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Dear Alan

IASB Project: Consolidation

On behalf of the German Accounting Standards Board (GASB) I am writing to comment on the deliberations of the IASB Staff in the context of the consolidation project. The IASB Staff proposed a new control model which we discussed using the support of our working group on consolidation. We greatly appreciate the opportunity to comment on the deliberations.

Control Model proposed by the IASB Staff

In the ongoing consolidation project, the IASB Staff proposes a new control model which does not focus on control over an entity per se but on control over specific assets and liabilities of an entity. According to paragraph 11 of paper 7A of the Information for Observers September 2006 control is defined by the IASB Staff as follows:

> *"An entity has a <u>controlling interest</u> in another entity when it has <u>exclusive rights</u> over that entity's assets and liabilities which give it <u>access to the benefits</u> of those assets and liabilities and the <u>ability to increase, maintain or protect</u> the amount of those benefits."*

Based on this control definition the IASB Staff derived a two-stage-model (see paragraph 96 of paper 7B of the Information for Observers September 2006):

> *"However, because there are situations in which control over an entity or its assets is not obvious, the solution therefore might be a two-stage model in which,*
> - *first, the existence of control is assessed[1] and [stage one],*
> - *second, if control cannot (or should not) be established by 'traditional' means, each investor will recognise the respective rights and responsibilities related to their interest in the entity [stage two],."*

As we understand the proposed model stage one refers to the existing consolidation requirements of IAS 27 while stage two rather refers to the new concept focussing on the asset level than on the existing requirements in IAS 27 and SIC 12.

[1] *The party that has control under the 'traditional' control model will consolidate the entity.*

According to the proposed model the generation of silos will be possible (see paragraph 97 of paper 7A of the Information for Observers September 2006):

> *"It might be that one entity controls the whole entity. Alternatively, it might be that the entity has control over particular assets and liabilities of the entity. When the rights and obligations to the individual assets and liabilities have been clearly identified, then the entity should recognise those rights and obligations for which it has control over,* ***and not others****."*

Analysis of the proposed Control Model

We welcome the IASB's efforts to develop a comprehensive standard which will define control in respect of all entities, including SPE's. As far as we have understood the proposed control model we have the following concerns:

1) Consistency of stage one of the proposed model with the proposed control definition

We evaluated the proposed two stage model concerning the control definition. In our opinion, the control definition does not match stage one of the proposed model.

According to stage one of the proposed model, a reporting entity with a majority interest in a subsidiary is considered to be the controlling party of this subsidiary (see paragraph 96 of paper 7B of the Information for Observers September 2006) because the reporting entity is able to direct the strategic financing and operating policies of the subsidiary. We are concerned that this circumstance does not fall within the proposed definition of control. The proposed definition focuses on the exclusive rights over assets and liabilities which enables the reporting entity to utilise or deal with the assets as if they were its own (see paragraph 5 of paper 7A of the Information for Observers September 2006). However, a reporting entity with a majority interest in a subsidiary has the ability to govern the strategic operating and financing policies only and thereby does not necessarily have an exclusive right to deal with each asset or liability of the subsidiary as if they were its own (e.g. demand the disposal of an asset). Rather, the strategic decision-making power provides an indirect right over the subsidiary's asset. Applicable law may even prohibit the shareholders' dealing with the entity's assets and liabilities as this falls into the responsibilities of management.

As a result, it seems that the proposed control definition does not match the first stage of the proposed model. Therefore, we propose to change the control definition according to an earlier proposal of the IASB Staff in the context of the consolidation project:

> *"<u>Control</u> is the <u>ability to direct</u> the strategic financing and operating <u>policies</u> of an entity so as to <u>access benefits</u> flowing from the entity and <u>increase, maintain or protect</u> the amount of those benefits."*

2) Stage two of the proposed model: rather a matter of recognition/derecognition of assets and liabilities than a consolidation matter?

Furthermore, we considered the second stage of the model and believe it mixes the control notion - which should define the economic unit - and the criteria for recognition/derecognition of assets and liabilities. While the second stage of the model seems to be in line with the proposed definition of control, the proposed definition of control focuses on the asset and liability level and therefore consults the criteria for the recognition of individual assets (see footnote 5 of paragraph 11 of paper 7A of the Information for Observers September 2006).

While assets and liabilities are recognised in the consolidated financial statements according to the proposed control definition which focuses on the asset level the assets and liabilities should already be recognised in the separate financial statements. The criteria of recognition of an asset include control over an asset. The definition of control should be the same for the purposes of separate financial statements and consolidated financial statements. Hence, the assets should already be recognised in the separate financial statements (and therefore would be included in the consolidated financial statements).

For that reason, the issue whether or not to recognise the rights and responsibilities in the investee (i.e. the investment) is a question that should be addressed in a project which considers recognition/derecognition of an asset rather than in the consolidation project. If the asset definition is broader than the current one, specific requirements like the existing SIC 12 would be obsolete because the rights and responsibilities are already recognised in the separate financial statements.

Hence, we believe that the issue of stage two of the proposed model (decision whether or not to recognise the rights and responsibilities in the investee) is a matter of recognition/derecognition of assets rather than a consolidation matter.

3) Practical problems in the context of the decision on recognition of rights and responsibilities

Another problem arises if the control model outlined above is applied to SPEs where one party has rights and responsibilities over a portion of the assets and liabilities of that SPE. As we understand the IASB Staff model, the decision about recognition of a portion of assets and liabilities does not refer to a minimum level of benefits like the requirements of the existing SIC 12 (e.g. more than 50 % of the total benefits). Therefore, every tiny interest appears to require recognition under the model proposed by the IASB Staff.

However, the decision in such circumstances raises the question which criteria determine whether or not the party has to recognise the right to a particular proportion of an asset?

4) Composition of the rights and responsibilities

In the example provided by the Staff in paragraph 99 of paper 7B of the Information for Observers September 2006, asset 1 and the related liability belong to the reporting entity. However, in other scenarios the reporting entity has a right to a proportion of all assets and liabilities, expecting cash flows with a specific risk which relate to a portion of all assets. Consider the following scenario:

> *Entity A sells receivables to an SPE. The receivables are securitized and different classes of notes are issued to different parties. The reporting entity which did not sell the receivables to the SPE purchases the most junior note issued by the SPE. Thereby, the reporting entity bears a certain portion of the potential loss arising from the receivables. However, the reporting entity does not have an exclusive right over certain receivables. Rather the reporting entity has a net residual interest in the SPE.*
>
> ***Accounting according to the current IAS 27/SIC 12***
>
> *It is not very likely that the total losses will exceed the amount which the reporting entity has to bear. Therefore, according to the requirements of SIC 12 the reporting entity controls the SPE and has to consolidate all assets and liabilities of the SPE.*
>
> ***Accounting according to the proposed control model***
>
> *Corresponding to the proposed control model the decision referring to consolidation has to be made at the asset level. In this case it is not possible to determine a specific asset because the reporting entity does not have to bear a loss of a specific asset rather than a particular loss of several assets which cannot be determined in advance.*

It is not clear what should be recognised under the new approach if the party of an SPE only has the right to a portion of assets and not to an asset as a whole. Should the reporting entity recognise the right to a portion of assets and liabilities net or gross? Should the reporting entity recognise a synthetic asset (e.g. present value of the expected future cash flows) or what kind of asset should represent this right?

Conclusion

As a result, we believe the proposed control model raises the following issues:

1. It seems that the first stage of the proposed model would result in a conflict with the proposed control definition.
2. We think that focussing on assets regarding stage two of the proposed model is rather a question of recognition/derecognition of an asset than a consolidation matter.
3. It is unclear to us which criteria determine whether or not the party has to recognise the right to a portion of assets?

4. It is unclear to us whether the reporting entity should recognise the rights to a portion of assets and liabilities net or gross? Should the party recognise a synthetic asset (e.g. present value of the expected future cash flows) or what kind of asset should represent this right?

If you have any questions, please do not hesitate to contact Lars Neubauer or me.

Yours sincerely

Prof. Dr. Harald Wiedmann
President