

## **Consolidation - Special Purpose Entities**

*Paragraph 14 of FRS 1 Presentation of Financial Statements requires that financial statements should not be described as complying with Financial Reporting Standards unless they comply with all the requirements of each applicable Standard and each applicable Interpretation of the Financial Reporting Standard. INT FRSs are not intended to apply to immaterial items.*

**Reference:** FRS 27 Consolidated and Separate Financial Statements

### **ISSUE**

1. An entity may be created to accomplish a narrow and well-defined objective (e.g., to effect a lease, research and development activities or a securitisation of financial assets). Such a special purpose entity ("SPE") may take the form of a corporation, trust, partnership or unincorporated entity. SPEs often are created with legal arrangements that impose strict and sometimes permanent limits on the decision-making powers of their governing board, trustee or management over the operations of the SPE. Frequently, these provisions specify that the policy guiding the ongoing activities of the SPE cannot be modified, other than perhaps by its creator or sponsor (i.e., they operate on so called "autopilot").
2. The sponsor (or enterprise on whose behalf the SPE was created) frequently transfers assets to the SPE, obtains the right to use assets held by the SPE or performs services for the SPE, while other parties ("capital providers") may provide the funding to the SPE. An enterprise that engages in transactions with an SPE (frequently the creator or sponsor) may in substance control the SPE.
3. A beneficial interest in an SPE may, for example, take the form of a debt instrument, an equity instrument, a participation right, a residual interest or a lease. Some beneficial interests may simply provide the holder with a fixed or stated rate of return, while others give the holder rights or access to other future economic benefits of the SPE's activities. In most cases, the creator or sponsor (or the enterprise on whose behalf the SPE was created) retains a significant beneficial interest in the SPE's activities, even though it may own little or none of the SPE's equity.
4. FRS 27 requires the consolidation of entities that are controlled by the reporting enterprise. However, the Standard does not provide explicit guidance on the consolidation of SPEs.
5. The issue is under what circumstances an enterprise should consolidate an SPE.
6. This Interpretation does not apply to post-employment benefit plans or other long-term employee benefit plans to which FRS 19 applies.
7. A transfer of assets from an enterprise to an SPE may qualify as a sale by that enterprise. Even if the transfer does qualify as a sale, the provisions of FRS 27 and this Interpretation may mean that the enterprise should consolidate the SPE. This Interpretation does not

address the circumstances in which sale treatment should apply for the enterprise or the elimination of the consequences of such a sale upon consolidation.

## CONSENSUS

8. An SPE should be consolidated when the substance of the relationship between an enterprise and the SPE indicates that the SPE is controlled by that enterprise.
9. In the context of an SPE, control may arise through the predetermination of the activities of the SPE (operating on “autopilot”) or otherwise. FRS 27.13 indicates several circumstances which result in control even in cases where an entity owns one half or less of the voting power of another entity. Similarly, control may exist even in cases where an entity owns little or none of the SPE’s equity. The application of the control concept requires, in each case, judgement in the context of all relevant factors.
10. In addition to the situations described in FRS 27.13, the following circumstances, for example, may indicate a relationship in which an entity controls an SPE and consequently should consolidate the SPE (additional guidance is provided in the Appendix to this Interpretation):
  - (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.
11. [Deleted]

## BASIS FOR CONCLUSIONS

12. FRS 27.1244 states that “~~a parent which issues~~ Consolidated financial statements shall include should consolidate all subsidiaries of the parent”. FRS 27.0406 defines a parent as “an entity enterprise that has one or more subsidiaries”, a subsidiary as “an entity, enterprise including an unincorporated entity such as a partnership, that is controlled by another entity enterprise (known as the parent)”, and control as “the power to govern the financial and operating policies of an entity enterprise so as to obtain benefits from its activities.” Paragraph 31 of the Framework and FRS 8.10(b)(ii) 4.20(b)(ii) (~~issued in 2003~~) require that transactions and other events are accounted for in accordance with their substance and economic reality, and not merely their legal form.
13. Control over another entity requires having the ability to direct or dominate its decision-making, regardless of whether this power is actually exercised. Under the definitions of FRS 27.0406, the ability to govern decision-making alone, however, is not sufficient to establish control. The ability to govern decision-making must be accompanied by the objective of obtaining benefits from the entity’s activities.
14. SPEs frequently operate in a predetermined way so that no entity enterprise has explicit decision-making authority over the SPE’s ongoing activities after its formation (i.e., they operate on “autopilot”). Virtually all rights, obligations, and aspects of activities that could be controlled are predefined and limited by contractual provisions specified or scheduled at inception. In these circumstances, control may exist for the sponsoring party or others

with a beneficial interest, even though it may be particularly difficult to assess, because virtually all activities are predetermined. However, 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.

~~15. FRS 27.13(b) indicates that a subsidiary should be excluded from consolidation when it “operates under severe long-term restrictions which significantly impair its ability to transfer funds to the parent.” Predetermination of the activities of an SPE by an enterprise (the sponsor or other party with a beneficial interest) is often a demonstration of control over ongoing activities as determined by that enterprise and would not represent the type of restrictions referred to in FRS 27.13(b).~~

15A. In 2005, the scope of INT FRS 12 was amended. That Amendment is effective for annual periods beginning on or after 1 January 2005, unless an entity applied FRS 102 for an earlier period, in which case the Amendment is effective for that earlier period. Before that Amendment, INT FRS 12 excluded from its scope equity compensation plans and post-employment benefit plans. Paragraphs 15B-15E summarise the considerations in reaching its consensus to amend the scope of INT FRS 12.

15B. The issue on whether the scope exclusion in INT FRS 12 for equity compensation plans should be removed when FRS 102 becomes effective was considered. Equity compensation plans were excluded from the scope of INT FRS 12 because they were within the scope of FRS 19 and that Standard did not specify recognition and measurement requirements for equity compensation benefits. However, once FRS 102 became effective, FRS 19 would no longer apply to equity compensation plans. FRS 102 specifies recognition and measurement requirements for equity compensation benefits.

15C. Also, FRS 102 amended FRS 32, to state that paragraphs 33 and 34, which relate to the treatment of treasury shares, should be applied to treasury shares purchased, sold, issued or cancelled in connection with employee share option plans, employee share purchase plans, and all other share-based payment arrangements. However, in some cases, those shares might be held by an employee benefit trust (or similar entity) set up by the entity for the purposes of its share-based payment arrangements. Removing the scope exclusion in INT FRS 12 would require an entity that controls such a trust to consolidate the trust and, in so doing, to apply the requirements of FRS 32 to treasury shares held by the trust.

15D. It was therefore concluded that, to ensure consistency with FRS 102 and FRS 32, the scope of INT FRS 12 should be amended by removing the exclusion of equity compensation plans.

15E. At the same time, the scope exclusion in INT FRS 12 for post-employment benefit plans was discussed. It was noted that, although INT FRS 12 did not exclude other long-term employee benefit plans from its scope, FRS 19 nevertheless requires those plans to be accounted for in a manner similar to the accounting for post-employment benefit plans. It was therefore concluded that, to ensure consistency with FRS 19, the scope exclusion in INT FRS 12 should also apply to other long-term employee benefit plans.

**Effective Date:** INT FRS 12 comes into effect on **1st February 2003**. Changes in accounting policies shall be accounted for in accordance with FRS 8. An entity shall apply the amendments for annual periods beginning on or after 1 January 2005. If an entity applies FRS 102 for an earlier period, the amendment shall be applied for that earlier period.

## Appendix

The purpose of the appendix is to illustrate the application of the Interpretation to assist in clarifying its meaning.

### INDICATORS OF CONTROL OVER AN SPE

The examples in paragraph 10 of this Interpretation are intended to indicate types of circumstances that should be considered in evaluating a particular arrangement in light of the substance-over-form principle. The guidance provided in the Interpretation and in this Appendix is not intended to be used as “a comprehensive checklist” of conditions that must be met cumulatively in order to require consolidation of an SPE.

#### (a) *Activities*

The activities of the SPE, in substance, are being conducted on behalf of the reporting enterprise, which directly or indirectly created the SPE according to its specific business needs.

Examples are:

- the SPE is principally engaged in providing a source of long-term capital to an enterprise or funding to support an enterprise’s ongoing major or central operations; or
- the SPE provides a supply of goods or services that is consistent with an enterprise’s ongoing major or central operations which, without the existence of the SPE, would have to be provided by the enterprise itself.

Economic dependence of an entity on the reporting enterprise (such as relations of suppliers to a significant customer) does not, by itself, lead to control.

#### (b) *Decision-making*

The reporting enterprise, in substance, has the decision-making powers to control or to obtain control of the SPE or its assets, including certain decision-making powers coming into existence after the formation of the SPE. Such decision making powers may have been delegated by establishing an “autopilot” mechanism.

Examples are:

- power to unilaterally dissolve an SPE;
- power to change the SPE’s charter or bylaws; or
- power to veto proposed changes of the SPE’s charter or bylaws.

#### (c) *Benefits*

The reporting enterprise, in substance, has rights to obtain a majority of the benefits of the SPE’s activities through a statute, contract, agreement, or trust deed, or any other scheme, arrangement or device. Such rights to benefits in the SPE may be indicators of control when they are specified in favour of an enterprise that is engaged in transactions with an SPE and that enterprise stands to gain those benefits from the financial performance of the SPE.

Examples are:

- rights to a majority of any economic benefits distributed by an entity in the form of future net cash flows, earnings, net assets, or other economic benefits; or

- rights to majority residual interests in scheduled residual distributions or in a liquidation of the SPE.

(d) *Risks*

An indication of control may be obtained by evaluating the risks of each party engaging in transactions with an SPE. Frequently, the reporting enterprise guarantees a return or credit protection directly or indirectly through the SPE to outside investors who provide substantially all of the capital to the SPE. As a result of the guarantee, the enterprise retains residual or ownership risks and the investors are, in substance, only lenders because their exposure to gains and losses is limited.

Examples are:

- the capital providers do not have a significant interest in the underlying net assets of the SPE;
- the capital providers do not have rights to the future economic benefits of the SPE;
- the capital providers are not substantively exposed to the inherent risks of the underlying net assets or operations of the SPE; or
- in substance, the capital providers receive mainly consideration equivalent to a lender's return through a debt or equity interest.