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**International
Accounting Standards
Board**

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Note: These notes are based on the staff paper prepared for the IFRIC. Paragraph numbers correspond to paragraph numbers used in the IFRIC paper. However, because these notes are less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

IFRIC meeting: July 2006, London

**Project: SIC-12 Consolidation: Special Purpose Entities –
Relinquishment of control (Agenda paper 10(v))**

Introduction

1. The IFRIC has received two submissions in connection with how to apply SIC-12 *Consolidation – Special Purpose Entities*, in particular paragraph 10 of SIC-12.
2. Paragraph 10 of SIC-12 states that there may be a control relationship between an entity and a special purpose entity (SPE) in the following situations:
 - (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 operations;
 - (b) in substance, the entity has the decision-making process 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.
3. The issue is whether any of the indicators in paragraph 10 of SIC-12 carry a greater weight in determining who has control over an SPE. Particularly, whether the risk and reward indicators set out in paragraph 10(c) and 10(d) of SIC-12 take precedence over the others set out in paragraph 10(a).
4. The issue is illustrated by the following two examples:
- Example 1- Entity A sets up an SPE to issue credit-linked notes to investors. Entity A disposes of more than half of the 'equity tranche' of the SPE to Entity B. Entity A still acts as an investment manager of the SPE after the disposal. Entity B has no decision-making power over the activities of the SPE. The business objectives of the SPE cannot be changed once they have been predefined by Entity A.
 - Example 2 - Entity C sets up an SPE to hold securitised assets. Entity D acquires 'equity interests' in the SPE in the secondary market. The interests acquired by Entity D represent more than half of the risks associated with the underlying assets of the SPE. Entity D has no decision-making power over the activities of the SPE. The business objectives of the SPE cannot be changed once they have been predefined by Entity C.
5. Since the business objectives of an SPE are usually narrow and well-defined, some suggest that in both examples the SPE is established primarily to meet the specific business needs of the creator (the party that sets up the SPE). They note that the fact that another party purchases the majority of the interests of the SPE does not change the business objectives of the SPE. In addition, the creator still retains some interests in the SPE. They conclude, therefore, that the creator should continue to consolidate the SPE (see paragraph 10(a) of SIC-12). Others argue that the benefits and risks tests (as set out in paragraph 10(c) and 10(d) of SIC-12) carry a greater weight than other indicators. Since the majority of the risks associated with the activities of the SPE are transferred to another party, they

conclude that the party owning the majority of the 'equity interests', rather than the creator, should consolidate the SPE.

Staff analysis

6. Paragraph 8 of SIC-12 states that an SPE shall be consolidated when there is a control relationship between an entity and an SPE.
7. IAS 27 *Consolidated and Separate Financial Statements* defines "control" as the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities. The definition of control contains two notions – one being "the power to govern the financial and operating policies" and the other being "the ability to obtain benefits from its activities". Importantly, these two criteria should not be viewed independently.
8. Paragraph 9 of SIC-12 also states that the application of the control concept requires, in each case, judgement in the context of all relevant factors.
9. The staff notes that SIC-12 only states that the examples set out in paragraph 10 of SIC-12 may indicate a relationship in which an entity controls an SPE. They are not necessarily conclusive factors. Indeed, the staff acknowledges that, since facts vary case-by-case, judgement and skill is required in applying the concept of control to determine who has control over an SPE.
10. The staff has simplified the above two examples for the ease of illustration – assuming that the buyer acquires all or substantially all the 'equity interest' of the SPE. An equity instrument normally gives the holder some rights associated with power (e.g. voting rights as well as beneficial rights). However, in the above examples, the buyer has no decision-making power over the activities of the SPE. Therefore, the staff believes that it may not be appropriate to draw a conclusion that the party that has the majority of the equity interests in the SPE should be the one that should consolidate the SPE. Instead, the staff believes that who has control over the SPE still depends on the relevant facts and circumstances.

11. In some cases, although the buyer acquires all or substantially all the ‘equity interests’ of the SPE, control may still be with the creator if it retains some benefits after the disposal. For instance, in autopilot situations, the creator’s ability to govern the financial and operating policies of the SPE may be perpetuated into the on-going activities of the SPE (see paragraph 9 of SIC-12 and paragraph 14 of the Basis of Conclusions of SIC-12)¹. The thought is that, since no one can change the activities of the SPE once they have been predefined by the creator, the creator may still have control over the SPE provided that it has some benefits flowing from the activities of the SPE. As mentioned above, the definition of control is met when the two notions – “power to govern” and “benefit” are satisfied. IAS 27 does not require that an entity has the majority of the benefits in order to meet the “benefit” criterion.
12. Furthermore, the staff notes that “benefits” are not confined to benefits flowing from equity interests. Paragraph 3 of SIC-12 states that a beneficial interest may take the form of a debt instrument, an equity instrument, a participation right, a residual interest or a lease. Appendix to SIC-12 further states that benefits can be derived through a statute, contract, agreement or trust deed, or any other scheme, arrangement or device that is specified in favour of an entity that is engaged in transactions with an SPE and that the entity stands to gain those benefits from the financial performance of the SPE.
13. On the other hand, in cases in which the identity of the party that has the decision-making power is not apparent, the indicators set out in paragraph 10(c) and 10(d) (i.e. majority risks and rewards) may be persuasive. Again, in determining who has the majority of the risks and rewards, “risks and rewards” should not be restricted to those flowing from equity interests. For instance, service fees paid by an SPE in favour of an entity, in the staff’s view, could also be considered as an example of “rewards” if they are set at above the market rate.

¹ Paragraph 9 of SIC-12 states that, in the context of an SPE, control may arise through the predetermination of the activities of the SPE (operating in an autopilot situation). Paragraph 14 of the Basis of Conclusions of SIC-12 explains that, since virtually all rights, obligations, and aspects of activities that could be controlled are pre-defined and limited by contractual provisions specified or scheduled at inception, control may arise for the sponsoring party or others with a beneficial interest. The predetermination of the activities of the SPE through an “autopilot” mechanism often provides evidence that the ability to control has been exercised by the party making the predetermination for its own benefit at the formation of the SPE and is being perpetuated.

14. Furthermore, when the creator still provides some services to the SPE after the disposal (e.g. management services), the terms and conditions of the relevant service agreement should be considered in order to determine whether the creator still has the power of governance.

Staff recommendation

15. In conclusion, the staff believes that, in determining who has control over an SPE, all factors that are relevant in determining whether the two components of control exist should be considered. The staff acknowledges that, since facts vary case-by-case, it would not be appropriate to conclude if any of the indicators set out in paragraph 10 of SIC-12 carry greater weight. It depends on the relevant facts and circumstances.
16. In addition, the staff believes that, in view of the ongoing Board project on control, it would not be appropriate to develop an Interpretation. The staff, therefore, recommends that the issue should not be taken onto the agenda.
17. [Omitted for observer notes purposes.]