IASB Meeting | Agenda reference **3D**

Staff Paper | Date **October 2009**

Project **Consolidation**

Topic **The sharing of power**

Introduction

1. ED10 *Consolidated Financial Statements* includes guidance and examples to help a reporting entity assess whether it controls another entity. That guidance does not specifically address situations in which multiple parties have decision-making authority over the activities of an entity.

2. Some respondents questioned how the requirements in ED10 would be applied to such a situation. Those respondents were mainly concerned that the absence of specific guidance would create structuring opportunities to avoid the consolidation of structured entities. Power could be easily disguised and divided among different parties so that it could be argued that no one would have the power to direct the activities of the entity. Those views mirror the alternative views of some Board members expressed in paragraphs AV8-AV12 of ED10.

3. The purpose of this paper is to discuss situations in which multiple parties have decision-making authority over the activities of an entity.

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.

Staff recommendations

4. We recommend that:

   (a) the final standard should note that IAS 31 *Interests in Joint Ventures* applies when two or more parties have joint control of an entity.

   (b) when two or more parties have discrete decision-making authority over the activities of an entity, the party that has the ability to direct the activities that most significantly affect the returns meets the power element of the control definition.

Staff analysis regarding the sharing of power

5. There are a number of situations in which multiple parties can have decision-making authority over the activities of an entity. We believe that it would be helpful to add some guidance in the final standard to address how to apply the requirements of the standard to those situations. In the absence of any guidance, the requirements could be applied inconsistently when multiple parties have decision-making authority over the activities of an entity. In addition, the requirements could be interpreted broadly to say that when multiple parties are involved in directing the activities of an entity, no one party controls the entity. This could potentially result in very few structured entities being consolidated because it may be possible to structure entities to involve multiple parties in directing the activities of the entity.

6. The following paragraphs in the paper discuss different situations in which multiple parties have decision-making authority over the activities of an entity that significantly affect the returns:

   (a) joint control (paragraphs 7-9),

   (b) shared decision-making that is not joint control (paragraph 10), and

(c) multiple parties having discrete decision-making authority over the activities that significantly affect the returns (paragraphs 11-40).

***Joint control*[1]**

7. IAS 31 *Interests in Joint Ventures* defines joint control 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'. That economic activity may be structured through an entity. Put into the words of the definition of control of an entity proposed in ED10, joint control is the contractually agreed sharing of the power to direct the activities of an entity to generate returns from those activities. Joint control requires the parties sharing control to consent to all decisions that relate to the activities of the entity that significantly affect the returns.

8. When two or more parties have joint control of an entity, no one party controls that entity and accordingly the entity is not consolidated. The parties (that have joint control) account for their respective interests in the jointly controlled entity either using the equity method or proportionate consolidation.[2]

9. IAS 31 is applicable to all entities in which two or more parties jointly control an entity. We do not propose to change or amend that application. However it may be useful to mention in the final consolidation standard that IAS 31 applies when an entity is subject to joint control.

[1] IAS 31 is not only applicable to joint arrangements structured through entities, but also to other joint arrangements that are not entities. Because the consolidation project is relevant for entities only, we have discussed IAS 31 in this paper only in the context of joint arrangements that are structured through entities.

[2] The Board has decided tentatively in its joint arrangements project that parties that have joint control of another entity either use the equity method (if the entity is a joint venture) or each party recognises its assets, liabilities, revenues and expenses that arise from its interest in the joint arrangement (if the entity is a joint operation).

Shared decision-making that is not joint control

10. The power to direct the activities of an entity that significantly affect the returns can be shared by multiple parties but not meet the definition of joint control. For example, five entities each own 20 per cent, and hold one seat on the board of directors, of Entity Z. All strategic decisions about the activities of Entity Z require the consent of any 4 of the 5 directors. The five entities do not jointly control Entity Z because each of them is not required to consent to all decisions relating to the activities of Entity Z that significantly affect the returns. Nevertheless, it is clear that the power to direct the activities of Entity Z is shared and no one party controls Entity Z. Those parties would have significant influence over Entity Z and would account for their investment in Entity Z using the equity method. [3]

Multiple parties have discrete decision-making authority over the activities that significantly affect the returns

11. A number of respondents questioned how the requirements of ED10 should be applied when multiple parties have the ability to direct the activities of an entity. Examples mentioned include:

    (a) Multi-seller conduits—an entity that is set up to securitise different bundles of receivables. Each bundle of receivables is usually serviced by the transferors of the receivables. The sponsor (a bank) generally manages the funding of the entity (which is often made up of short-term notes or commercial paper), authorises any new receivables transferred to the conduit, manages credit enhancement requirements and often provides program-wide credit enhancement, manages and may provide liquidity support.

    (b) Entities for which the assets are managed by one party, and the funding is managed by another party.

[3] We understand that such a situation is common in the oil and gas industry.

(c) Multi-seller securitisations (discussed in paragraphs 23-35).

In each of those situations, would the entity not be consolidated by any of the parties involved because multiple parties share the power to direct the activities of the entity?

12. For any of the situations in paragraph 11 to exist, more than one party must have discrete and unilateral decision-making authority over different activities of the entity that affect the returns. We believe that it will usually be clear that *one* party or body has decision-making authority to direct the activities of an entity that significantly affect the returns for the following reasons:

    (a) For traditional operating entities, strategic decision-making is usually the responsibility of a governing body or board of directors. There is likely to be various levels of decision-making—for example, a treasury committee might initiate proposals regarding the funding of an entity; a sales committee will determine sales prices and develop a business plan to determine the territories in which to sell products. However there will ultimately be a governing body that has overall responsibility for the activities of the entity, which reports to the shareholders of the entity. Consequently, different parties would not have discrete and unilateral decision-making authority over different activities of an entity that significantly affect the returns.

    (b) For structured entities or SPEs, the same reasoning applies. We understand that there is usually one party that has overall responsibility for the activities of an entity—third party investors generally want to have one party that they can turn to in terms of being accountable for the returns of the entity. The more complicated the activities of an entity, the more likely it is that one party is responsible for all of the activities of the entity, in a similar way to a governing body of a traditional operating entity. For example, in a multi-seller conduit, the transferors of receivables to the conduit often service the transferred assets, having decision-making discretion to manage any defaulting

assets. Although this activity affects the returns of the entity, the sponsor is usually the party that has the decision-making authority to direct the activities of the entity that *significantly* affect the returns. The sponsor will usually make decisions about the funding of the conduit, about any new receivables that are to be transferred into the conduit, about credit enhancement and liquidity support, and about the selection and terms of any other providers of services to the conduit (eg swap counterparties). Therefore, although the transferors have some decision-making authority over the assets transferred, we believe that in this case the sponsor of such a conduit has the ability to direct the activities of the conduit that significantly affect the returns.

13. Nevertheless, it is possible that more than one party might have decision-making authority over different activities of an entity that significantly affect the returns. For example, one party might have discrete, unilateral decision-making authority over the assets of an entity, while another party has discrete, unilateral decision-making authority over the liabilities or funding of an entity. Both activities may significantly affect the returns. Does one party have the ability to direct the activities that significantly affect the returns, or should no one consolidate because that power is shared? Indeed, in the multi-seller conduit example described in paragraph 12(b), some might argue that no one should consolidate because multiple parties (the sponsor and the transferors) share decision-making over the activities of the conduit that significantly affect the returns.

Staff recommendation

14. We recommend that when two or more parties have discrete decision-making authority over the activities of an entity, those parties should determine which of them has the ability to direct the activities of the entity that *most* significantly affect the returns. The party that has the ability to direct the activities that most significantly affect the returns would meet the power element of the control definition. In situations that involve multiple parties with discrete decision-

making authority, our recommendation, in effect, attributes power to the party that looks most like a controller.

15. Some may disagree with the recommendation on the grounds that this forces one party to consolidate when it might appear that multiple parties share the ability to direct the activities that significantly affect the returns. If those different activities do, in fact, significantly affect the returns, why would we artificially force the parties involved to conclude that one activity is more important than the other? Would this result in a reporting entity consolidating another entity when it does not have the ability to direct the activities of the entity?

16. We acknowledge that our recommendation could result in a reporting entity consolidating another entity, even though it does not have the ability to direct *all* of the activities of an entity that significantly affect the returns. And indeed, our recommendation would force one party to conclude that it meets the power element of the control definition even if it were the case that, for example, one party has the power to manage the assets of an entity, and another has the power to manage the funding of an entity, and both of those activities significantly affect the returns.

17. However, as noted in paragraph 12, we think that this situation would arise in rare circumstances because one predominant decision maker (or governing body) would usually exist for most entities. In any event, the reporting entity deemed to control the entity would have the ability to direct the activities of the entity that *most* significantly affect the returns. Therefore, our recommendation would *not* result in a reporting entity consolidating another entity when it has no ability to direct the activities of that entity.

18. An alternative to the staff recommendation would be to conclude that different parties could have the ability to direct different activities of an entity that significantly affect the returns. In that case, the entity would not be consolidated because multiple parties share the power to direct the activities of the entity. Those multiple parties are likely to have significant influence over the activities of the entity and would, therefore, use the equity method to account for their

interest in the entity. This approach would mean that a reporting entity would consolidate another entity when it has the ability to direct *all* of the activities of an entity that significantly affects the returns. We do not recommend following such an alternative, however, because we fear that it might be all too easy to avoid consolidation of particular structured entities by involving other parties in the entity.

19. The staff recommendation means that there is greater potential for an entity to be consolidated because one party will be deemed to have power when multiple parties have discrete decision-making authority over the activities of an entity. A reporting entity would have to give up the ability to direct the activities that *most* significantly affect the returns in order to avoid consolidation (if that were the objective). In that case, we believe that the reporting entity no longer has the ability to direct the activities of the entity and does not control the entity.

20. In contrast, the alternative set out in paragraph 18 would mean that a reporting entity might only have to give up the ability to direct *any* activity that affects the returns of an entity in order to avoid consolidation. Because of the subjectivity involved in determining whether an activity significantly affects the returns of an entity, such a requirement might be open to abuse.

21. As noted in paragraph 12, we understand that it is rarely, if ever, the case today that an entity is set up with different parties having the ability to direct different activities of an entity that significantly affect the returns. This would imply that there is no real business reason to segregate the power to direct the activities among multiple parties. We fear that if the Board decides on the alternative set out in paragraph 18 of this paper, there would be an accounting incentive to structure entities to involve multiple parties with decision-making authority. Without such an incentive, we think that it is likely that there will continue to be very few examples of substantive decision-making being shared by multiple parties, other than in joint arrangements.

22. The staff recommendation is consistent with the approach that the FASB has taken in SFAS 167 *Amendments to FIN 46(R) Consolidation of Variable Interest Entities*. Paragraph 14E of SFAS 167 states:

> If the activities that impact the entity's economic performance are directed by multiple unrelated parties, and the nature of the activities that each party is directing is not the same, then an enterprise shall identify which party has the power to direct the activities that most significantly impact the entity's economic performance. One party will have this power, and that party shall be deemed to have the characteristic in paragraph 14A(a) [paragraph 14A(a) refers to the power element of the definition of a controlling financial interest in SFAS 167].

Application of the staff recommendation to multi-seller securitisations

23. A multi-seller securitisation is an entity set up to securitise different bundles of receivables from different transferors. The entity issues notes to note holders, which could take a number of different forms, as described in the following paragraphs.

<u>Silos</u>

24. ED10 defines a subsidiary as 'an entity that is controlled by a parent. A legal structure such as a company or trust can comprise more than one entity.' The definition includes a footnote to say that 'an entity within a legal structure referred to in the definition of a subsidiary is sometimes referred to in national GAAP as a silo'. Many respondents asked for clarity as to what we meant when we referred to silos.

25. When drafting the exposure draft, what we had in mind when referring to silos was a concept similar to that included in US GAAP regarding variable interests in specified assets. Paragraph 13 of SFAS 167 states the following:

> An enterprise with a variable interest in specified assets of a variable interest entity shall treat a portion of the entity as a separate variable interest entity if the specified assets (and related credit enhancements, if any) are essentially the only source of payment for specified liabilities or specified other interests. That

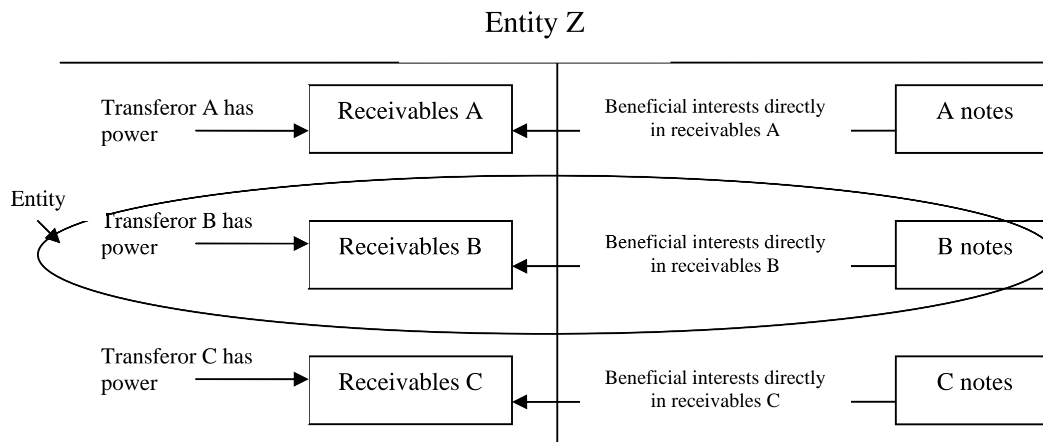
> requirement does not apply unless the entity has been determined to be a variable interest entity. If one enterprise is required to consolidate a discrete portion of a variable interest entity, the variable interest holders shall not consider that portion to be part of the larger variable interest entity.

26. An FSP that relates to SFAS 167 clarifies the application of the requirements:

> A separate variable interest entity is deemed to exist for accounting purposes only if essentially all of the assets, liabilities, and equity of the deemed entity are separate from the overall entity and specifically identifiable. In other words, essentially none of the returns of the assets of the deemed entity can be used by the remaining variable interest entity, and essentially none of the liabilities of the deemed entity are payable from the assets of the remaining variable interest entity.

27. The multi-seller securitisation example illustrated below is set up so that three unrelated transferors transfer receivables to the multi-seller securitisation entity, Entity Z. Each of the transferors has the ability to manage the receivables, including having decision-making discretion over defaulting receivables. Entity Z issues separate classes of notes to noteholders. Each class of noteholder has beneficial interests in only one bundle of receivables, and not in all of the assets of Entity Z.

28. Applying the concept of a silo to this example, if transferor B was also a holder of B notes in Entity Z, transferor B would consolidate receivables B and the B notes as if those assets and liabilities were the only assets and liabilities of an entity within Entity Z. For consolidation purposes, Entity Z would be divided into three distinct entities that could potentially be consolidated by three different reporting entities.



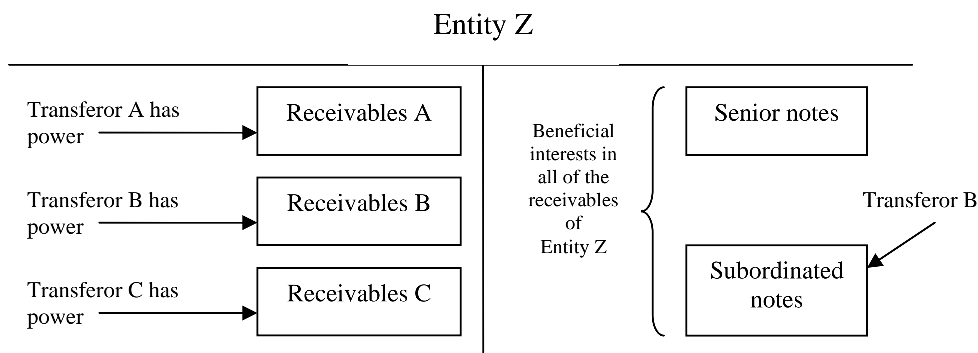
29. US GAAP defines silos narrowly and we understand that the definition of a silo is not often met. We would propose to retain that narrow definition so that a portion of a legal entity is treated as a separate entity for consolidation purposes only when that portion, in effect, is a separate entity and is isolated from the other assets and liabilities of the legal entity. We recommend adding application guidance that describes a silo in a similar way to the description in SFAS 167.

30. We believe that the concept of a silo ties in with the description of a reporting entity as a 'circumscribed area of economic activity' in the reporting entity phase of the conceptual framework project. In that project, the Board has concluded that the existence of a legal entity is not necessary to create a reporting entity.

<u>Multi-seller securitisation entity with noteholders that have beneficial interests in all assets of the entity</u>

31. When deliberating its amendments to FIN 46(R), the FASB discussed and addressed the following situation, which was highlighted by some respondents to its exposure draft. For example, Entity Z is a multi-seller securitisation entity, which issues notes to noteholders. The noteholders have beneficial interests in all of the assets of Entity Z. The only activity of Entity Z that significantly affects the returns is managing any defaulting receivables, and three unrelated transferors have the ability to manage different bundles of receivables of Entity Z. One of the tranferors, Transferor B, holds a significant portion of the subordinated notes of Entity Z. The example assumes that there is no sponsor or

other party that has overall decision-making authority over the activities of the entity, as there usually is in a multi-seller conduit discussed in paragraphs 11 and 12 of this paper.



32. In this example, should Transferor B consolidate Entity Z, or is Entity Z not controlled by any party?

33. The staff recommendation in paragraph 14 of the paper states that when two or more parties have discrete decision-making authority over the activities that affect the returns of an entity, the party that has the ability to direct the activities that *most* significantly affects the returns meets the power element of the control definition. If we apply that recommendation to this example, Transferor B would have the power to direct the activities of Entity Z if receivables B represented the largest portion of the receivables of Entity Z. This is because the ability to manage the largest portion of receivables would represent having the ability to direct the activities of Entity Z that most significantly affect the returns because the only activity of Entity Z that significantly affects the returns is managing any defaulting receivables. Therefore, Transferor B would meet the power element and consolidate Entity Z if receivables B represented, for example, 40 per cent of the assets of Entity Z, while receivables A and C represented 30 per cent each of the assets of Entity Z.

34. As noted earlier in the paper, our recommendation may appear to artificially force one party to consolidate Entity Z. However, again we would reiterate that in the absence of such a recommendation, we believe that a reporting entity would have an accounting incentive to structure entities in this way. For

example, assume that Transferor B had the ability to direct 95 per cent of the receivables of Entity Z, with Transferors A and C having the ability to direct 5 per cent of the receivables of Entity Z. If we did not address this situation, Transferor B could conclude that the ability to direct the activities of Entity Z that significantly affect the returns is shared and no one should consolidate.

35. For a multi-seller securitisation to be set up in this way, Transferor B would have to be willing to take on risk exposure to receivables that it does not have the ability to manage on default. We understand that there are very few, if any, examples of this situation in practice today. We think that our recommendation would create a barrier to establishing such structures solely to achieve a particular accounting outcome.

Consistency with SFAS 167

36. The FASB reached a slightly different conclusion regarding such entities when deliberating SFAS 167. Paragraph 14D of SFAS 167 states:

> '..[if] the activities that most significantly impact the entity's economic performance are directed by multiple unrelated parties and the nature of the activities that each party is directing is the same, then the party, if any, with the power over the majority of those activities shall be considered to have the characteristic in paragraph 14A(a).' [paragraph 14A(a) refers to the power element of the definition of a controlling financial interest in SFAS 167].

37. If we refer to the example in paragraph 31 of this paper, the FASB approach would mean that Transferor B would consolidate Entity Z when receivables B represented more than 50 per cent of the assets of Entity Z. This would result in the same answer as our staff recommendation when the largest portion of assets being directed by one party is greater than 50 per cent. However, according to our recommendation, it is possible that a reporting entity would consolidate an entity when it has the ability to direct less than a majority of the assets of an entity. This would not be the case according to the requirements of SFAS 167.

38. Similar to our conclusions, the FASB believed that it was necessary to address the situation to avoid anomalous results when multiple parties have the power to

direct the same activities of an entity. In addition, the majority concept adopted by the FASB is consistent with the US GAAP guidance on interests in specified assets. Paragraph 12 of SFAS 167 states that 'a variable interest in specified assets of a variable interest entity..shall be deemed to be a variable interest in the entity only if the fair value of the specified assets is more than half of the total fair value of the entity's assets..'.

39. We do not have a similar concept of an interest in specified assets. In addition, we think that the issue that arises regarding power is similar in each of the following two cases discussed in the paper and, therefore, it is appropriate to reach a similar conclusion:

    (a) Multiple parties have the ability to direct the activities of an entity that significantly affect the returns and the nature of those activities is the same (eg the multi-seller securitisation set out in paragraph 31);

    (b) Multiple parties have the ability to direct the activities of an entity that significantly affect the returns and the nature of those activities is not the same (eg one party has the ability to manage the operations of an entity and another party has the ability to manage the funding of an entity, and each of those activities affects the returns).

40. Our recommendation, therefore, is that when two or more parties have discrete decision-making authority over the activities of an entity, those parties should determine which of them has the ability to direct the activities that *most* significantly affect the returns. The party that has the ability to direct the activities that most significantly affect the returns would meet the power element of the control definition.

Question for the Board: the sharing of power
Does the Board agree with the staff recommendation that when two or more parties have discrete decision-making authority over the activities of an entity, the party that has the ability to direct the activities that most significantly affect the returns meets the power element of the control definition?