SIC-12 and FIN 46R

The substance of control

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Foreword

Management needs to send shareholders the right message about performance – unlocking value from assets and sound balance sheet management are a crucial part of good financial management. Gearing, debt ratios and interest cover are important measures of a company's performance. All these factors can be significantly influenced by whether or not SPEs are consolidated.

A good grip on SIC-12 and FIN 46R is crucial if management is to predict the impact that transactions will have on the balance sheet under IFRS and US GAAP.

The FASB and IASB each have a long-running project examining the consolidation requirements in the accounting for special purpose entities. Both standard-setters have issued interpretations on the subject, but each is different in some details of scope and application. This can lead to different and sometimes surprising outcomes under each framework.

Management needs to be aware of the divergences between SIC-12 and FIN 46R. The differences exist mostly in the devilish details. The market may also be expecting the outcome (on balance sheet or off) to be the same under the two sets of standards. Management should be prepared to explain why the differences arise.

Contents

Introduction

Special purpose entities (SPEs) have grabbed the headlines in the financial press for years. The International Accounting Standards Board (IASB) and US Financial Accounting Standards Board (FASB) have both addressed the issue with an interpretation of the respective consolidation requirements in each framework. This publication, produced by PricewaterhouseCoopers' Global Corporate Reporting Group and Transaction Services Structuring Group, looks at the guidance contained in both frameworks and highlights the similarities and differences. It examines the text of each framework and provides some real-life examples.

FASB Interpretation No. 46, 'Consolidation of Variable Interest Entities' (FIN 46R), was revised and reissued by the FASB in December 2003 to interpret ARB 51, 'Consolidated Financial Statements'. The FASB's initial focus was to address perceived abuses involving SPEs. However, it decided that a broader consolidation model that is based on risks and rewards, as opposed to voting control, would be a better indication of control in certain circumstances. The final guidance, FIN 46R, is both far-reaching and complex, with the potential to impact even operating businesses.

SIC-12, issued by the predecessor body to the current International Financial Reporting Interpretations Committee, deals with the consolidation of SPEs. SIC-12 (effective since July 1999) is an interpretation of IAS 27, 'Consolidated and Separate Financial Statements'. IAS 27 and SIC-12 together provide guidance on how to identify the party exercising control for all entities.

FIN 46R, IAS 27 and SIC-12 share some similarities. The most significant similarity is the recognition that consolidation based solely upon voting rights is not always the right answer. The interpretations start with a similar idea, but differences arise when they are applied. This publication highlights the differences between FIN 46R and SIC-12, as well as the potential impact of such differences.

International Financial Reporting Standards (IFRS) continue to gain worldwide momentum driven by its adoption across the EU, Australia and other countries. Companies that must reconcile to US Generally Applied Accounting Principles (GAAP) should understand the differences that arise in applying the two interpretations. But do other IFRS users need to pay attention to US GAAP as IFRS becomes widespread in public companies?

The answer is an emphatic 'Yes' – particularly given the focus on convergence between IFRS and US GAAP. The activities of the IASB and FASB influence each other. Both standard-setters are working to narrow differences in key areas such as consolidation, business combinations and equity-based compensation. Joint standard-setting projects are not the only result of this collaboration; regulators across Europe are increasing communication and collaboration with each other and the US Securities and Exchange Commission (SEC) to improve effectiveness and consistency of interpretation.

The SEC has no intention of abdicating its role as arbiter of accounting standards for all US public companies domestic and foreign, regardless of who promulgates a given standard. It favours consistency in the application of accounting standards and can be expected to expend significant effort in shaping practice to conform to its view. The SEC's role as a 'gatekeeper' to the US capital markets and its assertiveness in protecting US investors are likely to ensure that its views remain a vital consideration for reporting entities and their auditors.

How the IFRS and US GAAP frameworks compare

Convergence is the goal of both the IASB and the FASB, but it is unlikely that new or revised standards will eliminate all differences, even where the general principles are in harmony. This is due to differences in philosophy (principles-based versus rules-based), as well as differing views on the most appropriate model to apply to a given transaction (the scope of the standards and interpretations).

IFRS is a principles-based framework, and the approach to consolidation reflects this philosophy. IAS 27 and SIC-12 list indicators of control, some of which individually determine the need to consolidate. However, where control is not apparent, consolidation is based on an overall assessment of all the relevant facts. The indicators listed in SIC-12 help the reporting entity in making this assessment.

US GAAP is a rules-based framework, despite the fact that FIN 46R is often described as substance-based. The guidance is far more detailed than IFRS (25 pages of FIN 46R, compared with five pages of SIC-12), and the accounting treatment of variable interest entities (VIE's) can be impacted by form. Entities structured, for example, to meet specific characteristics such as qualifying SPEs (QSPEs) are exempt from FIN 46R and other US GAAP consolidation guidance. They should apply alternative guidance under US GAAP[1].

Guidance

IFRS

IFRS guidance on consolidation is based on the principles of control. IAS 27 requires the consolidation of all subsidiaries. A subsidiary is any entity (including an unincorporated entity) that is controlled by another entity. The power of control is a broad concept and includes control through a voting majority as well as through other means. IFRS guidance on consolidation is therefore a single model – the control model. However, SIC-12 brings the concepts of risks and rewards where the existence of control is not apparent, often because the entity is on 'autopilot'. There is a principle underlying SIC-12 that a parent entity will only accept exposure to the majority of economic risk if it has control of the SPE. SIC-12 also asserts that no parent entity will gather the majority of economic benefits unless it has control of the SPE. It therefore takes any structure on 'auto-pilot' and looks past the pre-established operations to the party that has the majority of economic risks or benefits. All parties that have dealings with an SPE – titular management, lenders, counterparties to derivatives – have an economic interest and take an economic reward. This does not mean that all must consolidate; rather, the party with a majority of rewards or the residual risk must consolidate.

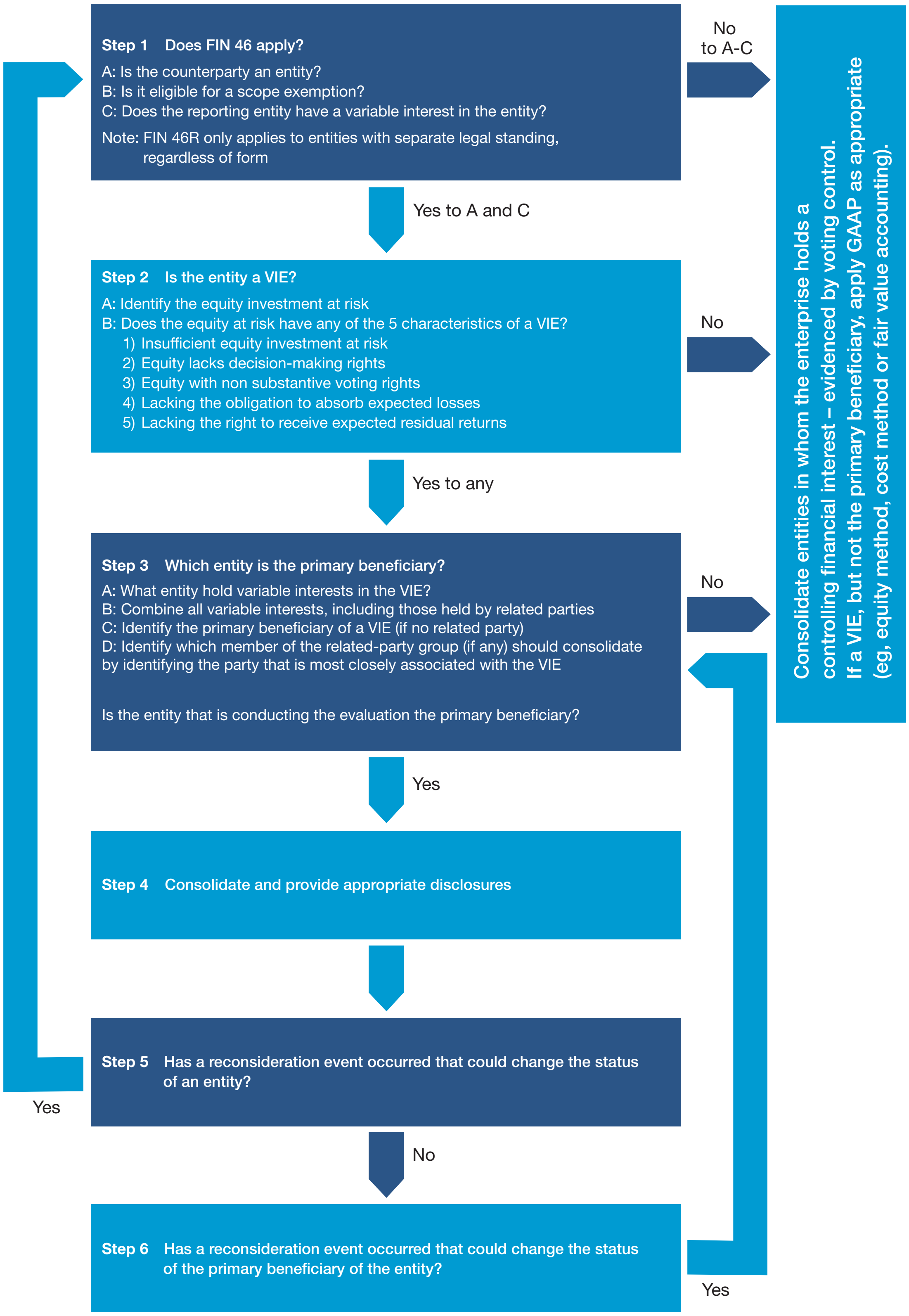
US GAAP

FIN 46R created a new consolidation model, the variable interest model. The variable interest model must be applied to evaluate those entities in which a controlling financial interest is obtained through means other than voting rights. The FIN 46R consolidation model applies when an entity holds a variable interest in another entity and that entity does not have sufficient equity or the equity security lacks decision-making authority or the rights to expected residual returns or exposure to expected losses. When the variable interest model is applied, the party exposed to a majority of an entity's expected loss or entitled to a majority of an entity's expected residual return consolidates that entity. Under US GAAP, therefore, the control and consolidation of an entity is evaluated using two different models. Consolidation under the variable interest model does not consider voting rights or governance provisions and does not require the ownership of any common stock.

The two different conceptual approaches are summarised in the decision trees on pages 6 and 7.

[1]The complex model governing accounting for QSPEs has been established by FAS 140. The FASB has a project in progress to re-consider aspects of FAS 140.

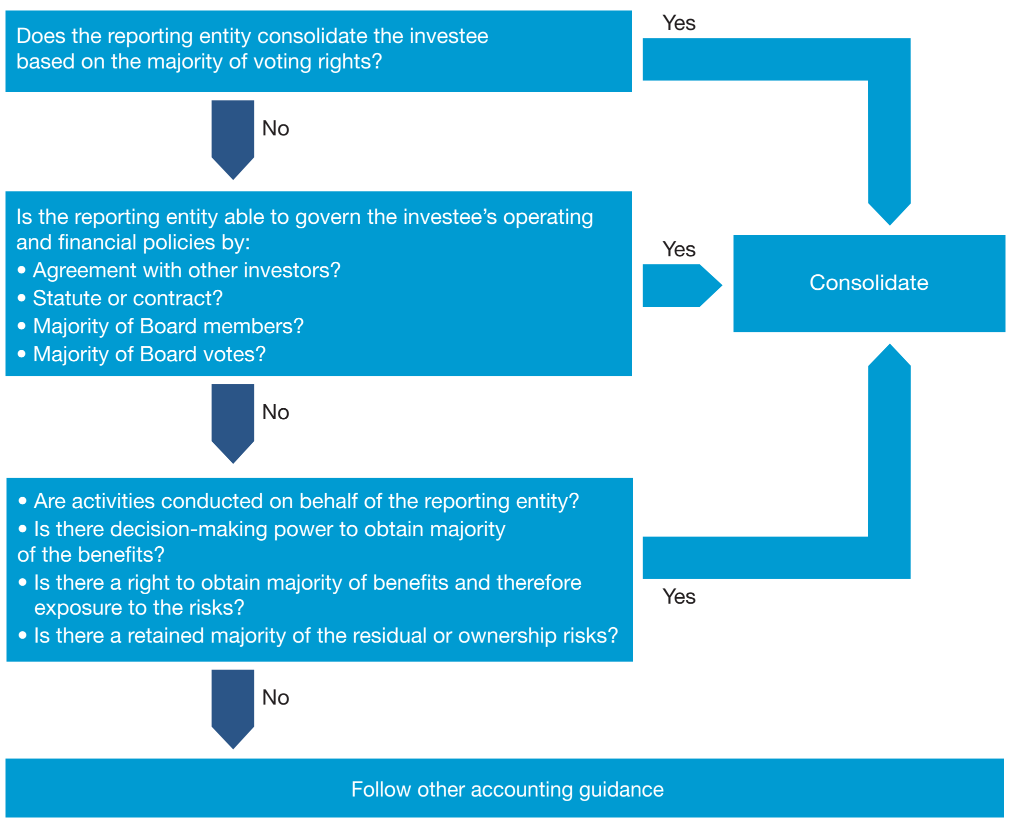
Application of FIN 46R



FIN 46R creates a new consolidation framework for US GAAP that applies only to variable interest entities (VIEs). Holders of variable interests in a potential VIE should evaluate the capital structure of the entity in which they hold their interest.

Without the use of a scope exemption, FIN 46R must be considered for all legal entities regardless of whether that entity would have been considered a traditional SPE. The first step is to determine if it lacks sufficient qualifying equity capital or when the outstanding equity securities lack decision-making rights or hold rights to expected residual returns or have exposure to expected losses. Where FIN 46R is applicable, the holder of a variable interest(s) that shares in the majority of the economic risks and rewards (measured using the expected losses and expected residual returns of the VIE) must consolidate the VIE. There may be a difference in how the economics are measured between US GAAP and IFRS.

Application of the concept of control under IFRS



IFRS relies on the concept of control, with additional guidance provided by SIC-12. A single consolidation model therefore applies for both 'normal' subsidiaries and SPEs that include economic risks and rewards analysis. An SPE under SIC-12 does not have to be a legal entity. Silos within a legal entity or ring-fenced groups of assets and liabilities in multi-cellular structures can be separate SPEs.

The indicator-based analysis of control listed in SIC-12 is used for all SPE consolidation assessments except those related to long-term employee benefit plans.

The principles-based approach taken by IFRS means that a variety of factors need to be evaluated to determine the substance of the arrangement and whether control is present. Indicators of control arise where:

- the subject entity conducts its activities on behalf of the reporting entity;
- the reporting entity has the decision-making power;
- the reporting entity can obtain the majority of the benefits of the subject entity; or
- the reporting entity has the majority of the residual or ownership risks of the subject entity or of its assets.

Devil in the details: FIN 46R and SIC-12

Differences arise in the application of FIN 46R and SIC-12 despite their similar objectives. The differences are presented in two categories: scope and application/methodology.

Scope differences

Legal entity

FIN 46R applies to legal structures; SIC-12 applies to activities regardless of whether they are conducted by a legal entity. SIC-12 can therefore capture activities conducted within a larger legal entity (host entity). SIC-12 may apply, for example, to unincorporated research and development activities or outsourcing arrangements that would not require assessment under FIN 46R. The activity may be outside the scope of FIN 46R, but the host entity would require evaluation to determine whether it is a VIE. The evaluation is based on the host entity's characteristics rather than those of the unincorporated activity. See 'Silos, interests and specified assets' (p12).

Qualifying SPEs

SIC-12 scope exceptions are limited to long-term employee benefit plans. US GAAP includes a concept of qualifying SPEs (QSPEs). QSPEs are outside the scope of FIN 46R. A QSPE is limited in the nature of its activities and the types of asset it can hold and is likely to fall within the scope of SIC-12. IFRS may require consolidation of QSPEs exempted from FIN 46R.

Joint ventures

Joint venture entities are accounted for under the equity method or proportionate consolidation under IFRS. Consolidation may not be required even when one party is the operator of the venture or has a majority of the entity's risks and rewards, provided there is joint control. FIN 46R is applicable to any joint venture not excluded from its scope (for example, the business scope exception in paragraph 4h). All arrangements between the parties (for example, service agreements, guarantees or even the holdings of related parties) may therefore impact the FIN 46R analysis. A full understanding of rights and responsibilities conveyed in management agreements or other agreements is important under both standards. For example, where the management agreement passes operating control to one of the venture partners, it may indicate control is not joint. Under FIN 46R, such decision-making rights embedded in a management contract indicate that the entity is a VIE. FIN 46R states that an entity is a VIE if arrangements, other than the equity holder's rights, give parties the ability to make significant decisions.

Example – Joint ventures

Two parties under a contractual agreement jointly develop a department store. The project has legal standing apart from its interest holders for tax purposes.

The parties contribute an equal amount of equity capital, which ranks pari passu. One of the parties has signed a contract to build and manage the department store. The fees payable for construction are fixed, but those related to subsequent management are based on a percentage of operating income.

The contract can only be cancelled with the agreement of both venture partners and would provide the managing party with significant authority over day-to-day activities. A significant portion of the entity's operating cash flows are expected to be paid as part of the management fee. The management fee is a variable interest under FIN 46R, as it absorbs a large portion of the residual economics. The venture partner receiving the fee will not therefore be able to avail itself of the business scope exception (ie, the fee may indicate that substantially all the entities involve that party (paragraph 4h2), or that party may absorb greater than half the expected residual returns and/or expected losses (paragraph 4h3)).

It is likely that the party receiving the fee (as well as the 50% equity return) would be the primary beneficiary, as the contract to build and run the department store would be considered a variable interest under FIN 46R. The management agreement under IFRS would not override a joint-control contract unless it has the effect of giving control to the party. The investment would therefore be accounted for under IFRS using proportional consolidation or the equity method.

There should be no net difference in income or equity arising from the different methods of accounting applied; however, the difference would affect key income statement and balance sheet line items.

Application/methodology differences

The divergence in approach between FIN 46R and SIC-12 can give rise to differences, even where both apply. For example, when an entity is considered a VIE under FIN 46R, consolidation decisions are driven solely by the right to expected residual returns or exposure to expected losses. Voting control as a means for determining consolidation is irrelevant to the identification of the primary beneficiary.

FIN 46R looks to variability in an entity's net income or loss, rather than the total amount of income or loss to determine the amount of equity required. The greater the entity's variability (driven by industry, maturity of the activity, etc), the higher the equity capital required to continue applying the voting interest model.

SIC-12 takes a broader view. It requires an evaluation of every entity based on its characteristics as a whole to determine the

Example – Leases

An operating company sells a 10-year-old vessel to a limited partnership operating on 'auto-pilot' in order to raise cash. The sale price is the fair value of the vessel. The purchase of the vessel by the partnership was financed 30% by equity and 70% by bank-borrowing. The sale was contingent upon the vessel being leased back to the operating company for a period of 14 years, representing 70% of the vessel's remaining economic life. The vessel will remain the property of the partnership at the end of the leasing period. The partnership has no other activities.

The present value of the minimum lease payments represents approximately 75% of the vessel's fair value. All costs related to operation, repair, insurance and maintenance and modifications to the vessel are the responsibility of the operating company. However, there is no other continuing involvement on the part of the seller-lessee.

The sale-leaseback would be accounted for as a sale and an operating lease under US GAAP, as there is no continuing involvement, the present value of the minimum lease payments is below 90% and the lease covers only 70% of the vessel's remaining economic life.

The limited partnership would be a variable interest entity under FIN 46R, as the activities of the limited partnership are on autopilot (ie, there are no decisions that would come to a vote of the limited partners or the general partner). An operating lease under FIN 46R is not a variable interest, and the operating company/lessee would not have a variable interest in the vessel owning company.

Analysis under SIC-12 indicates that the partnership's activities are being conducted on behalf of the operating company (ie, a source of long-term capital). The operating company also has the decision-making power to control the SPE's only asset and the rights to the majority of the economic benefits arising from the ownership of the vessel, except for the residual value of the vessel at the end of the leasing period. The capital investors in the limited partnership do not have a significant interest in the SPE's underlying asset. All these factors indicate that the operating company controls the partnership and should therefore consolidate it under IFRS.

Note: The presence of other features such as put/call arrangements between the parties, a residual value guarantee or a fixed price purchase option (regardless of whether it is a bargain purchase option) would require FIN 46R analysis by the lessee. These items are likely to be considered variable interests in the vessel-owning entity.

Note: The application of SIC-12 may require consolidation, resulting in the continued recognition of an asset that would otherwise have been derecognised (ie, consolidation based on majority holder of risks and rewards, while under the lease rules it is 'substantially all'). It is less likely that FIN 46R would apply in the case of a simple operating lease where no other variable interests are held by the lessee or its related parties.

controlling party. The concept of economic benefit or risk is just one part of the analysis (although an important one). Other factors considered in the evaluation are the entity's design, the nature of its activities and its governance.

Leases

Many sale and lease-back transactions through SPEs, for example, do not result in derecognition of the asset by the lessor. In such cases, the lessee accounts for the arrangement as an operating lease, which is not considered a variable interest under FIN 46R.

Assuming the lessee arrangement does not contain other variable interests such as residual value guarantees or fixed price purchase options, FIN 46R would not apply even where the lease is created through a separate legal entity. The lease payments under SIC-12 are considered when evaluating economic risk and reward. SIC-12 may therefore require consolidation in cases where the fair value of lease payments is significant but less than substantially all of the fair value of leased asset.

The below examples illustrate the challenge posed by related-party and de facto agent relationships.

Related-party group

Example 1

An entity is formed by three parties, each with a 33% ownership and voting rights. It does not qualify as a joint venture. The entity is funded with nominal capital but significant shareholder loans. The shareholder loans are pari passu but are believed sufficient to absorb all of the entity's expected losses. The venture partners have no other interests in the entity and are not related parties. The reporting entities do not qualify for the normal business exemption because the entity is not a joint venture under US GAAP, and the shareholders were involved in the entity's design.

The entity is a VIE regardless of its ability to finance its expected losses, as the shareholder loans are not 'at risk' equity under FIN 46R. No partner is exposed to a majority of expected losses or expected returns and neither party would consolidate under US GAAP. The transactions and operations of the entity would need further analysis before a conclusion could be reached under IFRS.

Example 2

Assume the same fact pattern as above, but in addition to the shareholder agreement is a provision that one venture partner (A) cannot sell, transfer or encumber their interest in the entity without the express permission of one of the other parties (B). This provision is considered appropriate and binding in the jurisdiction governing the agreement.

A and B are considered de facto agents and together are exposed to 66% of the entity's expected losses and residual returns and are the entity's primary beneficiary. Either A or B must consolidate, as the related-party group is the primary beneficiary. The fact that no party holds a majority of the shares or economic exposure/return is irrelevant, and the partners will have to find some basis for one or the other within the group to consolidate under US GAAP. This analysis requires significant judgment, taking into consideration all relevant facts and circumstances, including:

- The existence of a principal-agency relationship between parties within the related-party group;
- The relationship and significance of the activities of the VIE to the parties within the related-party group (refer to 'substantially all' characteristics);
- A party's exposure to the VIE's expected losses; and
- The VIE's design.

IFRS would not require A or B to consolidate.

Related-party group

The concept of a related-party group arises in FIN 46R. A related-party group includes the reporting entity's related parties and de facto agents, such as business partners, employees and parties whose variable interests are subject to restrictions related to sales, transfers and encumbrances, and those parties whose actions are likely to be influenced or controlled by the reporting entity. If the aggregate interests of the related-party group absorb more than 50% of the VIE's expected residual returns or expected losses, one member of the related-party group must consolidate, even if their interest alone would not otherwise be exposed to a majority of the risks and rewards of the VIE.

SIC-12 does not address the impact of related parties or de facto agents. The aggregation requirements could result in consolidation under FIN 46R where individual interests would not be sufficient to warrant consolidation under SIC-12.

Losses trump gains

The party exposed to the expected losses consolidates under FIN 46R if one party is exposed to the majority of the expected losses and another party is entitled to the majority of expected residual returns. SIC-12 does not have this 'hierarchy'. The substance of the arrangement would be considered to decide the controlling party for IFRS purposes. US GAAP and IFRS could have different controlling parties. Such instances should be rare, as it is unlikely, outside of highly structured transactions, that one party would accept exposure to the majority of risks without the entitlement to the majority of the benefits. However, the prescriptive manner in which losses are calculated under FIN 46R may not capture the economic realities that drive a transaction.

Non-substantive voting rights

Under FIN 46R, an entity is a VIE if one of its equity investors holds a disproportionately low voting interest relative to its economic interest in an entity and substantially all that entity's activities involve or are conducted on behalf of that equity investor. This type of VIE is often referred to as an entity with non-substantive voting rights (ie, an entity designed to share voting control with a non-substantive equity investor). Under FIN 46R, where both criterion are present, the entity is automatically a VIE, and the holder of the disproportionately lower vote would generally consolidate by virtue of its higher economics.

SIC-12 has no similar provision and, due to its consideration of voting rights and other factors along with economics, it is possible that a difference will arise.

Note: When considering whether disproportionate voting rights and economics are present, it is necessary to consider all variable interests in the entity, not simply those that arise from the voting shares held.

Considering whether an entity's activities are conducted substantially on behalf of the reporting entity is primarily an activities-based assessment but would also factor in economics. Evaluating substantially all requires judgement and should include a consideration of all the relevant quantitative and qualitative circumstances and interests held by related parties. For example, the existence of purchase and supply agreements, the level of economic interest held, whether a principal or agency relationship exists and other relevant factors should be considered. In cases where substantially all the activities involve or are conducted on behalf of one investor, it is possible that these factors will prove persuasive in determining the consolidating party under SIC-12 as well, in the absence of voting control. Differences on this point should be considered carefully to ensure they are supportable.

Reassessment

Determination of whether an entity is a VIE should be reconsidered when a specific reconsideration event occurs.

VIE status

Reconsideration events are specified in FIN 46R paragraph 7, and include incidences where:

- the entity's governing documents or contractual arrangements are changed in a manner that changes the characteristics or adequacy of the entity's equity investment at risk;
- the equity investment or some part thereof is returned to the equity investors, and other interests become exposed to expected losses of the entity;
- the entity undertakes additional activities or acquires additional assets, beyond those that were anticipated at the later of the inception of the entity or the latest reconsideration event, that increase the entity's expected losses; and
- the entity receives an additional equity investment that is at risk, or the entity curtails or modifies its activities in a way that decreases its expected losses.

Primary beneficiary reassessment

Reconsideration events are specified in FIN 46R, paragraph 15, and include incidences where:

- the VIE's governing documents or contractual arrangements are changed in a manner that reallocates between the existing primary beneficiary and other unrelated parties the obligation to absorb the expected losses or the right to receive the expected residual returns of the VIE;
- the primary beneficiary also shall reconsider its initial decision to consolidate a VIE if the primary beneficiary sells or otherwise disposes of all or part of its variable interests to unrelated parties;
- the VIE issues new variable interests to parties other than the primary beneficiary or the primary beneficiary's related parties; and
- a holder of a variable interest that is not the primary beneficiary acquires additional variable interests in the VIE.

Reassessment under IFRS

Consolidation under IFRS is re-considered at the end of each financial reporting period. There is no concept of a trigger event. An IFRS assessment at a more recent date could impact the consolidation decision and give rise to a difference over the entity's life.

Potential voting rights

IAS 27 imposes a requirement to include currently exercisable potential voting rights in assessing control. Currently exercisable fair value call options, warrants or convertible securities will therefore be factored into the consolidation analysis. Such rights may require consolidation under IFRS. FIN 46R would largely ignore potential voting rights in the analysis where they arise from fair value put or call options. However, a fixed price call or put option would be a variable interest if the entity is a VIE.

Silos, interests and specified assets

IFRS does not provide explicit guidance on silos. However, SIC-12 creates the obligation to consider whether a corporation, trust, partnership or other unincorporated entity has been created to accomplish a narrow and well-defined objective. These arrangements may impose strict and sometimes permanent limits on the decision-making ability of the entity's board, trustee or management, or unincorporated activities within a larger entity. IFRS requires the consideration of substance over form and discrete activities within a much larger operating entity to fall within its scope. When a silo is identified, the entity's economic risks, rewards and design are assessed in the same manner as a legal entity.

Example – Potential voting rights

Entity A has a 60% voting interest in a VIE and dominates policy decisions over the VIE. Entity B has a currently exercisable fair value call option that would reduce A's holding to 45%. B would hold 55% and have the ability to dominate policy decisions.

Under IFRS, B has the power to control. Under US GAAP, the fair value call option would not generally impact the consolidation analysis. Entity A would therefore be identified as the primary beneficiary. The primary beneficiary is required to consolidate the VIE.

FIN 46R only applies to legal entities. However, the FASB has included guidance to address circumstances in which an interest holder's risks and rewards are based not on the performance of the entity as a whole but on the performance of specific assets or activities (a silo) hosted by a larger entity. A party that holds a variable interest in the silo then needs to assess whether it is the silo's primary beneficiary. The key distinction is that the US GAAP silo guidance only applies when the larger entity is a variable interest entity; the IFRS silo guidance is less restrictive in scope.

A variable interest in specified assets under FIN 46R is present, when:

- an interest holder absorbs risks and rewards associated solely with the asset;
- the fair value of the asset in which the interest is held has a fair value that is more than 50% of the fair value of the total assets in the entity; and
- the interest holder has no other significant variable interests in the entity as a whole.

Example – Silos

Entity X creates an SPE to purchase unsecured loans from Bank 1, Bank 2 and Bank 3. The SPE was established with nominal capital. Asset purchases are funded from five-year AAA-rated public debt, which is recourse to all of the SPE's assets, and short-term commercial paper, which is recourse only to the specific asset tranche used to support its issuance (assets sold by Bank 1, 2 or 3).

The commercial paper raised and discounted to fair value on date of sale to the SPE depends solely upon the quality of the receivables provided. Banks 1, 2 and 3 have no residual interest in the assets once they are sold and servicing is done by entity X.

The existence of debt under FIN 46R, which is recourse to the entity as a whole, is likely to preclude silo treatment for loans sold by Banks 1, 2 and 3, as any expected losses absorbed by the debt are those of the entity as a whole. FIN 46R looks to variability rather than GAAP concepts of gain or loss when considering losses. The cross-collateralisation in this structure would be significant enough to preclude silo treatment for tranches of assets provided by Banks 1, 2 and 3.

AAA-rated debt is unlikely to be considered sufficiently at risk under SIC-12 to overcome the presumption that tranches 1, 2 and 3 should be considered separately and consolidated (by the respective originators) based on their specific risks and rewards.

FIN 46R includes anti-abuse guidance to reduce the possibility of structuring entities in such a way as to separate the rights and obligations of the different parties involved, effectively using a host VIE to hold one or more embedded variable interest entities. An embedded VIE would be present when specified assets (and related credit enhancements) are the only source of payments for specified liabilities or other interests. It is not a silo for US GAAP purposes if any of the returns arising from assets in the potential silo can be used to pay interest holders in the larger legal entity as a whole, or if any of the liabilities in the silo can be settled with the host entity's other assets.

Final thoughts

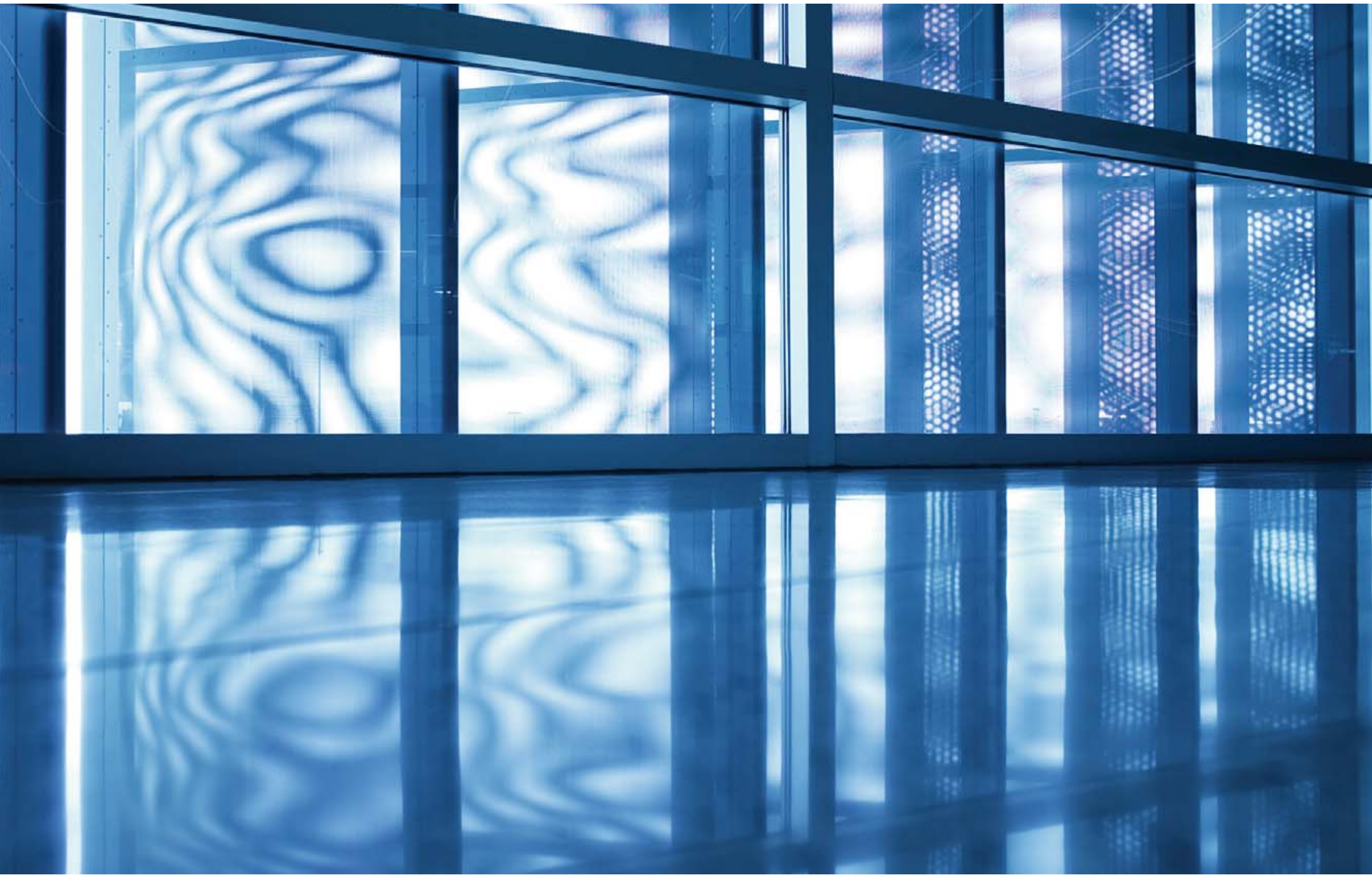
FIN 46R and SIC-12 both rely to a degree on judgment and lay out the factors to be considered in determining whether an entity should be consolidated; however, important differences remain.

The challenge imposed by the standards' respective interpretations is to ensure that all entities that should be considered are identified. The rules are extensive and affect many preparers. The result can be the consolidation of significant activities that have a material impact on the entity's financial statements.

FIN 46R applies to foreign private issuers in respect of all new entities and pre-existing legal entities as of the first US GAAP balance sheet date following 15 March 2004. Preparers must implement a robust process to identify, evaluate and conclude on the FIN 46R impact.

SIC-12 is already in force, but as its guidance continues to evolve – and in the light of the process required to adopt FIN 46R – its requirements are likely to be a focus of attention for the foreseeable future. It also applies to the entire body of IFRS preparers. There are no exemptions for first-time adopters.

IFRS preparers registered in the US or looking for registration need to have a sound understanding of the differences arising between IFRS and US GAAP. Some reconciling items cannot be avoided because of differences between IFRS and US GAAP, while GAAP differences in other areas may be hard to support. Preparers of financial statements should consult their professional advisers for an understanding of the differences between IFRS and US GAAP and of how those differences might affect their financial position.



Useful tools

Examples of transactions, relationships and structures that may be impacted by FIN 46R and/or SIC-12

Leasing/property

- Sale-leasebacks of property or equipment;
- Built-to-suit property or equipment subject to an operating lease (for example, office buildings, manufacturing plants, aeroplanes);
- Synthetic leases (lease structures that are treated as operating leases for accounting purposes, even though the lessee is considered the owner for tax purposes); and
- Certain partnerships in property investments.

Financial assets

- Transactions involving the sale/transfer of financial assets such as receivables to an SPE (for example, factoring arrangements or securitisations);
- Transactions involving a commercial paper conduit, such as sponsoring a conduit to purchase and securitise assets from third parties;
- Securitisation transactions involving commercial-debt obligations, collateralised-bond obligations and commercial-loan obligations; and
- Entities used to hedge off-balance sheet positions.

Start-ups, research and development

- Funding arrangements for research and development;
- Newly formed entities that are designed to manage or fund the start-up of a new product or business;
- Entities sponsored/funded by venture capital, private equity or financial entities; and
- Entities in the developmental stage.

Vendor financing

- Structures designed to help customers finance the purchase of products and services (ie, vendor financing), often in collaboration with a financial institution.

Insurance

- Insurance associations (reciprocals); and
- Reinsurance securitisations.

Transactions involving management, officers and employees

- The transfer or sale of assets to an entity owned by a single employee or by members of an entity's management;
- Management of an unconsolidated asset or business by an entity or its officers; and
- The funding of an entity's independent equity by another entity's managing members.

Obligations associated with other entities

- Certain captive arrangements operated on behalf of an investor;
- An entity's guarantee of:
  (i) an unconsolidated entity's performance or debt, or
  (ii) the value of an asset held by the unconsolidated entity (including explicit and implicit guarantees);
- An entity's contingent liability should an unconsolidated entity default;
- A transaction with an embedded 'put' option that enables the entity or an outside party to sell the assets and/or operations back to an entity;
- A transaction with an embedded call option that allows an entity to repurchase the assets and/or operations that were previously sold to another entity;
- An entity's enhancement of another entity's credit (for example, via escrow funds, collateral agreements, discounts on transferred assets and take-or-pay arrangements); and
- An agreement requiring an enterprise to make a payment if its credit is downgraded.

Rights to assets

- Rights to use an 'under construction' asset not recorded in the entity's balance sheet (the debt used to fund the construction being recourse only to that specific asset);
- Leasing assets from an entity that financed these assets with debt that is recourse to the individual asset rather than to all of the lessor entity's assets;
- The transfer of financial assets to an entity subject to debt that is recourse only to those financial assets rather than to all of the entity's assets;
- Variable lease payments, variable license-fee payments or other variable payments for the right to use an asset (for example, the payments change with fluctuations in market interest rates); and
- Ownership of an asset that an entity holds for tax purposes but does not record on its balance sheet.

Other

- Outsourcing arrangement – particularly when an entity's own employees/assets are sold prior to any entity and will continue to provide services to the seller;
- Sale of assets or operations where the seller retains some governance rights and/or an economic interest;
- The purchase of businesses or assets by a third party or a newly formed entity on behalf of another company (ie, an off-balance-sheet acquisition vehicle);
- Investments made through intermediaries in entities that generate losses from a financial-reporting perspective;
- Tolling arrangements with project finance companies;
- Transactions in which an entity's primary counterparties are financial institutions (for example, banks, private equity funds and insurance companies);
- Arrangements with an entity whose capital structure (often the equity) is partially owned (or provided) by a charitable trust;
- An unconsolidated entity whose name is included in the entity's name;
- When an entity provides administrative or other services on behalf of an unconsolidated entity or services its assets; and
- When an unconsolidated entity provides financing or other services exclusively to an entity, its vendors or customers.

Summary of IFRS and US GAAP requirements

IFRS	US GAAP
Literature	
IAS 27, 'Consolidated and separate financial statements', requires the consolidation of all subsidiaries (entities controlled by the reporting entity). SIC-12, 'Consolidation – Special Purpose Entities', provides further guidance in determining control in situations in which an entity has been created to accomplish a narrow and well-defined objective.	FIN 46R, 'Consolidation of Variable Interest Entities'. ARB 51, 'Consolidated Financial Statements'. FAS 94,' Consolidation of All Majority-Owned Subsidiaries and Amendment of ARB 51 with related amendments of APB 18 and ARB No. 43, Chapter 12'.
Scope	
SIC-12 does not apply to: – post-employment benefit plans; and – equity compensation plans (subject to change)	FIN 46R does not apply to: – not-for-profit organisations, with certain exceptions; – employee benefit plans; – registered investment companies; – separate life insurance accounts; – qualifying SPEs (QSPEs); – insignificant variable interests in a business (this does not mean the business is not a VIE); and – most entities that are not legal structures.
Indicators	
An SPE is not defined in SIC-12. It is described as an entity that has been created to accomplish a narrow and well-defined objective. SIC-12 lists the common features that identify an SPE: – it has 'auto-pilot' arrangements that restrict the decision-making capacity of the governing board or management; and – the creator or sponsor may transfer assets to the SPE, often as part of a derecognition transaction involving financial assets. Other indicators of an SPE might be: – it uses professional directors, trustees or partners; – it has 'thin' capitalisation, where the proportion of equity is too small to support the SPE's overall activities; – there is no apparent profit-making motive, such that the SPE is engineered to pay out all profits in the form of interest or fees; – it is domiciled in 'offshore' capital havens; – it has a specified life; and – it exists for financial engineering purposes.	A QSPE is a trust of another legal vehicle that: – is demonstrably distinct from the transferor; – has restrictions on its permitted activities; – has restrictions on the assets and derivatives that it may hold; – has restrictions on the way it can sell or otherwise dispose of non-cash financial assets; – has restrictions on agreements entered into between it and the transferor; and – has restrictions on the ability to reissue beneficial interests. A variable interest entity (VIE) is an entity that does not qualify for a scope exception under FIN 46R. VIEs can take different forms, and if any one of the following conditions is present, the entity is a VIE: – an insufficient amount of equity to finance the entity's activities without additional subordinated financial support from any party, including equity investors; – equity investors, as a group, do not have the rights to make decisions that significantly affect the success of the entity; – substantially all the entity's activities involve or are conducted on behalf of the investor and its related parties that has disproportionately fewer voting rights than its proportionate share of expected losses or expected residual returns; – equity investors, as a group, do not absorb the entity's expected losses, or a guaranteed a return; – equity investors, as a group, do not have the rights to the entity's expected residual returns, or their return is capped.

IFRS	US GAAP
Consolidation model	
Control model – Applicable to all entities; – Consolidate where an entity controls another by way of voting rights or a control contract; – Consolidate where the substance of relationship indicates control; and – The ability to govern decision-making alone is not sufficient to establish control. The ability to govern decision-making must be accompanied by the power to obtain benefits from the entity's activities.	*Voting control concept* – Applicable for entities that are not VIEs. *Variable interest concept* – Applicable for VIEs. – Consolidate if the entity, or the entity and its related parties (including de facto agents), have a variable interest (or a combination of variable interests) that will absorb a majority of the entity's expected losses, receive a majority of the entity's expected residual returns, or both. FIN 46R provides guidance to determine which party in a related-party group should consolidate. If one entity will absorb a majority of a variable interest entity's expected losses and another entity will receive a majority of that entity's expected residual returns, the entity absorbing a majority of the losses should consolidate the VIE.
Analysis	
SIC-12 lists circumstances that may result in the consolidation of an SPE: – Activities: the activities of the SPE are being conducted on behalf of the reporting entity; – Decision-making: the entity has the decision-making powers to obtain the majority of the benefits of the SPE's activities, or the entity has delegated these decision-making powers by setting up an 'auto-pilot' mechanism; – Benefits: the entity has rights to obtain a majority of the benefits of the SPE's activities; – Risks: the entity is exposed to risks incidental to the activities of the SPE or retains the majority of the residual or ownership risks related to the SPE or its assets.	Consolidate if the enterprise has a variable interest (or a combination of variable interests) that will absorb a majority of the entity's expected losses, receive a majority of the entity's expected residual returns or both. A VIE's expected losses and expected residual returns are measured as the negative and positive expected variability in the entity's net income or loss exclusive of variable interests. Expected losses and residual returns are not the same as GAAP losses and returns; they are deviations from the entity's expected outcome.
Disclosure requirements	
IAS 27 requires specific disclosures for subsidiaries that are consolidated for reasons other than majority ownership of equity interests. This includes the name and details of significant subsidiaries and a description of the relationship between the parent and subsidiary that gives rise to control and consolidation.	The primary beneficiary should disclose: – the VIE's nature, purpose, size and activities; – the carrying amount and classification of consolidated assets that are collateral for the VIE's obligations; and – lack of recourse if the VIE's creditors have no recourse to the general credit of the primary beneficiary. An enterprise that holds a significant variable interest but is not the primary beneficiary should disclose: – the nature of its involvement with the VIE and when that involvement began; – the nature, purpose, size and activities of the VIE; and – the entity's maximum exposure to loss as a result of its involvement with the VIE.

IFRS	US GAAP
Equity	
'Thin capitalisation' in practice is considered to be one of the criteria of an SPE, but it is not a necessary feature.	FIN 46R requires the equity investment at risk to be sufficient to permit the entity to carry on its activities without additional financial support from other parties in order for it not to be a VIE. It is not a necessary feature that an entity has to be thinly capitalised for it to be a VIE. An equity investment, for the purposes of this test, is an interest that is required to be reported as equity in that entity's financial statements. FIN 46R also includes additional considerations for identifying those equity investments that are considered to be at risk. FIN 46R focuses on the sufficiency of the equity investment at risk and the rights and obligations provided to the holders of that equity investment at risk.
Silos	
No explicit guidance provided in SIC-12. However, the interpretation is applicable to both incorporated and unincorporated entities. 'Protected cell' structures within larger legal entities would qualify for consolidation if the silos are controlled by the reporting entity.	FIN 46R requires an enterprise with a variable interest in a specified asset or assets of a VIE to treat a portion of the entity as a separate VIE (ie, 'silo') if the specified assets are essentially the only source of payment for specified liabilities or other interests. The requirement to evaluate a variable interest in specified assets would apply only if the fair value of the specified asset or assets is more than half of the total fair value of the entity's assets. If one entity is required to consolidate a discrete portion of a VIE, other variable interest holders should not consider that portion to be part of the larger VIE.
Related-party provisions	
SIC-12 applies to the reporting-entity level. Analysis of the controlling entity would include the group company and its subsidiaries. SIC-12 and IAS 27 do not state whether other related parties need to be included in the analysis. However, 'in substance' control may require analysis of specific arrangements made involving the reporting entity.	An enterprise with a variable interest should consider variable interests held by its related parties and de facto agents for determining if it is the primary beneficiary. FIN 46R expands the definition of related parties to include de facto agents. Related parties are also considered when evaluating whether an entity is a VIE because of non-substantive voting rights.
Decision maker and performance fees	
SIC-12 guidance on decision-making powers indicates that a subsidiary relationship may exist where the decision-making power results in the entity being able to obtain the majority of the benefits of the SPE's activities. The existence of arrangements where the decision-maker receives the majority of the SPE's benefits but is not exposed to a majority of the expected losses may indicate that the decision-maker is the controlling party.	Management contracts, other service contracts and other contracts that give a party the ability to make decisions that have a significant impact on the success of the entity may be considered a variable interest in the entity. Beyond decision-maker contracts, service arrangements in which fees earned are based on an entity's performance measures must be evaluated to determine that the arrangement is a variable interest in the entity.
Non-financial benefits	
The entity that receives a majority of non-financial benefits may be required to consolidate the SPE where the financial risks and rewards are shared equally between entities.	FIN 46R does not address the distribution of non-financial benefits; analysis that is required to be performed under FIN 46R does not capture such benefits.

IFRS	US GAAP
Reconsideration event	
SIC-12 does not have comparable guidance in respect of events that would trigger a required reconsideration of the status of the SPE. SIC-12 analysis should be re-performed when circumstances change.	The initial determination of whether an entity is a VIE must be reconsidered when any one of the following reconsideration events occur: • the entity's governing documents or contractual arrangements are changed in a manner that changes the characteristics or adequacy of the entity's equity investment at risk; • the equity investment or some part thereof is returned to the equity investors, and other interests become exposed to expected losses of the entity; • the entity undertakes additional activities or acquires additional assets, beyond those that were anticipated at the later of the inception of the entity or the latest reconsideration event, that increase the entity's expected losses; and • the entity receives an additional equity investment that is at risk, or the entity curtails or modifies its activities in a way that decreases its expected losses. The initial determination of whether an enterprise is the primary beneficiary of a VIE must be reconsidered when any of the following reconsideration events occurs: • the VIE's governing documents or contractual arrangements are changed in a manner that reallocates between the existing primary beneficiary and other unrelated parties the obligation to absorb the expected losses or the right to receive the expected residual returns of the VIE; • the primary beneficiary also shall reconsider its initial decision to consolidate a VIE if the primary beneficiary sells or otherwise disposes of all or part of its variable interests to unrelated parties; • the VIE issues new variable interests to parties other than the primary beneficiary or the primary beneficiary's related parties; and • a holder of a variable interest that is not the primary beneficiary acquires additional variable interests in the VIE.

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