Project **Consolidation**

Topic **The definition of control of an entity: activities and returns**

## Introduction

1. 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.

2. The purpose of this paper is to discuss two aspects of the definition of control of an entity—the returns element, and the link between the 'activities' of the entity and the returns element—taking into account comments received from respondents to ED10 *Consolidated Financial Statements*.

3. The power element of the definition of control of an entity, and application of the control definition, is discussed in Agenda Paper 10B and will be discussed further in papers to be brought to the Board in September 2009.

## Staff recommendations

4. We recommend that the final standard:

   (a) should clarify that 'the activities' in the control definition refers to those activities of an entity that affect the returns of the entity.

   (b) should define returns broadly, and add clarity about the returns that are relevant when assessing control as detailed in paragraph 21 of this paper.

## The activities of an entity

***Comments from respondents on 'the activities'***

5. Many respondents supported the control definition and believed that it could be applied to all entities. Most, however, requested additional guidance and clarity about the meaning of 'power', 'activities' and 'returns', and the interaction between those elements of the control definition.

6. One respondent noted that 'control is further explained in the structured entity section (paragraph 34) as having the power "to direct the activities that cause the returns to vary". We consider this definition to be stronger, and therefore preferable. Using it for all entities would preclude the need to include specific guidance for structured entities, with the consequent risk of creating two approaches to consolidation that may not always lead to the same answer'. [CL31] Another suggested that 'determining power to direct activities should require an assessment of whether powers can affect the variability of returns; the focus should be on strategic activities (which represent substantive powers)'. [CL15]

***Staff analysis regarding 'the activities'***

7. To meet the definition of control, a reporting entity must have power to direct the activities of another entity. Paragraph 22 of ED10 adds further guidance by saying that a reporting entity has the power to direct the activities of an entity if it can determine an entity's strategic operating and financing policies. Paragraph 35 of ED10 (within the structured entity section) refers to having power to direct 'the activities that cause the returns to vary'.

8. We believe that it would be helpful to clarify that, when assessing control of an entity, a reporting entity must have the power to direct the activities that cause the returns to vary. To put it in another way, it must have the power to direct the activities that affect the returns of the entity. This clarification helps to identify the activities over which a reporting entity must have the power to direct.

9. While comments suggest that such a clarification is needed more for structured entities, we believe that the wording works for all entities. In a traditional operating entity, it is generally the case that all of the activities affect the returns

of the entity—every sale, every purchase, capital expenditure, obtaining financing, etc. The *direction* of those activities that affect the returns is by means of strategic decision-making—determining the strategic operating and financing policies of the entity. It is important to identify who makes the strategic decisions about the ongoing activities, and who has the power to appoint the body or party that makes those decisions. For a structured entity, the same principles apply: a reporting entity must identify the activities that affect the returns of the entity (rather than the administrative activities that do not affect the returns) and must determine whether it has the power to direct those activities, or the power to appoint or remove the body or party that directs those activities.

10. We do not recommend changing the wording of the definition of control of an entity in this respect; ie we recommend retaining 'the power to direct the activities of another entity'. However, for the reasons noted in paragraph 9, we recommend clarifying that 'the activities' that are referred to in the definition are those that affect the returns of the entity.

11. The clarification provides a basis for a link between power and returns. To control another entity, a reporting entity must have the power and the ability to benefit from that power. A reporting entity can benefit from its power only if:

    (a) it has power to direct activities of an entity that affect the returns; and

    (b) it receives or is exposed to returns that vary with the activities of the entity (discussed in more detail in paragraphs 16-22 of this paper).

12. This recommendation aligns more closely the power element of the control definition with the definition of power in the amendments to US GAAP FIN 46(R) *Consolidation of Variable Interest Entities*, which states that 'an enterprise shall be deemed to have a controlling financial interest in a variable interest entity if it has both of the following characteristics: a. The power to direct the activities of a variable interest entity that most significantly impact the entity's economic performance b. [benefits/losses criterion not reproduced here]'.

**Question for the Board: the activities of an entity**

> Does the Board agree with the staff recommendation to clarity that 'the activities' in the control definition are those activities of an entity that affect the returns of the entity? If not, what do you propose and why?

## To generate returns for the reporting entity

### *Comments from respondents on returns*

13. Many respondents preferred the use of the term 'returns' in the definition of control, agreeing with the Board's view in the exposure draft that returns make it more explicit that a reporting entity may obtain positive or negative returns. Some preferred 'benefits', particularly respondents from territories in which IFRSs apply to not-for-profit entities. They believe that 'benefits' better reflect that service potential is a benefit that a controlling entity could receive. They argue that 'returns' implies a narrower definition.

14. Others suggested that the definition of returns should be narrower because of difficulties in measuring returns and difficulties in determining what weight should be attributed to, for example, synergistic returns versus traditional ownership benefits.

15. Respondents also questioned which returns were relevant when assessing control: those with the greatest variability or those that represent the greatest absolute amount? Returns in the future only or also those in the past? Could returns be wholly negative or wholly positive, or must they have the potential to be both? Do returns include those that are both monetary and non-monetary? Should a reporting entity receive or be exposed to *significant* returns in order to meet the definition of control? Are an agent's fees considered to be returns?

### *Staff analysis regarding returns*

16. ED10 defines returns from involvement with an entity as those 'that vary with the activities of an entity and can be positive or negative'. Paragraph 11 of

ED10 also provides a list of items that are considered to meet the definition of returns.[1]

17. We recommend retaining the word 'returns' in the definition of control rather than changing it to 'benefits'. While we acknowledge that 'returns' could be interpreted more narrowly than is intended, the broad description of items that are considered to be returns should ensure that the Board's intention to have a broad definition is clear.

18. We recommend that returns should be defined broadly in line with the definition and description of returns in paragraphs 10 and 11 of ED10. In practice, a reporting entity can benefit from controlling another entity in a variety of ways (not only, for example, by receiving dividends or changes in value of an investment). We do not think that the final standard should artificially restrict those ways of benefitting by narrowing the definition of returns.

19. If control or consolidation were to result from exposure to a particular threshold of returns, a broad definition of returns would be difficult to apply, because of difficulties in measuring the returns. However, the absence of a requirement to measure returns, or determine whether a reporting entity receives a majority of returns (or more returns than any other party), should eliminate this difficulty.

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[1] Paragraph 11 of ED10: A parent is exposed to the variability of returns and has the ability to affect the returns generated for it. Returns generated for a parent can include: (a) dividends, other forms of economic benefits distributed by a subsidiary, and changes in the value of the subsidiary attributable to the parent and any of the parent's other subsidiaries. (b) up-front fees, access to cash or fees for servicing a subsidiary's assets or liabilities, fees and exposure to loss from providing credit or liquidity support, residual interests in the subsidiary's assets and liabilities on liquidation of that subsidiary, tax benefits, and access to liquidity that a parent has from controlling a subsidiary. (c) returns that are not available to non-controlling interests. For example, a parent might use its own assets (including assets of its other subsidiaries) in combination with the assets of a subsidiary, such as combining functions to achieve economies of scale, sourcing scarce products, gaining access to proprietary knowledge or limiting some operations or assets, to enhance the value of the parent's other assets. (d) cost savings or a reduction in expenses.

20. Indeed, for this reason, we recommend deleting the sentence in paragraph 33 of ED10 that states 'a reporting entity is likely to have power to direct the activities of a structured entity if it is exposed to the variability of returns that are potentially significant to the structured entity and the reporting entity's exposure is more than that of any other party'. Deleting this sentence will make it easier to combine the guidance on assessing control into one section that applies to all entities. In addition, the sentence is unnecessary if we include exposure to variability of returns (risks and rewards) as an indicator of control for all entities as recommended in Agenda Paper 10A.

21. The staff recommend that the final standard should also clarify that:

    (a) to control another entity, a reporting entity must be exposed to variability of returns from its involvement with that entity. Without exposure to variability, a reporting entity is unable to benefit from any powers that it might have. For example, if a reporting entity provides services to an entity, and receives a fixed fee for those services but has no other involvement with the entity, that reporting entity cannot generate returns for itself from its involvement with the entity. The reporting entity receives the same fee irrespective of the performance of the entity, and regardless of the decision-making influence that the reporting entity has over the entity.

    (b) returns received in the past are not relevant when assessing control. Again, if a reporting entity is not exposed to variability of returns in the future, it is unable to benefit from any power that it might have. In that situation, a reporting entity uses any powers that it might have solely for the benefit of others, and therefore, would be acting as an agent. For example, suppose that a reporting entity received a large up-front fee for setting up an entity and marketing it to investors, but received no future returns (either potentially positive or negative) from any involvement with the entity. That reporting entity could no longer generate returns for itself, irrespective of any influence that it might have over the activities of the entity.

As a result, paragraphs 19 and 20 of ED10 should be amended accordingly, and 'upfront fees' should be removed from paragraph 11.

(c) returns have the potential to be wholly positive, wholly negative or either positive or negative. Therefore, a reporting entity controls another entity if it has the power to direct the activities of that entity, and any of the following three possibilities exist:

  (i) the reporting entity's future returns from its involvement could only ever be positive (eg a beneficial interest holder in an entity that has bought insurance to cover all potential losses).

  (ii) the reporting entity's future returns from its involvement could only ever be negative (eg a reporting entity that provides a guarantee of payments to beneficial interest holders when assets default).

  (iii) the reporting entity's future returns from its involvement could be either positive or negative (eg an equity shareholder in an entity).

22. We do not recommend including a significance or other threshold for returns at this stage of deliberations. This issue will be discussed in more detail in the context of agents at the Board meeting in September 2009. At that time, we will also discuss whether the definition of returns should include remuneration received by an agent.

*Requirements of FIN 46(R) regarding returns*

23. The amendments to FIN 46(R) state that:

> 'An enterprise [that holds a variable interest in the variable interest entity] shall be deemed to have a controlling financial interest in a variable interest entity if it has both of the following characteristics: a. [power criterion not reproduced here] b. The obligation to absorb losses of the entity that could potentially be significant to the variable interest entity or the right to receive benefits from the entity that could potentially be significant to the variable interest entity'.

24. Although the words are different, we do not believe that application of the benefits/losses criterion in FIN 46(R) for variable interest entities (combined with the requirement to have a variable interest) would produce different outcomes from our recommendations regarding returns. Both sets of words require a reporting entity to be exposed to variability of returns, and those returns could be wholly positive, wholly negative or either positive or negative.

25. Returns in FIN 46(R) are defined more narrowly than in our proposals: they are defined as losses of, or benefits from, a variable interest entity. The broader definition of returns in ED10, to encompass synergistic returns such as using assets in combination with other assets within a group to achieve economies of scale, is more relevant for traditional operating entities. Those types of returns are unlikely to exist in variable interest entities because the activities of a variable interest entity are generally not integrated with the activities of other group entities. Even if a reporting entity receives such returns from its involvement with a variable interest entity or indeed any entity, the reporting entity is unlikely to receive such returns without also receiving or being exposed to returns (benefits/losses) directly from the entity. Therefore, we do not anticipate differences in this respect.

26. FIN 46(R) also says that returns are those that 'could potentially be significant to the variable interest entity'. We are unsure whether this would create any differences in outcomes. Including the word 'potentially' could be interpreted to mean that any variable return would meet the requirement.

27. It should be noted that FIN 46(R) includes a threshold of 'not more than an insignificant' when describing remuneration of an agent that would not be considered to be a variable interest; ie an interest that absorbs an insignificant amount of an entity's expected losses or expected residual returns is *not* considered to be a variable interest. We will discuss this further in September 2009 when we discuss the agency guidance in detail.

| Question for the Board: the returns element of the control definition |
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| (a) Does the Board agree with the staff recommendation to retain a broad definition and description of returns? If not, what do you propose and why?<br><br>(b) Does the Board agree with the staff recommendations in paragraph 21 to clarity the following regarding the returns element of control definition:<br>- a reporting entity must be exposed to variability of returns in the future<br>- those returns can have the potential to be wholly positive, wholly negative or either positive or negative?<br>If not, what do you propose and why? |