The Differing Definitions of Control and the Impact on Accounting Recognition

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Control

Perpetual Issue – When to recognize an asset/ when to derecognize an asset (and realize revenue or gain/loss)

Example - Company A transfers an asset to Company B for cash consideration.

- Should Company A derecognize the transferred asset (and realize earnings)?
- Should Company B recognize the transferred asset?

What if based on risks and rewards?

- Provide consistent responses? Which risks, which rewards? How much?

Can control provide consistent accounting no matter what the asset is?

Definition of Control

Dictionary – A definition= authority or ability to manage or direct

Control is part of the definition of an asset in Conceptual Framework

- FASB Con 6 - Assets are probable future economic benefits obtained or **controlled** by a particular entity
- IASB Framework – An asset is a resource **controlled** by the entity

Control in Conceptual Framework

Con 6

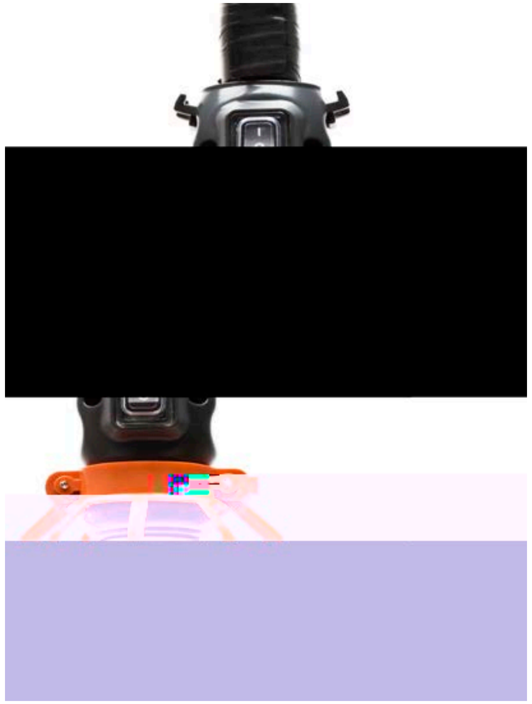
par 183 – To have an asset an entity must control future economic benefit to the extent that it can benefit from the asset and generally can deny or regulate access to the benefit by others…

Par 184 – Thus, an asset of an entity is the future economic benefit that the entity can control… The entity having an asset is the one that can exchange it, use it to produce goods or service, exact a price for others' use of it, use to settle liabilities, hold it, or perhaps distribute it to owners.

Control

Where do we use control in determination of recognition and/or derecognition?

- Inventory (revenue)
- Non inventory tangible assets
- Non inventory intangible assets
- Financial instruments
- Consolidations
  - Variable interest entities
  - Voting interest entities



Control – Non-financial assets

Proposed Revenue Recognition (not quote):

- An asset is transferred when (or as) the customer obtains control of that asset.
- Control of an asset refers to the ability to direct the use of and obtain substantially all of the remaining benefits from the asset
- Control includes the ability to prevent other entities from directing the use of and obtaining benefits from an asset
- Indicators of control:
  - Present right to payment
  - Legal title
  - Physical possession
  - Significant risks and rewards of ownership
  - Customer acceptance

Control – Financial Instruments (ASC 860-10)

A transfer of … financial asset…in which the transferor surrenders control..:

a…The transferred financial assets have been isolated from the transferor—put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership...

b.Transferee's rights to pledge or exchange. This condition is met if both of the following conditions are met:

- 1.Each transferee… has the right to pledge or exchange the assets (or beneficial interests) it received.
- 2. No condition does both of the following:
  - i. Constrains the transferee ,,, from taking advantage of its right to pledge or exchange
  - ii. Provides more than a trivial benefit to the transferor

cThe transferor…do not maintain effective control over the transferred financial assets

1.An agreement that both entitles and obligates the transferor to repurchase or redeem them before their maturity

2.An agreement…that provides the transferor with the unilateral ability to cause the holder to return specific financial assets and provides more-than-trivial benefit attributable to that ability.

3. An agreement that permits the transferee to require the transferor to repurchase the transferred financial assets at a price that is so favorable to the transferee that it is probable that the transferee will require the transferor to repurchase them

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Control – Entities (ASC 810)

Voting interest entities:

The usual condition for a controlling financial interest is ownership of a majority voting interest..The power to control may also exist ..by contract, lease, agreement with other stockholders, or by court decree

Variable interest entities:

A reporting entity … has a controlling financial interest in the VIE:

a. The power to direct the activities of a VIE that most significantly impact the VIE's economic performance
b. 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.

Only one reporting entity, if any, is expected to be identified as the primary beneficiary of a VIE.

Control

What are the elements of control?

- Power to direct
- Outcome is benefits

What aspects of power to direct are most important?

What benefits are most important?

Title

Does power to direct legal ownership (ability to transfer title) and benefit from fair value represent control?

Example 1: A transfers financial instrument to B. B has right to all cash flows collected from issuer of the security. B is restricted from selling security (or otherwise attaining changes in fair value). Should A derecognize and B recognize the security?

Example 2: A leases equipment to B for 75% of the equipment's useful life. A retains title over the equipment. B is not permitted to sublease. Should A derecognize and B recognize the equipment?

Title

Example 3- A sells to B a 40% undivided interest in an airplane. Should A derecognize and B recognize a portion of the airplane?

Example 4- A places the airplane in an SPE (entity's only asset). A sells to B 40% of the equity of the SPE. Should A derecognize and B recognize a portion of the airplane?

Example 3 & 4 are legally different but are they economically different?

What if asset was not an airplane but a financial instrument would answer to example 4 change?

Access to/ right to use

Does power to restrict access to/ direct right to use the asset to obtain benefits of output represent control?

What if power is segregated by time?

Example 1: A transfers to B right to use fixed asset in perpetuity

Example 2: A transfers to B right to use fixed asset for 75% of useful life

Example 3: A transfers to B right to use fixed asset for 51% of useful life

Should A derecognize the fixed asset in these examples?

Should answer depend on type of asset?

Rights over decisions

Relevance to other than entities?

Which decisions?

- Those that most significantly affect outcomes
- Participating rights vs. protective rights
- Exercising right as principal or agent
- Divided by time

Current control vs future control

Is control based on current power? If so, how determine if power is current?

Example 1: A has an option to buy B’s car in 2 years. Should A recognize car? (would view change if forward instead of option?)

Example 2: A has an option to buy B’s car at anytime. Should A recognize car?

Does view in either example depend on strike price?

What if underlying was not a car but B’s subsidiary?

Current control vs future control

Example 3- Company A owns a building. Company A sells Company B an option to purchase 51% undivided interest in building at anytime. Should Company B derecognize a portion of the building prior to exercise?

Example 4- Company A owns 100% of voting stock of Subsidiary S. Company A sells Company B an option to purchase 51% of the voting stock at anytime. Should Company A derecognize the subsidiary?

- Does view depend on strike price?

Potential to regain control

Is assessment of control path dependent?

Example 1: A enters into right & obligation to purchase B's car in 2 years. Should A recognize car?

Example 2: A sells car to B with the right & obligation to repurchase car in 2 years. Should A derecognize car?

Example 3: Same as example 1 but at same time A enters into right & obligation to purchase C's car (substantially the same as car sold) in 2 years. Views?

Would answer change if call option instead of forward? Does answer depend on strike price?

What if not a call option but a put option?

What if asset was not a car but a financial instrument?

Control

Other examples of path dependency:

Example 1: Insurance company A provides B an option to enter into an insurance contract in 1 year. There is a very high probability that B will exercise the option. Should A recognize the insurance contract? Does A control the insurance contract? Would view change if not insurance contract but a lease? Would view change if contract was for cleaning service?

Example 2: Insurance company A enters into a 1 year insurance contract with B. At the same time, A provides B a renewal option (very high probability of renewal). Should A recognize the insurance contract related to the renewal option? Does A control renewal of the insurance contract? What if a lease? What if for cleaning service?

Control and Risks & Rewards

Do risks and rewards evidence control or are risks and rewards an outcome of control?

Do we modify definitions of control because of notions of risks and rewards (or other reasons)?

Financial instruments:

- Repurchase agreements
- Legal isolation

Revenue recognition

- Certain long term contracts

Consolidation

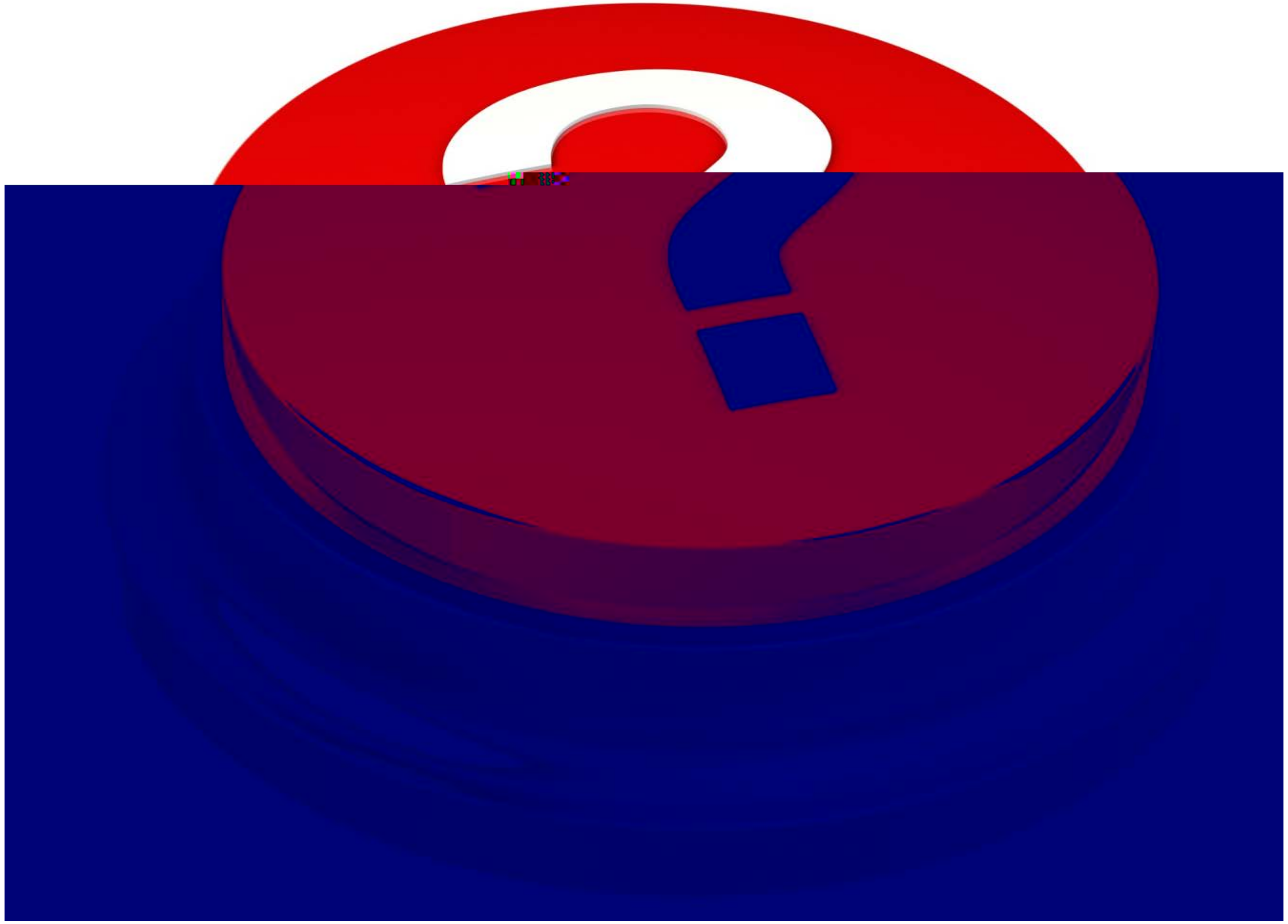
- Kick-out rights

Control

How do different definitions of control affect practice?

- Scope complexity
  - Increased risk of misjudgments
  - Structuring opportunities?
- Will we ever be able to get to principle based standards?

Questions?



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