the activities of the SIV cannot be substantially predetermined and that one party controls the entity as a whole and should consolidate it.

17. Alternatively, assume an entity has an investment in a conduit arrangement. During an assessment of the risks and rewards of each of the investors, it becomes evident that the entity does not control the conduit as a whole, but has the rights to some assets and some liabilities of the conduit.

    [Diagram omitted from the observer notes].

18. We are not proposing full consolidation of **all** entities that are within the scope of SIC-12, or that **none** of them be consolidated, but rather accounting for each party's economic investment in these entities. This is because control is sometimes held over the investment in the entity, not the entity itself or its underlying assets. The amounts to be recognised by each investor include:

(f) the assets over which rights are held,

(g) the obligations and risks assumed, and

(h) any income or losses received.

Concerns

19. There may be a number of concerns about the approach that we are proposing:

(i) Surely, parties would not be exposed to significant risks or entitled to benefits without controlling the activities that create those risks and rewards in some way. Is it really possible that entities are set up to be significantly predetermined such that no one really controls the entity as a whole?

(j) Is there a risk that we will be encouraging banks and others to hide exposures to risks; that we will be encouraging 'off balance sheet' financing?

20. Regarding concern (a), we believe that there are some entities that can be set up to operate without any active decision-making by having policies that are significantly, if not totally, predetermined. For example, an entity that is set up to hold risk-free securities only (such as government bonds) with predetermined contractual cash flows that are matched with payments to be made to investors. Those assets have very limited risks (almost no credit or liquidity risk), and require very little management or servicing. Investors exposed to risks and rewards would not require ongoing control over the entity because their risks have been reduced or entirely predetermined in setting up the entity. It can be argued that investors in these types of arrangements implicitly have accepted the predetermined policies of the entity and are therefore unable to control the entity's assets or the associated future economic benefits. Presumably, they are not interested in doing so.

21. In addition, there are arrangements in which it would appear that investors effectively have joint control of an arrangement.[2]

22. Regarding concern (b), we think that our approach will not result in risks being hidden. Our approach would ensure that where an entity has rights to assets (and is exposed to their risks) and has responsibility for obligations, those assets and liabilities would be shown in its financial statements. Our approach will avoid the possibility of including items in an entity's statements of financial position when the entity has no rights to those assets and no responsibility for the liabilities.

23. In addition, we think that our approach might require consolidation of entities or recognition of assets and liabilities that are not consolidated today. For example, newspaper articles and other sources suggest that many SIVs are kept 'off balance sheet', presumably because they meet the criteria of SFAS 140 to be qualifying special purpose entities. Under our approach, this is unlikely to happen.

24. Although it is too soon to discuss disclosure in detail, we anticipate proposing disclosures about risks and rewards in the discussion paper. For example,

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[2] We understand that many securitisation arrangements have limited activities that allow some flexibility in the entity's activities. This flexibility can be in the form of agreement by all parties involved in the arrangement, ie all note holders or investors. Because the investors in a securitisation agreement agree to take on particular risks, their consent is often required in order to change the entity's activities in any way, and consequently, change the risk profile of the entity and ultimately, the risks that those investors are exposed to. For example, the entity's incorporation documents might require that when funding is raised, all financiers, or at least a majority, would have to consent to any changes. Or the offering documents relating to debt issued by the entity would provide that investor consent (unanimous or majority) is needed to modify the contract (the contract being the terms in the offering document). A change in the activities of the entity might change the risk profile of the investors and thus, modify the contract with the investors. In this situation, we are of the view that control of the entity will often be shared among various investors, such that no one party controls the entity (in effect, the entity would be a joint venture). No one party has the ability to direct the activities of the entity. Obviously, if one party holds enough of the variable interest in the entity (eg if one party is the only debt financier), that party could be a position to control without the consent of any other party.

(k) it might be useful that any investments in securitisations or other arrangements (that are not consolidated) are described as such in the statement of financial position (as a separate line item).

(l) when an entity provides credit enhancement of, say, CU20 million, but that obligation is recognised and measured appropriately at CU1 million in its statement of financial position, we would propose that disclosures are given of the credit enhancement provided, how the obligation has been measured and the entity's maximum potential exposure of CU20 million.

Example

25. Agenda paper 2A illustrates the application of our approach to an asset-backed securitisation arrangement.