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ED 10

EXPOSURE DRAFT

ED 10 Consolidated Financial Statements

Comments to be received by 20 March 2009

International
Accounting Standards
Board®

Exposure Draft

ED 10 CONSOLIDATED FINANCIAL STATEMENTS

Comments to be received by 20 March 2009

ED 10 *Consolidated Financial Statements* is published by the International Accounting Standards Board (IASB) for comment only. The proposals may be modified in the light of the comments received before being issued as an International Financial Reporting Standard (IFRS). Comments on the draft IFRS and its accompanying documents (see separate booklets) 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.

All responses will be put on the public record unless the respondent requests confidentiality. However, such requests will not normally be granted unless supported by good reason, such as commercial confidence.

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Introduction and invitation to comment

Introduction

1 The International Accounting Standards Board initiated its project on consolidated financial statements with the objective of publishing 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*. The main objectives of the project are to improve the definition of control and related application guidance so that a control model can be applied to all entities, and to improve the disclosure requirements about consolidated and unconsolidated entities.

2 In April 2008, in response to the global financial crisis and the recommendations of the Financial Stability Forum, the Board decided to accelerate the consolidation project and proceed directly to the publication of an exposure draft before the end of 2008.

3 The exposure draft proposes a single definition of control for all entities, and provides guidance on how to apply that definition in particular situations that have been found difficult when applying IAS 27 and SIC-12. As a consequence, the Board expects that entities will be consolidated on a more consistent basis, making the financial statements of groups more comparable and understandable.

4 In addition to the proposals in this exposure draft, the Board is also reviewing, in a separate project, its requirements for the derecognition of financial instruments. The derecognition of financial instruments sometimes involves the use of structured entities. Therefore the projects on consolidation and derecognition of financial instruments are closely related in those circumstances. The Board would have preferred to publish exposure drafts for these projects at the same time. However, in response to the wide demand for a revised consolidation standard, the Board decided not to delay publication of the consolidation exposure draft. The Board expects that it will be able to publish an exposure draft on the derecognition of financial instruments at the end of the first quarter or start of the second quarter of 2009.

Summary of the proposals and invitation to comment

5 The Board seeks comment on whether the control definition proposed in this exposure draft, and the accompanying guidance on how to apply that definition, provides clearer guidance for determining when one entity

controls another. The Board is also seeking comment on whether the enhanced disclosure requirements for consolidated and unconsolidated entities will give capital providers and other users of financial statements information that is useful for their decision-making.

6 The Board invites comments on all matters in this exposure draft, and in particular on the questions set out in the following paragraphs. Respondents need not comment on all of the questions. Comments are most helpful if they:

- respond to the questions as stated
- indicate the specific paragraph or paragraphs to which the comments relate
- contain a clear rationale
- describe any alternatives the Board should consider.

7 The Board will consider all comments that it receives in writing by 20 March 2009.

Control

8 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. Further guidance on when an entity should consolidate special purpose entities is provided in SIC-12. However, many have noted that the consolidation models in IAS 27 and SIC-12 differ. Some have indicated that there can be difficulties determining whether particular entities are within the scope of IAS 27 or SIC-12, resulting in diversity in practice and reduced comparability of consolidated financial statements. Some are also concerned about the structuring incentives that those inconsistencies might have created.

9 This exposure draft proposes to address those inconsistencies by replacing the definition of control in IAS 27 and the indicators of control in SIC-12 with a single definition of control that would apply to all entities.

10 The Board proposes the following definition of control of an entity:

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

11 Consequences of the definition are that only one party can control an entity and there could be circumstances in which an entity is not controlled by any party.

Power to direct the activities

12 Control of another entity requires the power to direct the activities of that other entity. The Board believes that the power to govern the financial and operating policies, as stated in IAS 27, is one means of having power to direct the activities of another entity, but it is not the only means. Power can be achieved in many ways, including by having voting rights, by having options or convertible instruments, by means of contractual arrangements, or a combination of these, or by having an agent with the ability to direct the activities for the benefit of the controlling entity.

13 A reporting entity need not have exercised its power to direct the activities of an entity to control that entity. A reporting entity can have power even if, for example, it has not exercised its voting rights or options to acquire voting rights, or is not actively directing the activities of another entity.

Returns

14 The proposed definition retains the concept in IAS 27 that control conveys the right to obtain benefits from another entity. The exposure draft uses the term 'returns' rather than 'benefits', as used in IAS 27, because many interpret 'benefits' to imply only positive returns. The Board believes that 'returns' makes more explicit that a reporting entity may obtain positive or negative returns.

15 Paragraphs 4–11 of the draft IFRS set out the Board's proposals regarding the definition of control. The Board sets out its reasoning for those proposals in paragraphs BC32–BC62 of the Basis for Conclusions.

Question 1

Do you think that the proposed control definition could be applied to all entities within the scope of IAS 27 as well as those within the scope of SIC-12? If not, what are the application difficulties?

Question 2

Is the control principle as articulated in the draft IFRS an appropriate basis for consolidation?

Assessing control

16 The exposure draft retains the presumption in IAS 27 that a reporting entity that can exercise more than half of the voting rights in another entity has power to direct the activities in the absence of circumstances that indicate otherwise. The exposure draft provides guidance on how to assess power and returns when:

(a) a reporting entity has less than a majority of the voting rights.

(b) assessing control of a structured entity.

Power without a majority of the voting rights

17 The exposure draft clarifies the Board's view that a reporting entity that holds less than half of the voting rights in another entity can control that other entity in some situations. The exposure draft includes application guidance on how to apply the control principle when assessing whether a reporting entity has power to direct the activities of another entity with less than half of the voting rights. This guidance also considers:

(a) options and convertible instruments to obtain voting rights of an entity.

(b) how to assess whether an entity has control if it holds voting rights both directly and on behalf of other parties as an agent.

18 Paragraphs 26–29 and B9–B16 of the draft IFRS set out the Board's proposals regarding the assessment of power with less than half of the voting rights. The Board sets out its reasoning for those proposals in paragraphs BC63–BC97 of the Basis for Conclusions.

Question 3

Are the requirements and guidance regarding the assessment of control sufficient to enable the consistent application of the control definition? If not, why not? What additional guidance is needed or what guidance should be removed?

Question 4

Do you agree with the Board's proposals regarding options and convertible instruments when assessing control of an entity? If not, please describe in what situations, if any, you think that options or convertible instruments would give the option holder the power to direct the activities of an entity.

Question 5

Do you agree with the Board's proposals for situations in which a party holds voting rights both directly and on behalf of other parties as an agent? If not, please describe the circumstances in which the proposals would lead to an inappropriate consolidation outcome.

Structured entities

19 The exposure draft introduces the term 'structured entity'. Special purpose entities referred to in SIC-12 have characteristics similar to structured entities.

20 Paragraphs 30–38 of the draft IFRS contain guidance on assessing control of a structured entity. 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, the exposure draft proposes that a reporting entity should assess the particular circumstances of its relationship with a structured entity, and consider factors such as the purpose and design of the structured entity and how decisions are made about the activities that cause the returns of the entity to vary. The Board sets out its reasoning for the proposals for structured entities in paragraphs BC98–BC121 of the Basis for Conclusions.

21 For the reasons set out in paragraph BC112, power can be difficult to assess when considering who controls a structured entity. Some think that power could be easily disguised and, therefore, that a reporting entity might more easily avoid consolidating a structured entity that it controls than would be the case in accordance with SIC-12. One way of addressing this would be to propose a risks and rewards 'fall back' test if power cannot be assessed. According to that approach, a reporting entity would consolidate another entity if it is exposed to a particular level of variability of returns of a structured entity, without any requirement to have the power to direct the activities of that structured entity. Others think that consolidation on the basis of control creates fewer structuring opportunities than control with a 'fall back' test. They are concerned that a 'fall back' test creates an incentive to deliberately shift the basis of consolidation away from control.

Question 6

Do you agree with the definition of a structured entity in paragraph 30 of the draft IFRS? If not, how would you describe or define such an entity?

Question 7

Are the requirements and guidance regarding the assessment of control of a structured entity in paragraphs 30–38 of the draft IFRS sufficient to enable consistent application of the control definition? If not, why not? What additional guidance is needed?

Question 8

Should the IFRS on consolidated financial statements include a risks and rewards 'fall back' test? If so, what level of variability of returns should be the basis for the test and why? Please state how you would calculate the variability of returns and why you believe it is appropriate to have an exception to the principle that consolidation is on the basis of control.

Disclosure

22 The exposure draft proposes enhanced disclosure requirements for consolidated entities, particularly relating to the effect of non-controlling interests.

23 In addition, the global financial crisis has highlighted a need for better disclosure about the nature of, and risks associated with, a reporting entity's involvement with structured entities that the reporting entity does not control. Such disclosure is often referred to as information about 'off balance sheet' activities. Therefore, the exposure draft proposes requiring a reporting entity to disclose:

(a) information about the basis of control and the related accounting consequences.

(b) information about the interest that the non-controlling interests have in the group's activities.

(c) information about restrictions on assets and liabilities held in subsidiaries, including the claims of non-controlling interests.

(d) information about unconsolidated structured entities that the reporting entity does not control, but with which the reporting entity has involvement.

24 Paragraphs 48–50 and B30–B49 of the draft IFRS set out the proposed disclosure requirements. The Board sets out its reasoning for those proposals in paragraphs BC122–BC145 of the Basis for Conclusions.

Question 9

Do the proposed disclosure requirements described in paragraph 23 provide decision-useful information? Please identify any disclosure requirements that you think should be removed from, or added to, the draft IFRS.

Question 10

Do you think that reporting entities will, or should, have available the information to meet the disclosure requirements? Please identify those requirements with which you believe it will be difficult for reporting entities to comply, or that are likely to impose significant costs on reporting entities.

Other matters

Reputational risk

25 In the context of the exposure draft, 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. 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.

26 The Board concluded that reputational risk is not an appropriate basis for consolidation. However, the exposure draft proposes that a reporting entity should be required to disclose that it has provided support to unconsolidated structured entities despite not having a contractual or constructive obligation to do so.

Question 11

(a) Do you think that reputational risk is an appropriate basis for consolidation? If so, please describe how it meets the definition of control and how such a basis of consolidation might work in practice.

(b) Do you think that the proposed disclosures in paragraph B47 are sufficient? If not, how should they be enhanced?

Accounting for associates and the equity method

27 The exposure draft reaffirms that a group is a parent and all its subsidiaries. Associates, as defined in IAS 28 *Investments in Associates*, are not part of the group. Yet the equity method in IAS 28 treats an associate as if it were part of the group because it requires an entity to make consolidating adjustments for associates similar to those required for subsidiaries. For example, the equity method requires elimination of profits and losses resulting from transactions between an investor and its associates.

28 Some argue that the equity method is not a consolidation method but a measurement method for investments in entities that are outside the group. However, if the equity method represents a measurement method only, it is unclear why the equity method requires consolidating procedures. Respondents to ED 9 *Joint Arrangements* have noted these issues.

29 When the concept of significant influence in IAS 28 was developed it was in the context of a consolidation requirement that focused on who has a majority of the voting rights. There was a clear need to address the circumstances in which a reporting entity had involvement with an entity beyond that of a passive investor.

30 The consolidation model in IFRSs has developed well beyond a simple voting rights model. IAS 27 has a focus on control of the strategic operating and financing policies and identifies circumstances in which other factors override voting rights. The proposals in this exposure draft go even further by focusing on the different ways that a reporting entity might have power to direct the activities of another entity. The disclosures proposed are intended to assist investors and other users in assessing the risks to which the reporting entity is exposed as a consequence of its involvement with entities that the reporting entity does not control.

31 Despite the improvements to the consolidation model, the concept of significant influence has not been deliberated by the Board. During its deliberations on consolidation the Board noted the overlap, and possible conflict, between the proposals in the exposure draft and the requirements in IAS 28.

32 The issues identified in IAS 28 raise the question of whether the Board should consider the definition of significant influence and the use of the equity method in IAS 28. The Board noted that consideration of the requirements in IAS 28, together with the proposals in this exposure draft and the concurrent development of a replacement for IAS 31 *Interests in Joint Ventures*, would permit the development of a cohesive set of requirements for all investments in entities.

Question 12

Do you think that the Board should consider the definition of significant influence and the use of the equity method with a view to developing proposals as part of a separate project that might address the concerns raised relating to IAS 28?

[Draft] International Financial Reporting Standard X *Consolidated Financial Statements* ([draft] IFRS X) is set out in paragraphs 1–54 and Appendices A–C. All the paragraphs have equal authority. Paragraphs in **bold type** state the main principles. Terms defined in Appendix A are in *italics* the first time they appear in the [draft] IFRS. Definitions of other terms are given in the Glossary for International Financial Reporting Standards. [Draft] IFRS X should be read in the context of its core principle and the Basis for Conclusions, the *Preface to International Financial Reporting Standards* and the *Framework for the Preparation and Presentation of Financial Statements*. IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* provides a basis for selecting and applying accounting policies in the absence of explicit guidance.

[Draft] International Financial Reporting Standard X *Consolidated Financial Statements*

Core principle

1 **A reporting entity presents financial statements that consolidate its assets, liabilities, equity, income, expenses and cash flows with those of the entities that it controls.**

Scope

2 This [draft] IFRS applies to all entities, except as follows:

(a) a *parent* need not present *consolidated financial statements* if it meets all of the following conditions:

(i) the parent is a wholly-owned *subsidiary* or is a partially-owned subsidiary of another entity and its other owners, including those not otherwise entitled to vote, have been informed about, and do not object to, the parent not presenting consolidated financial statements;

(ii) the parent's debt or equity instruments are not traded in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local and regional markets);

(iii) the parent did not file, nor is it in the process of filing, its financial statements with a securities commission or other regulatory organisation for the purpose of issuing any class of instruments in a public market; and

(iv) the ultimate or any intermediate parent of the parent produces consolidated financial statements available for public use that comply with IFRSs.

(b) this [draft] IFRS does not apply to post-employment benefit plans or other long-term employee benefit plans to which IAS 19 *Employee Benefits* applies.

3 This [draft] IFRS does not deal with the accounting for business combinations and its effect on consolidation, including goodwill arising on a business combination (for which see IFRS 3 *Business Combinations*).

Control of an entity

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

5 A parent does not share control of a subsidiary. The parent's power to direct the activities of a subsidiary precludes others from controlling the subsidiary.

6 Although a parent does not share control of a subsidiary, its power need not be absolute. *Protective rights* held by other parties do not preclude a parent from controlling a subsidiary but might restrict its power. Paragraphs B1 and B2 provide additional guidance on protective rights.

7 Although a parent has the power to direct the activities of a subsidiary to generate returns for its own benefit, other parties, including *non-controlling interests*, can share those returns.

Power to direct the activities

8 A reporting entity can possess the power to direct the activities of another entity by different means, including by having voting rights, by having options or convertible instruments to obtain voting rights, by means of contractual arrangements, or a combination of these. A reporting entity need not have exercised its power to direct the activities of an entity to control that entity.

9 A reporting entity can have power by having an agent act on its behalf. In contrast, a reporting entity does not have power when it is acting solely as an agent. Paragraphs B3–B8 provide guidance on the relationship between a principal and its agent.

Returns*

10 *Returns from involvement with an entity* vary with that entity's activities and can be positive or negative.

* Note for readers of the exposure draft. The term 'returns', as used in this draft IFRS, replaces the term 'benefits' used in IAS 27 *Consolidated and Separate Financial Statements*, which the proposed IFRS revises.

11 A parent is exposed to the variability of returns and has the ability to affect the returns generated for it. Returns generated for a parent can include:

(a) dividends, other forms of economic benefits distributed by a subsidiary, and changes in the value of the subsidiary attributable to the parent and any of the parent's other subsidiaries.

(b) upfront fees, access to cash or fees for servicing a subsidiary's assets or liabilities, fees and exposure to loss from providing credit or liquidity support, residual interests in the subsidiary's assets and liabilities on liquidation of that subsidiary, tax benefits, and access to liquidity that a parent has from controlling a subsidiary.

(c) returns that are not available to non-controlling interests. For example, a parent might use its own assets (including assets of its other subsidiaries) in combination with the assets of a subsidiary, such as combining functions to achieve economies of scale, sourcing scarce products, gaining access to proprietary knowledge or limiting some operations or assets, to enhance the value of the parent's other assets.

(d) cost savings or a reduction in expenses.

Assessing control

12 When assessing control, a reporting entity shall consider power and returns together, and how the reporting entity can use its power to affect the returns.

13 A reporting entity's power to direct the activities of another entity is generally correlated with its exposure to the variability of returns from that other entity.

14 A reporting entity shall consider all relevant facts and circumstances when assessing control.

Assessment is continuous

15 A reporting entity shall assess control continuously.

16 A reporting entity's power to direct the activities of another entity can change as a consequence of actions by the reporting entity or because of changes in facts and circumstances. Fluctuations in the reporting entity's returns, without a change in the reporting entity's power to

direct the activities of another entity, does not cause that reporting entity to obtain or lose control of that other entity. However, if the reporting entity ceases to receive returns from its involvement with an entity, it does not control that entity.

Related arrangements

17 **A reporting entity shall consider the terms and conditions of all related arrangements when assessing control.**

18 One or more of the following indicate that a reporting entity should treat multiple arrangements as related when assessing control:

(a) The arrangements are entered into at the same time or in contemplation of each other.

(b) The arrangements form a single arrangement designed to achieve an overall commercial effect.

(c) One arrangement considered on its own is not justified economically, but it is justified economically when considered together with other arrangements.

Assessing returns

19 **The returns generated for a reporting entity are returns it receives from its involvement with another entity, including returns from related arrangements.**

20 A reporting entity's returns can include fixed fees in conjunction with variable returns from related arrangements, and include returns already received as well as those to be received. For example, if a reporting entity receives an initial fixed fee for sponsoring an entity and, as a result of a related arrangement, provides credit and liquidity support, the initial fixed fee and the returns (both positive and negative) relating to the credit and liquidity support are considered together.

Assessing power to direct activities

21 **A reporting entity shall assess whether it has power to direct the activities:**

(a) of an entity by having voting rights or other arrangements (see paragraphs 23–29).

(b) of a *structured entity* (see paragraphs 30–38).

22 A reporting entity has the power to direct the activities of another entity if it can determine that other entity's strategic operating and financing policies.

Power to direct activities with a majority of the voting rights

23 A reporting entity can have the power to direct the activities of another entity by having the power to appoint or remove the members of that entity's governing body that have more than half of the voting rights within that body, if the determination of strategic operating and financing policies is by that body.

24 If the appointment or removal of the members of an entity's governing body is determined by voting rights, a reporting entity with more than half of those voting rights controls that governing body and has the power to direct the activities of that entity unless paragraph 25 applies.

Majority of the voting rights but no power to direct activities

25 A reporting entity with more than half of the voting rights of another entity might not have the power to direct the activities of that other entity. This situation will exist if legal requirements, the founding documents of the other entity or other contractual arrangements restrict the power of the reporting entity to the extent that it does not have the power to direct the activities of the entity, or if another *party* has the power to direct the activities of the entity. For example, if an entity in which a reporting entity has more than half of the voting rights is placed under legal supervision, the reporting entity is prevented from having the power to direct the activities of that entity and does not control that entity.

Power to direct activities without a majority of the voting rights

26 A reporting entity can have the power to direct the activities of another entity even if it holds less than half of the voting rights of that entity.

27 A reporting entity with less than half of the voting rights has the power to direct the activities of another entity if:

(a) the reporting entity has more voting rights than any other party; and

(b) the reporting entity's voting rights are sufficient to give the reporting entity the ability to determine the entity's strategic operating and financing policies.

28 For example, a reporting entity can have the power to direct the activities of another entity if the reporting entity is the dominant shareholder that holds voting rights and all the other shareholders with voting rights are widely dispersed and are not organised in such a way that they actively co-operate when they exercise their votes so as to have more voting power than the reporting entity.

29 A reporting entity can also have the power to direct the activities of another entity by means of other arrangements. Paragraphs B9–B16 provide application guidance for circumstances in which a reporting entity has the power to direct the activities of another entity even though it holds less than half of the voting rights of the entity.

Structured entities

30 A structured entity is an entity whose activities are restricted to the extent that those activities are not directed as described in paragraphs 23–29.

31 When assessing control of a structured entity, it is necessary to identify how returns from the entity's activities are shared and how decisions, if any, are made about the activities that affect those returns. A reporting entity shall consider all relevant facts and circumstances, including the following:

(a) the purpose and design of the structured entity (see paragraph 32)

(b) the reporting entity's returns from its involvement with the structured entity (see paragraph 33)

(c) the activities of the structured entity, including the extent to which the strategic operating and financing policies that direct those activities have been predetermined (see paragraphs 34–36)

(d) related arrangements (see paragraph 37)

(e) the reporting entity's ability to change the restrictions or predetermined strategic operating and financing policies (see paragraph 38)

(f) whether the reporting entity acts as an agent for other parties, or another party acts as its agent (see paragraphs B3–B8).

Purpose and design

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

Returns

33 Generally, the more a reporting entity is exposed to the variability of returns from its involvement with an entity, the more power the reporting entity is likely to have to direct the activities of that entity that cause the returns to vary. A reporting entity is likely to have power to direct the activities of a structured entity if it is exposed to the variability of returns that are potentially significant to the structured entity and the reporting entity's exposure is more than that of any other party.

Activities

34 Control of an entity that has a limited range of activities, such as an entity that manages an asset securitisation, is determined on the basis of how that limited range of activities is directed and how the returns it receives from its involvement with the entity are shared. A reporting entity identifies what activities cause the returns to vary and assesses whether it has power to direct those activities. A reporting entity's ability to act when circumstances arise or events happen constitutes power if that ability relates to the activities that cause the reporting entity's returns to vary. A reporting entity does not have to exercise its power in order to have power to direct the activities of a structured entity.

35 For example, if the only assets of an entity are receivables, then managing any defaulting receivables is the only activity that causes the returns to vary and, thus, affects the returns of the structured entity's participants. In this example, the party with the power to direct how any defaulting receivables are managed, and in having that power can affect its returns from its involvement with the entity, controls that entity. A party has

that power by managing any defaulting receivables itself or by delegating to its agent the management of defaulting receivables. That party has the power to direct the activities of the entity irrespective of whether any of the receivables actually defaults.

36 Sometimes some activities of a structured entity are directed by means of predetermined strategic operating and financing policies that specify the actions that must be taken in response to anticipated events or circumstances. Such predetermined policies can give a reporting entity the power to direct those activities. Those policies are often, although not always, implemented by an agent of the party with the power to direct those activities (see paragraphs B3–B8).

Related arrangements

37 A reporting entity can control a structured entity by means of related arrangements (see paragraphs 17 and 18). For example, a reporting entity could establish a structured entity, whose founding documents restrict its activities to purchasing fixed rate receivables of the reporting entity for cash, collecting payments from those receivables and passing those payments to the investors in the structured entity. Receivables that are overdue by more than a specified period are put back to the reporting entity. In this example, in the absence of other facts, the reporting entity controls the structured entity. The entity's founding documents and the put agreement ensure that the reporting entity is exposed to all of the variability of returns generated from the receivables of the structured entity, and has the ability to affect those returns by managing any defaulting receivables. The reporting entity has the power to direct the activities of the structured entity by having the ability to direct how the assets of the structured entity are managed.

Ability to change restrictions or predetermined strategic policies

38 A reporting entity can have the power to direct the activities of a structured entity if the reporting entity has the ability to change the restrictions or predetermined strategic operating and financing policies according to which the structured entity operates. For example, a reporting entity can have the power to direct the activities of a structured entity by having the right to dissolve the entity or to change (or veto any changes to) the entity's charter or bylaws. A reporting entity can have the right to dissolve an entity by holding liquidation, redemption or other rights.

Accounting requirements

39 **A reporting entity shall present financial statements that consolidate its assets, liabilities, equity, income, expenses and cash flows with those of the entities that it controls and shall present them as those of a single entity.**

40 Consolidation of a subsidiary begins from the date when a parent obtains control of the subsidiary and ceases on the date when the parent loses control.

41 **A reporting entity shall prepare consolidated financial statements using uniform accounting policies for like transactions and other events in similar circumstances.**

42 Paragraphs B17–B21 provide guidance on the preparation of consolidated financial statements.

Non-controlling interests

43 A reporting entity presents non-controlling interests in the consolidated statement of financial position within equity, separately from the equity of the owners of the parent.

44 Changes in a parent's ownership interest in a subsidiary that do not result in the parent losing control of the subsidiary are equity transactions (ie transactions with owners in their capacity as owners).

45 Paragraphs B22–B25 provide guidance on accounting for non-controlling interests in consolidated financial statements.

Loss of control

46 If a parent loses control of a subsidiary, the parent:

(a) derecognises the assets and liabilities of the former subsidiary from the consolidated statement of financial position;

(b) recognises the gain or loss associated with the loss of control attributable to the former controlling interest; and

(c) accounts for any investment retained in the former subsidiary and any amounts owed by or to the former subsidiary in accordance with other IFRSs from the date when control is lost.

47 Paragraphs B26–B29 provide guidance on accounting for the loss of control.

Disclosure

48 **A reporting entity shall disclose information that enables users of its financial statements to evaluate:**

- **(a) the basis of control and the related accounting consequences;**
- **(b) the interest that the non-controlling interests have in the *group*'s activities;**
- **(c) the nature and financial effect of restrictions that are a consequence of assets and liabilities being held by subsidiaries;**
- **(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 that do not result in a loss of control; and**
- **(f) the accounting consequences when the reporting entity loses control of a subsidiary during the reporting period.**

49 To meet the objectives in paragraph 48, a reporting entity shall disclose the information specified in paragraphs B30–B49.

50 If the specific disclosures required by this and other IFRSs do not meet the objectives in paragraph 48, a reporting entity shall disclose whatever additional information is necessary to meet those objectives.

Effective date and transition

Effective date

51 A reporting entity shall apply this [draft] IFRS prospectively for annual periods beginning on or after [date to be inserted after exposure]. Earlier application is permitted. If a reporting entity applies this [draft] IFRS in its financial statements for a period before [date to be inserted after exposure], it shall disclose that fact.

Transition

52 When application of the requirements of this [draft] IFRS for the first time results in a reporting entity consolidating an entity that was not consolidated in accordance with IAS 27 *Consolidated and Separate Financial Statements* and SIC-12 *Consolidation—Special Purpose Entities*, a reporting entity applies the requirements of IFRS 3. The date of first applying the [draft] IFRS is the deemed acquisition date, unless the acquisition date as defined in IFRS 3 is after the date of first applying the [draft] IFRS.

53 When application of the requirements of this [draft] IFRS for the first time results in a reporting entity no longer consolidating an entity that was consolidated in accordance with IAS 27 and SIC-12, a reporting entity applies the requirements of the [draft] IFRS relating to the loss of control on the date of first applying the [draft] IFRS, unless the date of losing control is after the date of first applying the [draft] IFRS.

Withdrawal of SIC-12

54 This [draft] IFRS supersedes SIC-12 *Consolidation—Special Purpose Entities*.

Appendix A
Defined terms

This appendix is an integral part of the [draft] IFRS.

consolidated financial statements	The financial statements of a **parent** and the entities that it controls presented as a single entity.
control of an entity	The power of a reporting entity to direct the activities of another entity to generate returns for the reporting entity.
group	A **parent** and all its **subsidiaries**.
involvement with a structured entity	For the purposes of this [draft] IFRS, involvement with a **structured entity** includes both contractual and non-contractual involvement that exposes the reporting entity to variability of returns of the structured entity. Involvement includes the holding of equity or debt instruments, as well as other forms of involvement such as the provision of funding, liquidity support, credit enhancement, guarantees, and asset management services.
non-controlling interest	Equity in a **subsidiary** not attributable, directly or indirectly, to a **parent**.
parent	An entity that has one or more **subsidiaries**.
party	For the purposes of this [draft] IFRS, party is used broadly to include legal and other entities as well as a single individual or a group of individuals.
protective rights	Rights of a **party** relating to the activities of an entity that do not give the party **control of the entity**, nor do they prevent another party from controlling that entity.
returns from involvement with an entity	Returns that vary with the activities of an entity and can be positive or negative.

structured entity	An entity whose activities are restricted to the extent that those activities are not directed as described in paragraphs 23–29.
subsidiary	An entity that is controlled by a **parent**. A legal structure such as a company or trust can comprise more than one entity.*

* Note for the readers of the exposure draft. An entity within a legal structure referred to in the definition of a subsidiary is sometimes referred to in national GAAP as a silo.

Appendix B
Application guidance

This appendix is an integral part of the [draft] IFRS.

Protective rights

B1 A reporting entity can control another entity even though other parties have protective rights relating to the activities of that other entity.

B2 Protective rights are designed to protect the interests of the party holding those rights without giving that party control of the entity to which they relate. They include, for example:

(a) approval or veto rights granted to other parties that do not affect the strategic operating and financing policies of the entity. Protective rights often apply to fundamental changes in the activities of an entity, or apply only in exceptional circumstances. For example:

(i) a lender might have rights that protect the lender from the risk that the entity will change its activities to the detriment of the lender, such as selling important assets or undertaking activities that change the credit risk of the entity.

(ii) non-controlling interests might have the right to approve capital expenditure greater than a particular amount, or the right to approve the issue of equity or debt instruments.

(b) the ability to remove the party that directs the activities of the entity in circumstances such as bankruptcy or on breach of contract by that party.

(c) limitations on the operating activities of an entity. For example, a franchise agreement for which the entity is the franchisee might restrict the pricing, advertising or other operating activities of the entity but would not give the franchisor control of the franchisee. Such rights usually protect the brand of the franchisor.

Agency relationships

B3 An agent is a party engaged to act on behalf of another party or parties (the principal(s)). An agent might have the ability to direct the activities of an entity, for example by making decisions concerning the operating and financing activities of the entity. However, that ability is governed by agreement, law or fiduciary responsibility that requires the agent to act in the best interests of the principal. The agent must use any decision-making ability delegated to it to generate returns primarily for the principal.

Removal rights

B4 Removal rights can indicate an agency relationship. A principal often has the right to remove, without cause, an agent that is empowered to direct the activities of an entity for the principal. That unconditional right to remove the agent ensures that the principal has the power to direct the activities of the entity. Rights to remove a party only in circumstances such as bankruptcy or on breach of contract by that party are protective rights.

Remuneration of an agent

B5 An agent is remunerated for the services it performs by means of a fee that is commensurate with those services. Fees that are not commensurate with the services performed indicate involvement with an entity beyond that of an agent and, therefore, might indicate control.

B6 Any of the following factors might indicate that fees are not commensurate with the services performed:

(a) The fees are more than would be received for similar services negotiated on an arm's length basis.

(b) The fees are large relative to the total expected returns of the entity to which the services are provided.

(c) The expected variability in the fees is large relative to the total expected variability of the returns of the entity to which the services are provided.

B7 The remuneration of an agent can be a fixed or performance-related fee. If the agent receives a performance-related fee, the agency relationship can be difficult to distinguish from a controlling relationship. This is because the agent can use its ability to direct the activities of the entity to affect its remuneration. However, if this ability is limited by the agent's responsibility to act in the best interests of the principal, the performance-related fee that the agent receives is remuneration for the services it performs and does not indicate involvement with the entity beyond that of an agent.

B8 A performance-related fee of an agent is often distinguishable from the returns of the investors for whom the agent is acting. For example, an investor in a fund will benefit from increases in the value of the fund and suffer from decreases in the value of the fund. In contrast, an agent might be paid a performance-related fee for a specified period and the agent is unlikely to be required to contribute to the fund (ie refund fees already received) if the value of the fund decreases.

Power to direct activities without a majority of the voting rights

B9 When assessing control, a reporting entity considers all relevant facts and circumstances, including the following indicators of power to direct the activities of an entity:

(a) The reporting entity can dominate the governing body, and therefore determine the strategic operating and financing policies. Examples of indicators are:

   (i) dominating the process of electing members of the entity's governing body or obtaining proxies from other holders of voting interests; and

   (ii) appointing members to fill vacancies on the entity's governing body until the next election.

(b) The reporting entity can appoint, hire, reassign or dismiss the entity's key management personnel.

(c) The reporting entity shares resources with the entity. For example, the entity and the reporting entity might have the same members of their governing bodies, or share key management personnel or other staff.

(d) The reporting entity has the ability to direct the entity to enter into significant transactions that benefit the reporting entity.

(e) The reporting entity has access to the residual assets of the entity, such as:

   (i) by dissolving the entity and redirecting the use of its assets; or

   (ii) having access, under a statute or an agreement, to the entity's resources.

Agreement with other vote holders

B10 An agreement between a reporting entity and other vote holders can give the reporting entity the right to exercise voting rights sufficient to give the reporting entity the power to direct the activities of another entity, even though the reporting entity itself holds voting rights that would not be sufficient to give it power. If the reporting entity can exercise those voting rights to generate returns for itself, the reporting entity controls the other entity to which the voting rights relate.

B11 Sometimes it can be difficult to identify whether a reporting entity that holds voting rights, both directly and on behalf of other parties as an agent, uses the voting rights of the other parties for its own benefit or for the benefit of those other parties. In such circumstances, in assessing whether it has voting rights sufficient to control another entity, the reporting entity excludes the voting rights it holds as an agent only if the reporting entity can demonstrate that it is obliged to act in the best interests of those other parties or has implemented policies and procedures that ensure the independence of the decision-making in its role as an agent from that as a holder of voting rights directly.

Parties that act for a reporting entity

B12 The following are examples of parties that often act for a reporting entity:

(a) the reporting entity's related parties as defined in IAS 24 *Related Party Disclosures*.

(b) a party that received its interest in the entity as a contribution from the reporting entity.

(c) a party that has agreed not to sell, transfer or encumber its interests in the entity without the prior approval of the reporting entity.

(d) a party that cannot finance its operations without financial support from the reporting entity.

(e) an entity with the same board of directors as the reporting entity.

Options and convertible instruments

B13 When assessing control, a reporting entity considers whether its power from holding options or convertible instruments to obtain voting rights, taken in conjunction with other relevant facts and circumstances, gives it the power to direct the activities of another entity. A reporting entity that holds options or convertible instruments has power to direct the activities of another entity if (a), (b) or (c) applies:

(a) the governing body of that entity determines strategic operating and financing policies in accordance with the wishes of the reporting entity. This might be the case if, for example, the reporting entity holds voting rights together with options or convertible instruments to obtain voting rights that, if exercised or converted, would give the reporting entity voting rights sufficient to determine the entity's strategic operating and financing policies.

(b) any party with voting rights that is the counterparty to an option agreement acts as an agent for the reporting entity and those voting rights are sufficient to give the reporting entity the ability to determine the entity's strategic operating and financing policies.

(c) the option or conversion agreement gives the reporting entity particular rights relating to the strategic operating and financing policies that enable the reporting entity to have the power to direct the activities of the entity.

Other arrangements

B14 When assessing control, a reporting entity shall consider what powers it has to direct activities of an entity that arise from arrangements other than those that give the reporting entity voting rights.

B15 Such arrangements could enable the reporting entity to direct activities that would normally be directed by the governing body of that other entity, such as agreements that give the reporting entity the power to direct the manufacturing processes of an entity, appoint personnel or direct other operating activities.

B16 Economic dependence of an entity on the reporting entity (such as relations of a supplier to its main customer) does not, by itself, lead to the reporting entity having the power to direct the activities of that other entity. However, the reporting entity might have that power if its other arrangements are considered in conjunction with its voting rights. Sometimes having more voting rights than any other party enables a reporting entity to prevent other parties from changing the contractual arrangements the reporting entity uses to direct the activities of another entity.

Accounting requirements

Consolidation procedures

B17 Consolidated financial statements:

(a) combine like items of assets, liabilities, equity, income, expenses and cash flows of the parent and its subsidiaries;

(b) offset (eliminate) the carrying amount of the parent's investment in each subsidiary and the parent's portion of equity of each subsidiary (IFRS 3 explains how to account for any related goodwill); and

(c) eliminate in full intragroup assets and liabilities, equity, income, expenses and cash flows relating to transactions between entities of the group (profits or losses resulting from intragroup transactions that are recognised in assets, such as inventory and fixed assets, are eliminated in full).

Measurement

B18 A reporting entity includes the income and expenses of a subsidiary in the consolidated financial statements from the acquisition date as defined in IFRS 3 until the date when the reporting entity ceases to control the subsidiary. Income and expenses of the subsidiary are based on the amounts of the assets and liabilities recognised in the consolidated financial statements at the acquisition date. For example, depreciation expense recognised in the consolidated statement of comprehensive income after the acquisition date is based on the fair values of the related depreciable assets recognised in the consolidated financial statements at the acquisition date.

Options and convertible instruments

B19 When a subsidiary has instruments that give other parties an option to obtain equity instruments or to convert a liability into equity instruments, a parent determines the proportions of profit or loss and changes in equity allocated to the parent and non-controlling interests on the basis of current ownership interests. The proportions allocated to the parent and non-controlling interests do not reflect the possible exercise of options or convertible instruments.

Reporting date

B20 The financial statements of the parent and its subsidiaries used in the preparation of the consolidated financial statements have the same reporting date. When the end of the reporting period of the parent is different from that of a subsidiary, the subsidiary prepares, for consolidation purposes, additional financial statements as of the same date as the financial statements of the parent unless it is impracticable to do so.

B21 When it is impracticable to do so, the financial statements of a subsidiary used in the preparation of consolidated financial statements are prepared as of a date different from that of the parent's financial statements. The reporting entity makes adjustments for the effects of significant transactions or events that occur between that date and the date of the parent's financial statements. In any case, the difference between the date of the subsidiary's financial statements and that of the parent's financial statements can be no more than three months, and the length of the reporting periods and any difference between the dates of the financial statements must be the same from period to period.

Non-controlling interests

B22 A reporting entity attributes profit or loss and each component of other comprehensive income to the owners of the parent and to the non-controlling interests. The reporting entity attributes total comprehensive income to the owners of the parent and to the non-controlling interests even if this results in the non-controlling interests having a deficit balance.

B23 If a subsidiary has outstanding cumulative preference shares that are classified as equity and are held by non-controlling interests, the reporting entity computes its share of profit or loss after adjusting for the dividends on such shares, whether or not such dividends have been declared.

B24 A reporting entity identifies non-controlling interests in the net assets of subsidiaries separately from the parent's interests in them.

Changes in the proportion held by non-controlling interests

B25 When the proportion of the equity held by non-controlling interests changes, a reporting entity adjusts the carrying amounts of the controlling and non-controlling interests to reflect the changes in their relative interests in the subsidiary. The reporting entity recognises directly in equity any difference between the amount by which the non-controlling interests are adjusted and the fair value of the consideration paid or received and attributes it to the owners of the parent.

Loss of control

Derecognition

B26 If a reporting entity loses control of a subsidiary, it:

(a) derecognises:

(i) the assets (including any goodwill) and liabilities of the subsidiary at their carrying amounts at the date when control is lost;

(ii) the carrying amount of any non-controlling interests in the former subsidiary at the date when control is lost (including any components of other comprehensive income attributable to them).

(b) recognises:

(i) the fair value of the consideration received, if any, from the transaction, event or circumstances that resulted in the loss of control;

(ii) if the transaction that resulted in the loss of control involves a distribution of shares of the subsidiary to owners in their capacity as owners, that distribution; and

(iii) any investment retained in the former subsidiary at its fair value at the date when control is lost.

(c) reclassifies to profit or loss, or transfers directly to retained earnings if required in accordance with other IFRSs, the amounts recognised in other comprehensive income in relation to the subsidiary on the basis described in paragraph B27.

(d) recognises any resulting difference as a gain or loss in profit or loss attributable to the parent.

Other comprehensive income

B27 If a reporting entity loses control of a subsidiary, the reporting entity shall account for all amounts recognised in other comprehensive income in relation to that subsidiary on the same basis as would be required if the reporting entity had directly disposed of the related assets or liabilities. Therefore, if a gain or loss previously recognised in other comprehensive income would be reclassified to profit or loss on the disposal of the related assets or liabilities, the parent reclassifies the gain or loss from equity to profit or loss when it loses control of the subsidiary. For example, if a subsidiary has available-for-sale financial assets and the reporting entity loses control of the subsidiary, the reporting entity shall reclassify to profit or loss the gain or loss previously recognised in other comprehensive income in relation to those assets. Similarly, if a revaluation surplus previously recognised in other comprehensive income would be transferred directly to retained earnings on the disposal of the asset, the reporting entity transfers the revaluation surplus directly to retained earnings when it loses control of the subsidiary.

Investment retained on the loss of control

B28 Paragraph 46 states that on the loss of control of a subsidiary, any investment retained in the former subsidiary and any amounts owed by or to the former subsidiary shall be accounted for in accordance with other IFRSs from the date when control is lost.

B29 The fair value of any investment retained in the former subsidiary at the date when control is lost shall be regarded as the fair value on initial recognition of a financial asset in accordance with IAS 39 *Financial Instruments: Recognition and Measurement* or, when appropriate, the cost on initial recognition of an investment in an associate or jointly controlled entity.

Disclosures (application of paragraphs 48–50)

B30 To meet the disclosure objectives in paragraph 48, a reporting entity must disclose the information set out in paragraphs B32–B49.

B31 A reporting entity decides, in the light of its circumstances, how much detail it provides to satisfy the requirements of this [draft] IFRS, how much emphasis it places on different aspects of the requirements and how it aggregates information to display the overall picture without combining information with different characteristics. It is necessary to strike a balance between burdening financial statements with excessive detail that may not assist users of financial statements and obscuring important information as a result of too much aggregation. For example, a reporting entity shall not obscure important information by including it among a large amount of insignificant detail. Similarly, a reporting entity shall not disclose information that is so aggregated that it obscures important differences between the types of involvement or associated risks.

Basis of control (paragraph 48(a))

B32 To help meet the objective in paragraph 48(a), a reporting entity shall describe the basis for its assessment and any significant assumptions or judgements when the reporting entity has concluded that:

(a) it controls an entity whose activities are directed through voting rights even though the reporting entity has less than half of that entity's voting rights.

(b) it does not control an entity whose activities are directed through voting rights even though the reporting entity is the dominant shareholder with voting rights.

(c) it does not control a structured entity from which the reporting entity receives returns that are potentially significant to the structured entity.

B33 A reporting entity shall disclose, in aggregate in relation to the subsidiaries identified in accordance with paragraph B32(a), information to assist users in evaluating the accounting consequences of its assessment that it controls such entities. Such information might include the amounts in the consolidated financial statements relating to total assets, liabilities, revenue and profit or loss of those subsidiaries.

B34 A reporting entity shall disclose in aggregate, in relation to the entities identified in paragraph B32(b), information to assist users in evaluating the accounting consequences of its assessment that it does not control such entities. Such information might include total assets, liabilities, revenue and profit or loss of those entities.

The interest that the non-controlling interests have in the group's activities (paragraph 48(b))

B35 To meet the objective in paragraph 48(b), a reporting entity shall disclose information to enable users to evaluate the interest that the non-controlling interests have in the performance, cash flows and net assets of the group. Such information includes, for example:

(a) the non-controlling interests' share of the group profit or loss and comprehensive income;

(b) the non-controlling interests' proportionate interest in dividends paid by subsidiaries; and

(c) the business activity or segment to which the non-controlling interests relate.

B36 A reporting entity shall disclose the date of the financial statements of a subsidiary when such financial statements are used to prepare consolidated financial statements and are as of a date or for a period that is different from that of the consolidated financial statements. The reason why the subsidiary uses a different date or period shall also be disclosed.

Restrictions on consolidated assets and liabilities (paragraph 48(c))

B37 To meet the objective in paragraph 48(c), a reporting entity shall disclose the nature of restrictions that are a consequence of assets and liabilities being held by subsidiaries, including:

(a) the extent to which non-controlling interests can restrict the activities of subsidiaries.

(b) legal, contractual and regulatory restrictions, such as:

(i) those that restrict the ability of subsidiaries to transfer cash to entities within the group; and

(ii) guarantees that may restrict dividends being paid to entities within the group.

(c) the carrying amount in the consolidated financial statements of the assets and liabilities to which those restrictions apply.

Involvement with unconsolidated structured entities and associated risks (paragraph 48(d))

B38 To achieve the disclosure objective in paragraph 48(d), a reporting entity shall disclose information that enables users of its financial statements to evaluate:

(a) the nature and extent of the reporting entity's involvement with structured entities that it does not control;

(b) the nature and extent of, and changes in, the market risk (interest rate, prepayment, currency and other price risk), credit risk and liquidity risk from the reporting entity's involvement with structured entities that it does not control. This exposure may arise from both contractual and non-contractual commitments, and from past and present activities.

B39 If obtaining any of the information for the disclosures required by this [draft] IFRS is impracticable, the reporting entity shall disclose why it is impracticable to obtain the information, and how it manages its exposure to risk from its involvement with unconsolidated structured entities for which it is impracticable to obtain the information.

Nature and extent of involvement (paragraph B38(a))

B40 In accordance with the disclosure objective in paragraph B38(a), a reporting entity shall disclose information about its involvement with unconsolidated structured entities that the reporting entity set up or sponsored, or with which it has involvement at the date of the consolidated financial statements. This includes summary information about the nature, purpose and activities of the structured entities.

Structured entities set up or sponsored

B41 A reporting entity shall disclose for unconsolidated structured entities that the reporting entity has set up or sponsored, in tabular format, unless another format is more appropriate, a summary of:

(a) income from the reporting entity's involvement with structured entities, including a description of the types of income presented in the summary; and

(b) the value of assets transferred to those structured entities, at the date the transfers were made.

The summary shall separate the activity into relevant categories (such as by type of structured entity or asset that exposes the reporting entity to different risks). The reporting entity shall also identify the extent to which the activity relates to structured entities with which the reporting entity has involvement at the date of the consolidated financial statements and those with which the reporting entity has none.

B42 A reporting entity shall disclose the information in paragraph B41 for the current reporting period and the preceding two reporting periods. A reporting entity shall assess whether this information meets the disclosure objective in paragraph B38(a), and provide comparative information for additional reporting periods if that information is necessary to meet the objective.

Nature of risks (paragraph B38(b))

B43 To achieve the disclosure objective in paragraph B38(b), a reporting entity shall disclose information about its exposure to risks from its involvement with unconsolidated structured entities. The disclosure requirements in paragraphs B44–B47 supplement the disclosure requirements in IFRS 7 *Financial Instruments: Disclosures*.

B44 A reporting entity shall present in tabular format, unless another format is more appropriate, a summary of:

(a) the carrying amount of the assets and liabilities recognised in the reporting entity's consolidated financial statements relating to the reporting entity's involvement with structured entities.

(b) the line items in the consolidated statement of financial position in which those assets and liabilities are recognised.

(c) the reported amount of assets held by structured entities with which the entity has involvement, measured at the date of the reporting entity's consolidated financial statements. The reporting entity shall disclose the measurement basis of the assets presented in the summary, distinguishing between assets originated by the reporting entity and those originated by other entities.

(d) the amount that best represents the reporting entity's maximum exposure to loss from its involvement with structured entities, including how the maximum exposure to loss is determined.

B45 The information required in paragraph B44 should be classified into categories that are representative of a reporting entity's exposure to risk (such as by type of structured entity or type of asset).

B46 In addition, a reporting entity shall disclose other information that is relevant to an assessment of the risks to which the reporting entity is exposed. That other information might include any of the following:

(a) in relation to structured entities' assets, their categories and credit rating, their weighted-average life, and whether any assets have been written down or downgraded by rating agencies.

(b) in relation to funding and loss exposure:

(i) the forms of structured entities' funding (eg commercial paper, medium-term notes) and their weighted-average life. That information might include maturity analyses of the assets and funding of structured entities if the structured entities have longer-term assets funded by shorter-term funding.

(ii) any difficulties structured entities have experienced in financing their activities during the reporting period.

(iii) losses incurred by the reporting entity during the reporting period relating to its involvement with structured entities.

(iv) estimated exposure to loss or range of outcomes of that loss that were reasonably possible at the date of the reporting entity's consolidated financial statements, if the reporting entity believes that the maximum exposure to loss is not representative of the estimated exposure to loss. The reporting entity shall explain the methodology used to determine the estimated exposure to loss or range of that loss.

(v) whether the reporting entity is required to bear any losses before other investors in the structured entity, the ranking and amounts of losses borne by each category of party involved, and the maximum limit of such losses.

(c) the types of returns the reporting entity received during the reporting period from the financial instruments it holds in structured entities.

(d) the nature and terms of any obligation of the reporting entity to provide liquidity support to structured entities (eg to purchase assets or commercial paper of the structured entity), including:

(i) a description of any triggers associated with the obligation.

(ii) whether there are any terms that would limit the obligation.

(iii) whether there are any other parties that provide liquidity support and, if so, how the reporting entity's obligation ranks with those other parties.

(e) in relation to support that has been provided by a reporting entity to structured entities during the reporting period whether:

(i) the reporting entity purchased any debt or equity interests in structured entities, and whether any agreement required the reporting entity to make these purchases.

(ii) other assistance was provided to structured entities in obtaining any other type of support.

(iii) there are any current intentions to provide support or other assistance to structured entities in obtaining any other type of support.

B47 If, during the reporting period, a reporting entity has, without having a contractual or constructive obligation to do so, provided support to structured entities that were not consolidated at the time of providing the support, it shall disclose:

(a) the extent of support provided, including its nature and amount, including situations in which the reporting entity assisted the structured entity in obtaining another type of support, or in which there are current intentions to do so;

(b) an explanation of why the support was provided;

(c) an explanation of how the provision of the support resulted in the reporting entity controlling the structured entity, if applicable.

Accounting consequences of changes in a reporting entity's ownership interest without loss of control (paragraph 48(e))

B48 To meet the objective in paragraph 48(e), a reporting entity shall disclose a schedule that shows the effects on the equity attributable to the owners of the parent of any changes in the ownership interest of the parent in a subsidiary that do not result in a loss of control.

Accounting consequences when a reporting entity loses control of a subsidiary (paragraph 48(f))

B49 To meet the objective in paragraph 48(f), a reporting entity shall disclose the gain or loss, if any, recognised in accordance with paragraph 46, and:

(a) the portion of that gain or loss attributable to recognising any investment retained in the former subsidiary at its fair value at the date when control is lost; and

(b) the line item(s) in the statement of comprehensive income in which the gain or loss is recognised (if not presented separately in the statement of comprehensive income).

Appendix C
Amendments to other IFRSs

The amendments in this [draft] appendix shall be applied for annual periods beginning on or after [date to be inserted after exposure]. If an entity applies this [draft] IFRS for an earlier period, these amendments shall be applied for that earlier period. Amended paragraphs are shown with new text underlined and deleted text struck through.

C1 In International Financial Reporting Standards (including International Accounting Standards and Interpretations) applicable at [date to be inserted after exposure], the following references are amended as described below, unless otherwise stated in this appendix.

- References to the current version of SIC-12 *Consolidation—Special Purpose Entities* are amended to [draft] IFRS X *Consolidated Financial Statements*.
- References to 'special purpose entity (entities)' are amended to 'structured entity (entities)'.

IFRS 1 *First-time Adoption of International Financial Reporting Standards*

C2 In IFRS 1, paragraphs B7 and C1 are amended as follows.

B7 A first-time adopter shall apply the following requirements of ~~IAS 27 (as amended in 2008)~~ [draft] IFRS X *Consolidated Financial Statements* prospectively from the date of transition to IFRSs:

(a) the requirement in paragraph ~~28~~ B22 that total comprehensive income is attributed to the owners of the parent and to the non-controlling interests even if this results in the non-controlling interests having a deficit balance;

(b) the requirements in paragraph~~s 30 and 31~~ B25 for accounting for changes in the parent's ownership interest in a subsidiary that do not result in a loss of control; and

(c) the requirements in paragraphs ~~34–37~~ B26–B29 for accounting for a loss of control over a subsidiary, and the related requirements of paragraph 8A of IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*.

However, if a first-time adopter elects to apply IFRS 3 (as revised in 2008) retrospectively to past business combinations, it also shall apply ~~IAS 27 (as amended in 2008)~~ [draft] IFRS X in accordance with paragraph C1 of this IFRS.

C1 A first-time adopter may elect not to apply IFRS 3 (as amended in 2008) retrospectively to past business combinations (business combinations that occurred before the date of transition to IFRSs). However, if a first-time adopter restates any business combination to comply with IFRS 3 (as amended in 2008), it shall restate all later business combinations and shall also apply ~~IAS 27 (as amended in 2008)~~ [draft] IFRS X from that same date. For example, if a first-time adopter elects to restate a business combination that occurred on 30 June 20X6, it shall restate all business combinations that occurred between 30 June 20X6 and the date of transition to IFRSs, and it shall also apply ~~IAS 27 (amended 2008)~~ [draft] IFRS X from 30 June 20X6.

IFRS 3 *Business Combinations* (as revised in 2008)

C3 In IFRS 3, paragraphs IN2 and 7, Appendix A and paragraphs B13 and B63(e) are amended as follows.

IN2 The second phase of the project addressed the guidance for applying the acquisition method. The boards decided that a significant improvement could be made to financial reporting if they had similar standards for accounting for business combinations. Thus, they decided to conduct the second phase of the project as a joint effort with the objective of reaching the same conclusions. The boards concluded the second phase of the project by issuing this IFRS and FASB Statement No. 141 (revised 2007) *Business Combinations* and the related amendments to IAS 27 *Consolidated and Separate Financial Statements* and FASB Statement No. 160 *Noncontrolling Interests in Consolidated Financial Statements*.*

*In 200X the requirements for consolidated financial statements in IAS 27 were replaced by [draft] IFRS X *Consolidated Financial Statements.*

7 The guidance in ~~IAS 27~~ [draft] IFRS X *Consolidated* ~~*and Separate*~~ *Financial Statements* shall be used to identify the acquirer—the entity that obtains *control* of the acquiree. If a business combination has occurred but applying the guidance in ~~IAS 27~~ [draft] IFRS X does not

clearly indicate which of the combining entities is the acquirer, the factors in paragraphs B14–B18 shall be considered in making that determination.

Appendix A (Defined terms)

Control <u>of an entity</u>	The power of <u>a reporting entity</u> to ~~govern~~ <u>direct</u> the ~~financial and operating policies~~ <u>activities</u> of an<u>other</u> entity ~~so as~~ to ~~obtain benefits from its activities~~ <u>generate returns for the reporting entity</u>.

B13 The guidance in ~~IAS 27~~ <u>[draft] IFRS X</u> ~~*Consolidated and Separate Financial Statements*~~ shall be used to identify the acquirer—the entity that obtains control of the acquiree. If a business combination has occurred but applying the guidance in ~~IAS 27~~ <u>[draft] IFRS X</u> does not clearly indicate which of the combining entities is the acquirer, the factors in paragraphs B14–B18 shall be considered in making that determination.

B63 Examples of other IFRSs that provide guidance on subsequently measuring and accounting for assets acquired and liabilities assumed or incurred in a business combination include:

(a) ...

(e) ~~IAS 27~~ <u>[draft] IFRS X</u> ~~(as amended in 2008)~~ provides guidance on accounting for changes in a parent's ownership interest in a subsidiary after control is obtained.

IFRS 7 *Financial Instruments: Disclosures*

C4 In IFRS 7, paragraph 3(a) is amended as follows.

3 This IFRS shall be applied by all entities to all types of financial instruments, except:

(a) those interests in subsidiaries, associates or joint ventures that are accounted for in accordance with <u>[draft] IFRS X *Consolidated Financial Statements*,</u> IAS 27 ~~*Consolidated and*~~ *Separate Financial Statements*, IAS 28 *Investments in Associates* or IAS 31 *Interests in Joint Ventures*. ...

IAS 1 *Presentation of Financial Statements* (as revised in 2007)

C5 In IAS 1, paragraphs 4 and 124 are amended as follows.

4 This Standard does not apply to the structure and content of condensed interim financial statements prepared in accordance with IAS 34 *Interim Financial Reporting*. However, paragraphs 15–35 apply to such financial statements. This Standard applies equally to all entities, including those that present consolidated financial statements and those that present separate financial statements defined in [draft] IFRS X *Consolidated Financial Statements* and IAS 27 ~~*Consolidated and*~~ *Separate Financial Statements*.

124 Some of the disclosures made in accordance with paragraph 122 are required by other IFRSs. For example, ~~IAS 27~~ [draft] IFRS X requires an entity to disclose the ~~reasons why the entity's ownership interest does not constitute control, in respect of an investee that is not a subsidiary even though more than half of its voting or potential voting power is owned directly or indirectly through subsidiaries~~ judgements made by management when reaching decisions about whether it controls other entities and the accounting consequences of those judgements. ...

IAS 7 *Statement of Cash Flows*

C6 In IAS 7, paragraph 42B is amended as follows.

42B Changes in ownership interests in a subsidiary that do not result in a loss of control, such as the subsequent purchase or sale by a parent of a subsidiary's equity instruments, are accounted for as equity transactions (see ~~IAS 27~~ [draft] IFRS X *Consolidated* ~~*and Separate*~~ *Financial Statements* ~~(as amended in 2008)~~). ...

IAS 21 *The Effects of Changes in Foreign Exchange Rates*

C7 In IAS 21, paragraphs IN12, 19, 45 and 46 are amended as follows.

IN12 The Standard permits an entity to present its financial statements in any currency (or currencies). For this purpose, an entity could be a stand-alone entity, a parent preparing consolidated financial statements in accordance with [draft] IFRS X *Consolidated Financial Statements* or a parent, an investor or a venturer preparing separate financial statements in accordance with IAS 27 ~~*Consolidated and*~~ *Separate Financial Statements*.

19 This Standard also permits a stand-alone entity preparing financial statements or an entity preparing separate financial statements in accordance with IAS 27 ~~*Consolidated and*~~ *Separate Financial Statements* to present its financial statements in any currency (or currencies). ...

45 The incorporation of the results and financial position of a foreign operation with those of the reporting entity follows normal consolidation procedures, such as the elimination of intragroup balances and intragroup transactions of a subsidiary (see ~~IAS 27~~ [draft] IFRS X *Consolidated Financial Statements* and IAS 31 *Interests in Joint Ventures*). ...

46 When the financial statements of a foreign operation are as of a date different from that of the reporting entity, the foreign operation often prepares additional statements as of the same date as the reporting entity's financial statements. When this is not done, ~~IAS 27~~ [draft] IFRS X allows the use of a different date provided that the difference is no greater than three months and adjustments are made for the effects of any significant transactions or other events that occur between the different dates. In such a case, the assets and liabilities of the foreign operation are translated at the exchange rate at the end of the reporting period of the foreign operation. Adjustments are made for significant changes in exchange rates up to the end of the reporting period of the reporting entity in accordance with ~~IAS 27~~ [draft] IFRS X. ...

IAS 24 *Related Party Disclosures*

C8 In IAS 24, paragraphs 3, 5, 9 and 14 are amended as follows.

3 This Standard requires disclosure of related party transactions and outstanding balances in the separate financial statements of a parent, venturer or investor presented in accordance with IAS 27 ~~*Consolidated and*~~ *Separate Financial Statements*.

5 Related party relationships are a normal feature of commerce and business. For example, entities frequently carry on parts of their activities through subsidiaries, joint ventures and associates. In these circumstances, the entity's ability to affect the strategic ~~financial and~~ operating and financing policies of the investee is through the presence of control, joint control or significant influence.

9 **The following terms are used in this Standard with the meanings specified:**

Control of an entity **is the power of a reporting entity to ~~govern~~ direct the ~~financial and operating policies~~ activities of another entity ~~so as~~ to ~~obtain benefits from its activities~~ generate returns for the reporting entity.**

Significant influence **is the power to participate in the strategic ~~financial and~~ operating and financing policy decisions of ~~the investee~~ an entity, but is not control over those policies. Significant influence may be gained by share ownership, statute or agreement.**

14 The identification of related party relationships between parents and subsidiaries is in addition to the disclosure requirements in ~~IAS 27,~~ [draft] IFRS X ~~IAS 28 and IAS 31, which require an appropriate listing and description of significant investments in subsidiaries, associates and jointly controlled entities.~~

IAS 27 *~~Consolidated and~~ Separate Financial Statements*

C9 In IAS 27, the requirements for consolidated financial statements would be deleted and replaced with IFRS X. The accounting and disclosure requirements for separate financial statements would remain in IAS 27; paragraphs would be renumbered, the scope adjusted and editing changes made.

IAS 28 *Investments in Associates*

C10 In IAS 28, paragraph 8 is deleted and paragraphs IN6, IN8, 2, 5, 9, 12, 13(b), 20 and 35 are amended as follows.

IN6 Furthermore, the Standard provides exemptions from application of the equity method similar to those provided for certain parents not to prepare consolidated financial statements. These exemptions include when the investor is also a parent exempt in accordance with ~~IAS 27~~ [draft] IFRS X *Consolidated ~~and Separate~~ Financial Statements* from preparing consolidated financial statements (paragraph 13(b)), and when the investor, though not such a parent, can satisfy the same type of conditions that exempt such parents (paragraph 13(c)).

IN8 The Standard clarifies that investments in associates over which the investor has significant influence must be accounted for using the equity method whether or not the investor also has investments in subsidiaries and prepares consolidated financial statements. However, the investor does not apply the equity method when presenting separate financial statements prepared in accordance with IAS 27 *Separate Financial Statements*.

2 The following terms are used in this Standard with the meanings specified:

***Control of an entity* is the power of a reporting entity to ~~govern~~ direct the ~~financial and operating policies~~ activities of another entity ~~so as~~ to ~~obtain benefits from its activities~~ generate returns for the reporting entity.**

***Significant influence* is the power to participate in the strategic ~~financial and~~ operating and financing policy decisions of ~~the investee~~ an entity, but is not control or joint control over those policies.**

A *subsidiary* is an entity~~, including an unincorporated entity such as a partnership,~~ that is controlled by ~~another entity (known as the parent)~~ a parent.

5 Entities that are exempted in accordance with paragraph ~~10~~ 2(a) of ~~IAS 27~~ [draft] IFRS X *Consolidated ~~and Separate~~ Financial Statements* from consolidation, paragraph 2 of IAS 31 *Interests in Joint Ventures* from applying proportionate consolidation or paragraph 13(c) of this Standard from applying the equity method may present separate financial statements, in accordance with IAS 27 *Separate Financial Statements*, as their only financial statements.

9 In assessing ~~whether potential voting rights contribute to~~ significant influence, the entity considers whether its power from holding options or convertible instruments to obtain voting rights, taken in conjunction with other relevant facts and circumstances, gives it the power to participate in the strategic operating and financing policy decisions of an entity. ~~examines all facts and circumstances (including the terms of exercise of the potential voting rights and any other contractual arrangements whether considered individually or in combination) that affect potential rights, except the intention of management and the financial ability to exercise or convert.~~

12 When an investor has instruments that give other parties an option to obtain equity instruments or to convert a liability into equity instruments, ~~When potential voting rights exist,~~ the investor's

share of profit or loss of the investee and of changes in the investee's equity is determined on the basis of present ownership interests and does not reflect the possible exercise or conversion of options or convertible instruments ~~potential voting rights~~.

13 **An investment in an associate shall be accounted for using the equity method except when:**

(a) ...

(b) the exception in paragraph ~~10~~ 2(a) of ~~IAS 27~~ [draft] IFRS X, allowing a parent that also has an investment in an associate not to present consolidated financial statements, applies; or ...

20 Many of the procedures appropriate for the application of the equity method are similar to the consolidation procedures described in ~~IAS 27~~ [draft] IFRS X. Furthermore, ...

35 **An investment in an associate shall be accounted for in the investor's separate financial statements in accordance with paragraphs ~~38–43~~ x–x of IAS 27 (as amended in 200X).**

IAS 31 *Interests in Joint Ventures*

C11 In IAS 31, paragraphs IN3, IN6, IN9, 2(b), 3, 6, 33, 45 and 46 are amended as follows.

IN3 For IAS 31 the Board's main objective was to make the amendments necessary to take account of the extensive changes being made to IAS 27 *Consolidated and Separate Financial Statements** *and Accounting for Investments in Subsidiaries* and IAS 28 *Accounting for Investments in Associates* as part of the Improvements project. ...

*In 200X the requirements for consolidated financial statements in IAS 27 (as revised in 2003 and amended in 2008) were replaced by [draft] IFRS X *Consolidated Financial Statements*.

IN6 Furthermore, the Standard provides exemptions from application of proportionate consolidation or the equity method similar to those provided for certain parents not to prepare consolidated financial statements. These exemptions include when the investor is also a parent exempt in accordance with ~~IAS 27~~ [draft] IFRS X *Consolidated* ~~*and Separate*~~ *Financial Statements* from preparing consolidated financial statements (paragraph 2(b)), and when the investor, though not such a parent, can satisfy the same type of conditions that exempt such parents (paragraph 2(c)).

IN9 The requirements for the preparation of an investor's separate financial statements are established by reference to IAS 27 *Separate Financial Statements*.

2 **A venturer with an interest in a jointly controlled entity is exempted from paragraphs 30 (proportionate consolidation) and 38 (equity method) when it meets the following conditions:**

(a) ...

(b) the exception in paragraph ~~10~~ 2(a) of ~~IAS 27~~ [draft] IFRS X *Consolidated ~~and Separate~~ Financial Statements* **allowing a parent that also has an interest in a jointly controlled entity not to present consolidated financial statements is applicable; or ...**

3 **The following terms are used in this Standard with the meanings specified:**

Control of an entity **is the power of a reporting entity to ~~govern~~ direct the ~~financial and operating policies~~ activities of another entity ~~so as~~ to ~~obtain benefits from its activities~~ generate returns for the reporting entity.**

Significant influence **is the power to participate in the strategic ~~financial and~~ operating and financing policy decisions of an ~~economic activity~~ entity, but is not control or joint control over those policies.**

6 Entities that are exempted in accordance with paragraph ~~10~~ 2(a) of ~~IAS 27~~ [draft] IFRS X from consolidation, paragraph 13(c) of IAS 28 *Investments in Associates* from applying the equity method or paragraph 2 of this Standard from applying proportionate consolidation or the equity method may present separate financial statements as their only financial statements.

33 The application of proportionate consolidation means that the statement of financial position of the venturer includes its share of the assets that it controls jointly and its share of the liabilities for which it is jointly responsible. The statement of comprehensive income of the venturer includes its share of the income and expenses of the jointly controlled entity. Many of the procedures appropriate for the application of proportionate consolidation are similar to the procedures for the consolidation of investments in subsidiaries, which are set out in ~~IAS 27~~ [draft] IFRS X.

45 **When an investor ceases to have joint control over an entity, it shall account for any remaining investment in accordance with IAS 39 from that date, provided that the former jointly controlled entity does not become a subsidiary or associate. From the date when a jointly controlled entity becomes a subsidiary of an investor, the investor shall account for its interest in accordance with IAS 27** *Separate Financial Statements* **or [draft] IFRS X and IFRS 3** ***Business Combinations*** **(as revised in 2008). ...**

46 **An interest in a jointly controlled entity shall be accounted for in a venturer's separate financial statements in accordance with paragraphs ~~38–43~~ x–x of IAS 27 (as amended in 200X).**

IAS 32 *Financial Instruments: Presentation*

C12 In IAS 32, paragraphs 4(a) and AG29 are amended as follows.

4 **This Standard shall be applied by all entities to all types of financial instruments except:**

(a) **those interests in subsidiaries, associates or joint ventures that are accounted for in accordance with [draft] IFRS X** ***Consolidated Financial Statements*****, IAS 27** ***~~Consolidated and~~ Separate Financial Statements*****, IAS 28** ***Investments in Associates*** **or IAS 31** ***Interests in Joint Ventures*****. However, ...**

AG29 In consolidated financial statements, an entity presents non-controlling interests—ie the interests of other parties in the equity and income of its subsidiaries—in accordance with IAS 1 and ~~IAS 27~~ [draft] IFRS X *Consolidated Financial Statements*. When ...

IAS 33 *Earnings per Share*

C13 In IAS 33, paragraph 4 is amended as follows.

4 **When an entity presents both consolidated financial statements and separate financial statements prepared in accordance with [draft] IFRS X** ***Consolidated Financial Statements*** **and IAS 27** ***~~Consolidated and~~ Separate Financial Statements*****, respectively, the disclosures required by this Standard need be presented only on the basis of the consolidated information. An ...**

IAS 36 *Impairment of Assets*

C14 In IAS 36, paragraphs IN4 and 4(a) are amended as follows.

IN4 The second phase of the project resulted in the Board issuing simultaneously in 2008 a revised IFRS 3 and amendments to IAS 27 *Consolidated and Separate Financial Statements**. ...

*In 200X the consolidation requirements in IAS 27 were replaced by [draft] IFRS X *Consolidated Financial Statements*.

4 This Standard applies to financial assets classified as:

(a) subsidiaries, as defined in ~~IAS 27~~ [draft] IFRS X *Consolidated* ~~*and Separate*~~ *Financial Statements*; ...

IAS 38 *Intangible Assets*

C15 In IAS 38, paragraph 3(e) is amended as follows.

3 If another Standard prescribes the accounting for a specific type of intangible asset, an entity applies that Standard instead of this Standard. For example, this Standard does not apply to:

(a) ...

(e) financial assets as defined in IAS 32. The recognition and measurement of some financial assets are covered by [draft] IFRS X *Consolidated Financial Statements*, IAS 27 ~~*Consolidated and*~~ *Separate Financial Statements*, IAS 28 *Investments in Associates* and IAS 31 *Interests in Joint Ventures*.

IAS 39 *Financial Instruments: Recognition and Measurement*

C16 In IAS 39, paragraphs 2(a) and 15 are amended as follows.

2 This Standard shall be applied by all entities to all types of financial instruments except:

(a) those interests in subsidiaries, associates and joint ventures that are accounted for ~~under~~ in accordance with [draft] IFRS X *Consolidated Financial Statements*, IAS 27 ~~*Consolidated and*~~ *Separate Financial Statements*, IAS 28 *Investments in Associates* or IAS 31 *Interests in Joint Ventures*. However, ...

15 In consolidated financial statements, paragraphs 16–23 and Appendix A paragraphs AG34–AG52 are applied at a consolidated level. Hence, an entity first consolidates all subsidiaries in accordance with ~~IAS 27 and SIC 12~~ ~~*Consolidation–Special Purpose Entities*~~ [draft] IFRS X *Consolidated Financial Statements* and then applies paragraphs 16–23 and Appendix A paragraphs AG34–AG52 to the resulting group.

IFRIC 5 *Rights to Interests arising from Decommissioning, Restoration and Environmental Rehabilitation Funds*

C17 In IFRIC 5, paragraph 8 is amended as follows.

8 The contributor shall determine whether it has control, joint control or significant influence over the fund by reference to ~~IAS 27~~ [draft] IFRS X *Consolidated Financial Statements*, IAS 28~~,~~ and IAS 31~~ and SIC 12~~. If it does, the contributor shall account for its interest in the fund in accordance with those Standards.

Approval of ED 10 by the Board

The exposure draft ED 10 *Consolidated Financial Statements* was approved for publication by ten of the thirteen members of the International Accounting Standards Board. Messrs Garnett, Leisenring and Smith voted against publication. Their alternative views are set out after the Basis for Conclusions.

Sir David Tweedie	Chairman
Thomas E Jones	Vice-Chairman
Mary E Barth	
Stephen Cooper	
Philippe Danjou	
Jan Engström	
Robert P Garnett	
Gilbert Gélard	
James J Leisenring	
Warren J McGregor	
John T Smith	
Tatsumi Yamada	
Wei-Guo Zhang	

December 2008

Basis for Conclusions
ED 10

BASIS FOR CONCLUSIONS ON EXPOSURE DRAFT

ED 10 Consolidated Financial Statements

Comments to be received by 20 March 2009

International
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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.

All responses will be put on the public record unless the respondent requests confidentiality. However, such requests will not normally be granted unless supported by good reason, such as commercial confidence.

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CONTENTS

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.

DRAFT ILLUSTRATIVE EXAMPLES

ED 10 Consolidated Financial Statements

Comments to be received by 20 March 2009

International
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Draft Illustrative Examples

ED 10 CONSOLIDATED FINANCIAL STATEMENTS

Comments to be received by 20 March 2009

These draft Illustrative Examples accompany 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.

All responses will be put on the public record unless the respondent requests confidentiality. However, such requests will not normally be granted unless supported by good reason, such as commercial confidence.

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CONTENTS

[*Draft*] Illustrative examples
IFRS X *Consolidated Financial Statements*

These [draft] illustrative examples accompany, but are not part of, [draft] IFRS X.

[Draft] IFRS X paragraph reference

Introduction

Examples 1–4 illustrate some of the disclosure requirements of the [draft] IFRS. A reporting entity is required to provide some of the disclosures in a tabular format, unless another format is more appropriate. However, the formats used in the illustrations are not mandatory.

Example 1 relates to a reporting entity, Company X, and illustrates the disclosure requirements relating to the basis of control and related accounting consequences. Examples 2–4 relate to a reporting entity, XYZ Bank, and illustrate some of the risk disclosures associated with XYZ Bank's involvement with structured entities.

Example 1—Basis of control and related accounting consequences

Illustrating the application of paragraphs 48(a) and B32–B34 of the [draft] IFRS.

This example illustrates the disclosure requirements relating to the basis of control and related accounting consequences.

B32(a) ***Example 1A—control with less than half of the voting rights***

Company X, a venture capital entity, holds 35 per cent of the voting rights of Company Z, a tyre manufacturer. Company X also arranged for third party investors to purchase 30 per cent of the voting rights of Company Z. At the time of investing, the third party investors entered into an agreement with Company X, giving Company X the power to vote on their behalf at meetings of Company Z. Because of the power given to Company X by the investors, Company X can cast the majority of votes when appointing the Board of Directors of Company Z, who in turn determine the strategic operating and financing policies of Company Z.

B33 Therefore, Company X has the ability to direct the activities of Company Z to generate returns for itself. Company X controls Company Z and consolidates it. Of the group's consolidated assets and liabilities, Company Z has consolidated assets of CU250 million and consolidated liabilities of CU195 million at 31 December 20X8. Company Z generated revenue of CU450 million and profit of CU22 million for the year ended 31 December 20X8.

B32(c) ***Example 1B—involvement with structured entities that are not controlled***

Company X provides credit enhancement for a market fee, in the form of guarantees, to some structured entities set up to hold lease receivables. The receivables are sold to those entities by third party leasing entities. Company X provides either first or second loss protection for other investors, up to a maximum of 10 per cent of the value of the lease receivables. The guarantees expose Company X to losses that are potentially significant to the entities holding the lease receivables. Company X, however, has no means of exerting power over the activities of those entities and, therefore, does not control the entities. Note A *Risk disclosures relating to unconsolidated structured entities* provides further information about Company X's exposure to risk from the provision of the credit enhancement.

Example 2—Nature and extent of involvement in unconsolidated structured entities

Illustrating the application of paragraphs 48(d) and B38–B42 of the [draft] IFRS.

This example illustrates some of the disclosure requirements of the [draft] IFRS relating to the nature and extent of involvement of a reporting entity in unconsolidated structured entities that it has set up or sponsored, or with which it has involvement at the date of the consolidated financial statements. The example is not intended to be all-inclusive. It may, however, include information that is not required explicitly by the [draft] IFRS but which is provided to meet the disclosure objectives.

Structured entities

B40 XYZ Bank enters into securitisation arrangements for a variety of business purposes, mainly relating to the securitisation of mortgages and credit card receivables, and providing investors with investment opportunities. Securitisation entities are entities in which interests in consumer and commercial receivables are sold to investors. The securitisation entities acquire assets originated by XYZ Bank itself or other third parties. The securitisation entities issue commercial paper, debt securities or equity interests to investors to fund the purchase of receivables. Cash received from the collection of receivables is used to service the finance provided by the investors.

XYZ Bank consolidates the majority of securitisation entities that hold receivables originated by itself because it controls those entities. XYZ Bank has the power to direct the activities of the entities to generate returns for its benefit both as a result of the extent of its involvement in setting up the entities and because of the powers that it has in managing the assets when payments are in default. XYZ Bank does not consolidate securitisation entities that hold receivables originated by itself if it has no involvement with those entities after selling the receivables to the entities.

XYZ Bank also facilitates the establishment of structured entities on behalf of third parties. These entities are established to securitise third party receivables, to hold assets leased by third parties and for investing purposes (for example, collateralised debt obligations are used to provide investment opportunities for investors). XYZ Bank generally does not control entities that it sets up or sponsors on behalf of third parties. It sometimes provides asset management services to those entities, or has involvement with the entities as described below.

Structured entities set up or sponsored

B41 The following tables summarise XYZ Bank's involvement with securitisation and other investing entities that XYZ Bank set up or sponsored, by asset type. The tables present XYZ Bank's income recognised in each reporting period (which consists of fees for setting up the structured entities and providing asset management services) and the fair value of the assets securitised at the date the securitisation transactions were completed. In some cases, XYZ Bank retained some involvement with the structured entities, in the form of investments in the structured entities, credit guarantees or liquidity commitments. Further information is provided about those involvements in [Note A *Risk disclosures relating to unconsolidated structured entities*].

	Type of asset in unconsolidated entity	Total fee income for the year ended 20X8 CU million	20X7 CU million	20X6 CU million
B41(a)	Collateralised debt obligations	1,025	820	697
	Residential mortgage-backed securities	6,055	4,844	4,117
B42	Commercial mortgage-backed securities	878	703	597
	Assets under lease	332	265	226
	Credit card receivables	189	151	128
	Total	**8,479**	**6,783**	**5,765**

	Type of asset in unconsolidated entity	Assets securitised during the year 20X8 CU million	20X7 CU million	20X6 CU million
B41(b)	Collateralised debt obligations	14,650	11,720	9,962
	Residential mortgage-backed securities	86,500	69,200	58,820
B42	Commercial mortgage-backed securities	12,546	10,037	8,532
	Assets under lease	4,739	3,791	3,223
	Credit card receivables	2,695	2,156	1,833
	Total	**121,130**	**96,904**	**82,370**

The tables below provide a split between those transactions in which XYZ Bank retains some involvement at 31 December 20X8 and those in which it does not, by asset type.

Involvement at 31 December 20X8

	Type of asset in unconsolidated entity	Total fee income for the year ended 20X8 CU million	20X7 CU million	20X6 CU million
B41(a)	Collateralised debt obligations	410	328	279
	Residential mortgage-backed securities	2,422	1,938	1,647
B42	Commercial mortgage-backed securities	351	281	239
	Assets under lease	332	265	226
	Credit card receivables	189	151	128
	Total	**3,704**	**2,963**	**2,519**

No involvement at 31 December 20X8

	Type of asset in unconsolidated entity	Total fee income for the year ended 20X8 CU million	20X7 CU million	20X6 CU million
B41(a)	Collateralised debt obligations	615	492	418
	Residential mortgage-backed securities	3,633	2,906	2,470
B42	Commercial mortgage-backed securities	527	422	358
	Total	**4,775**	**3,820**	**3,246**

Involvement at 31 December 20X8

		Assets securitised during the year		
	Type of asset in unconsolidated entity	**20X8 CU million**	**20X7 CU million**	**20X6 CU million**
B41(b)	Collateralised debt obligations	5,860	4,688	3,985
	Residential mortgage-backed securities	34,600	27,680	23,528
B42	Commercial mortgage-backed securities	5,018	4,015	3,413
	Assets under lease	4,739	3,791	3,223
	Credit card receivables	2,695	2,156	1,833
	Total	**52,912**	**42,330**	**35,982**

No involvement at 31 December 20X8

		Assets securitised during the year		
	Type of asset in unconsolidated entity	**20X8 CU million**	**20X7 CU million**	**20X6 CU million**
B41(b)	Collateralised debt obligations	8,790	7,032	5,977
B42	Residential mortgage-backed securities	51,900	41,520	35,292
	Commercial mortgage-backed securities	7,528	6,022	5,119
	Total	**68,218**	**54,574**	**46,388**

Example 3—Risk disclosures relating to unconsolidated structured entities

Illustrating the application of paragraphs 48(d) and B43–B46 of the [draft] IFRS.

This example illustrates some of the disclosure requirements about the risks associated with a reporting entity's involvement with unconsolidated structured entities. This example is not intended to be all-inclusive. It may, however, include information that is not required explicitly by the [draft] IFRS but which is provided to meet the disclosure objectives.

Risk associated with unconsolidated structured entities

The following table summarises XYZ Bank's involvement at 31 December 20X8 with structured entities, by asset type. XYZ Bank's involvement with structured entities takes the form of investments in the structured entities, credit guarantees and liquidity commitments.

B44 **At 31 December 20X8**

B45 **Maximum exposure to loss in unconsolidated structured entities**

B44(a)
B44(c)
B44(d)

CU million		Maximum exposure to loss					
Type of asset in unconsolidated entity	**Current carrying amounts of assets held by structured entities**	**Total**	**Investments**	**Credit guarantees**	**Liquidity commitments**	**Carrying amount in statement of financial position**	
Originated by XYZ Bank						**Assets**	**Liabilities**
Collateralised debt obligations	13,080	**196**	196			196	
Subtotal	**13,080**	**196**	**196**			**196**	
Originated by other entities						**Assets**	**Liabilities**
Collateralised debt obligations	92,780	**6,031**	1,856		4,175	1,856	(167)
Real estate, credit-related and other investing	167,400	**6,944**		248	6,696		(258)
Assets under lease	8,520	**512**	43		469	43	(2)
Credit card receivables	42,000	**1,260**	1,260			1,260	
Subtotal	**310,700**	**14,747**	**3,159**	**248**	**11,340**	**3,159**	**(427)**
Total	**323,780**	**14,943**	**3,355**	**248**	**11,340**	**3,355**	**(427)**

Carrying amount of assets and liabilities in unconsolidated structured entities recognised in XYZ Bank's statement of financial position

B44(b)

				Total	
Class of financial asset or liability	**Investments**	**Credit guarantees**	**Liquidity commitments**	**Assets**	**Liabilities**
Debt securities (fair value through profit or loss)	2,052			2,052	
Loans and investments (at amortised cost)	1,303			1,303	
Financial guarantee contracts		(7)			(7)
Provisions			(420)		(420)
Total	**3,555**	**(7)**	**(420)**	**3,355**	**(427)**

Maximum exposure to loss

B44(d) The maximum exposure to loss presented in the table above is contingent in nature and may arise as a result of the provision of liquidity facilities, and any other funding commitments, such as financial guarantees provided by XYZ Bank to structured entities. XYZ Bank's investments in structured entities also create exposure to loss from impairment.

The maximum exposure to loss is calculated as the notional amounts of credit lines, guarantees, other credit support and liquidity facilities, less any related liabilities recognised. The maximum exposure to loss relating to XYZ Bank's investments is their carrying amount. The maximum exposure to loss does not take into account the effects of any hedging activities of XYZ Bank designed to reduce that exposure to loss.

Liquidity commitments

B46(d) XYZ Bank provides liquidity support to structured entities containing collateralised debt obligations (CDOs), real estate, credit-related and other investing receivables, and entities that hold assets under lease. The liquidity support takes the form of a commitment to purchase securities issued by these entities if they experience problems in attracting investment on refinancing.

B44(d) XYZ Bank's maximum exposure is limited to the amortised cost of assets held by the structured entities, which reflects the risk that XYZ Bank may be required to fund the vehicle if debt is redeemed without reinvestment from third parties.

B46(b)(iv) At 31 December 20X8 XYZ Bank recognised a liability of CU420 million relating to the provision of liquidity support. The provision reflects XYZ Bank's best estimate of amounts that will be drawn and not repaid under its liquidity facilities. XYZ Bank expects that in the light of current market conditions some CDO entities, real estate, credit-related and other investing entities will not be able to roll over their financing without drawing on liquidity facilities with XYZ Bank. The deterioration of these entities' credit standing has made some of the liquidity commitments onerous.

Credit guarantees

B43 XYZ Bank provides credit enhancement to some investing vehicles in the form of financial guarantee contracts. XYZ Bank is required to reimburse investors for some losses incurred when a debtor defaults on payment.

Investments in structured entities

B44(d) XYZ Bank invests in some structured entities, acquiring debt or equity securities of those entities. The maximum exposure to loss represents the carrying amount of these investments at 31 December 20X8. The table below presents XYZ Bank's investments in structured entities by nature of the investment (ie subordinated, mezzanine and senior) and provides information on losses incurred for the year ended 31 December 20X8.

Maximum exposure to loss from investments in unconsolidated structured entities

B46(b)(v)

Maximum exposure to loss at 31 December 20X8	*Total*	*Subordinated interest*	*Mezzanine interest*	*Senior interest*
Type of asset in unconsolidated entity	**CU million**	**CU million**	**CU million**	**CU million**
Collateralised debt obligations	2,052	2	1,954	96
Assets under lease	43	—	—	43
Credit card receivables	1,260	7	50	1,203
Total	**3,355**	**9**	**2,004**	**1,342**

B46(b)(iii)

Losses incurred for the year ended 31 December 20X8	*Total losses*	*Losses-subordinated interest*	*Losses-mezzanine interest*	*Losses-senior interest*
Type of asset in unconsolidated entity	**CU million**	**CU million**	**CU million**	**CU million**
Collateralised debt obligations	1,190	9	1,146	35
Assets under lease	—	—	—	—
Credit card receivables	33	12	19	2
Total	**1,223**	**21**	**1,165**	**37**

Collateralised debt obligations (CDOs)

B40 XYZ Bank arranges a number of CDO transactions, in which it administers the activities of the CDO entities on behalf of investors. The CDO entities are established to facilitate the rating of the securities issued to investors. The structured entities are not consolidated by XYZ Bank because it acts as an agent on behalf of investors, administering the activities of the entities according to policies approved by the investors.

B46(b)(iii) XYZ Bank re-securitises subprime mortgage backed securities rated AA or lower in CDO securitisations, which create senior to junior securities of CDOs. The holders of the most junior (subordinated) securities are exposed to losses before the holders of mezzanine and senior securities. In some transactions, XYZ Bank purchased an insignificant amount of senior securities in CDO entities. In the second half of 20X8, the credit ratings of some senior CDO securities, many with exposures to US subprime mortgages, were downgraded. This resulted in a loss of CU35 million for XYZ Bank.

B46(b)(iii) XYZ Bank acquired investments in mezzanine and subordinated securities of CDO entities, the assets of which were originated by third parties. XYZ Bank incurred losses of CU9 million in 20X8 relating to the subordinated securities that it holds in CDO entities. Owing to the severe deterioration in the value of assets held by these CDO entities, XYZ Bank incurred further losses of CU1,146 million on its investments in mezzanine securities. The losses incurred by XYZ Bank represent losses incurred by the CDO entities in excess of the amounts absorbed by the holders of subordinated securities.

B46(b)(v) XYZ Bank's mezzanine interest in CDO entities of CU1,954 million at 31 December 20X8 exposes the bank to loss when first loss protection provided by other third parties is fully drawn. Assets held in CDO entities with which XYZ Bank has involvement at 31 December 20X8 total CU105,860 million, and third party investors provide first loss protection to XYZ Bank of CU10,000 million. The total carrying amount of XYZ Bank's investment in CDO entities of CU2,052 million at 31 December 20X8 is measured at fair value [description of how fair value was measured not included in this example].

Assets under lease

B40 XYZ Bank provides leasing facilities and arranges finance for aircraft and other physical assets, customarily placed in structured entities.

At 31 December 20X8, XYZ Bank holds senior securities in such structured entities of CU43 million, measured at fair value [description of how fair value was measured not included in this example].

Credit card receivables

B40 XYZ Bank acquired investments in senior, mezzanine and subordinated securities of securitisation entities that hold credit card receivables originated by third parties. Credit card securitisations are revolving securitisations, ie as customers pay their credit card balances, the cash proceeds are used to purchase new receivables and replenish the receivables in the securitisation entities.

B46(b)(iii)	Owing to an unprecedented increase in defaults on credit card payments during the year ended 31 December 20X8, XYZ Bank suffered a total loss of CU33 million. Impairment losses of CU12 million resulted from XYZ Bank's exposure to first losses as the most subordinated investor. In addition, the value of XYZ Bank's investments in mezzanine and senior securities suffered an impairment loss of CU21 million due to the subordinated securities not being sufficient to absorb the losses incurred by some credit card securitisation entities.
B46(b)(v)	XYZ Bank's senior interest in credit card securitisation entities of CU1,203 million at 31 December 20X8 exposes the bank to loss when loss protection provided by third parties holding more junior securities is fully drawn. Assets held by those securitisation entities with which XYZ Bank has involvement at 31 December 20X8 total CU42,000 million. First loss protection, provided by third party investors, absorbs credit losses of CU5,000 million. In addition, investors holding mezzanine interests in those entities absorb a further CU14,600 million of losses before XYZ Bank is exposed to loss. The total carrying amount of XYZ Bank's investment in credit card securitisation entities of CU1,260 million at 31 December 20X8 is measured at fair value [description of how fair value was measured not included in this example].

Example 4—Risk disclosures relating to non-contractual support provided to structured entities

Illustrating the application of paragraphs 48(d) and B47 of the [draft] IFRS.

This example illustrates the disclosure requirements of the [draft] IFRS in situations in which a reporting entity has no investment in or other contractual involvement with structured entities, but has provided non-contractual liquidity support.

Non-contractual support provided to structured entities

The provision of non-contractual support results in consolidation

B46(b)(ii)
B47(a)
B47(b)
B47(c)

In February 20X8, because of disruption in the supply of commercial paper (CP) funding, XYZ Bank provided CU17,500 million of funding in the form of CP purchases to Company S (founded in 20X7). The amount of CP purchased represented 90 per cent of the asset value of Company S. As a consequence, XYZ Bank obtained the power to change the restrictions according to which Company S operates, and concluded that it controlled Company S. XYZ Bank consolidated Company S from February, resulting in CU20,000 million of BBB-rated mortgage receivables being recognised in the statement of financial position. The CP was acquired as an act of good faith to the clients who had invested in the fund on the basis of XYZ Bank's advice.

The provision of non-contractual support does not result in consolidation

B46(b)(ii)
B47(a)
B47(b)

In May 20X8 XYZ Bank was approached by the administrators of the fund, Company Y (founded in 20X4), which was having difficulties obtaining short-term funding from other sources. CU65 million was provided in the form of short-term liquidity support to Company Y. The full amount was repaid within fourteen days of the funding being advanced and no additional support has been provided since that date. XYZ Bank was not contractually obliged to provide funding, but did so to prevent the fund going into administration. In addition, XYZ Bank considered the risk associated with providing the funding to be minimal.