IASB Meeting | Agenda reference **10A**

Staff Paper | Date **July 2009**

Project **Consolidation**

Topic **The control model**

Introduction

1. The purpose of this paper is to discuss control as the basis for consolidation, taking into account comments received from respondents to ED10 *Consolidated Financial Statements*.

2. We are asking the Board to make decisions about control as the basis for consolidation of all entities, and the extent to which risks and rewards (including reputational risk) are considered when assessing control of an entity.

3. The appendix to this paper includes two examples that demonstrate the application of the control model and result in outcomes that are different from the application of the current requirements in IFRS.

Staff recommendations

4. We recommend that:

   (a) control should be the only basis of consolidation [paragraphs 17-37].

   (b) exposure to variability of returns (ie risks and rewards) should be an indicator of control [paragraphs 22-25].

   (c) when assessing control, reputational risk should be a factor to consider in a similar manner to other non-contractual business risks [paragraphs 38-42].

This paper has been prepared by the technical staff of the IASCF for discussion at a public meeting of the IASB.

The views expressed in this paper are those of the staff preparing the paper. They do not purport to represent the views of any individual members of the IASB.

Comments made in relation to the application of an IFRS do not purport to be acceptable or unacceptable application of that IFRS—only the IFRIC or the IASB can make such a determination.

The tentative decisions made by the IASB at its public meetings are reported in IASB *Update*. Official pronouncements of the IASB, including Discussion Papers, Exposure Drafts, IFRSs and Interpretations are published only after it has completed its full due process, including appropriate public consultation and formal voting procedures.

The control model

5. ED10 proposes that control should be the only basis for consolidation, in line with the Board's preliminary views on the conceptual framework project. ED10 states as its core principle that 'a reporting entity presents financial statements that consolidate its assets, liabilities, equity, income, expenses and cash flows with those of the entities that it controls'.

6. Paragraph 4 of ED10 defines control of an entity as follows:

> 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.

Comments from respondents on the control model

Control versus risks and rewards

7. The vast majority of respondents supported control as the basis for consolidation. Some suggested, however, that the Board should address *why* consolidated financial statements are prepared in determining the basis for consolidation.

8. Although expressing support for a control model, some respondents appeared to support the premise that, at least for some entities (structured or special purpose entities (SPEs)), consolidated financial statements should present the assets and liabilities that underlie a reporting entity's exposure to risks and rewards, irrespective of whether the reporting entity has the power to direct those assets and liabilities.

9. The respondents referred to in paragraph 8 believe that the control definition that requires 'power to direct the activities of an entity' does not work well for entities that do not require substantive ongoing decision-making. They argue that such entities do not have substantive activities to direct. Therefore, it is difficult to identify one party that has power to direct the activities—power is often not evident.

10. These respondents suggest that 'in particular where entities do not require substantive ongoing decision making, then exposure to risks and benefits will typically be the most reliable indicator of ability to control (or who has the greatest interest in how the entity was initially set-up to run).' [CL122] They suggest that exposure to risks and rewards be used as a proxy for control when power is not evident. This suggestion is largely in line with how many apply SIC-12 *Consolidation—Special Purpose Entities* in practice.

11. Some respondents also expressed concern that applying the proposed control definition to all entities could lead to more structuring opportunities than SIC-12 'as meaningless control could be deliberately assigned to different parties to achieve a desired outcome.' [CL57] For such situations, these respondents agreed with the alternative views in ED10 that 'presumptively fewer entities will be consolidated because power is more easily disguised'. [paragraph AV8 of ED10]

Risks and rewards within the control model

12. Many respondents to ED10 believed that the exposure draft did not express clearly enough the importance of risks and rewards when assessing control. They suggested different ways to make the role of risks and rewards more explicit.

    (a) Some suggested clarifying that the returns element of the definition of control is about exposure to variability of returns; variability of returns would equate to risks and rewards.

    (b) Some suggested clarifying the link between the power element of the definition and risks and rewards, ie a reporting entity must have the ability to affect or influence its exposure to risks and rewards in order to control an entity.

    (c) Some suggested stating more explicitly that exposure to risks and rewards is an *indicator* of control.

    (d) Others favoured including a presumption of control on the basis of exposure to the majority of the risks and rewards, or another specified level of exposure, unless the reporting entity could demonstrate otherwise.

(e) Some agreed with the alternative view in ED10 that exposure to the majority of the risks and rewards, or another specified level of exposure, should be included as a ‘fall back’ test for control.

Feedback from the round table meetings held in June 2009

13. The participants at the round table meetings held in June 2009 were asked both about control (defined to require power and returns) as the basis for consolidation and how to integrate risks and rewards into the control model more explicitly.

14. Participants unanimously agreed that control should be the basis of consolidation, and that control should incorporate both the power to direct and the ability to benefit from that power. Participants also agreed that risks and rewards had an important role to play in such a control model. Participants agreed that risks and rewards alone should *not* lead to consolidation, and most agreed that power in the form of particular decision-making rights should be evident in order to constitute control.

15. Some, however, expressed the view that exposure to significant risks and rewards, together with a consideration of the purpose and design of an entity, should be sufficient to meet the definition of control for some entities (those in which there is little or no substantive ongoing decision-making).

16. Participants supported the inclusion of exposure to risks and rewards as an indicator of control. Some thought that it was useful to clarify the link between risks and rewards and the elements of the control definition. There was some support for a presumption of control on the basis of exposure to a majority of the risks and rewards. None of the participants, however, supported including a risks and rewards ‘fall back’ test.

Staff analysis regarding the control model

17. In the Reporting Entity phase (phase D) of the conceptual framework project, the Board has confirmed its view that consolidated financial statements, in which entities are consolidated on the basis of control, are most likely to provide

decision-useful information to the greatest number of capital providers. When one entity controls another entity, the cash flows and other benefits flowing from the parent to its capital providers often depend significantly on the cash flows and other benefits obtained from its subsidiaries. These cash flows and other benefits depend in turn on the subsidiary's activities and the parent's actions in directing those subsidiaries. Accordingly, the Board concluded that if a parent controls one or more entities, it would be useful to present the assets, liabilities, and activities of the parent and of the entities that it controls (ie its subsidiaries) as a single unit.

18. The definition of control in ED10 was developed on the premise that consolidated financial statements should present the assets and liabilities that a reporting entity has the power to direct, and where it can benefit from that power. Returns without any means of influencing those returns, or power that cannot be used for a reporting entity's own benefit, do not constitute control.

19. The control definition in ED10 implies that power must be evident—ie a reporting entity controls another entity if it has the power to direct the activities of that other entity to generate returns for itself. That power must be evident through the existence of decision-making rights (eg substantive voting rights or rights within other contractual arrangements).

20. The control definition requires that a reporting entity has rights or exposure to variable returns. The reporting entity's power must also give it the ability to manage or influence the variability in its returns, ie a reporting entity can only benefit from its power if that power affects the returns that the reporting entity receives from its involvement with the entity.

21. The staff believe that control of an entity should incorporate a power element, a returns element and a link between those elements. We think that the definition of control of an entity in ED10 captures these elements.

22. In isolation, exposure to risks and rewards, or variability of returns, is an indicator of control but not more than that. We propose including a statement in the final standard that exposure to risks and rewards (or variability of returns) is an indicator of control and an important factor to consider when assessing

control. Understanding how risks and rewards are shared among the parties involved with an entity can be the most important factor (and the best starting point) in identifying who has particular rights and who, if anyone, controls the entity.

23. The more a reporting entity is exposed to risks and rewards from its involvement with an entity, the greater the incentive for the reporting entity to obtain rights sufficient to give it the power to direct the activities of the entity. This would enable it to manage that exposure. However, power and returns are not necessarily perfectly correlated. To say that exposure to risks and rewards is anything more than an indicator would appear to be inconsistent with a control model that requires both power and returns. It would also be inconsistent with our agent/principal concept (ie there are situations when power and returns are not correlated, in that a party can have decision-making authority delegated to it that is used primarily for another party or parties. In addition, investors can be entitled to all of the returns of an entity without having the power to direct the activities of that entity).

24. There are a number of other reasons that we object to exposure to risks and rewards being a presumption of, or proxy for, control:

    (a) One of the main objectives of the consolidation project is to develop a consistent approach to determining when one entity consolidates another, irrespective of the nature of the entity. Those respondents who suggested including a particular level of exposure to risks and rewards as a presumption of control or a 'fall back' test did so in the context of structured entities or SPEs. Assuming that the criterion would apply only to SPEs, this would appear to go against the objective of developing one consistent model for consolidation that applies to all entities.

    (b) Having a different consolidation model for some entities necessitates defining precisely those entities to which the different model applies. We understand that there are difficulties today in identifying which entities are SPEs to which SIC-12 applies. A number of respondents to

ED10 noted that 'any attempt to split the continuum of entity types into distinct populations will lead to variation in practice for entities not clearly in either subset'. For that reason, we intend to remove from ED10 the distinction between structured entities and others when assessing control.

(c) Including exposure to risks and rewards as a presumption of, or proxy for, control in particular situations puts more pressure on the measurement of that exposure. This would result in a greater need for guidance on how to measure the exposure to risks and rewards. This might lead to re-creating the old US GAAP FIN 46(R) approach, with detailed guidance on measuring the majority of risks and rewards, which has proven not to work.[1]

(d) The FASB published amendments to FIN 46(R) *Consolidation of Variable Interest Entities* in June 2009. Those amendments require the consolidation of variable interest entities on the basis of a control model that requires both power and returns—the FASB has included exposure to risks and rewards as an indicator of control.[2] In light of our

[1] In the basis for conclusions to its amendments to FIN 46(R), the FASB noted the following regarding the old FIN 46(R) quantitative risk and rewards basis for consolidation: 'some constituents..stated that the quantitative analysis previously required by Interpretation 46(R) was difficult to understand, apply and audit. Those constituents maintained that the calculation often required a high degree of mathematical expertise and that entities often performed a significant number of calculations for a single variable interest entity, particularly structured financial vehicles, to determine the primary beneficiary. Constituents also noted that, in practice, several different approaches and methodologies were used to apply the expected loss calculations. This diversity led to inconsistent application and results for variable interest entities with similar characteristics and traits…Certain constituents were troubled that the quantitative analysis often seemed to identify a different primary beneficiary of a variable interest entity from that identified by applying a qualitative analysis to the same entity…For example, to avoid consolidation of certain structured finance vehicles that are variable interest entities, sponsors of these vehicles sold interests to third parties that absorbed the majority of the expected losses (expected loss note holders). An expected loss note holder received a substantial return on its investment but typically had very limited power, if any, to direct the activities that most significantly impacted the economic performance of the variable interest entity. Additionally, the maximum exposure to economic losses that was absorbed by the expected loss note holders was typically limited to their investment in the notes, while other variable interest holders were often at risk of incurring significantly larger economic losses (either explicitly or implicitly)..'

[2] In its amendments to FIN 46(R), the FASB has included the following wording in this respect: Paragraph 14G.: 'Consideration should be given to situations in which an enterprise's economic interest in a variable interest entity, including its obligation to absorb losses or its right to receive benefits, is disproportionately greater than its stated power to direct the activities of a variable interest entity that

Memorandum of Understanding commitment to work towards developing a common standard, it would appear strange that we would put more emphasis on a risks and rewards model at the very time that the FASB has moved away from such a model.

Staff recommendation regarding the control model

25. We recommend that:

    (a) control, defined to require a reporting entity to have power and the ability to benefit from that power, be retained as the only basis for consolidation.

    (b) the final standard should include exposure to risks and rewards as an indicator of control such that, the greater a reporting entity's exposure to risks and rewards from its involvement with an entity, the greater the incentive for the reporting entity to obtain rights sufficient to give it the power to direct the activities of that entity.

The implications of the control model for all entities

26. As noted in paragraph 6 of this paper, the proposed control definition requires a reporting entity to have the power to direct the activities of another entity, and the ability to benefit from that power. Both power and returns must be evident.

27. The proposed control definition is similar to the control definition in IAS 27 and, therefore, does not require a significant change in how a reporting entity assesses whether it controls entities other than SPEs (referred to in this paper as traditional operating entities).[3]

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most significantly impact the entity's economic performance. Although this factor is not intended to be determinative in identifying a primary beneficiary, the level of an enterprise's economic interest may be indicative of the amount of power that enterprise holds.'

[3] We note that ED10 does propose changes to some aspects of assessing control of traditional operating entities, eg power with less than a majority of voting rights and the holding of options. Those aspects are discussed in more detail in Agenda Papers 10B and 10C.

28. The proposed control definition does, however, require a change in how a reporting entity assesses whether it controls some SPEs. SIC-12, being an interpretation of IAS 27, states that an SPE is consolidated when the substance of the relationship between a reporting entity and the SPE indicates that the reporting entity controls the SPE. However, SIC-12 includes four indicators of control, two of which refer to the majority of risks and rewards, and two of which focus on the purpose of the SPE and the decision-making powers of whoever benefits from the activities of the SPE. Because many of the decision-making powers can be predetermined in an SPE, it appears that SIC-12 is applied in practice with a strong emphasis on the majority of risks and rewards.

29. Our proposal is that exposure to significant risks and rewards would be an indicator of control but not more than that. The proposals require an assessment of power as well as returns for all entities. Therefore:

    (a) a reporting entity can control an entity (including an SPE) even if it is exposed to less than a majority of the variability in returns (ie the risks and rewards) of the entity.

    (b) if a reporting entity does not have power (ie if it does not have any visible means of directing the activities that affect the returns of the entity), it does not control that entity even if it is exposed to a majority of the risks and rewards of the entity

30. The appendix to this paper includes two examples to illustrate the application of the proposed control model.

Structuring opportunities

31. Some have suggested that using a control model is likely to create structuring opportunities; example 2 in the appendix may reinforce that view. We accept that using a control model is likely to create new structuring opportunities but it will also remove others. In proposing a control model that applies to all entities, the main structuring opportunities removed relate to: (a) distinguishing between an SPE and all other entities, in order to apply different consolidation criteria in

SIC-12 versus IAS 27, and (b) selling portions of expected losses or benefits to third parties in order to avoid consolidation.

32. In contrast, the main structuring opportunity created is the possibility that a reporting entity could retain significant risks and rewards, or indeed all of the risks and rewards, from its involvement with another entity and could choose to 'give up' power in order to avoid consolidation. *However, if we believe in control as the only basis for consolidation, then we must accept that this can and probably will happen*. If a reporting entity chooses to 'give up' power, it does not control the other entity and, in our view, giving up any means of influencing or managing exposure to risks and rewards is a sufficiently big price to pay to avoid consolidation. The pricing of a transaction in which a reporting entity has power is likely to be very different from one in which it does not have power, because having power puts a reporting entity in a very different position.

33. We do not accept that an entity could create artificial and hollow powers to engineer control, because artificial power would not meet the definition of power. Our assessment is that it is easier to engineer a particular accounting outcome with a quantitative risks and rewards test than with a qualitative power assessment.

Autopilot

34. Others believe that a control model permits entities on 'autopilot' not to be consolidated because an entity on 'autopilot' does not have any activities to direct. This is also true—there is no ability to exercise power and consequently no basis for control. However, we must be clear about the meaning of 'autopilot'. 'Autopilot' means that no party has any decision-making rights over the entity either now or at any point in the future. At inception, the activities and policies of the entity are determined and 'locked' so that no party can 'unlock', change or terminate the activities, or otherwise influence the returns of the entity. The entity might simply be liquidated or dissolved on a specified date or on the occurrence of a specified event. Any reporting entity that has exposure to risks and rewards from its involvement with such an 'autopilot'

entity would have no means of influencing that exposure and, accordingly, would not control the entity.

35. It is important to note, however, that the concept of an 'autopilot' or 'brain-dead' entity existed in US GAAP—a qualifying SPE or 'Q'—until June 2009 in the context of securitisation entities. In our view, the concept of a 'Q' was not wrong—ie if an entity is on autopilot, it is difficult to see how any party can control that entity. The reason that the FASB removed the 'Q' from its literature was because such a 'brain-dead' securitisation entity had proved not to exist in practice. Although many respondents to ED10 mention 'autopilots' and the difficulty in applying a control model to 'autopilots', there are almost no examples of such entities existing in practice. We have seen only one type of entity that is arguably an 'autopilot'. Interestingly, that 'autopilot' entity is not consolidated by any party in accordance with SIC-12.

Summary

36. Using control (as defined) as the only basis for consolidation results in consolidating those assets and liabilities (and only those assets and liabilities) that a reporting entity has the power to direct, and where it can benefit from that power. Control is expected to result in consolidating assets and liabilities that underlie a large part, and in many cases all, of a reporting entity's exposure to risks and rewards. We assume that a reporting entity will generally want to control an entity for which it has significant exposure to risks and rewards.

37. If a reporting entity has economic exposure but does not have the power to direct, the control model does not combine assets and liabilities of another entity together with those of the reporting entity. It therefore does not imply that the reporting entity controls those assets and liabilities, and thus has the ability to manage its exposure to risks and rewards, when it does not. Information about such exposure to risks and rewards is fundamental and provides useful information to users of financial statements. We believe, however, that it is more appropriate to disclose information about such exposure in the notes to the financial statements.

Reputational risk

38. The standard and application guidance of ED10 did not make any explicit reference to reputational risk when assessing control. The basis for conclusions discussed why the Board thought that reputational risk was not an appropriate basis for consolidation.

39. Respondents to ED10 agreed, almost unanimously, that reputational risk is not an appropriate basis for consolidation. Some, however, were of the view that reputational risk is part of risks and rewards and is a factor to be considered when determining control of an entity.

40. In our view, reputational risk is part of a reporting entity's exposure to risks and rewards, albeit a risk that arises from non-contractual sources. It may, therefore, increase a reporting entity's incentive to obtain rights that give it the power to direct the activities of an entity. Nevertheless, reputational risk alone (just like other risks) cannot give a reporting entity power nor take power away from another party.

41. For that reason, we propose to explain, either in the standard or basis, that when assessing control, reputational risk is a factor to consider when considering all facts and circumstances in a similar manner to other non-contractual business risks. However, reputational risk alone (and without the power to direct the activities) does not lead to control of an entity.

42. In its amendments to FIN 46(R), the FASB included the following words on reputational risk (referred to as implicit financial responsibility):

> '…For example, if a sponsor has an explicit or implicit financial responsibility to ensure that the entity operates as designed, the sponsor may have established arrangements that result in the sponsor being the enterprise with the power to direct the activities that most significantly impact the economic performance of the entity.'

Questions for the Board
(a) Does the Board agree that control, defined to require both power and returns, should be the only basis of consolidation? If not, what would you propose and why?

(b) Do you agree that the final standard should include exposure to risks and rewards as an indicator of control such that, the greater a reporting entity's exposure to risks and rewards from its involvement with an entity, the greater the incentive for the reporting entity to obtain rights sufficient to give it the power to direct the activities of the entity? If not, what would you propose and why?

(c) Do you agree that the final standard or basis should explain that reputational risk is a factor to consider when assessing control in a similar manner to other non-contractual business risks? If not, what would you propose and why?

Appendix—application of the control model

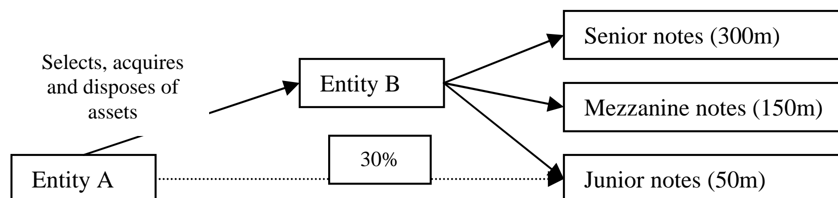
A1. The following examples illustrate two situations in which the proposed control model would result in consolidation outcomes that are different from those that result when applying the requirements of SIC-12.

Example 1—illustration of paragraph 29(a) of this paper

Fact pattern

A2. Entity A is the collateral manager of a CLO-type structure, Entity B. Entity A is responsible for the selection, acquisition and disposal of the assets of Entity B within portfolio guidelines, set by a rating agency and agreed to by the noteholders (investors). Entity A also takes decisions about hedging currency and interest rate risk. Entity A receives a market-based fixed fee (which is senior) and a market-based performance fee (which is paid after payments are made to the senior and mezzanine noteholders). Entity A also holds 30% of the junior notes issued by Entity B.

A3. The other notes are held by unrelated third party investors (the remaining 70% of the junior notes are held by various investors, none of which hold more than 50% of the junior notes). The noteholders can remove Entity A for cause. The noteholders do not have any other rights that give them the power to direct the activities of Entity B.



Consolidation analysis

A4. Entity A has the power to direct the activities of Entity B that affect the returns by having decision-making authority about the selection, acquisition and disposal of the assets of Entity B as well as hedging decisions. The noteholders' rights to remove Entity A for cause are protective rights. Entity A also has

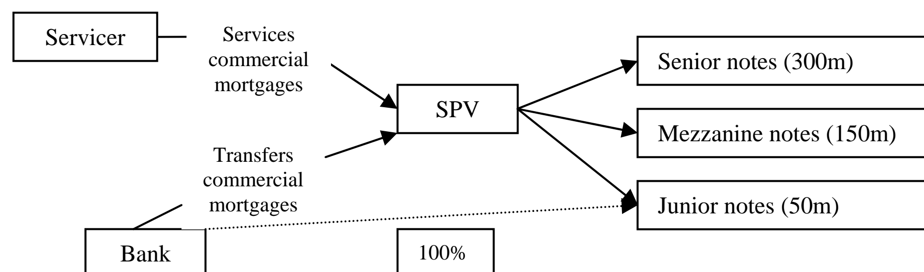
exposure to variability of returns because of its 30% holding of junior notes and its performance-related fee that ranks junior to the senior and mezzanine notes. Therefore we would conclude that Entity A controls and would consolidate Entity B.

A5. We understand that, according to SIC-12, Entity B would not be consolidated by any party. No one party is exposed to a majority of risks or benefits of the entity, and the entity was set up, arguably, for the benefit of both Entity A and all of the investors.

Example 2—illustration of paragraph 29(b) of this paper

Fact pattern

A6. Bank transfers commercial mortgage loans (with a value of CU500 million) into a securitisation vehicle, SPV, which issues senior, mezzanine and junior notes to investors. Bank holds all of the junior notes, which means that Bank is entitled to any excess spread, takes the prepayment risk and the junior notes are expected to cover the majority of the expected losses of SPV. Bank appoints a third party as the servicer of the loans. That third party servicer makes all decisions regarding the collection of the cash flows, including dealing with delinquent and defaulted loans. The activities of the SPV are restricted and cannot be changed, nor can the terms of the servicing agreement be changed without the consent of a majority of the noteholders. The servicer receives a market-based fee commensurate with the services performed (paid senior to any payments made to noteholders) and can be removed for cause by the noteholders. Bank cannot remove the servicer and has no influence over how delinquent or defaulted loans are directed.



Consolidation analysis (including derecognition)

A7. Bank is exposed to the majority of the variability of returns of SPV through its holding of junior notes. Bank, however, has no means of influencing that exposure and, as such, does not have the power to direct the activities of SPV. Although Bank was involved in setting up the SPV, after inception it has no decision-making authority that affects the returns of SPV. Bank is no different from any of the other investors in terms of its ability to control SPV. Similar to the other investors, it has exposure to variability of returns (albeit, greater exposure to variability) but cannot influence that variability. The noteholders' right to remove the servicer for cause is a protective right.

A8. The only activity that affects the returns of SPV is the servicing of the loans, which includes managing defaulting loans. Therefore, the servicer directs the activities of SPV that affect the returns, but is paid a market fee commensurate with the services performed. The servicer acts as an agent because it uses its decision-making powers to generate returns for the noteholders. Consequently, SPV would not be consolidated by any party.

A9. According to SIC-12, Bank would consolidate SPV because it is exposed to the majority of the risks and rewards of SPV. It could be argued that SPV was set up both for the benefit of Bank (for financing purposes) and for the investors (investment opportunity in specific loans with substantial credit enhancement). However, according to SIC-12, Bank would be deemed to control SPV because of its exposure to the majority of the risks and rewards.

A10. It is important to think about the consolidation outcome of this example together with derecognition. It is also important to note the disclosures that Bank would be required to make even if it derecognised the loans. Assuming that Bank receives CU450 million cash and the junior notes of SPV in return for the commercial loans transferred (and those assets were recognised and sold for CU500 million), Bank would recognise and disclose the following in its consolidated financial statements:

No consolidation and derecognition—proposed approach	**No consolidation and derecognition—alternative approach**
Statement of financial position: Assets 500m Financial liabilities—amounts owed to SPV (450m) Disclosure: - The nature of the commercial mortgage loans, and the risks to which the entity remains exposed. - The carrying amount of the loans and the associated liability (the obligation to pay SPV cash flows received from the loans). - Linked presentation showing the fair value of the loans, the fair value of the associated liability and the net position, together with information about restrictions on Bank's use of the loans and cash flows received from the loans.	Statement of financial position Assets—beneficial interest in SPV 50m Disclosure: - The fair value (and carrying amount, if different) of its investment in SPV, and sensitivity analysis to show the possible effect of risk variables on the fair value. - The fair value of the assets (commercial loans) of SPV. - The maximum exposure to loss. - Information about the ranking of exposure to losses, and any losses incurred from its involvement with SPV or difficulties encountered by SPV during the reporting period. - The gain or loss recognised at the date of transferring the loans to SPV.

A11. If the Board proceeds with the proposed approach to derecognition of financial assets set out in the March 2009 exposure draft, Bank would not derecognise the commercial mortgage loans, irrespective of whether it consolidated SPV. Therefore the consequence of not consolidating SPV is simply a change in the

description of the liability recognised by Bank—ie if Bank were to consolidate SPV, the only change to Bank's consolidated financial statements would be that it would derecognise an obligation to pay cash flows from the loans to SPV, and recognise an obligation to pay the noteholders of SPV.

A12. If the Board proceeds with the alternative approach to derecognition of financial assets set out in the March 2009 exposure draft, Bank would derecognise the commercial loans and recognise its investment in the SPV. That outcome is likely to make many feel uncomfortable about applying a control model (that requires both power and returns) when assessing whether to consolidate SPEs. However, we need to ask whether it is the right outcome. Should Bank consolidate SPV and, if so, is it because Bank controls SPV and the control definition is wrong, or is it because control is not the right basis for consolidation of SPEs?

A13. Does Bank control SPV? There is general agreement that control should combine both power over an entity and the ability to benefit from that power, and that it should be current power. In this example, Bank has rights to any profits and obligations for some of the potential losses of SPV. However, Bank would appear to have no power—no current means of directing or managing the assets and liabilities of SPV, or of controlling the servicer who can manage the assets, and thereby affecting the returns of SPV. Bank is in exactly the same position, in terms of power, as the other investors; Bank simply has greater exposure to risks and rewards. We do not think that Bank controls SPV.

A14. Some might argue that Bank set up SPV, and in restricting the activities and selecting the commercial mortgage loans transferred to SPV, it has already exercised the power to direct the activities that most significantly affect the returns of SPV. That argument would assume that, in this example, power comes solely from being involved in setting up SPV. However, the investors would have had to agree to those decisions to restrict the activities and select the transferred loans—Bank could not take those decisions alone without the consent and approval of the investors. If power comes solely from being involved in setting up SPV, it would appear that power is shared between Bank

and the investors—Bank and the investors have joint control.[4] We disagree with this answer.

A15. Further, what if the fact pattern was changed so that another party, Bank Z, was not involved in setting up SPV, but at a later date, acquired all of the notes of SPV and became the servicer of the loans? The argument would follow that Bank Z would not control SPV because it was not involved in restricting the activities or selecting the loans at inception of SPV. We also disagree with this answer. In this case, Bank Z would have all of the exposure to variability of returns of SPV and would have the ability to manage that exposure (and direct the activities that affect the returns of SPV) by servicing the loans. In our view, Bank Z would control SPV.

A16. Others might argue that Bank should consolidate SPV because of its exposure to risks and rewards. This view would suggest that control is not the right basis for consolidation for SPEs, and supporters of this view would presumably propose exposure to a particular level of risks and rewards as the basis for consolidation. For the reasons noted in paragraphs 22-24 of the paper, we disagree with this view.

[4] Joint control is defined in IAS 31 as 'the contractually agreed sharing of control over an economic activity, and exists only when the strategic financial and operating decisions relating to the activity require the unanimous consent of the parties sharing control.' In this example, if it is assumed that all of the strategic financial and operating decisions are made at inception, and Bank as well as the investors must agree to those decisions, our view is that Bank and the investors would jointly control SPV. Accordingly, no one would consolidate SPV.