Project **Consolidation**

Topic **The definition of control of an entity: the activities of an entity**

Introduction

1. ED10 *Consolidated Financial Statements* 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 ‘the activities’ of the entity, taking into account comments received from respondents to ED10.

3. The power element of the definition of control of an entity, and application of the control definition, are discussed further in agenda papers 3C-3F.

Staff recommendations

4. We recommend that the final standard should clarify that ‘the activities’ in the control definition refers to those activities of an entity that significantly affect the returns.

Comments from respondents regarding ‘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.

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.

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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]

7. Many suggested that power should relate to significant activities, or activities that cause the returns to vary significantly. They were concerned that power could be determined on the basis of activities or decision-making that was non-substantive and had little effect on the returns.

8. Participants at the consolidation round tables generally supported clarifying that power relates to the activities of an entity that significantly affect the returns. They did not think that we should state that power relates to the activities that *most* significantly affect the returns. Similar to some of the concerns in comment letters, they feared that such a reference would mean that power could be interpreted as the ability to direct the most significant of a number of insignificant activities that have little effect on the returns. They held the view that power should relate to significant activities.

Staff analysis regarding 'the activities'

9. To meet the definition of control, a reporting entity must have power to direct the activities of another entity, and be able to use that power for its own benefit by having the ability to affect the amount of its returns. Paragraph 22 of ED10 adds further guidance regarding power 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'.

10. 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 of the entity that significantly affect the returns.

11. 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 a range of operating and financing activities significantly affect the returns—sales of goods or services, purchases, capital expenditure, obtaining financing, etc. The *direction* of those activities that significantly 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 current ability to appoint the body or party that makes those decisions.

12. For a structured entity, the same principles apply. A reporting entity must identify the activities of the entity that significantly affect the returns (rather than the administrative activities that have little or no effect on the returns) and must determine whether it has rights that are sufficient to give it the ability to direct those activities, or the ability to appoint or remove the body or party that directs those activities.

13. Some might question why we need to add the word 'significant' when describing the activities that matter. Wouldn't it be sufficient to say that the activities are those that affect the returns? Adding the word 'significant' raises the question of what significant means and how it should be applied.

14. We believe, however, that adding the word 'significant' is helpful, particularly when applying the control model to structured entities, because different parties can direct different activities. It can be difficult to determine who, if anyone, meets the power element of the control definition in those situations. There is also a risk that, without adding 'significant', a reporting entity with very little

ability to affect the returns could be considered to have the power to direct the activities of that entity (paragraphs 33-38 discuss this issue further).

15. Examples of activities that, depending on the circumstances, can significantly affect the returns are:

    (a) Determining or changing the strategic operating and financing policies of an entity.

    (b) Determining or changing the restrictions on an entity's activities.

    (c) Managing the amount of economic benefits derived from use or disposal of the assets of an entity (eg managing defaulting receivables or the leasing and operation of investment property).

    (d) Managing the selection, acquisition or disposal of assets of an entity.

    (e) In some entities, managing the funding of the entity.

16. Examples of activities that do not significantly affect the returns (ie those activities are administrative in nature) are:

    (a) Collecting cash flows on performing assets and allocating them to investors in accordance with predetermined policies.

    (b) Monitoring compliance with portfolio guidelines (without the ability to adjust those guidelines).

17. 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 11, we recommend clarifying that 'the activities' that are referred to in the definition are those that significantly affect the returns. We also recommend including in the application guidance of the final standard examples of the activities that significantly affect the returns, and those that do not (ie the examples set out in paragraphs 15 and 16 of this paper).

18. Clarifying that to control an entity, a reporting entity must have the power to direct the activities of the entity that significantly affect the returns provides a basis for the link between power and returns. To control another entity, a

reporting entity must have the power to direct 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 agenda paper 3B *Returns*).

The activities of an entity that significantly affect the returns

19. To identify the activities of an entity that significantly affect the returns, particularly those of a structured entity, it is essential to understand the purpose and design of the entity. Understanding the purpose and design of an entity means understanding the objectives of each of the parties involved with the entity, how the risks and benefits of the entity are shared among those parties and what rights each of the parties has to direct the activities of the entity.

20. In an asset securitisation in which the securitisation entity has been set up for the purpose of providing financing to the transferor of long–term receivables and providing a particular credit exposure to investors (eg a commercial mortgage securitisation), the only activity of the entity that can be directed, which significantly affects the returns is managing any defaulting receivables (note: we assume that the activities of the securitisation entity is restricted to securitising specified receivables and those restrictions cannot be changed). In essence, all of the variability of returns of such a securitisation entity is generated from the recovery of cash flows of the receivables. Having the power to direct that recovery by having the ability to direct how any defaulting receivables are managed is the means by which a reporting entity has the power to influence the returns received by those involved with the entity.

21. A reporting entity can obtain that ability to direct how any defaulting receivables are managed in different ways—eg by having rights within a servicing or special servicing agreement; by having the right to appoint or remove the servicer or special servicer; by having a written put on the receivables that is triggered when the receivables default; by having a repurchase agreement to buy the assets when the receivables default; by providing a guarantee and having a right of first

refusal to buy the receivables if the entity chooses to sell the receivables when they default.

22. Paragraph 37 of ED10 included an example in which a reporting entity had written a put on the receivables of a structured entity—the receivables being put back to the reporting entity when they became overdue by more than a specified period. We concluded that the reporting entity would consolidate the structured entity in this example.[1] One respondent disagreed with the example noting that 'a structured entity should be consolidated by the party that controls the activities of the entity, not the party that controls the relevant assets before they are inserted into or after they have been removed from the entity.' Others who agree with those arguments might compare this situation to one in which a reporting entity has an option or a forward to buy assets owned by, for example, General Electric (GE). Surely the reporting entity would not consider consolidating GE simply because it has agreed to buy assets owned by GE in the future? In addition, that entity would not typically recognise the assets itself in that scenario—it would recognise the forward.

23. Control is about having the ability to direct the activities of an entity that significantly affect the returns, and being able to benefit from that ability. The *activities* of the entity are determined by looking at the purpose and design of the entity. The purpose of such a securitisation entity is to allocate the risks (mainly credit risk) and rewards (cash flows received) of the securitised receivables to the parties involved with the entity. The entity is designed in such a way that the only activity that can be directed, and can affect the returns, is managing those receivables when they default. The entity is programmed to

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[1] Extract from paragraph 37 of ED10: 'For example, a reporting entity could establish a structured entity, whose founding documents restrict its activities to purchasing fixed rate receivables of the reporting entity for cash, collecting payments from those receivables and passing those payments to the investors in the structured entity. Receivables that are overdue by more than a specified period are put back to the reporting entity. In this example, in the absence of other facts, the reporting entity controls the structured entity. The entity's founding documents and the put agreement ensure that the reporting entity is exposed to all of the variability of returns generated from the receivables of the structured entity, and has the ability to affect those returns by managing any defaulting receivables. The reporting entity has the power to direct the activities of the structured entity by having the ability to direct how the assets of the structured entity are managed.'

ensure that the reporting entity has decision-making authority over the activities that matter at the only time that such decision-making is required—this gives the reporting entity the current ability to direct those activities. The terms of the put agreement are integral to the overall transaction and the establishment of the securitisation entity. For example, those investing in the securitisation entity would not have agreed to invest without the put agreement being in place. Therefore, we would consider the terms of the put agreement together with the founding documents of the securitisation entity and conclude that the reporting entity has the power to direct the activities of the securitisation entity that significantly affect the returns.

24. This fact pattern is different from one in which a guarantor agrees to take on the credit risk associated with the assets of an entity and is paid a fee for taking that risk. The guarantee is likely to be integral to the overall transaction in a similar way to the put agreement described above in paragraph 23 (ie the investors in the entity may have agreed to provide their investment only with the guarantee in place). Therefore, when assessing control, the terms of the guarantee contract would be considered together with the founding documents of the entity. However, if the guarantee is net settled, the guarantor is exposed to variability of returns from the activities of the entity but does not have any ability to direct those activities.

25. This fact pattern is also different from one in which an entity is established for, perhaps, tax or investment reasons and any variability in returns from the assets or the activities of the entity *cannot* be managed by any party involved with the transaction. The entity is, in essence, passive or 'on autopilot'. For example, an entity is established to give the investors in the entity particular exposure to credit risk that is referenced to a particular event—the entity is exposed to that credit risk by entering into a credit default swap (CDS). The investors may suffer losses on the derivative held by the entity if the credit event happens but no decisions are made by any party involved with the entity. The entity is not designed to allocate the ability to manage that credit risk exposure to any party or parties involved in the transaction—the purpose of the entity is simply to create that exposure. If none of the parties involved in the transaction has any

means of managing the exposure to credit risk or otherwise directing the activities of the entity, none of those parties would consolidate the entity.

26. We plan to include an illustrative example in the final standard that addresses the asset securitisation example set out in paragraph 20 of this paper (including a variation in which a reporting entity has the ability to direct how the receivables are managed on default by means of a put agreement).

The requirements of SFAS 167 regarding 'the activities'

27. The staff recommendation aligns the power element of the control definition more closely with the definition of power in SFAS 167 *Amendments to FASB Interpretation No. 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]'.

28. The approach to identifying the activities that matter set out in paragraphs 19-25 of this paper is similar to the approach that would be taken when applying the requirements of SFAS 167.

29. SFAS 167 describes the activities as being those that *most* significantly impact the entity's economic performance. Put into our words, it refers to those activities of an entity that most significantly affect the returns. We understand that there are two main reasons for including the word 'most':

    (a) The first is to address situations in which multiple parties have discrete decision making authority over the activities of an entity that affect the returns.

    (b) The second is to limit the situations in which some might argue that there are no activities that significantly affect the returns, and therefore that no one controls an entity.

30. We believe that we can address the situation described in paragraph 29(a) by adding the word ‘most’ when describing those situations in which multiple parties have discrete decision making authority over the activities of an entity that affect the returns. In this situation, agenda paper 3D *The sharing of power* recommends that a reporting entity that has the power to direct the activities that most significantly affects the returns would meet the power element of the control definition.

31. We believe that we can address the concern noted in paragraph 29(b) by including examples of activities that significantly, and do not significantly, affect the returns. This should help to clarify the activities that matter when assessing control, and limit the situations in which some might argue that there are no activities that significantly affect the returns. We also intend to include illustrative examples, which should demonstrate how we intend the requirements to be applied.

32. We have a number of concerns about adding ‘most’ when describing, in general, the activities that matter:

    (a) We fear that a reporting entity may be required to consolidate another entity when it would be inappropriate to do so (see paragraphs 33-38 of this paper).

    (b) We think that it is potentially confusing when considered together with the guidance on protective rights. Particularly for traditional operating entities, the activities that would *most* significantly affect the returns are often those that require the consent of parties with protective rights (those activities that relate to fundamental changes to an entity’s operations, eg mergers and acquisitions; major capital expenditure). Although this could be addressed by stating that such approval rights are protective rights (and are neither sufficient to control the entity nor negate another party’s control of the entity), we think that including ‘most’ would be confusing.

    For those reasons, we recommend adding the word ‘most’ *only* when referring to situations in which multiple parties have discrete decision making

authority over the activities of an entity, rather than when describing the activities that matter in general.

Power relates to activities that significantly affect the returns of an entity

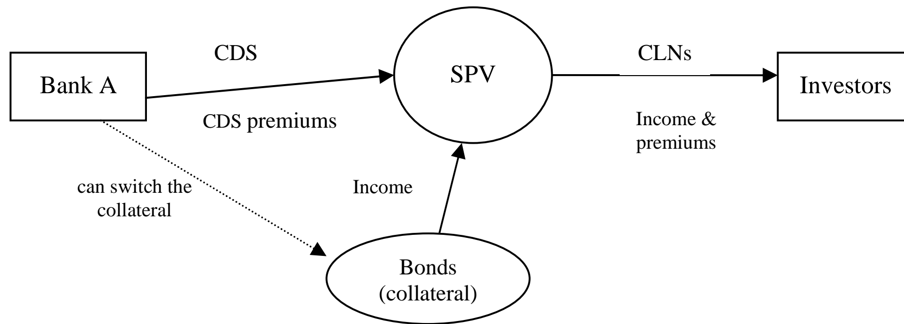
33. As mentioned in paragraph 32, we are concerned that adding the word 'most' when describing the activities of an entity that matter when assessing control might lead to inappropriate consolidation. If we were to include the word 'most', a reporting entity would meet the power element of the control definition if it had the power to direct the activities of an entity that most significantly affect the returns. This would capture entities in which there are no substantive decisions to be taken, but a reporting entity that has limited decision making authority and influence over the assets and liabilities of an entity might be required to consolidate that entity just because they have more authority than others.

34. In essence, we believe that it is inappropriate to consolidate the assets and liabilities of another entity if a reporting entity has little, if any, ability to direct those assets and liabilities to generate returns for the reporting entity. When an entity is set up so that there are virtually no decisions to be made either now or in the future that could affect the returns (ie 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), we do not think that such an entity is controlled because the entity, in effect, does not have any activities to direct.

35. Some might argue that our concern regarding the inclusion of 'most' is misplaced because if a reporting entity's decision making is so restricted that it has very little ability to direct the assets and liabilities of another entity, then surely that reporting entity would be paid an insignificant fee for those restricted services. If that were the case, even if the reporting entity met the power element of the control definition, it would not be deemed to generate returns for itself and would not control the other entity. However, we have come across one type of entity, which is set up frequently, in which we think that an inappropriate consolidation answer might be reached if we were to include the

words 'most significantly' when referring to 'the activities' in the control definition.

36. For example, a number of investors want a particular credit risk/return profile that is not readily available in the marketplace. They approach a bank, Bank A, who sets up an entity, SPV, to create that risk/return profile. Bank A transfers third party credit risk to SPV by entering into a credit default swap (CDS) with SPV at market rates. SPV issues credit linked notes (CLNs) to the investors that are referenced to the third party credit. SPV uses the proceeds received from issuing the CLNs to purchase high quality bonds that are used as collateral for the CDS counterparty (Bank A). In effect, the investors take on the desired credit risk profile in return for income from the bonds and the premium on the CDS received from Bank A. Bank A buys credit protection from SPV in return for paying a premium on the CDS. There are very little, if any, decisions to be taken after initially setting up SPV. Bank A has the ability to switch the collateral within predefined parameters, which allows Bank A to manage the default risk on the collateral. Bank A's ability to switch the collateral affects the returns of SPV to a small extent, but does not *significantly* affect the returns. The credit risk profile is the primary factor that affects the returns of SPV, which is agreed to by Bank A and the investors at inception of SPV and cannot be changed. Neither Bank A nor the investors have any voting or other rights that give them the ability to direct the activities of SPV. Bank A does not get a fee for setting up SPV but receives a return from its involvement with SPV that represents the spread between the CDS premiums that it pays to SPV and those that it receives from selling equivalent CDS protection to a third party. The investors receive all of the returns of SPV.



37. In this example, we think that no one should consolidate SPV because no one has the power to direct the activities of SPV to generate returns for itself. The investors receive all of the returns and are exposed to all of the risks of SPV, but have no means of managing that exposure, or of accessing or directing the assets and liabilities of SPV. Bank A has the ability to make the only decisions that can be made about the activities of SPV, ie Bank A can decide to switch the collateral of SPV within predefined parameters. Although that decision making affects the returns of SPV to a small extent, the returns of SPV essentially vary on the basis of whether the credit event occurs. Bank A does not receive a direct return from SPV. However it does receive a return from its involvement with SPV indirectly via the CDS. Because of our broad definition of returns and the fact that we refer to 'returns from involvement with an entity', Bank A could be deemed to meet the returns element of the control definition.

38. Consequently, we think that if we were to use the words 'most significantly' when referring to 'the activities' in the control definition, Bank A is likely to be deemed to meet both the power element and the returns element of the control definition and would consolidate the entity. We disagree with this answer.

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 significantly affect the returns? If not, do you think that we should refer to the activities of an entity that most significantly affect the returns? Or do you have another proposal?