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International
Accounting Standards
Board

INFORMATION FOR OBSERVERS

Board Meeting:	**March 2009, London**
Project:	**Conceptual Framework**
Subject:	**Reporting Entity (Phase D): Redeliberation of Issues (Part 2) (Agenda paper 14A)**

INTRODUCTION

1. The objective of this meeting is to redeliberate the issues related to *control of an entity* that were included in the May 2008 Discussion Paper (DP), *Preliminary Views on an improved Conceptual Framework for Financial Reporting: The Reporting Entity*.

2. Both Boards have made progress in their respective projects related to consolidation since the DP was issued. In November 2008, the FASB issued a proposed Statement of Financial Accounting Standards (Exposure Draft), *Amendments to FASB Interpretation No. 46(R)* (the ED to amend FIN46(R)). In December 2008, the IASB issued Exposure Draft (ED) 10, *Consolidated Financial Statements*. These documents reflect each Board's most recent views about the definition of control, which are also considered in this memorandum.

DEFINING "CONTROL OF AN ENTITY" AT THE CONCEPTUAL LEVEL

3. The DP presented the Boards' preliminary view that *control of an entity* should be defined at the conceptual level. Most respondents agreed with the Boards' preliminary view.

4. However, some respondents noted that the definition should be provided at the standards level so that it would be given higher authoritative status within the GAAP hierarchy. As noted in paragraph 2, the Boards expect to provide definitions in their respective standards level projects.

Question for the Boards:

1. Do the Boards agree that *control of an entity* should be defined at the conceptual level?

DEFINITION OF "CONTROL OF AN ENTITY"

Definitions Proposed in Recent Documents

5. The DP defined control of an entity as follows:

> Control of an entity is the ability to direct the financing and operating policies of an entity, so as to access benefits from that entity (or to reduce the incidence of losses) and increase, maintain, or protect the amount of those benefits (or reduce the amount of those losses).

6. In paragraph 4(b) of the November 2008 ED to amend FIN46(R), which is intended to apply only to variable interest entities (VIEs), the FASB proposed the following:

> The enterprise with a variable interest or interests that provide the enterprise with a controlling financial interest in a variable interest entity will have both of the following characteristics:
> a. The power to direct matters that most significantly impact the activities of a variable interest entity, including, but not limited to, activities that impact the entity's economic performance; and
> b. The right to receive benefits from the variable interest entity that could potentially be significant to the variable interest entity or the obligation to absorb losses of the entity that could potentially be significant to the variable interest entity.

7. In paragraph 4 of the December 2008 ED 10, the IASB proposed the following definition of control:

> 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.

8. The concepts embodied in that definition are similar to those that the FASB had proposed almost a decade earlier in its February 1999 Exposure Draft, *Consolidated Financial Statements: Purpose and Policy.* At that time, the FASB had proposed to define control as the "the ability of an entity to direct the policies and management that guide the ongoing activities of another entity so as to increase its benefits and limit its losses from that other entity's activities" (paragraph 6(a)). Unlike the scope of the ED to amend FIN46(R), its proposed scope was not limited to VIEs.

Overall Considerations

Consideration of All the Existing Facts and Circumstances

9. In the DP, the Boards presented their preliminary view that establishing whether control of another entity exists involves considering all the existing facts and circumstances. Therefore, no one particular fact or circumstance – such as ownership of a majority voting interest – should be a necessary condition for deciding that control of an entity exists. Almost all respondents to the DP agreed with the Boards' preliminary view, and a majority of these respondents suggested that this point be clarified at the conceptual level.

10. No new information was provided by respondents to the DP and the staff is unaware of any information that the Boards did not consider in reaching their preliminary view. Accordingly, the staff recommends that there be no change made to the Boards' preliminary view that establishing whether control of another entity exists involves considering all the existing facts and circumstances and note this point in the forthcoming Exposure Draft.

Facts and Circumstances at Present

11. In the DP, the Boards stated that "because circumstances may change, an assessment of whether control exists should be based on facts and circumstances existing at the time of that assessment" (paragraph 147).

12. The *at present* notion is consistent with the Boards' view presented in the DP that the concept of control of an entity does not exclude situations in which control of an entity exists but might be temporary. Most respondents agreed with the Boards' preliminary view. However, respondents were split as to whether this should be addressed at the conceptual level or the standards level.

13. The staff recommends that there be no change made to the Boards' preliminary view that the concept of *control of an entity* does not exclude situations in which control of an entity exists but it might be temporary. However, the staff thinks that this *at present* notion should be made explicit in the definition of *control of an entity*.

Control of an Asset and Control of an Entity

14. The DP discussed the relationship between *control of an asset* and *control of an entity*. The Boards presented their preliminary view that the reporting entity concept should first determine what constitutes the entity that is reporting, and only then should the asset definition (and other element definitions) be applied to that entity. The Boards noted that the asset definition in existing conceptual frameworks refers to an 'entity' and, thus, it would be circular to use the asset definition to determine what constitutes the 'entity.' The same reasoning would apply to the definition of liabilities and other elements of financial statements.

15. The DP did not ask a specific question on this point, but several respondents suggested that the Boards consider the definition of *control of an asset* when considering the definition of *control of an entity* because they are interrelated. However, the staff found no compelling reasons in their comments and is not convinced there are benefits to be derived from such consideration.

16. The staff recommends that the Boards confirm their preliminary view that the reporting entity concept should first determine what constitutes the entity that is reporting, and only then should the asset definition (and other element definitions) be applied to that entity.

Questions for the Boards:

2. **Do the Boards agree that the forthcoming Exposure Draft should retain the point that the assessment of control would require considering all existing facts and circumstances?**

3. **Do the Boards agree that that the definition of *control of an entity* in the forthcoming Exposure Draft should include the *at present* notion?**

4. **Do the Boards agree that the forthcoming Exposure Draft should retain the point that *control of an entity* does not exclude situations in which control of an entity exists but might be temporary?**

5. **Do the Boards agree that the forthcoming Exposure Draft should retain the point that the reporting entity concept should first determine what constitutes the entity that is reporting, and only then the element definitions should be applied to that entity?**

Power Element

Power to Direct the Activities

17. All of the proposed definitions quoted earlier in this memorandum include a power element. Most respondents to the DP agreed with the Boards' preliminary view that control of an entity should include a power element.

18. However, this power element is described differently in those above quoted proposals. The DP refers to the "ability to direct the financing and operating policies" of an entity. That is similar to both the FASB's 1999 ED's reference to the "ability . . . to direct the policies and management that guide the ongoing activities" of another entity and the IASB's ED 10's reference to the "power to direct the activities" of an entity, both of which seem broader than the DP's reference to just the financing and operating policies. Paragraph BC44 of ED 10 provides a reason for proposing this change:

> The Board noted that governing the strategic operating and financing policies of an entity is in most cases the same as having the power to direct the activities of the entity. However, the power to govern the strategic operating and financing policies of an entity is only one way in which power to direct activities can be achieved.

> A reporting entity can have the power to direct the activities of another entity by means of contractual arrangement – through its involvement in establishing the activities of the entity, or in the ongoing decision-making that affects the activities of the entity.

19. The ED to amend FIN46(R) refers to the "power to direct matters that most significantly impact the activities" of an entity. It clarifies that the activities of the other entity include, but are not limited to, activities that impact that entity's economic performance.

20. Limiting the entity's power to its "ability to direct the financing and operating policies" of an entity seems to be too restrictive. Moreover, while referring to matters that impact the activities rather than the activities themselves seem to broaden the scope of an entity's power, restricting the matters to those "that most significantly impact the activities" seems to be too restrictive. At the conceptual level, the staff recommends that the power element refer to "the power to direct the activities of the entity."

21. The staff acknowledges that this description of the power element may not be sufficient for determining decisively whether an entity has control of another entity. The following paragraphs discuss issues that the staff thinks should be included in the explanatory paragraphs in the forthcoming Exposure Draft. Other issues should be discussed at the standards level rather than at the conceptual level.

Power to Direct the Activities is Not Shared

22. The DP stated that, to satisfy the power element of control, power must be held by one entity only. Most respondents to the DP agreed with the Boards' preliminary view. However, one respondent noted that the Boards should clarify that power held by entities within a group reporting entity is considered to be included in the "one entity." Respondents to the DP were split as to whether this issue should be addressed at the conceptual level or standards level.

23. Both Accounting Research Bulletin No. 51, *Consolidated Financial Statements,* and IAS 27, *Consolidated and Separate Financial Statements*, state that an entity may have control directly or indirectly. FIN 46(R) requires that an enterprise with a variable interest treat variable interests in that same entity held by its related parties (which include parties identified in FASB Statement No. 57, *Related Party*

Disclosures, and certain other parties that are acting as de facto agents or de facto principals of the variable interest holder) as its own interests.

24. As discussed earlier, an entity would need to consider all existing facts and circumstances when determining whether it has control of another entity. That consideration would generally include whether the entity has achieved control by itself. Itself would include the entity's use of others acting on its behalf. Those others acting on its behalf would typically include related parties that the parent controls and agents of the parent.

25. ED 10 proposed that "a parent does not share control of a subsidiary. The parent's power to direct the activities of a subsidiary precludes others from controlling the subsidiary" (paragraph 5). It also proposed that "although a parent has the power to direct the activities of a subsidiary to generate returns for its own benefit, other parties, including *non-controlling interests,* can share those returns" (paragraph 7). The staff thinks this clarification is useful to include in the forthcoming Exposure Draft.

26. The staff recommends that the Boards affirm that only one entity can have control of another entity, with the clarification noted in paragraph 24 that those acting on behalf of the entity are part of the entity's control by itself. Moreover, the staff recommends that the Boards clarify that the power to direct the activities of another entity cannot be shared with others but the benefits from exercising that power can be shared. The staff thinks that clarifying these points in the forthcoming Exposure Draft would help understanding the notion of control, how it may be accomplished, and how it differs from the so-called shared or joint control.

Power Need Not be Absolute

27. The DP stated that, while power must be held by one entity only, it does not imply that power must be *absolute:*

> An entity is not required to have total, unrestricted power over another entity's financing and operating policies for power to exist. There are often limits on power that are imposed by law, regulations, fiduciary responsibilities and contractual rights. Those limits or restrictions are usually protective in nature, and do not usually deprive the controlling entity of the ability to direct the operating and financing policies of the controlled entity. Rather, to

> have the ability to direct another entity's financing and operating policies, the first entity must have that ability itself, rather than in conjunction with others. [Paragraph 158]

28. A few respondents to the DP suggested that the Boards clarify that regulatory power does not constitute control by the government or regulator. For example, although a government authority may have the power to impose fines or close down the operations of entities that do not comply with regulations, this power, in itself, does not constitute *control*, as defined. Rather, the staff thinks that regulatory power is merely one example of the limits or restrictions imposed on the power of the controlling entity. However, in certain extreme circumstances a regulatory authority's mere ability and threat of expropriation may be sufficient to give it the power to direct the activities of the regulated entity. In that case, an assessment of all existing facts and circumstances, including those related to the benefit element, might lead to a different conclusion about which entity, if any, controls the regulated entity.

29. The staff recommends that the Boards affirm that power need not be absolute. The staff thinks the discussion on regulatory powers should be included in the forthcoming Exposure Draft to illustrate this point, perhaps in the context of an example in which the regulated entity is controlled by a parent holding company.

Power Need Not be Exercised

30. ED 10 proposed that "a reporting entity need not have exercised its power to direct the activities of an entity to control that entity" (paragraph 8).

    The staff agrees with the IASB's proposal in ED 10 and thinks that a reporting entity's absence of taking explicit steps to exercise its existing power to direct the activities of another entity does not lead to the determination that the reporting entity does not have that power. The absence of explicit evidence may raise doubts and problems in practice but that absence itself is not evidence of the lack of power. The staff recommends that this point be clarified in the forthcoming Exposure Draft.

Present Control and Present Ability to Control

31. Several respondents noted that the DP did not make a clear distinction between *present control* and *present ability to control*. A few of these respondents stated

that it is unclear which approach the Boards intend to use, and that diversity in practice is likely to continue unless the distinction is made and articulated clearly by the Boards. The definition of *control* in the DP referred to "the **ability** to direct the financing and operating policies of an entity" (paragraph 49, emphasis added) and, thus, the *ability* notion was included in the proposed definition. However, that may not have come through clearly.

32. The difference between *present control* and *present ability to control* typically comes into question when an entity does not have sufficient voting rights at present to have an unequivocal legal right to meet the power element of control but nonetheless has the ability to meet the power element. One example is an entity that is able to obtain sufficient voting rights if it chooses to do so (usually at little or no cost). Another is an entity with such a large voting interest that it can (and perhaps already has) exercised its ability by directing the controlled entity's directors to make desired policy and management changes that effectively direct the activities of that entity.

33. The staff thinks that the assessment of the power element in these situations should be made based on the following principles:

    a. An entity should consider the powers (including those other than voting rights) it has at present

    b. An entity should not hypothetically assume it actually obtained sufficient voting rights.

34. Even if an entity is able to obtain sufficient voting rights if it chooses to do so, an entity should not hypothetically assume that it actually did. At the same time, the assessment of control by an entity in this specific position should be different from other entities because this entity may be able to influence others based on the fact that it is in this position. That ability to influence others is the power this entity has at present and should be considered when assessing the power element. The determination of whether the entity meets the power element would depend on how strong the present ability to influence others is (that is, it may or may not lead to the conclusion that this entity has control). The staff acknowledges that in these close-call circumstances, this determination is likely to require difficult judgments when applied in practice. However, that should not lead to the

conclusion that the concept is flawed. The staff thinks this analysis and conclusion is consistent with that in ED 10.

Benefit Element

35. All of the proposed definitions quoted earlier in this memorandum include a benefit element. Most respondents to the DP agreed with the Boards' preliminary view that the definition of control should include a benefit element.

36. However, this benefit element is described differently in those proposals. The DP states that an entity would need to be able to "access benefits from that entity (or to reduce the incidence of losses) and increase, maintain, or protect the amount of those benefits" in order to have control. That is similar to the 1999 ED that states that an entity would need to be able to use its power "so as to increase its benefits and limit its losses from that other entity's activities."

37. ED 10 states that an entity would need to "generate returns for the reporting entity" and that those returns "vary with that entity's activities and can be positive or negative."

38. The ED to amend FIN46(R) states that an entity would need to have "the right to receive benefits from the variable interest entity that could potentially be significant to the variable interest entity or the obligation to absorb losses of the entity that could potentially be significant to the variable interest entity" in order to have control over the VIE.

39. All of the proposed definitions share the view that the benefit should vary with the entity's activities and that the benefit can be positive or negative. Moreover, none of the proposals limit the benefits to particular types of benefits.

40. ED 10 replaces the term *benefit* with *returns* to clarify that the benefit can be positive or negative. The ED to amend FIN46(R) refers to both benefits and losses, implying that perhaps benefits might be misinterpreted by constituents as referring only to those that are positive. The DP and the 1999 ED also refer to both benefits and losses in their proposed definitions of control.

41. Several respondents to the DP noted that the phrase "increase, maintain, or protect the amount of those benefits" was unclear and suggested either clarifying the language or eliminating it. The staff's understanding is that the phrase was used

to indicate that the benefits would vary with the entity's activities. Because this view is common to the proposals quoted earlier in this memorandum, the staff thinks that the second element should be clarified to say that the benefits vary with the entity's activities. The phrase "increase, maintain, or protect the amount of those benefits" that was used in the DP should not be used in the forthcoming Exposure Draft.

42. The essence of the proposals quoted earlier in this memorandum are the same, with differences the staff thinks should be addressed at the standards level. The question at the conceptual level is how to find a better label that avoids unnecessary confusion. The staff considered the following alternatives:

Alternative 1: Refer to the *return element* and explain that an entity has the power to "generate positive (or limit the negative) returns" that vary with the other entity's activities.

Alternative 2: Refer to the *benefit element* and explain that an entity has the power to "generate benefits (or limit the losses)" that vary with the other entity's activities.

43. The staff thinks that negative returns (Alternative 1) and losses (Alternative 2) should be included in parentheses because, while the controlling entity may incur negative returns or losses, the objective of the controlling entity is usually to generate positive returns or benefits by controlling the other entity. Consistent with the DP, returns and benefits in this context would not be limited to particular types of benefits.

44. The major advantage of Alternative 1 is that the conceptual framework could be simplified by referring to one notion that may more readily convey the notion of being either positive or negative. However, the term *returns* may imply that the Boards are referring to financial returns, which may not work well for not-for-profit entities. Alternative 2 would refer to two notions, *benefits* and *losses*, but are likely to alleviate some of the concerns for not-for-profit entities. On balance, the staff recommends Alternative 2, but is not opposed to using *returns* for the forthcoming Exposure Draft and seeking input on this matter of labelling.

Other Possible Elements

45. Several respondents to the DP suggested that, in addition to the power element and the benefit element, the definition of *control of an entity* refer to *risks*.

46. The staff thinks that the notion of risks is incorporated in the definition of *control of an entity* as part of the benefit element because the bearing of risks result in the generation of benefits or absorption of losses from the other entity. Consistent with the DP, the benefits in this definition would not be limited to particular types of benefits.

Staff Recommendation

47. Based on the discussions above, the staff recommends that the forthcoming Exposure Draft propose the following definition of *control of an entity*:

> A reporting entity controls another entity when the reporting entity has the present power to direct the activities of that entity so as to generate benefits (or limit the losses) that vary with the activities of that entity.

Question for the Boards:

6. **Do the Boards agree with the definition of *control of an entity* in paragraph 47? Specifically, do the Boards agree that:**

    a. **The definition of *control of an entity* consists of two elements**

    b. **The first element (the power element) refers to an entity having "the present power to direct the activities of that entity"**

    c. **Only one entity can have control of another entity, where the one entity would include those acting on behalf of the entity (including related parties the parent controls and agents of the parent)**

    d. **The power to direct the activities of another entity cannot be shared with others but the benefits received from exercising that power can be shared**

    e. **Power to direct the activities of another entity need not be absolute**

    f. **Power to direct the activities of another entity need not be exercised**

    g. **When assessing control, an entity should consider the power it has at**

present and not hypothetically assume that the power to direct the activities of another entity exists through rights that could but have not been obtained

h. The second element (benefit element) refers to an entity having power so as to "generate benefits (or limit the losses) that vary with the activities of that entity".

SIGNIFICANT INFLUENCE AND PROPORTIONATE CONSOLIDATION

Significant Influence

48. In the DP, the Boards presented their preliminary view that the relationship referred to as "significant influence" is not a control relationship. Most respondents to the DP agreed with the Boards' preliminary view. However, these respondents were split as to whether this issue should be addressed at the conceptual level or standards level.

49. No new information was provided by respondents to the DP and the staff is unaware of any information that the Boards did not consider in reaching their preliminary view. Accordingly, the staff recommends that there be no change made to the Boards' preliminary view that the relationship referred to as "significant influence" does not constitute control over an entity.

50. In ED 10, the IASB asked its constituents a question regarding the definition of significant influence and the use of the equity method. The staff recommends not discussing significant influence in detail in the forthcoming Exposure Draft because this notion would only apply to investments in entities that are not under the control of the parent.

Question for the Boards:

7. Do the Boards continue to support that the relationship referred to as "significant influence" does not constitute control of an entity?

Proportionate Consolidation

51. One respondent to the DP suggested that the Boards discuss proportionate consolidation in the conceptual framework. The staff recommends not discussing proportionate consolidation in the forthcoming Exposure Draft because proportionate consolidation, if ever, would only apply to investments in entities that are not under the control of the parent.

52. The staff also notes that in September 2007, the IASB issued Exposure Draft 9, *Joint Arrangements*, and stated that proportionate consolidation is not an appropriate method of accounting for jointly controlled entities.

Question for the Boards:

8. Do the Boards agree that proportionate consolidation should not be discussed in detail in the forthcoming Exposure Draft?