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Re: IASB Staff Draft, *Consolidated Financial Statements*

Grant Thornton LLP appreciates the opportunity to respond to questions in the FASB Roundtable Meeting Agenda for the November 22, 2010 meetings on the International Accounting Standards Board Staff Draft, *Consolidated Financial Statements*. This letter provides our responses to those questions.

We believe that adopting a single concept of control as the basis for consolidation for all entities would provide for more consistent consolidation decisions for all types of entities. We also believe that the principles of control articulated in paragraphs 5 through 7 of the Staff Draft would provide a reasonable basis for consolidation. However, as indicated in our responses to the FASB's questions, we are concerned about the clarity of some of the Staff Draft application guidance.

In addition, before adopting a single model approach to assess control for all types of entities, we believe the FASB should fully consider how it would be applied to common private company and not-for-profit entity arrangements.

#### Private company experience

Questions have arisen about whether the consolidation of variable interest entities (VIEs) by private companies provides useful information. The amendments to the guidance on the consolidation of VIEs became effective for fiscal years, and for interim period within those years, beginning after November 15, 2009. Therefore, historical experience on how practice has implemented the new guidance is limited, especially for private companies that have not yet issued financial statements under the new guidance. We encourage the FASB to consider how the Staff Draft guidance would be applied to typical private company arrangements and whether the resulting private company consolidated financial statements would meet the needs of their users.

#### Not-for-profit entities

The single model approach to assessing control described in the Staff Draft was developed without specific consideration of not-for-profit entity financial reporting. Our responses in this letter to the FASB's questions on the Staff Draft neither consider nor address the application of

the Staff Draft guidance by not-for-profit entities. However, we recommend that the FASB fully consider the consolidation by not-for-profit entities *before* adopting a single-model approach to assess control for *all* type of entities.

#### Responses to roundtable meeting agenda questions

**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 believe that adopting a single concept of control as the basis for consolidation for all entities would provide for more consistent consolidation decisions for all types of entities. Currently under U.S. GAAP, opportunities to structure an arrangement for an accounting result may exist because of different consolidation guidance for different types of entities. For example, Statement 167, *Amendments to FASB Interpretation No. 46(R)*, imposed certain restrictions on consideration of kick-out rights and on participating rights only for variable interest entities (VIEs).

**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<sup>TM</sup> Subtopic 810-10, *Consolidation*<sup>1</sup>)? 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?**

<sup>1</sup> Originally issued as FASB Statement No. 167, *Amendments to FASB Interpretation No. 46(R)*.

Limitation on the nature and extent of our response to this question

This question asks for a comparison of the consolidation conclusions that would be reached under U.S. GAAP for VIEs and under the Staff Draft, without consideration of differences in guidance on decision-making relationships and on related-party arrangements. However, decision making relationships and related party arrangements are often significant and pervasive elements of the VIE analysis; therefore, it is not clear how one could reach a consolidation conclusion without considering those elements.

Furthermore, as previously indicated, the amendments to the guidance on consolidation of VIEs became effective for fiscal years, and for interim period within those years, beginning after November 15, 2009. Therefore, historical experience on how practice has implemented the newly amended guidance on consolidation of VIEs is limited, especially for private companies that have not yet issued financial statements under the new guidance.

Comparison of Staff Draft and U.S. GAAP guidance

Any differences in the scope of the Staff Draft and U.S. consolidation standards could result in differences in consolidation conclusions. In addition, we believe that the Staff Draft guidance could result in consolidation of many arrangements that currently qualify for the partial deferral in FASB Accounting Standards Update 2010-10, *Amendments for Certain Investment Funds*.

We believe that application of the controlling financial interest characteristics for VIEs in ASC 810-10-25-38A could lead to different conclusions than the application of the elements of control in paragraph 7 of the Staff Draft. For example, consider the following:

- “Exposure, or rights, to variable returns,” an element of control in the Staff Draft, might not be the functional equivalent of “the obligation to absorb losses of the VIE that could potentially be significant to the VIE or the right to receive benefits from the VIE that could potentially be significant to the VIE,” a characteristic of a controlling financial interest in ASC 810-10-25-38A. As such, there would likely be some consolidation conclusions under the Staff Draft guidance that would be different than those under U.S. GAAP. In addition, it is possible that application of the Staff Draft guidance on “exposure, or rights, to variable returns” by U.S. GAAP reporting companies would be influenced by prior experience in applying the concepts of “variable interests” and “expected losses and expected residual returns,” as defined in ASC 810-10.
- Paragraph 14 of the Staff Draft states, “[A]n investor can control an investee even if other entities have existing rights that give them the current ability to participate in the direction of the relevant activities.” It is not clear, however, how an investor could have the power over the investee’s relevant activities if other parties have the current ability to participate in the direction of those activities. Under current U.S. GAAP, substantive “participating” rights held by other parties can overcome control by a decision maker in a VIE, by the holder of majority vote in a voting interest entity, or by the general partner in a limited partnership.

Silos

In general, consolidation is an entity concept. The requirement to consolidate a silo raises questions about the entity concept and whether a portion of an entity can itself be considered an entity. We note that the FASB and the IASB have not completed the reporting entity phase of their joint conceptual framework project. Therefore, it is not clear why the silo consolidation requirement should be expanded to include all entities.

**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>2</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 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?**

<sup>2</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.

We agree that the control principle articulated in the Staff Draft would provide a reasonable basis for consolidation. As previously noted, however, we believe the FASB should fully consider how the control principle would be applied to common private company and not-for-profit entity arrangements before adopting a single model approach to assess control for all types of entities.

We also agree that an investor holding less than a majority of the voting rights in an entity could have power to unilaterally direct the relevant activities of the entity if the investor also holds substantive potential voting rights that are in the money. However, as indicated in our response to Question 4, we believe that an entity for which relevant activities are directed by a majority vote would not be controlled by an investor holding less than a majority of the voting rights and no substantive potential voting rights.

**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?**

This question is based on a presumption that an investor holding less than a majority of the voting rights can have the power to unilaterally direct the relevant activities of an investee when the relevant activities are directed through voting rights and no potential voting rights or other contractual rights exist.

Assuming that (a) the relevant activities of an entity are directed solely by majority vote of all voting rights, and (b) no potential voting rights or other contractual rights exist, then the holder of less than a majority of the voting rights of the entity would always require the voting support of at least one other voter to be able to exercise the power to direct the relevant activities of that entity. In those circumstances, we believe that the holder of less than a majority of the voting rights would *not* have the power to unilaterally direct the entity's relevant activities, regardless of the factors listed below:

- The absolute size of the reporting entity's holding of voting rights or 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
- Other arrangements

The absolute size of the reporting entity's holding of voting rights or the size of its voting rights relative to the size and dispersion of holdings of the other vote holders

Regardless of the absolute or relative size of a reporting entity's holding of voting rights, if that holding is less than the minimum votes required to exercise power, then the holder would always require the voting support of at least one other voter to exercise the power to direct the relevant activities of that entity. In those circumstances, the reporting entity would not have the power to unilaterally direct such activities.

The voting patterns at previous shareholders' meetings

Regardless of prior voting patterns, if the holder of less than a majority of the votes does not have the right or ability to unilaterally exercise power, it does not have control. Paragraph 12 in the Staff Draft states that

An investor with the current ability to direct the relevant activities has power even if its rights to direct have yet to be exercised. Evidence that the investor has been directing relevant activities can help determine whether the investor has power, but such evidence is not in itself conclusive in determining whether the investor has power over an investee.

Absent some contractual rights, such as a vote proxy or voting commitments, past voting patterns do not give the holder of less than a majority voting interest the unilateral ability to direct the relevant activities in any current or future vote.

Other arrangements

In our view, the Staff Draft guidance in paragraphs B30 through B44 on consideration of other arrangements in the analysis of an entity whose significant activities are directed by voting interests is not clear. Except for certain contractual agreements between holders of voting interests, such as a vote proxy, other arrangements that provide the holder of less than a majority of the voting interests with the power over an entity's relevant activities may indicate that the entity's relevant activities are not in fact being directed through voting rights.

According to paragraph B30, the guidance in paragraphs B31 through B44 would apply when the entity's significant activities are directed through voting rights. However, some of the guidance in paragraphs B31 through B44 seems to describe entities for which power is provided by contractual arrangements rather than voting rights. For example, paragraph B36 indicates that other decision-making rights from contractual arrangements may be necessary in addition to voting rights for the holder of those rights to have power. Paragraph B39 states that

*When the direction of relevant activities is determined by majority vote* and an investor holds significantly more voting rights than any other vote holder or organised group of vote holders, and the other shareholdings are widely dispersed, the factors listed in paragraphs B38(a)-(c) alone may be sufficient evidence to conclude that the investor has power over the investee. [Emphasis added]

Paragraph B39 also provides examples to illustrate that guidance, implying that the examples represent entities for which the direction of relevant activities is determined by majority vote. The second application example in paragraph B39 indicates that the holder of 40 percent of the voting rights of an investee has the unilateral right under a shareholder agreement to appoint, remove, and set the compensation for management responsible for directing the relevant activities. We believe that the existence and substance of the shareholder agreement should have been considered in the determination of whether the entity's relevant activities are directed through voting rights. If the rights under the shareholders' agreement provide substantive unilateral ability to direct the entity's relevant activities, then we question whether the direction of that entity's relevant activities is in fact determined by contract rights rather than by a majority vote.

Other comments

As stated in paragraph B7, "Understanding the purpose and design of an investee may help identify the relevant activities, how decisions about the relevant activities are made, who has the ability to direct those activities and who receives returns from that direction." That understanding is an important step because it is the basis for determining whether or not an entity's relevant activities are directed by voting rights. Therefore, it is not clear why paragraph B45 indicates that the guidance on the purpose and design of an investee in paragraphs B45 through B48 would only be considered if voting rights do not have a significant effect on an investee's return. We are concerned that the stated limitation on when such guidance should be considered could result in a reporting entity incorrectly concluding that the power over a investee's relevant activities is exercised through voting rights.

**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?**

Please see our response to Question 4.

**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?**

We believe the Staff Draft guidance on consideration of a reporting entity's rights to obtain additional voting rights in another entity and of potential voting rights held by other parties in paragraphs B18 through B22 is appropriate and operational. However, we do not think the second application example in paragraph B44 provides an appropriate conclusion that Investor A's potential voting rights provide it with the power over the investee. If the conversion feature in the debt instrument is out of the money, it is unclear why Investor A would benefit from the exercise of the conversion right.

**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?**

It is not clear to us whether the Staff Draft would lead to appropriate consolidation conclusions in all circumstances or whether consistent conclusions would be reached by all preparers and auditors. The forthcoming proposal for investment companies may address some of our concerns. While applying the guidance on decision-making arrangements would appear to result in the same consolidation conclusions when applied to the examples in ASC 810-10-55-93 through 55-205 (Case A through Case I), it is not clear how the guidance would apply to other examples such as many of the arrangements entered into by entities to manage various types of investment funds.

Guidance on agency relationships and related parties

The Staff Draft guidance on identifying agency relationships includes the following two rules:

- Paragraph B64 states, “A decision-maker cannot be an agent unless the [remuneration] factors set out in paragraphs B63(a) and B63(b) are present.”
- Guidance in paragraphs B56 and B61 provides that, in isolation, substantive removal rights held by a single party would be sufficient to conclude that the decision maker is an agent.

We think that paragraph B64 may be too restrictive in some structures involving related parties, although the Staff Draft is not clear as to how an investor’s related parties should be considered in assessing whether the investor should consolidate an investee. Paragraph BC 113 states that

The Board decided to clarify its intentions by stating that an investor would consider the interests and involvement of its related parties, together with its own, when the nature of its relationship with a related party is such that the related party is acting on behalf of the investee. The IFRS also includes guidance on the consequences of concluding that a related party acts for the investor when assessing control of an investee.

We do not think the information in paragraph B113 is clearly reflected in the authoritative sections of the Staff Draft. Paragraphs B69 through B71 describe “de facto agents,” which include the investor’s related parties. However, there is no mention of how such de facto agent relationships should be considered or would affect an investor’s analysis of control. For example, in a related-party structure, could a decision maker be an agent or de facto agent if it is subject to removal by a single related party without cause (paragraphs B56 and B61), but it is not entitled to receive remuneration at market terms or commensurate with services provided (paragraph B64)?

**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 substantive removal (kick-out) rights held by more than one party, even held by numerous parties, could be an indicator that the party subject to such rights is acting as a hired service provider or agent.

The examples of removal rights that could be indicators that the decision maker is a hired service provider include the following:

- More than one party holds substantive removal rights, but each holder has the unilateral ability to remove the decision maker.
- Exercise of substantive removal rights requires a majority vote when the direction of other relevant activities is also determined by a majority vote of the parties that hold the removal rights.

In our view, the effect of such indicators in the assessment of whether to consolidate an entity would need to be carefully considered in the context of all relevant facts and circumstances.

The FASB considered the effects of removal rights on consolidation in both FASB Interpretation 46 (revised December 2003), *Consolidation of Variable Interest Entities*, and Statement 167. Paragraph A47 of Statement 167 states, “The Board was troubled by the fact that kick-out rights considered ‘substantive’ for accounting purposes are rarely exercised in practice.” In addition, Statement 167, paragraph A48, indicates a concern that the factors listed in paragraph B20 of Interpretation 46R had been incorrectly considered all-inclusive when determining whether kick-out rights were substantive. In response, Statement 167 removed the previous guidance for VIEs on whether kick-out rights are substantive.

We acknowledge that kick-out rights have been a focus of structuring efforts to achieve off-balance sheet reporting and that such efforts have resulted in the FASB’s increased restrictions on consideration of kick-out rights for VIEs. We suggest that the FASB should carefully consider what additional guidance may be necessary to ensure that any new requirements for the consideration of kick-out rights are applied as the Board intends.

According to paragraph B60 in the Staff Draft, some liquidation rights are similar to substantive removal rights. Based on our experience with current U.S. GAAP in ASC 810-20, we believe that additional guidance would be needed to clarify when liquidation rights should be considered similar to removal rights to avoid inappropriate reliance on liquidation rights to avoid consolidation. However, we also believe that in some arrangements an investor’s unilateral ability to have its interest redeemed at fair value or at net asset value without liquidation could have the effect of substantive removal rights.

**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?**

In general, we believe that the requirement for 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, would be appropriate and operational. However, we also believe that

the application of that reassessment requirement, as described in paragraph BC84, would be neither appropriate nor operational. Paragraph BC84 states that

It might be the case that when an investor initially acquires voting rights in an investee by considering the size of that holding and the voting rights held by others, sufficient evidence is not available to conclude that the investor has power. However, the assessment must be reconsidered as additional evidence becomes available. For example, the voting rights held by an investor and others may be unchanged but over time the investor may have been able to appoint a majority of the investee's board of directors and have entered into significant transactions with the investee, enabling the overall assessment to be made that the investor now has control and should consolidate the investee.

As of the date the investor initially acquires voting rights in the investee, the investor would need to reach a conclusion as to whether or not it controls the entity. Paragraph BC84 implies that the subsequent accumulation of evidence over time, without any change in the rights or obligations of the parties involved with the investee, could change the control assessment. Paragraph B84 cites as evidence a history of board appointments, without consideration of why the investor was able to appoint board members in the past, whether the investor has the current ability to appoint a majority of the board members in the future, or when the investor obtained that ability. Business combination accounting is based on the principle that change of control is an event that requires remeasurement as of the date the event occurred. Without any event—that is, without any change in the rights and obligations of the parties involved with the investee—it is unclear why subsequent evidence of control would not require correction of an error as of a previous assessment date rather than a change of control as of the new assessment date.

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We would be pleased to discuss our comments with you. If you have any questions, please contact Mark Scoles, Partner – Accounting Principles Consulting Group, at 312.602.8780 or [Mark.Scoles@gt.com](mailto:Mark.Scoles@gt.com).

Sincerely,

/s/ Grant Thornton LLP