

## Heads Up

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## IASB Issues an Exposure Draft on Consolidation.

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### Introduction

The International Accounting Standards Board (IASB) recently issued [ED 10, Consolidated Financial Statements](#), an exposure draft (ED) that proposes to replace IAS 27<sup>1</sup> and SIC-12<sup>2</sup> with a new consolidation standard. ED 10 is the product of the IASB's efforts to date on its consolidation project, which was added to the IASB's active agenda in 2003. ED 10's comment deadline is March 20, 2009. The IASB is expected to host roundtable discussions during the comment period and issue a final standard in the second half of 2009. The IASB also intends to allow a minimum of one year between the issuance of a final standard and its implementation date, which suggests that the final standard is unlikely to be effective before 2011.

**Editor's Note:** Rather than issue a discussion paper, the IASB decided to proceed directly to an ED in response to the recommendations of the Financial Stability Forum (a group of major national financial authorities, such as finance ministries, central bankers, and international financial bodies, that promote international financial stability) to accelerate the improvement of the accounting and disclosure standards for off-balance-sheet vehicles and work with other standard setters toward international convergence. The IASB is also developing a proposal on the derecognition of financial assets and expects to publish an ED on this subject at the end of the first quarter or start of the second quarter of 2009.

### Overview of ED 10

The IASB's objective in drafting ED 10 was to develop a single source of authoritative guidance on consolidation accounting that focuses on control. Key items in the ED are:

- A revised definition of control, including additional application guidance.
- Enhanced disclosure requirements related to consolidated and unconsolidated entities.

The Board revised the definition of control to make it more comprehensive and to address perceived inconsistencies between IAS 27 (which focuses on control) and SIC-12 (which focuses on risks and rewards).

<sup>1</sup> IAS 27, *Consolidated and Separate Financial Statements*.

<sup>2</sup> SIC-12, *Consolidation — Special Purpose Entities*.

Although the assessment of whether an entity should be consolidated often would be the same under the ED as it would under current IFRS guidance, situations more likely to be affected include:

- Those involving special-purpose entities (or “structured entities,” as defined in the ED).
- Those in which control is being assessed in the absence of majority voting rights.
- Those in which control is being assessed with regard to potential voting rights.

The IASB did not revisit the consolidation procedures or the accounting treatment for changes in ownership interests and, consequently, much of the guidance in IAS 27 (revised 2008) would be carried forward verbatim to the new standard. In addition, the IASB did not propose changes to the guidance on which entities are required to prepare consolidated financial statements.

## Revised Definition of Control

The ED defines control as follows:

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.  
[Emphasis added]

The key elements of this definition, which are discussed below, are (1) the power to direct the activities of the other entity and (2) the right to obtain returns. The ED states that 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.” Generally, a reporting entity’s power to direct the activities of another entity correlates to its exposure to the variability of the entity’s returns. The reporting entity would conduct the assessment of control continually.

### Power to Direct Activities

The IASB intended the power to “direct the activities” of another entity to apply more broadly than the power, described in IAS 27, to “govern the financial and operating policies” of another entity. ED 10’s [Basis for Conclusions](#) states that “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.” According to paragraph 12 of the ED, “[p]ower 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.”

Such power could be achieved through the reporting entity’s “involvement in establishing the activities of the entity or in the ongoing decision-making that affects the activities of the entity.” For example, when an entity’s documents of incorporation restrict the activities or transactions in which an entity may participate, the entity may not need a governing board or other corporate governance structure to direct its activities because strategic operating and financing policy decisions would not likely need to be made on an ongoing basis. However, control over the entity may still be achieved if the reporting entity was involved in establishing the entity’s activities.

Because an entity’s possession of power to direct the activities of another entity does not mean that the reporting entity must actively use that power, ED 10’s definition of control focuses on the *ability* to exercise control rather than the *exercise* of that control. For example, a passive shareholder with the majority of voting rights that does not regularly use its voting powers would be considered to control the entity by virtue of its power to choose at any time to direct the activities of the entity by exercising its voting rights.

"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."

The ED retains IAS 27's presumption that an entity that holds more than half of the voting rights in another entity has the power to direct its activities.

## Generation of Returns

ED 10's proposed revised definition of control refers to the generation of "returns" for the reporting entity (as opposed to "benefits" being obtained by the reporting entity, as described under IAS 27). The IASB changed the terminology to clarify that the word "returns" encompasses both positive and negative returns for the parent (under IAS 27, some have interpreted "benefits" to encompass only positive returns). The ED states that such returns should not be limited to quantifiable returns but rather can accrue to the reporting entity in various forms, such as dividends, fees, know-how, cost savings, or synergies.

## Control Is Not Shared

The expanded application guidance supporting the ED's revised definition of control clarifies that a parent does not share control of a subsidiary — that only one parent can control a subsidiary, although other entities may have rights to protect their interests.

The ED retains IAS 27's presumption that an entity that holds more than half of the voting rights in another entity has the power to direct its activities. It also contains significant additional guidance that applies when a reporting entity holds less than a majority of the voting rights or when structured entities are involved.

## Holding Less Than a Majority of the Voting Rights

ED 10 clarifies that 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." This could occur when a reporting entity with less than half of the voting rights nevertheless "has more voting rights than any other party [and those] voting rights are sufficient to give the reporting entity the ability to determine the entity's strategic operating and financing policies."

For example, the ED refers to a situation in which the reporting entity is a "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." Such "de facto control" has been controversial under IAS 27.

Paragraph B9 in ED 10 sets out the following list of "indicators of power to direct the activities of an entity" when an entity holds less than the (absolute) majority of voting rights:

- (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.

The ED provides additional factors for consideration in the assessment of whether control exists over structured entities.

## Options and Convertible Instruments

IAS 27 requires an entity to consider potential voting rights that are currently exercisable or convertible as current voting rights in its assessment of control. ED 10 proposes a more general requirement — that a reporting entity consider whether the power to obtain voting rights achieved through holding options or convertible instruments, "in conjunction with other relevant facts and circumstances, also gives it the power to direct the activities of another entity." Such instruments would not need to be currently exercisable to affect the assessment of control, nor would currently exercisable instruments automatically affect the assessment of control.

## Structured Entities

Under the ED, structured entities are considered separately from "normal" consolidation situations. A structured entity is "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 considers structured entities to be similar to special-purpose entities. In ED 10's Basis for Conclusions, the Board noted that a reporting entity's conclusion "that an entity in which it has an interest is a structured entity should not affect the control assessment." However, the determination that an entity is a structured entity, but is not controlled by the reporting entity, is significant from a disclosure perspective.

The ED provides additional factors for consideration in the assessment of whether control exists over such structured entities. It emphasizes that key features to be analyzed are (1) the arrangements for the sharing of returns and (2) how decisions are made about the activities of the structured entity. The ED requires that all relevant facts and circumstances be examined in the assessment of whether control exists and suggests the following (not all-inclusive) list of factors for consideration:

- The "purpose and design of the structured entity."
- The "reporting entity's returns from its involvement with the structured entity" (generally, the more a reporting entity is exposed to variability of return the more likely it is that it has power).
- The "activities of the structured entity, including the extent to which the strategic operating and financing policies that direct those activities have been predetermined" (usually, such activities are limited and pre-determined).
- "[R]elated arrangements."
- The "reporting entity's ability to change the restrictions or predetermined strategic operating and financing policies."
- "[W]hether the reporting entity acts as an agent for other parties, or another party acts as its agent."

## Agency Relationships

The ED provides additional guidance on assessing control when an agency relationship exists in which the agent acts on behalf of another party (the principal). While agents might have power to direct the activities of an entity, they have to act in the best interest of the principal. Therefore, if the reporting entity acts exclusively as an agent, it cannot have control because its power over an entity does not enable it to benefit from the returns of that entity.

Agents can receive a fixed fee from the principal for providing services to it. However, if the remuneration to the agent is related to performance, an agency relationship may be difficult to distinguish from a control relationship, and the reporting entity must decide whether the fees and their variability are comparable to those of an investor.

## Disclosures

ED 10 proposes new disclosure objectives that are designed to enable users of the reporting entity's financial statements to evaluate the following:

- (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.

Detailed requirements for meeting these objectives are set out in paragraphs B30–B47 of the ED's application guidance. ED 10 also contains a catch-all clause stating that if the specific disclosures specified in the application guidance do not meet the above objectives, a reporting entity would be required to "disclose whatever additional information is necessary to meet those objectives."

Compliance with the six-plus pages of disclosures proposed in the ED is likely to be burdensome, particularly for entities over which the reporting entity has determined that it does not have control and for which it may not have access to detailed information.

**Editor's Note:** The disclosure objectives in the FASB's Exposure Draft on Interpretation 46(R)<sup>3</sup> are similar to those being proposed by the IASB. However, the FASB's disclosures would apply only to entities that are considered variable interest entities. In addition, the FASB recently issued FSP FAS 140-4 and FIN 46(R)-8,<sup>4</sup> which accelerates the requirement for public companies to provide disclosures that are similar to those proposed in the Exposure Draft for periods ending after December 15, 2008.

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## Effective Date and Transition

The effective date of the final standard will be set when it is approved by the IASB. As discussed above, it is not expected to be effective before 2011 accounting periods, with early application likely to be permitted.

The Board has acknowledged that retrospective application of the standard could give rise to significant costs and difficulties. ED 10 therefore proposes the following:

- "When application of the requirements of [the standard] for the first time results in a reporting entity consolidating an entity that was not [previously consolidated, the requirements of IFRS 3, *Business Combinations*, would be applied, with the deemed acquisition date being the date of first applying the new standard] unless the acquisition date as defined in IFRS 3 is after the date of first applying the [new standard]."
- "When application of the requirements of [the standard] for the first time results in a reporting entity no longer consolidating an entity that was [previously consolidated, the date of first applying the new standard would be treated as the date on which the reporting entity loses control of that entity] unless the date of losing control is after the date of first applying the [new standard]."

<sup>3</sup> Proposed FASB Statement, *Amendments to FASB Interpretation No. 46(R)*.

<sup>4</sup> FASB Staff Position (FSP) No. FAS 140-4 and FIN 46(R)-8, "Disclosures by Public Entities (Enterprises) About Transfers of Financial Assets and Interests in Variable Interest Entities."

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