Project **Consolidation**

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

[This paper includes the contents of paragraphs 13-27 of agenda paper 10D prepared for the July 2009 Board meeting. The Board did not discuss that paper at the July meeting because of time constraints. The contents of this paper is largely unchanged from the contents of paragraphs 13-27 of agenda paper 10D at the July meeting.]

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 returns element of the control definition, taking into account comments received from respondents to ED10.

Staff recommendations

3. We recommend that the final standard:

   (a) should define and describe returns broadly, in a similar manner to how they are described in paragraphs 10 and 11 of ED10.

   (b) add clarity about the returns that are relevant when assessing control as detailed in paragraph 11 of this paper.

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.

Comments from respondents regarding returns

4. 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.

5. 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.

6. 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?

Staff analysis regarding returns

7. 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]

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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

8. 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.

9. 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.

10. We also 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 given the Board’s tentative decision to include exposure to variability of returns (risks and rewards) as an indicator of control for all entities at the July 2009 Board meeting.

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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.

11. 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).

12. This paper does not discuss whether to include a significance or other threshold for returns. This issue is discussed in more detail in the context of agents in agenda paper 3F.

Requirements of SFAS 167 regarding returns

13. SFAS 167 *Amendments to FASB Interpretation No. 46(R) Consolidation of Variable Interest Entities* states that:

> 'An enterprise [that holds a variable interest in a 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'.

14. Although the words are different, we do not believe that application of the benefits/losses criterion in SFAS 167 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.

15. Returns in SFAS 167 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.

16. SFAS 167 also says that returns are those that 'could potentially be significant to the variable interest entity'. We are not aware that this would create any differences in outcomes. Including the word 'potentially' could be interpreted to mean that any variable return would meet the requirement.

17. It should be noted that SFAS 167 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. This is discussed further in agenda paper 3F when we discuss the remuneration of an agent.

Questions for the Board: returns
(a) Does the Board agree with the staff recommendation to retain a broad definition and description of returns, similar to the description included in paragraphs 10 and 11 of ED10? If not, what do you propose and why? (b) Does the Board agree with the staff recommendations in paragraph 11 to clarity the following regarding the returns element of control definition: - a reporting entity must be exposed to variability of returns - returns received in the past are not relevant when assessing control - a reporting entity's returns can have the potential to be wholly positive, wholly negative or either positive or negative? If not, what do you propose and why?