Project **Consolidation**

Topic **Kick-out rights**

Purpose

1. The purpose of this paper is to provide analyses for the boards regarding kick-out rights[1] and participating rights[2] (hereinafter referred to as kick-out rights as their purpose and function is similar) and the role that these rights have (a) in determining which reporting entity should consolidate another entity and (b) whether kick-out rights should be considered in determining whether a reporting entity is an agent or a principal. This paper will provide background regarding how substantive kick-out rights were defined in Interpretation No. 46(R) *Consolidation of Variable Interest Entities* before the amendments to the Interpretation in Statement No.167, *Amendments to Interpretation No.46(R)*, and how that Statement changed how and when kick-out rights should be considered in determining the reporting entity that has a controlling financial interest in a variable interest entity. This paper will also address comments received by the

[1] *Kick-out rights* are the ability to remove a reporting entity that directs the activities of an entity that most significantly (significantly in IASB definition of control) impact the entity's economic performance. Kick-out rights are referred to as removal rights in ED10 *Consolidated Financial Statements*.

[2] *Participating rights*, if held by one party, give that party the ability to direct the activities of an entity that most significantly (significantly in IABS definition of control) impact the entity's economic performance. If held by more than one party, participating rights provide the ability to block the actions through which a reporting entity directs the activities of an entity that most significantly impact the entity's economic performance.

This paper has been prepared by the technical staff of the FASB and the IASCF for discussion at a public meeting of the FASB or 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 FASB or the IASB.

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IASB on ED10 related to kick-out rights and the staff analysis and recommendations as to how these rights should be considered in consolidation.

2. This paper primarily discusses the effect of kick-out rights when assessing control of an entity in isolation. However, because we are developing a model that would be applied consistently to all entities, it is important to consider the analysis in this paper, together with the analysis included in agenda papers 3A, 3B and 3D relating to voting rights, options and convertible instruments and agency relationships.

Overall staff view regarding the role of kick-out rights

3. The staff believe that substantive kick-out rights should be considered when assessing control of an entity. Although a party might actively make decisions about the activities of an entity that most significantly impact the entity's economic performance, if another party holds substantive kick-out rights, the party that is actively making the decisions most likely does not have the *ability* to direct those activities; rather it most likely acts as an agent for the party with substantive kick-out rights.

4. A reporting entity can have the ability to direct the activities of an entity through voting rights or kick-out rights. A voting right gives its holder the right to appoint, and subsequently to 'step in' and replace, the members of the governing body of an entity. A kick-out right gives the principal the right to 'step in', remove the agent and claim back the decision-making rights that it had previously delegated to the agent. For the same reasons, kick-out rights may be considered similar to currently exercisable options and convertible instruments.

5. Therefore, similar to an entity that passively holds more than half of the voting rights in an entity, an entity that has the ability to exercise substantive kick-out rights has the current ability to 'step in', exercise its rights and remove any party that directs the activities of the entity to enforce its will.

6. However not every kick-out right prevents the entity that directs the activities of an entity from having the ability to enforce its will. For the holder of kick-out rights to have power, the terms and conditions of the kick-out rights should be

such that the holder has the current ability to remove the incumbent decision-maker. In other words, the removal right must be 'substantive' and must give the holder the ability to direct the activities of an entity that most significantly impact the entity's economic performance.

7. Views differ on whether kick-out rights can be substantive if more than one party must agree to their exercise. The remainder of this paper discusses the differing views regarding kick-out rights exercisable on agreement by more than one party.

Conclusions Reached in Statement 167

Background

8. Paragraph B19(d) of Interpretation 46(R) (before it was amended in June 2009) concluded that decision making fees were not variable interests if the decision maker was subject to substantive kick-out rights, as that term was described in paragraph B20 of the Interpretation. Paragraph B20 stated:

> The ability of an investor or another party to remove the decision maker (that is, kick-out rights) does not affect the status of a decision maker's fees in the application of paragraphs B18 and B19 unless the rights are substantive. The determination of whether the kick-out rights are substantive should be based on a consideration of all relevant facts and circumstances. Substantive kick-out rights must have both of the following characteristics:
>
> a. The decision maker can be removed by the vote of a simple majority of the voting interests held by parties other than the decision maker and the decision maker's related parties.
>
> b. The parties holding the kick-out rights have the ability to exercise those rights if they choose to do so; that is, there are no significant barriers to the exercise of the rights. Barriers include, but are not limited to:
>
>   (1) Kick-out rights subject to conditions that make it unlikely they will be exercisable, for example, conditions that narrowly limit the timing of the exercise
>
>   (2) Financial penalties or operational barriers associated with replacing the decision maker that would act as a significant disincentive for removal

(3) The absence of an adequate number of qualified replacement decision makers or inadequate compensation to attract a qualified replacement

(4) The absence of an explicit, reasonable mechanism in the contractual arrangement, or in the applicable laws or regulations, by which the parties holding the rights can call for and conduct a vote to exercise those rights

(5) The inability of parties holding the rights to obtain the information necessary to exercise them.

9. EITF 04-5, *Determining Whether a General Partner, or the General Partners as a Group, Controls a Limited Partnership or Similar Entity When the Limited Partners Have Certain Rights,* addresses kick-out rights specific to limited partnerships (or similar entities) that are not variable interest entities (VIEs). Accordingly, this EITF addresses a limited class of voting interest entities (VREs). EITF 04-5 concludes that a general partner has the controlling financial interest in a limited partnership unless the limited partners hold substantive kick-out rights. The factors for considering whether kick-out rights are substantive are consistent with those in Interpretation 46(R) (before the amendments in Statement 167) as documented in the preceding paragraph.

10. Although Interpretation 46(R) (before the amendments in Statement 167) and EITF 04-5 stress that determining whether kick-out rights are substantive depends on all relevant facts and circumstances, the analysis for determining substance is generally limited to considering the specific characteristics in paragraph 8 of this memorandum. The FASB staff highlights that the likelihood or probability as to whether kick-out rights will be exercised was not a factor considered in practice for determining whether these rights are substantive.

Summary of FASB Deliberations and Guidance for Considering Kick-Out Rights in VIEs and Responses to Comment Letters to the September 2008 Exposure Draft

11. In its exposure draft issued in September 2008, the FASB concluded that kick-out rights should be ignored for purposes of determining which reporting entity, if any, had "the power to direct matters that most significantly impact the activities of a variable interest entity, including, but not limited to, its economic performance" (paragraph 14A(a) of the exposure draft) unless a single enterprise

(including its related parties and de facto agents) had the unilateral ability to exercise these kick-out rights.

12. In reaching this conclusion, the FASB noted that many entities that were, or could have been, within the scope of Interpretation 46(R) were highly structured and had used kick-out rights as a means to either avoid classifying an entity (including non-financial structures) as a VIE or to avoid consolidation. The FASB supported its conclusion, in part, based on the fact that constituents acknowledged that kick-out rights are typically not exercised in practice.

13. The FASB concluded that if kick-out rights were included in the primary beneficiary analysis, enterprises would have significant structuring opportunities to achieve a conclusion that no single party with a variable interest in a VIE had power pursuant to paragraph 14A(a) of the exposure draft proposing amendments to Interpretation 46(R). The FASB concluded that these structuring opportunities could undermine the principles developed for consolidation of VIEs and, thus, imposed the limitation as to when kick-out rights could be considered in determining the primary beneficiary of a VIE as provided in paragraph 11 of this paper.

14. In the comment letter process, the majority of respondents, excluding users, asserted that it was inappropriate to ignore substantive kick-out rights when conducting the analysis in paragraph 14A(a) for purposes of determining which reporting entity, if any, was the primary beneficiary of the VIE. They asserted that the existing guidance on kick-out rights was sufficient in identifying whether these rights were substantive.

15. Some respondents asserted that kick-out rights were analogous to voting rights, which are used when determining which reporting entity, if any, controls a VRE under Accounting Research Bulletin 51, *Consolidated Financial Statements*, (ARB 51). They asserted that holding the majority of voting shares is effectively a kick-out right over the corporation's Board of Directors. Those respondents noted that currently, voting shares in a corporation that is not a VIE are considered relevant to the ARB 51 consolidation analysis, even if the voting rights are frequently not exercised by shareholders. In other words, if a

shareholder owns more than 50% of the voting shares they are presumed to control the entity.

16. The FASB staff agreed with this assertion and counters that the ownership of over 50% of the voting rights only results in a controlling financial interest (and, thus, consolidation by the controlling shareholder) when **one party** (the majority shareholder) owns over 50% of the voting rights. Having a majority of a VRE's voting rights seems consistent with the notion that kick-out rights should only be considered when held by a single party with the unilateral ability to exercise its kick-out rights.

17. The FASB staff had conversations with several users regarding the issue of including or excluding kick-out rights from the analysis of which reporting entity, if any, had power as defined for determining whether the reporting entity was the primary beneficiary of a VIE. The users asserted their preference for excluding kick-out rights from the assessment of which reporting entity was the primary beneficiary of a VIE. This assertion was primarily based on significant concerns that reporting entities with a variable interest that otherwise would have power would avoid consolidation by inserting kick-out rights into structured entities, including those formerly considered qualifying special purpose entities (QSPEs) in US GAAP. The users were sceptical that kick-out rights are indeed substantive because they believe that such rights are rarely exercised in practice. One comment letter from a user group stated that it agreed "with the FASB's conclusion that the qualitative analysis should not consider substantive kick-out rights unless the enterprise has the unilateral and sole ability to exercise such kick-out rights. It is our understanding that kick-out rights are typically not exercised."

18. The FASB staff also held informal meetings with an asset management industry group and representatives from the large accounting firms. The representatives had a significant amount of experience in dealing with, among other things, kick-out rights and the related accounting guidance. The purpose of these meetings was to obtain feedback on the overall power principle and the constituents' ability to apply the guidance for determining which reporting

entity, if any, was the primary beneficiary of a VIE, including the evaluation of kick-out rights.

19. These constituents acknowledged that kick-out rights are rarely exercised in practice regardless of whether the rights were concluded to be "substantive" according to EITF Issue 04-5 or paragraph B20 of Interpretation 46(R). Examples provided to the staff were limited to situations in which the illiquidity in the market for certain interests made it difficult, if not impossible, for these investors to exit structures through market mechanisms.

20. These constituents also asserted that unless the investor has the unilateral ability to exercise kick-out rights, it cannot be reasonably confident that other parties holding kick-out rights will call for and conduct a vote to exercise their rights and that the result would be the removal of the decision maker. This argument is based on investors often having different cost bases, investment objectives, expectations, confidence in the decision maker, and abilities to accept (or tolerate) volatility. Simply stated, these constituents did not rebut the presumption that control typically resides with the decision maker, who generally acts in the best interest of the investors and itself in situations in which the decision maker's fee varies based on the performance of the entity.

Summary of FASB Redeliberations and Basis for Conclusions Reached in Statement No.167

21. The FASB disagreed with the assertions by constituents that, although they are a decision maker that has a variable interest, they do not have the power to direct the activities of an entity as a principal merely as a result of other interest holders' holding kick-out rights that are currently considered substantive in US GAAP. Although the kick-out rights granted to investors may be deemed "substantive" based on an evaluation of current GAAP, the FASB continued to be significantly concerned that obvious structuring opportunities existed as noted in the previous section of the paper. The FASB, in expressing its concerns around structuring opportunities, highlighted that, in many situations, kick-out rights are currently granted to avoid consolidation under both Interpretation

46(R) and under EITF 04-5 and yet, these kick-out rights are rarely exercised in practice.

22. The FASB staff also was unable to obtain convincing evidence that a substantial difference in pricing existed in arrangements that provided investors with kick-out rights and those that did not. Although the FASB staff acknowledged that an inherent value for substantive kick-out rights may exist, the staff asserted its concern that if the probability that kick-out rights will be exercised is and will continue to be remote, pricing/yields for arrangements with kick-out rights when compared to those without will be substantially similar. The FASB staff highlight its concern around the substance of kick-out rights when reviewing some public filings of reporting entities seeking to execute an initial public offering. One entity deconsolidated the limited partnerships for which it was the general partner by "granting" kick-out rights to limited partners shortly before the initial public offering. Some constituents acknowledged that if the FASB changed its decision on kick-out rights, then the result could potentially be that the majority, if not all, of future securitization structures include provisions that would meet the current EITF Issue 04-5 and Interpretation 46(R) definition of substantive kick-out rights.

23. The FASB was also concerned that kick-out rights and/or participating rights that could be considered substantive based on a set of criteria that does not require (or even allow) consideration of the probability of exercise. They held the view that consideration of that probability might serve to indicate that the party that is subject to those rights is not being constrained by the existence of such rights.

24. The FASB concluded that the number of parties that held kick-out or participating rights, if greater than a single party, was irrelevant for applying the consolidation guidance in Statement No.167. This is because relying on practice to determine substance when more than a single party holds these rights is not practical. Moreover, the FASB concluded that unless a single party held substantive kick-out rights, the reporting entity with the power to direct the activities of a VIE currently controls the entity until it is removed. Consequently, the Board retained the amended guidance related to kick-out

rights and participating rights in Statement No.167. Specifically, kick-out or participating rights are not considered in the determination of whether an entity is a variable interest entity or whether a reporting entity is the primary beneficiary unless kick-out or participating rights are held by a single party with the unilateral ability to exercise these rights and the rights are substantive.[3]

Comparison of Kick-Out Right Conclusions to Voting Interests

25. Some staff believe that the FASB Board's decision to ignore kick-out rights (unless they are exercisable by one party) is consistent with the control model being developed, including its application to entities controlled by voting rights. Similar to a single party holding kick-out rights, those staff believe that a valid conclusion is that the controlling financial interest in a VRE cannot be readily removed as its interests effectively provide the reporting entity with more than a majority of the decision-making rights, regardless of the level of its voting percentage.

26. Agenda paper 3A sets out two views regarding the evaluation of voting rights—the 'contractual rights' view in that paper concludes that a reporting entity controls another entity only if it has the contractual right to direct the activities of the entity that significantly affect the returns. Therefore, a reporting entity holding a majority of the voting rights in an entity will generally control that entity. The reporting entity that holds less than a majority of the voting rights in an entity would also control the entity if, together with its voting rights, it had other rights in contractual arrangements that gave it the contractual right to direct the activities.

27. Staff supporting the 'contractual rights' view in agenda paper 3A and **view 1** in this paper argue that the control model is applied consistently in that a reporting entity that has the unilateral ability to kick-out the decision-maker is in a similar position to a reporting entity that holds a majority of the voting rights in an

[3] The Board members should note that, according to Statement No.167, kick-out rights that are exercisable on agreement by the reporting entity and any of its related parties would be considered when assessing control of a variable interest entity.

entity. Both have the unilateral ability to remove the party or body that directs the activities of the entity.

28. The staff supporting the 'contractual rights' view in agenda paper 3A would apply the same criteria to kick-out rights as follows. Parties A, B and C have interests of 45%, 30%, and 25%, respectively, in an entity. Assume that the parties are independent and thus, not considered related parties. Parties A, B and C enter into a contractual arrangement with Party D, such that the activities that most significantly impact the entity's economic performance are solely directed by Party D (Party D does not hold an investment in the entity but receives a performance-related fee for its services). Party D can be kicked out by a combined vote of parties A, B and C at any time. The critical question is which entity, if any, "currently" controls the entity. If none of the parties are related, is it feasible to make an assumption that Parties A, B and C would collude to remove Party D such that a conclusion is reached that Party D does not have the ability to direct the activities of the entity? If parties A, B and C are truly unrelated, is it practicable to assume that they will always, or even a majority of the time, share the same views regarding Party D? It would appear to be difficult, if not impossible, to determine whether their views of Party D's performance are consistent. Therefore, the staff supporting the 'contractual rights' view in agenda paper 3A and supporting the FASB position on kick-out rights in Statement No.167 would conclude that if Party D is currently directing the activities of the entity as a result of a contractual arrangement that gives it the right to direct those activities, then Party D meets the power element of the control definition until it is removed. In contrast, if for example Party A alone could kick-out Party D, then those kick-out rights would be considered when assessing control and it is likely that Party A would control the entity.

29. However, it is important to note that, in the example set out above in paragraph 28, the 'contractual rights' view in agenda paper 3A (and **view 1** in this paper) might not necessarily conclude that Party D controls the entity. An assessment would be required to determine whether Party D uses its power to direct the activities to generate returns for itself or for others—ie Party D would assess

whether it acts as an agent or a principal (agenda paper 3D discusses how that assessment might be made).

View 1 – Kick-out rights considered only when exercisable by a single party

30. Staff supporting **view 1** believe that kick-out rights should only be considered in determining whether a decision maker should consolidate another entity when a single party holds these rights and can unilaterally exercise them. This view is consistent with the FASB's conclusion in Statement No.167 and is primarily based on the reasons and basis set forth within the Statement. Although the staff supporting this view would ideally hope that a strong principle and factors could be developed regarding substantive kick-out rights and be applied appropriately and consistently in practice, those staff does not have the confidence that the appropriate judgment and application of any developed principles would be applied effectively. Moreover, those staff believe that any specific conditions or requirements for determining "substance" will inevitably result in structuring opportunities, regardless of whether one of the principles is related to the number of parties holding these rights.

31. The staff supporting **view 1** believe that practice will develop whereby entities will insert kick-out rights into most arrangements that meet any requirements and conditions for being considered substantive. Then, the stress will be placed on the number of parties holding the rights. The staff question how practice will apply guidance that inevitably will rely on the number of parties holding the rights (as it fully expects that the other criteria will be met). Specifically, if the kick-out rights are held by two parties, will practice conclude that this makes the kick-out rights substantive due to the likelihood of the rights being exercised? Staff supporting **view 1** believe that in situations in which kick-rights are held by multiple unrelated parties, it will be difficult if not impossible, to determine whether the parties will (a) agree to exercise their rights and (b) vote consistently.

32. Placing the analysis as to whether kick-out rights are substantive squarely on the number of parties holding these rights and, thus, the likelihood of the rights being exercised (assuming all other conditions are met) will inevitably cause operational issues and inconsistency in application. For example, the inevitable question from practice will be "what is the appropriate threshold for determining whether kick-out rights are substantive?" We certainly feel comfortable with a single party, maybe comfortable with 2, but how about 5? 10? 100? 1,000? With the evidence gathered and analyzed by the FASB during its deliberations and development of Statement 167, those staff question why consideration would be given to situations in which multiple parties hold kick-out rights and why this would be a factor in determining whether a decision maker is an agent or a principal.

33. The staff supporting this view believe that ascertaining a decision maker's role as either an agent or a principal should be based on other factors, including the significance of its decision making abilities and the latitude provided in making decisions, remuneration structure, other interests held in the entity, its exposure to the returns of an entity for which it is involved in, and other factors exclusive of kick-out rights (discussed in agenda paper 3D).

Illustration of concerns under this view

34. Consider a structured entity, such as a commercial paper conduit that under US GAAP was previously considered a QSPE. The sponsor of the entity, a financial institution, creates a trust and transfers $100 million of loans into the trust. The trust issues $95 million of beneficial interests (debt certificates) to unrelated third-parties, while the sponsor retains a five percent interest that is subordinate to the other beneficial interests. The sponsor retains the servicing rights for the transferred loans and is compensated at a market rate. As the other beneficial interest holders have no experience in servicing loans, they provide the sponsor with the sole discretion for servicing the loans, including work-outs of defaulted loans. Presumably, the sponsor is going to service the loans to ensure that it mitigates the risk that it will lose a portion or all of its retained interest and to ensure that the other beneficial interest holders receive the

stipulated return attached to their investment, including their principal investment. Currently, the third-party beneficial holders have no kick-out or participating rights. The sponsor, under the provisions of Statement No.167 and the current direction of the joint project, would consolidate the trust.

35. Now assume that the sponsor grants the third-party beneficial interest holders with kick-out rights. Also assume that although there may be a few or many third-party beneficial interest holders, the staff supporting **view 1** fear that the sponsor could demonstrate that, based on the guidance for determining whether the kick-out rights are substantive in current GAAP or under v**iew 2** set out below (excluding the number of parties holding the rights), the kick-out rights are indeed substantive. Although it may be obvious that these kick-out rights were granted so that the sponsor could avoid consolidation, those staff fear that the sponsor could represent that the rights are substantive and thus, they should not consolidate. In the US, kick-out rights have been pervasively granted historically primarily for reporting entities that otherwise would have consolidated VIEs or VREs to avoid consolidation. Nonetheless, practice has determined that regardless of the likelihood that these rights will be exercised, the rights are substantive as they met the characteristics of substantive kick-out rights in paragraph B20 of Interpretation 46(R), before being amended by Statement No.167. The staff supporting **view 1** question how auditors or regulators will be able to determine the substance of kick-out rights based on the number of parties holding the rights. It appears virtually impossible to forecast if multiple holders of these rights, if unrelated, will actually exercise these issues. They would have to have, among other things, the same goals, risk tolerances, and assessment of a decision maker's performance.

View 2 – Kick-out rights can be substantive if their exercise requires the agreement of more than one party

36. IFRS does not currently include any guidance regarding the consideration of kick-out rights when assessing control of an entity. ED10 *Consolidated Financial Statements* identified two indicators of an agency relationship:

(a) *Removal (kick-out) rights*: The right to remove a party, without cause, is an indicator that that party acts as an agent.

(b) *Remuneration*: Remuneration that is commensurate with the services performed by a party is an indicator that the party acts as an agent. [Agenda paper 3D discusses the remuneration of an agent.]

37. ED10 developed criteria to identify an agency relationship that included an assumption that, often, the principal will insist on having the right to remove the agent when it is unhappy with the services provided. As a consequence, the existence of a kick-out right is an indicator of an agency relationship.

38. Many respondents to ED10 asked the IASB to clarify the role of kick-out rights for determining whether a reporting entity acts as an agent or principal. In particular, they asked whether the application guidance should apply to substantive kick-out rights only and, if so, the circumstances in which a reporting entity should consider a kick-out right to be substantive. Other respondents argued that liquidation and redemption rights are economically similar to removal rights and that the IASB should explicitly address those instruments in the application guidance.

39. Some staff believe that substantive kick-out rights are an indicator of an agency relationship for the reasons noted in paragraphs 3-6 of this paper. Those staff recommend including guidance in the final consolidation standard to help when assessing whether kick-out rights are substantive.

40. An assessment of whether a kick-out right is substantive requires judgement and the consideration of all relevant facts and circumstances. Factors to consider include assessing whether there are any barriers to exercising the rights that, in effect, mean that the holder does not have the current ability to direct the activities that matter. Examples of such barriers include:

(a) financial penalties that would prevent the holder from exercising its rights;

(b) other conditions attached to the exercise of the rights that prevent the holder from having the ability to direct the activities that matter (eg timing restrictions); or

(c) operational barriers that would prevent the holder from exercising its rights (eg the absence of other managers willing or able to provide all of the specialized services, or provide all of the services and financial support provided by the incumbent manager; highly liquid investments that make it much easier for the holder to 'walk away' than to exercise its kick-out right).

These indicators are consistent with most of those present in Interpretation 46(R) before the amendments to the Interpretation in Statement No.167 and in EITF 04-5—reproduced in paragraph 8 of this paper.

41. Those staff also agree that the more parties that must agree on the exercise of a kick-out right, the less likely it is that the kick-out right is substantive. However, the staff supporting this view believes that a kick-out right can be substantive, even though more than one party must agree to its exercise.

Comparison of kick-out rights proposals to the proposals regarding voting rights

42. Staff supporting **view 2** think that this conclusion is consistent with the proposals relating to voting rights. Agenda paper 3A sets out two views regarding voting rights. The 'dominant shareholder' view in that paper concludes that a reporting entity that holds less than half of the voting rights in an entity (and without other contractual rights) would control that entity when all of the following are met:

(a) the reporting entity holds significantly more voting rights than any other shareholder;

(b) the other shareholders are not organised to vote together;

(c) the other shareholdings are widely dispersed; and

(d) there is evidence that the reporting entity has the ability to direct the activities of the entity that matter.

43. Accordingly, supporters of the 'dominant shareholder' view in agenda paper 3A believe that voting rights held by more than one party can prevent a shareholder with less than a majority of the voting rights from controlling an entity. The

smaller the number of other shareholders that must vote together to outvote the largest minority shareholder, the less likely it is that that minority shareholder has the ability to direct the activities of the entity. Similarly, the more investors that need to agree on the exercise of a kick-out right, the more likely it is that those investors pursue different individual interests and, as a consequence, might not agree on whether to exercise the kick-out right.

44. Therefore, in the example noted in paragraph 28 of this paper in which three investors must agree to remove Party D (who contractually has the right to direct the activities of the entity), staff supporting **view 2** believe that it is likely that none of the parties involved control the entity (in the absence of other factors). This is because those three investors have the ability to remove Party D that actively direct the activities of the entity if they choose to do so. Party D is being 'permitted' to direct the activities by the three investors. Party D is unlikely to have the ability to enforce its will and prevent the investors from collectively exerting their influence if they were unhappy with the direction of the activities. None of the investors would unilaterally control the entity.

45. Staff supporting **view 2** acknowledge the concerns of the FASB regarding structuring opportunities. However, those staff believe that it is important to note the following regarding the opportunities that would exist to avoid consolidation:

    (a) The proposals in this view include considering the number of parties that must agree to exercise kick-out rights as one factor, among others, that should be considered when assessing whether a party acts as an agent or a principal. Other factors to consider include the remuneration of the party that has decision-making authority (discussed in agenda paper 3D), as well as the factors listed in paragraph 40 of this paper relating to determining whether kick-out rights are substantive. As a result, the number of parties that must agree to the exercise of kick-out rights will *not* be the only determining factor when assessing whether one party consolidates another entity—it is simply one of many factors to consider. This should reduce the opportunity to insert non-substantive kick-out rights in order to avoid consolidation.

(b) The proposals in this view are similar to the requirements in FIN 46(R) (before it was amended in June 2009) and EITF 04-5, with one important difference. Staff supporting **view 2** do *not* propose including a criterion to say that kick-out rights are substantive if they are exercisable by a simple majority of investors in an entity. We think that including such a number creates a bright line that increases the risk of structuring opportunities.

(c) The entire assessment of control of an entity requires the application of judgement. It would appear unusual and inconsistent to assume that practice can apply all of the judgement necessary to assess control in every other respect, but to conclude for this one factor (ie the number of parties that must agree to the exercise of kick-out rights) practice could not apply appropriate judgement.

(d) Staff supporting this view suggest including wording in the final standard to say that a reporting entity should consider, among other factors, whether a mechanism is in place that facilitates parties collectively exercising their rights if they choose to do so. The holders of substantive kick-out rights should have the current ability to act together to prevent the party that currently directs the activities of an entity to take substantive decisions that are contrary to their wishes. The more parties that are required to agree to exercise the rights, the less likely it is that those parties have that ability to act together.

46. In addition, we note that none of the 148 respondents to ED10, or any of the participants at the IASB round tables held in June 2009, suggested that the IASB should restrict the consideration of kick-out rights to those that are exercisable by one party only. It is important to note that the FASB received similar feedback except for users of financial statements, even after acknowledging that structuring opportunities could exist.

47. Finally, the staff supporting **view 2** believe that the reason why kick-out rights are rarely exercised in practice is not because the rights are not substantive, but rather that the existence of those rights is generally sufficient to ensure that the decision-maker acts according to the wishes of the investor or investors holding

such kick-out rights. This conclusion is consistent with the proposed treatment of options, for which those staff supporting **view 2** has concluded that the option holder can have the current ability to enforce its will in directing the activities, regardless of whether the options are actually exercised (see Agenda paper 3B).

Liquidation / redemption rights

48. Both the IASB and FASB staff agree that some liquidation or redemption rights are also substantive kick-out rights, ie they are similar to substantive kick-out rights, and should be considered when assessing control of an entity. To illustrate, assume that the investors in an investment fund cannot remove the fund manager. However, the investors are allowed to redeem their shares at any time. We believe that, for example, if an investor holds an investment in the fund that, if redeemed, is large enough to force the liquidation of the fund, the redemption right should be treated in the same way as a substantive removal right. In this situation, the liquidation right is likely to give the holder the ability to direct the activities of the entity that significantly affect the returns.

49. For the purposes of assessing control of an entity, we recommend that such liquidation rights are treated in a similar manner to kick-out rights. Therefore the staff supporting **view 1** in this paper would propose that liquidation rights should be considered only if one party has the unilateral ability to liquidate an entity. The staff supporting **view 2** would propose that such liquidation rights can be substantive and considered when assessing control even when more than one party must exercise those rights in order to cause the liquidation of an entity. Therefore, for example, if investors hold the substantive right to liquidate their investments in an entity, and a decision by two of those investors would cause the liquidation of the entity, **view 2** would conclude that the incumbent decision-maker is unlikely to have the ability to enforce its will in directing the activities of the entity. This is because the decision-maker could not prevent those two investors from liquidating the entity if they were unhappy with the direction of the activities.

Question for the boards

50. There are two views that the boards must consider and ultimately conclude on in relation to kick-out rights. These views are as follows:

View 1: – *Include the FASB guidance in Statement No.167 that limits the consideration of kick-out rights in the power analysis to situations in which only a single party has the unilateral ability to remove the decision maker.*

View 2: – *Consider whether kick-out rights are substantive on the basis of all facts and circumstances, including the factors listed in paragraphs 40 and 45(d) of this paper. Kick-out rights are an indicator of an agency relationship, to be considered together with the remuneration received by the party that has been delegated decision-making authority. This view would allow kick-out rights held by more than one party to be considered in determining which reporting entity has power over another entity.*

Question for the boards
Do the boards believe that kick-out rights should be limited to a single party with the unilateral ability to exercise those rights or, alternatively, should more than one party be allowed to have kick-out rights in the assessment of power with the determination of the substance of these rights based on facts and circumstances?