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International Accounting Standards Board

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

INFORMATION FOR OBSERVERS

Board Meeting:	**November 2008, London**
Project:	**Consolidation**
Subject:	**Consolidation: Sweep Issues—Assessing control of a structured entity (Agenda paper 16C)**

Introduction and staff recommendation

1 The staff draft of the consolidation exposure draft discussed by the Board at its October meeting included a rebuttable presumption as follows:

> This [draft] IFRS presumes that if the reporting entity obtains returns that are substantially more than those received by any other party from its interest in a structured entity, then the reporting entity has power sufficient to control that structured entity. This presumption is on the basis that power and returns are related.
>
> A reporting entity that obtains substantially more returns than any other party from its interest in a structured entity must demonstrate that it does not control the structured entity.

2 We recommend:

a removing the rebuttable presumption relating to the assessment of control of a structured entity, and

b replacing it with wording that requires the assessment of both power and returns when assessing control of a structured entity.

Staff analysis

3 The proposed definition of control of an entity requires the consideration of both power and returns when assessing control of an entity. We think that power and returns are related and must be considered together.

4 The statement we used in the draft ED, that the party that has the most to gain or lose from an entity's activities is the party most likely to have the power to direct that entity's activities, reflects rational economic behaviour. A party that is exposed to a large part of the variability of an entity is unlikely to want to give up the ability to direct the activities that affect the variability to which the party is exposed. Similarly, the party that has power to direct the activities of an entity is assumed to use that power to generate returns for its own benefit.

5 Power can be more difficult to assess when the activities of an entity are not directed by strategic operating and financing policies—such as, when an entity's activities are restricted by allocating responsibilities to parties by way of contractual arrangement, including predetermining how a party must respond to anticipated circumstances arising in the entity. The staff draft describes entities, whose activities are directed in such a manner, as *structured entities*. The rebuttable presumption regarding control of a structured entity (as set out in paragraph 1 of this paper) removes the requirement to assess power. Although it is *rebuttable*, an entity could easily engineer a situation in which it passes a substantial portion of the returns of a structured entity to another party and avoid consolidation, even if it controls the entity.

6 The rebuttable presumption was included in previous drafts of the ED to ensure that a reporting entity could not avoid consolidation by arguing that it does not have power to direct a structured entity's activities. We are concerned that the rebuttable presumption fails to meet this objective. Further, we think that the rebuttable presumption undermines the principles underlying the consolidation ED and could have the opposite of its intended effect by creating structuring opportunities.

Consequences of including a rebuttable presumption relating to structured entities

Undermining the control principle

7 The principle underlying the notion of control of an entity is reflected in the definition:

> A reporting entity controls another entity when the reporting entity has the power to direct the activities of that other entity to generate returns for the reporting entity.[1]

8 The definition is built on the principle that a reporting entity requires *both* power and returns to have control of an entity; one without the other is simply not control.

9 The rebuttable presumption relating to structured entities effectively disregards power. A reporting entity can ignore power when assessing control of a structured entity if the reporting entity obtains substantially more returns than any other party. Similarly, a reporting entity can ignore the power that it has if another party obtains substantially more returns than any other party.

Proposed amendments to FIN 46(R)

10 The FASB published an exposure draft of amendments to FIN 46(R) *Consolidation of Variable Interest Entities* in September 2008. The main change proposed in the exposure draft relating to control is that the assessment of control is no longer solely on the basis of a quantitative analysis of the majority of expected returns. Rather, the exposure draft proposes that control is assessed qualitatively by determining the party that:

a has <u>power</u> to direct matters that most significantly impact the activities of a variable interest entity, *and*

b has the right to receive <u>returns</u> from the variable interest entity that could potentially be significant.[2]

If the qualitative assessment is inconclusive, a reporting entity performs a quantitative analysis of expected returns.

11 That proposed change reflects problems that the FASB and constituents identified when applying FIN 46(R)—the main problems arising because the determination of control ignores power, and is assessed solely on the basis of a calculation of expected returns. The proposed change also indicates that the FASB think that an assessment

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[1] We have modified the control definition based on discussions at the October Board meeting. The definition now refers to returns, rather than benefits.

[2] The exposure draft of amendments to FIN 46(R) uses the words 'benefits' and 'losses' to describe returns.

of control of a variable interest entity can be made using power and returns. It is not necessary to create a test that ignores power.

12 At the IASB meeting in October, the FASB staff indicated that:

a they do not envisage a situation in which the qualitative assessment would be inconclusive; and

b they believe that, if the FASB had balloted on the exposure draft one month later, it would have removed the quantitative assessment.

13 The FASB held roundtables on 6 November to discuss the proposed amendments to FIN 46(R). All but one of the participants at those roundtables expressed a view that the quantitative test should be removed. The only exception was [a participant] who indicated that a quantitative safeguard is appropriate but not calculated on the basis of expected losses. Participants at the roundtables described the expected loss model in FIN 46(R) as a discredited model.

14 It would appear strange that, just at the time that the FASB is moving away from a quantitative calculation of expected returns, we would move in the opposite direction and include such an approach in our exposure draft.

FIN 46(R)-type analysis without guidance

15 When discussing this project, the Board has been clear that it does not want to publish a document with bright line requirements, similar to those included in FIN 46(R), ie requirements that mean that a reporting entity must consolidate another entity when it receives the majority of the expected returns of that entity, regardless of whether it has power to direct the activities of that entity. FIN 46(R) has proven to create structuring opportunities, such as the creation of expected loss notes, which can result in an entity consolidating when it does not control an entity, and not consolidating when it does.

16 Some might argue that the inclusion of a rebuttable presumption, as set out in paragraph 1, is different from the FIN 46(R) requirements—the presumption is rebuttable and therefore, as long as the entity can demonstrate that it does not control the structured entity, it will rightly not consolidate; the consolidation ED does not

include detailed guidance on how returns should be calculated; the presumption does not draw a line at 50 per cent.

17 We agree with those differences identified, and it is for those reasons that we believe that the rebuttable presumption would not be better than FIN 46(R)'s requirements:

a The presumption is rebuttable. Therefore, if an entity (that has substantially more returns than any other party) does not control a structured entity, it should be able to demonstrate that lack of control assuming that it wishes not to consolidate. However, the presumption would not result in the right answer if such an entity wishes to consolidate a structured entity without control (for example, if the structured entity is highly profitable) or if it is unable to demonstrate that it does not control the structured entity.

b The rebuttable presumption makes the calculation of returns the pressure point in terms of consolidation (ie the consolidation decision is based on returns alone), as do the requirements in FIN 46(R). However, our exposure draft would not include detailed guidance on the calculation of those returns; our draft defines returns broadly. FIN 46(R) includes such guidance on the calculation of returns, which provides a means for consistency but also makes the 'bright line' even brighter in terms of creating structuring opportunities.

c The consolidation exposure draft would not draw a line at 50 per cent because we think that a reporting entity can control a structured entity with rights to less than 50 per cent of the returns of the structured entity. That would mean that a reporting entity could avoid consolidation by transferring less than a majority of the returns of an entity to a third party, although the reporting entity itself would then have to retain substantially less returns than that third party to avoid consolidation.

Staff recommendation

18 We recommend removing the rebuttable presumption relating to the assessment of control of structured entities because we think that:

- a structured entities should not be treated differently from other entities when applying the definition of control of an entity;
- b the rebuttable presumption is not needed to assess control of such entities; and
- c a quantitative analysis would inevitably create structuring opportunities and problems in terms of calculating returns. We should learn from the FASB's experience, rather than ignoring it.

19 Some think that power should be ignored when assessing control of a structured entity because the activities of such entities are often predetermined, which can make power more difficult to assess. Their view is that power cannot be assessed if there is no demonstration of power on an ongoing basis because ongoing decision-making is not required when the activities are predetermined.

20 We do not agree with that assessment. We are of the view that a reporting entity should be able to reach a decision as to whether or not it controls a structured entity by applying the definition of control of an entity, ie by assessing both power <u>and</u> returns. A reporting entity can exert power over the activities of a structured entity:

- a through its involvement in establishing the activities of the entity. The staff draft of the consolidation ED states specifically that predetermination of an entity's activities does not preclude that entity from being controlled on the basis that control is not current.
- b through its involvement in the ongoing decision-making that affects the activities of the entity. We understand that a structured entity is rarely, if ever, set up with activities that are entirely predetermined. There are often ways of exerting power over the activities by having, for example, the ability to change the restrictions under which the structured entity operates, or having other related arrangements with the structured entity that ensures power over the activities or assets of the entity. Therefore, we think that there will always be ways of determining power to direct the activities of a structured entity, if such power resides with one entity.