

Urgent Issues Group

Interpretation 112

December 2004

Consolidation – Special Purpose Entities



Australian Government

**Australian Accounting
Standards Board**

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PREFACE

Reasons for Issuing UIG Interpretation 112

The Australian Accounting Standards Board (AASB) is implementing the Financial Reporting Council's policy of adopting the Standards of the International Accounting Standards Board (IASB) for application to reporting periods beginning on or after 1 January 2005. The AASB has decided it will continue to issue sector-neutral Standards, that is, Standards applicable to both for-profit and not-for-profit entities, including public sector entities. Except for Standards that are specific to the not-for-profit or public sectors or that are of a purely domestic nature, the AASB is using the IASB Standards as the "foundation" Standards to which it adds material detailing the scope and applicability of a Standard in the Australian environment. Additions are made, where necessary, to broaden the content to cover sectors not addressed by an IASB Standard and domestic, regulatory or other issues.

The same approach applies to UIG pronouncements. This Interpretation is part of the set of Australian equivalents to each International Accounting Standard (IAS), International Financial Reporting Standard (IFRS) and Interpretation of the IASB (collectively defined by the IASB as IFRSs). This set includes UIG Interpretations that correspond to the IASB Interpretations originated by the International Financial Reporting Interpretations Committee (IFRIC) or the former Standing Interpretations Committee (SIC).

Main Features of this Interpretation

This Interpretation is applicable to annual reporting periods beginning on or after 1 January 2005. To promote comparability among the financial reports of Australian entities, early adoption of this Interpretation is not permitted.

Application of this Interpretation will begin in the first annual reporting period beginning on or after 1 January 2005 in the context of adopting all Australian equivalents to IFRSs. The requirements of Accounting Standard AASB 1 *First-time Adoption of Australian Equivalents to International Financial Reporting Standards*, the Australian equivalent of IFRS 1 *First-time Adoption of International Financial Reporting Standards*, must be observed. AASB 1 requires prior period information, presented as comparative information, to be restated as if the requirements of this Interpretation had always applied. This differs from previous Australian requirements where changes in accounting policies did not require the restatement of the income statement and balance sheet of the preceding period.

This Interpretation applies when an entity applies AASB 127 *Consolidated and Separate Financial Statements*. The Interpretation requires a special

purpose entity (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 provides guidance in determining whether an entity controls an SPE, including discussion of the predetermination of the activities of the SPE by the sponsoring entity.

Comparison with Superseded Requirements

There is no substantive difference with the previous requirements in Australia in the superseded UIG Abstract 28 *Consolidation – Special Purpose Entities*, except for some differences in the scope of this Interpretation. The scope of this Interpretation was amended in December 2004 to encompass equity compensation plans and to exclude other long-term employee benefit plans that are accounted for in a manner similar to post-employment benefit plans. Abstract 28 was based on the then requirements of Standing Interpretations Committee Interpretation SIC-12 *Consolidation – Special Purpose Entities*.

COMPARISON WITH INTERNATIONAL PRONOUNCEMENTS

UIG Interpretation 112 is equivalent to Interpretation SIC-12, issued by the IASB. Paragraphs that have been added to this Interpretation (and do not appear in the text of the equivalent SIC Interpretation) are identified with the prefix “Aus”, followed by the number of the relevant SIC paragraph and decimal numbering.

Entities that comply with Interpretation 112 will simultaneously be in compliance with SIC-12.

International Public Sector Accounting Standards (IPSASs) are issued by the Public Sector Committee of the International Federation of Accountants. IPSAS 6 *Consolidated Financial Statements and Accounting for Controlled Entities* (May 2000) does not address special purpose entities.

URGENT ISSUES GROUP
INTERPRETATION 112
CONSOLIDATION –
SPECIAL PURPOSE ENTITIES

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 entity 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 entity 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 entity 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. Accounting Standard AASB 127 *Consolidated and Separate Financial Statements* requires the consolidation of entities that are controlled by the reporting entity. However, the Standard does not provide explicit guidance on the consolidation of SPEs.
5. The issue is under what circumstances an entity should consolidate an SPE.

6. This Interpretation does not apply to post-employment benefit plans or other long-term employee benefit plans to which AASB 119 *Employee Benefits* applies.
7. A transfer of assets from an entity to an SPE may qualify as a sale by that entity. Even if the transfer does qualify as a sale, the provisions of AASB 127 and this Interpretation may mean that the entity should consolidate the SPE. This Interpretation does not address the circumstances in which sale treatment should apply for the entity or the elimination of the consequences of such a sale upon consolidation.

CONSENSUS

8. **An SPE shall be consolidated when the substance of the relationship between an entity and the SPE indicates that the SPE is controlled by that entity.**
9. **In the context of an SPE, control may arise through the predetermination of the activities of the SPE (operating on “autopilot”) or otherwise. AASB 127.13 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 AASB 127.13, the following circumstances, for example, may indicate a relationship in which an entity controls an SPE and consequently shall 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 by the IASB]

Application

- Aus11.1 This Interpretation applies when AASB 127 applies.**
- Aus11.2 This Interpretation applies to annual reporting periods beginning on or after 1 January 2005.**
- Aus11.3 This Interpretation shall not be applied to annual reporting periods beginning before 1 January 2005.**
- Aus11.4 The requirements specified in this Interpretation apply to the financial report where information resulting from their application is material in accordance with AASB 1031 *Materiality*.**
- Aus11.5 When applicable, this Interpretation supersedes Abstract 28 *Consolidation – Special Purpose Entities*, as issued in July 1999.**
- Aus11.6 Abstract 28 remains applicable until superseded by this Interpretation.**

DISCUSSION

- 12. AASB 127.12 states that “Consolidated financial statements shall include all subsidiaries of the parent”. AASB 127.4 defines a parent as “an entity that has one or more subsidiaries”, a subsidiary as “an entity, including an unincorporated entity such as a partnership, that is controlled by another entity (known as the parent)”, and control as “the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities.” Paragraph 35 of the *Framework for the Preparation and Presentation of Financial Statements* and AASB 108 *Accounting Policies, Changes in Accounting Estimates and Errors*, paragraph 10(b)(ii), 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 AASB 127.4, 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 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.
- 15A. In 2004, the UIG amended the scope of Interpretation 112 *Consolidation – Special Purpose Entities*. That amendment is effective for annual periods beginning on or after 1 January 2005. Before that amendment, Interpretation 112 excluded from its scope equity compensation plans and post-employment benefit plans.
- 15B. Equity compensation plans were excluded from the scope of the superseded UIG Abstract 28 *Consolidation – Special Purpose Entities* because Australian Standards did not specify recognition and measurement requirements for equity compensation benefits. However, AASB 2 *Share-based Payment* specifies recognition and measurement requirements for equity compensation benefits.
- 15C. AASB 132 *Financial Instruments: Disclosure and Presentation*, 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 Interpretation 112 would require an entity that controls such a trust to consolidate the trust and, in so doing, to apply the requirements of AASB 132 to treasury shares held by the trust.
- Aus15C.1 The AASB has added a footnote to AASB 132.33 and 132.34 that "The Corporations Act prohibits a company from acquiring shares (or units of shares) in itself except in limited

circumstances. Accordingly, an entity subject to the Corporations Act cannot have treasury shares.”

15D. [Deleted by the UIG]

15E. [Deleted by the UIG]

Date of SIC’s Consensus: [Deleted by the UIG]

Effective Date of SIC-12: [Deleted by the UIG]

APPENDIX

This appendix accompanies, but is not part of, Interpretation 112.

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 entity, 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 entity or funding to support an entity’s ongoing major or central operations; or
- the SPE provides a supply of goods or services that is consistent with an entity’s ongoing major or central operations which, without the existence of the SPE, would have to be provided by the entity itself.

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

(b) *Decision-making*

The reporting entity, 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 entity, 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 entity that is engaged in transactions with an SPE and that entity 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 entity 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 entity 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.

REFERENCES

Australia

The Urgent Issues Group discussed Issues Paper 04/4 “Amendment to Scope of Interpretation on Consolidation of Special Purpose Entities” in relation to this amended Interpretation at meetings on 26 August and 25 November 2004. In developing the superseded Interpretation, the UIG discussed Issues Paper UIG/SIC 04/1 “Adoption of Various SIC Interpretations in Australia” in relation to this Interpretation at its meeting on 18 March 2004.

Accounting Standard AASB 108 *Accounting Policies, Changes in Accounting Estimates and Errors*

Accounting Standard AASB 127 *Consolidated and Separate Financial Statements*

Framework for the Preparation and Presentation of Financial Statements

International Accounting Standards Board

International Accounting Standard IAS 27 *Consolidated and Separate Financial Statements*

Standing Interpretations Committee Interpretation SIC-12 *Consolidation – Special Purpose Entities*

IFRIC Amendment to SIC-12 *Scope of SIC-12 Consolidation – Special Purpose Entities*

IFAC Public Sector Committee

International Public Sector Accounting Standard IPSAS 6 *Consolidated Financial Statements and Accounting for Controlled Entities*