1800-UCF Comment Letter No. 14



Deloitte & Touche LLP 10 Westport Road P.O. Box 820 Wilton, CT 06897-0820 USA

www.deloitte.com

November 2, 2010

Mr. Russell G. Golden Financial Accounting Standards Board 401 Merritt 7 P.O. Box 5116 Norwalk, CT 06856-5116

## Re: FASB Roundtable Meeting Agenda on IASB Staff Draft, Consolidated Financial Statements

Deloitte & Touche LLP respectfully requests participation in the FASB's November 22, 2010, roundtable on the IASB's staff draft *Consolidated Financial Statements*.

The views in this letter represent those of the Deloitte U.S. Firms.

We recognize the importance of this project and fully support the objectives of issuing a single, converged standard on consolidation. Further, we believe that applying a single definition of control to all entities is the appropriate basis for the consolidation model.

However, because several of the staff draft's key concepts are either internally inconsistent or ambiguous, we believe that the overall model is likely to result in significant diversity in practice and that it will be interpreted and applied inconsistently without further implementation guidance or clarification. In addition, without further development, the guidance on principal/agent relationships will most likely result in many of the interpretive issues that prompted the FASB to defer Statement 167<sup>1</sup> (codified in ASC 810<sup>2</sup>) for investment managers.

The appendix includes our responses to questions posed in the FASB roundtable meeting agenda.

\*\*\*\*\*

If you have any questions concerning our responses, please contact Jim Schnurr at (203) 761-3539 or Jeff Nickell at (203) 761-3779.

Yours truly,	
Deloitte & Touche LLP	
cc: Robert Uhl	

<sup>&</sup>lt;sup>1</sup> FASB Statement No. 167, Amendments to FASB Interpretation No. 46(R).

<sup>&</sup>lt;sup>2</sup> FASB Accounting Standards Codification Topic 810, Consolidation.

## Deloitte & Touche LLP Appendix Responses to FASB Roundtable Meeting Agenda Questions

Question 1: The Staff Draft provides a single concept of control that is used to evaluate control on a consistent basis for all types of entities (both voting interest entities and variable interest entities). Do you agree that a single-model approach to assess control will provide more consistent financial reporting for all types of entities rather than providing separate models for voting interest entities and variable interest entities? If not, why not?

Yes. We continue to believe that the FASB should work with the IASB to develop a single, common consolidation model that can be applied by all entities reporting under either U.S. GAAP or IFRSs. Entities operate under a variety of legal structures and contractual relationships. Establishing rules to differentiate the varying structures and types of entities into limited subsets complicates the consolidation analysis and sometimes leads to illogical results. In addition, it is impossible to contemplate all structures that would need to be addressed. Using a single concept of control allows for appropriate and consistent evaluation of the various entities.

Question 2: The Staff Draft does not incorporate the U.S. GAAP concept of a variable interest entity or a structured entity. Rather, the Staff Draft provides that the way in which control is assessed will vary depending on how the activities that significantly affect the entities' returns are directed. For example, how control is assessed will depend on whether the decisions that significantly affect the returns of an entity are made through voting rights. Without an explicit definition of a variable interest entity, do you believe that (ignoring the differences when analyzing decision making relationships and the effect related party arrangements have on the analysis) the Staff Draft will produce the same consolidation conclusions as the recently issued U.S. GAAP guidance for consolidating variable interest entities (FASB Accounting Standards Codification™ Subtopic 810-10, Consolidation)? If not, what are the situations that produce a different conclusion and why? Do you think it is sufficiently clear how to assess power and control for all types of entities in the Staff Draft?

We agree that the consolidation principle should be consistent for all entities and that the term "variable interest entity" (or "structured entity") would therefore not need to be defined separately in a comprehensive standard on consolidation.

It is not clear whether the staff draft will result in the same consolidation conclusions as the recently issued U.S. GAAP guidance on consolidating variable interest entities. If this is truly a concern of the boards, we suggest that a final standard include the examples from the Statement 167 implementation guidance and an assessment, on the basis of the staff draft's proposed model, of which party would perform the consolidation.

The overall principle of the staff draft appears consistent with Statement 167. However, several key concepts of the staff draft's model are either internally inconsistent or ambiguous, which makes it difficult (if not impossible) to determine whether the overall model is consistent with that in Statement 167 or whether an entity would reach consistent consolidation conclusions under the two models. For these same reasons, we believe that the staff draft's overall model would most likely be interpreted and applied inconsistently without further clarification. Specifically, we have noted the following:

• The differences between the facts in the example from paragraph B39 and those in the example from paragraph B41 are relatively minor; however, the two examples lead to different conclusions. The example in paragraph B39 describes a situation in which one investor holds 47 percent of the voting rights of an investee. The next two largest holdings of voting rights

are 10 percent and 4 percent; the remaining voting rights are held by thousands of shareholders, none individually holding more than 1 percent of the voting rights. In this example, the reporting entity concludes that the 47 percent shareholder meets the power criterion. The example in paragraph B41 describes a situation in which one investor holds 45 percent of the voting rights of an investee. Eleven other shareholders each hold 5 percent of the voting rights in the investee. In this example, the reporting entity concludes, without considering additional facts and circumstances, that the 45 percent shareholder does not meet the power criterion. It is unclear how these two examples differ and why they would lead to different conclusions. We believe that paragraph B19(c), which describes a situation in which multiple parties must agree to exercise rights, is similarly unclear.

- Paragraph B41 is extremely difficult to understand. It appears to require the consideration of one list of factors in paragraph B38(a)–(c) (a reporting entity may be able to reach a power conclusion on the basis of these factors in some cases but not in others). If a reporting entity cannot reach a conclusion on the basis of those factors, the entity must consider other factors and indicators in paragraphs B14 and B15 along with past voting patterns. Paragraph B14 appears to require a consideration of the indicators in paragraph B15, but the factors in B14 are given greater weighting than the indicators in paragraph B15. We have significant concerns that a consideration of three different lists of factors as well as past voting patterns will result in inconsistent consolidation conclusions.
- Paragraph B68 is included in the section on principal/agent determination and states, in part:

The greater the decision maker's exposure to variable returns from its involvement with an investee, considering its remuneration and other interests in the aggregate, the greater the weighting that should be placed on this factor and the more likely it is that the decision maker is not an agent.

The staff draft does not provide guidance on determining what level of financial interest would lead to a weighting of this factor that would result in consolidation. The lack of guidance on this topic is the same issue that resulted in the deferral of Statement 167 for investment managers. While the staff draft requires an entity to consider factors other than the decision maker's financial interest, the lack of implementation examples illustrating this concept makes it unlikely that consistent conclusions would be reached. In addition, if the staff draft is assumed to result in the same conclusions as Statement 167, it is unclear whether a reporting entity could assume that a "more than insignificant" or "potentially significant" financial interest would result in consolidation. We believe that the boards should be explicit regarding their intentions on this matter and that implementation guidance on how an entity should weight all of the factors in performing the principal/agent analysis is essential. The implementation guidance should clarify the weight an entity should place on the financial interest of a decision maker that has no equity at risk and that provides no other financial support to the entity or other variable interest holders.

Question 3: The Staff Draft proposes that in order to control an entity, the reporting entity must have the power to direct the activities of that entity<sup>3</sup>. Power is defined as having existing rights that give the reporting entity the current ability to direct the activities that significantly affect the entity's returns. Do you agree with the control principle as articulated in the Staff Draft? Do you agree that there are

<sup>&</sup>lt;sup>3</sup> A reporting entity controls another entity when the reporting entity has (1) power over the other entity, (2) exposure, or rights to variable returns from their involvement with the other entity, and (3) the ability to use its power over the other entity to affect the amount of the reporting entity's returns.

situations when a reporting entity can have control of an entity controlled through voting rights with less than a majority of voting rights? Why or why not?

## **Overall Control Principle**

The staff draft lists three elements of control:

- "Power over the investee
- Exposure, or rights, to variable returns from its involvement with the investee; and
- The ability to use its power over the investee to affect the amount of the investor's returns."

We believe that these elements generally consist of (1) the current power of a reporting entity to direct the activities of an entity that most significantly affect its performance, whether by voting rights or other arrangements, and (2) exposure, or rights, to variable returns from a reporting entity's involvement with the entity that could potentially be significant to the entity. While we believe these two elements are generally consistent with those in the staff draft, we think they more clearly state the overall principle.

## **Control With Less Than a Majority of Voting Rights**

We believe that the reporting entity may have control when it has less than a majority of voting rights over another entity. However, this would typically occur only if the reporting entity has unconditional contractual or other legal rights to unilaterally determine/control the activities of that entity regardless of the actions or inactivity of other stakeholders. We would agree that, in rare circumstances, the types of noncontractual factors listed in paragraphs B14 and B15 could cause a reporting entity to have power.

We do not believe that ownership of a large percentage of the shares in an entity (that entitles the reporting entity to less than the majority of the voting rights) would allow the reporting entity to control that entity simply because the other shareholders are dispersed and not organized. While, at a particular time, an unorganized and dispersed shareholder group may permit a dominant shareholder to make decisions about the activities of an entity, in the absence of factors that give the dominant shareholder an unconditional power to direct activities, the dominant shareholder does not possess control. Nothing prevents the other dispersed shareholders from voting jointly against any decision they do not support (i.e., at any time they can take away the ability of the dominant shareholder to direct the entity's activities). This is particularly true since, in practice, the majority of dispersed shareholders are institutional investors.

We do not believe that the control determination should be based solely on the actions (or absence of actions) of others, as is suggested in the first example in paragraph B39. In essence, we believe that control has to be unilateral and not simply the forbearance of exercising existing rights by the various parties who hold those rights.

Question 4: The Staff Draft states that if the activities that significantly affect an entity's returns are directed through voting rights, a reporting entity holding less than a majority of the voting rights (assuming no potential voting rights or other contractual rights exists) has power when it can unilaterally direct the activities of the entity that significantly affect the entity's returns. This assessment requires judgment. The Staff Draft provides application guidance to determine when a reporting entity holding less than a majority of the voting rights in an entity controlled through voting rights has power. Specifically, the Staff Draft provides that, in some cases, a determination can be made about whether a reporting entity has power by just considering the absolute size of the reporting

entity's holding of voting rights, the size of its voting rights relative to the size and dispersion of holdings of the other vote holders, the voting patterns at previous shareholders' meetings, and other arrangements. Do you believe that there are circumstances when, considering only these factors, an assessment could be made about whether a reporting entity has power? Why or why not?

See response to Question 3.

Question 5: In other circumstances the Staff Draft provides that additional evidence may be needed in order to conclude that a reporting entity holding less than a majority of the voting rights in an entity controlled through voting rights has power. The Staff Draft includes indicators that may provide additional evidence in these circumstances to assist in determining whether the reporting entity has power. Do you believe that these indicators provide sufficient guidance to conclude that a reporting entity has power in situations where it is unclear as to whether a reporting entity has power solely based on the absolute size of the reporting entity's holding of voting rights, the size of its voting rights relative to the size and dispersion of holdings of the other vote holders, the voting patterns at previous shareholders' meetings, and other arrangements? If not, what additional indicators should be included or which of these indicators should be removed?

See response to Question 3.

Question 6: The Staff Draft requires a reporting entity to consider its rights to obtain additional voting rights of another entity, as well as such potential voting rights (options or convertibles, for example) held by other parties, to determine whether the reporting entity has power. Do you believe the guidance in the Staff Draft is appropriate and operational? Specifically, do you believe that the guidance for determining when potential voting rights are considered substantive is operational? If not, what additional guidance would you suggest?

To exercise options, the holder must pay the exercise price. A holder that owns shares receives different rights and obligations than one that simply owns the option. As indicated in our earlier comments, we believe that the party must have the current ability to unilaterally control the activities of the entity. Therefore, we believe that, generally, an arrangement must exist that provides an option holder with the power to direct the activities of the other entity, regardless of whether the options are actually exercised.

In rare situations, options alone (i.e., in the absence of another arrangement) may provide the holder with control regardless of their exercise price. However, this is only true if the options provide the holder with the current effective means of directing the activities of the entity to generate returns (in the broad sense) for the option holder, even in the absence of actual exercise, because other shareholders do not have any realistic prospect of doing something other than what the option holder desires. For this same reason, options may indicate that a decision maker is serving as an agent of an option holder (in certain circumstances). We believe that paragraph B44 and the associated examples convey principles similar to these; thus, we agree with the staff draft's guidance.

However, we also believe that to assess power over the remaining life of an entity, a reporting entity must consider all contractual rights and obligations, including those that will arise in the future (e.g., a call option or a residual value guarantee on a leased asset at the end of the lease term) pursuant to contracts in existence as of the balance sheet date. Relevant considerations may include the pricing of the feature (e.g., fixed exercise price or fair value exercise price, whether the option is in the money) and other business factors (e.g., whether a reporting entity holds a call option on an asset that is critical to its business operations). We believe that the following example should be added to the implementation guidance to help illustrate the consideration of forward starting rights:

Entity A is created and financed to purchase a single property to be leased for five years under an operating lease to Entity B. Entity B must provide a first-loss residual value guarantee for the expected future value of the leased property at the end of the lease term and has a fixed-price purchase option to acquire the leased property at the end of the lease term. In accordance with its design, A will not buy or sell any other assets (i.e., A is a single-asset leasing entity). In this example, A was designed to provide B with the risks and rewards of ownership of the leased asset. Even though the purchase option is not exercisable until the end of the lease term, it is central to the design of A and would be considered in the consolidation analysis. In addition, B would have control of A and the related leased property because of a combination of the lease and the purchase option.

Question 7: When determining whether a reporting entity acts as an agent, the reporting entity must consider the overall relationship between it and other parties involved with the entity, considering the following factors:

- a. The scope of its decision-making authority over the entity
- b. The rights held by other parties
- c. The remuneration the reporting entity is entitled to in the arrangement
- d. The reporting entity's exposure to variability in returns as a result of other interests that it holds in the entity.

Do you believe the guidance related to assessing decision-making arrangements in the Staff Draft is appropriate and operational? Do you believe the Staff Draft would lead to appropriate consolidation conclusions?

We believe that the principal/agent evaluation should be guided by the typical characteristics of an agent. Such characteristics may include whether the party:

- Has equity at risk.
- Provides financial support.
- Can be removed by the principals.
- Receives a market-based fee for services (the fee may be fixed, based on performance, or both).
- Has any other limitations on its decision-making ability.

In general, we agree that the factors listed as part of the decision-maker analysis are appropriate to the evaluation of whether a party is an agent. However, we believe that the guidance will lead to inconsistent application and may not address the implementation issues related to the application of Statement 167 by the investment management industry that resulted in the deferral of certain aspects of Statement 167 earlier this year. Specifically, paragraph B68 states, in part:

The greater the decision-maker's exposure to variable returns from its involvement with an investee, considering its remuneration and other interests in aggregate, the greater the weighting that should be placed on this factor and the more likely it is that the decision-maker is not an agent.

The staff draft includes no guidance on determining the level or nature of financial interests that would lead to a weighting of this factor that would result in consolidation. While the staff draft requires consideration of factors other than the decision maker's financial interest — which we support — the lack of implementation examples illustrating this concept make it unlikely that consistent conclusions would be reached.

November 2, 2010 Page 7

We strongly believe that, in the absence of further implementation guidance or examples, the proposed guidance would result in the same implementation issues as those associated with the interpretation of a "more than insignificant" economic interest in Statement 167.

Question 8: When evaluating a decision-maker's role, rights held by other parties are considered when determining whether a decision-maker is an agent. Specifically, situations in which a single party holds substantive removal rights and can remove the decision-maker without cause, in isolation, would be sufficient to conclude that the decision-maker is an agent. However, if numerous parties hold such rights, those rights would not, in isolation, be conclusive in determining whether a decision-maker is an agent. In such a situation, those rights would be considered together with the other factors included in question 7 above, to determine whether the decision-maker is an agent. Do you believe that removal rights held by numerous parties should be a factor when evaluating whether a decision-maker is an agent? If so, do you agree that it should be one factor but not in and of itself determinative, when evaluating whether a decision-maker is an agent?

We believe that removal rights held by multiple parties may be one factor in this evaluation but that a reporting entity should consider all facts and circumstances when assessing whether a decision maker is an agent. The Board should include implementation guidance to help illustrate the interaction between (1) removal rights and the number of parties that must agree to exercise those removal rights and (2) the weighting and significance of the financial interest held by the decision maker.

Question 9: The Staff Draft requires a reporting entity to reassess whether it controls another entity if facts and circumstances indicate that there are changes to one or more of the three elements of control. Do you believe this principle, and the related guidance in the Staff Draft, is sufficiently clear and operational?

We agree that a reporting entity should continually reassess whether it controls another entity and that, typically, this reassessment will be triggered by specific transactions or events that have an impact on one of the elements of control. However, we question whether this requirement would be operational if consolidation is required for reporting entities because they own a large percentage of the shares in an entity when other shareholders are dispersed and not organized. The population of investors could change daily (or even more frequently). In such cases, it may be extremely difficult for a reporting entity to continually assess the composition of the other shareholders, any agreements among the other shareholders to consult with each other when making decisions, and any potential voting rights the other shareholders may own. We question whether a reporting entity would have access to the relevant information to perform such a continual assessment in such circumstances.