

Sir David Tweedie
Chairman
International Accounting Standards Board
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20 March 2009

Dear Sir David,

Exposure Draft ED 10 Consolidated Financial Statements

Deloitte Touche Tohmatsu is pleased to respond to the International Accounting Standards Board's (the IASB's) *Exposure Draft ED 10 Consolidated Financial Statements* (referred to as the 'exposure draft' or 'ED').

We recognise the importance of this project and fully support the objectives of issuing a single Standard for consolidation and improving the disclosure requirements relating to consolidated and unconsolidated entities. Furthermore, we believe that applying a single definition of control to all entities is the appropriate basis for the consolidation model.

However, the principles underlying the consolidation model proposed in the ED are not well established and the guidance within the ED is ambiguous and inconsistent in a number of fundamental areas, not least of which in the failure to distinguish between 'power to control' and 'ability to control'. Without a clear definition of control, the resulting Standard will be difficult to interpret and apply on a consistent basis. As a consequence, the financial statements of groups will be less, not more, comparable and understandable. We do not believe that the ED in its current form is an improvement on existing IFRSs.

It is crucial that the Board responds on a timely basis to the global financial crisis and the recommendations of the Financial Stability Forum. We therefore believe that improved disclosure requirements should be issued as swiftly as possible. We are providing comments on specific aspects of the proposed disclosure requirements later in this letter. However, further work, including appropriate field testing, is required to adequately address concerns about the consolidation model itself. Once the results of such additional work has been analysed, we believe that the consolidation Standard should be re-exposed.

We are also concerned that this ED is not the result of joint efforts between the IASB and the FASB. We strongly encourage collaboration between the two Boards on the topic of consolidation with the goal of issuance of a converged Standard.

Our detailed comments and answers to your questions on the exposure draft along with other comments and suggested editorial changes are included in the Appendices to this letter.

If you have any questions concerning our comments, please contact Ken Wild in London at +44 (0)20 7007 0907.

Yours sincerely,

A handwritten signature in black ink, appearing to read "Ken Wild", written over a horizontal line.

Ken Wild
Global IFRS Leader

Appendix 1

Response to questions on ED 10 Consolidated Financial Statements

Control

Question 1

Do you think that the proposed control definition could be applied to all entities within the scope of IAS 27 as well as those within the scope of SIC-12? If not, what are the application difficulties?

No, we do not think that the proposed control definition could be applied to all entities as the two elements of the definition – ‘power to direct activities’ and generation of ‘returns’ are not clearly explained within the ED. In order to develop a clear definition of control, the ED should first establish the core principle underlying the preparation of consolidated financial statements. The ED currently explains *how* consolidated financial statements should be prepared (i.e. by grouping entities that are under the control of the parent) rather than the more fundamental issue of *why* consolidated financial statements should be prepared, i.e. the purpose of consolidated financial statements. We would expect this core principle to be consistent with the principles proposed by the Board in its Discussion Paper *Preliminary Views on an improved Conceptual Framework for Financial Reporting*. Once an appropriate core principle has been established, the definition of control can be developed. An appropriate definition of control would be one that can be applied to all entities in order to determine which entities should be consolidated by reference to the core principle, i.e. are the appropriate boundaries drawn around the reporting entity.

Further, consolidation is one of the building blocks that ensure that the financial statements of a group reporting entity ultimately present all of the assets and liabilities controlled directly and indirectly by the entity. It is therefore important that the consolidation Standard be developed using principles that are consistent with those used elsewhere in IFRS, in particular those used in the Conceptual Framework and in the revenue recognition and derecognition (future) Standards. For example, it is important that the consolidation Standard does not require consolidation of assets (or liabilities) that need to be derecognised under the derecognition Standard. Because of the various on-going projects affecting these fundamental principles, we encourage the Board to take the time to ensure that the final Standards will form a cohesive set of principles.

We support use of the control model as a basis for the consolidation model, recognising however that such a control model must necessarily incorporate concepts of risks and rewards. It is difficult to conceive that control can exist if the controlling party is not also the recipient of risks and rewards arising from the controlled entity. However, at present, the ED expands on the notion of risks and rewards principally in relation to ‘structured entities’. This may lead some to believe that this notion is relevant only to structured entities and that the Board has developed a ‘model within a model’ specific to structured entities. We do not believe that this is the case, nor should it be. In order to rectify the situation, one of the key aspects of the definition of control that needs to be improved is the articulation of the manner in which risks and rewards are integral to control, in particular the interaction between the ‘power to direct the activities’ of an entity and ‘exposure to risks and rewards’ of that entity as the two elements that yield control. In some entities, such as the ‘traditional’ operating entities, control can readily be established by determining who directs the activities of the entity. In other entities, exposure to risks and rewards provides an unambiguous indication of the party that controls the entity. This would be the case, for example, for entities established by the reporting entity clearly for its own benefit. In both cases, identification of the controlling party is easy because there is no contradiction between the indicators of the power to direct the activities of the entity and those related to risks and rewards from the entity. However, between these two ends of the spectrum there exists a variety of entities for which the identification of the controlling party is not straight forward because indicators of control may point in different directions. This would be the case, for example, when

several parties participate in the establishment of an entity, each with its own objectives and specific exposure to risks and rewards. In order to ensure appropriate and consistent consolidation of these entities, it is necessary for the Standard to establish clearly the relationship between the ‘power to direct’ and ‘exposure to risks and rewards’ and the balance between these two elements that may sometimes appear to contradict each other. In addition to improving the consistency of the control model, we believe that such an approach would also have the merit of avoiding recreating the main flaw within the existing IFRS on consolidation: identifying which particular guidance on consolidation applies to an entity, with the result that certain entities that should be consolidated inadvertently fall through the gap because it is unclear whether they are within the scope of IAS 27, SIC 12 or neither.

Question 2

Is the control principle as articulated in the draft IFRS an appropriate basis for consolidation?

No, we do not agree that the control principle as articulated in the ED provides an appropriate basis for consolidation, as we do not believe that control has been defined clearly. At a basic level, the guidance seems to imply that ‘ability’ to control is synonymous with ‘power’ to control. We do not believe this to be the case. We understand the concept of ‘power’ in this context to be an absolute right to direct the activities of another entity (in the sense that it is a right which cannot be taken away by others), whereas ‘ability’ is only the opportunity to do so currently.

Power

The ED defines control as ‘power to direct the activities’ of another entity. However, the guidance explains that ‘power to direct’ is the ability to do so in practice. Practical ability is a subset of power but is not equal to power. It therefore follows that, while power must incorporate the concept of practical ability, practical ability alone is not sufficient to provide an entity with power to direct the activities of another entity. This lack of clarity is illustrated by the guidance on de facto control and voting rights. For example, paragraph 28 indicates that the dominant shareholder may have control over an entity by virtue of the fact that the other shareholders are dispersed and not organised in such a way that they can actively cooperate (de facto control). While an unorganised and dispersed shareholder group may permit a dominant shareholder to make decisions over the activities of an entity at a particular point in time, in the absence of factors that give the dominant shareholder an unconditional power to direct activities, this does not equate to control by the dominant shareholder. Nothing prevents the other dispersed shareholders from voting jointly against any decision which 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 are concerned that, unless the position of the Board with respect to the defining factor (i.e. present power to control or present ability to control) is clearly expressed, the resulting Standard will be difficult to interpret. We believe control should be defined as the current power to direct the activities of an entity, whether by means of voting rights or other arrangements. In particular we do not believe that the control determination should be based solely on the actions (or absence of actions) of others.

The ambiguity inherent in the proposed guidance on control is increased by the fact that the ED uses various terms, such as ‘power’, ‘right’ and ‘ability’, apparently interchangeably. As stated above, we do not believe that these terms are synonymous. The Board should ensure that consistent terms are used to refer to the same concept and that all key terms are clearly defined.

Further, paragraph B9 (a) uses the term ‘dominate’ to describe situations where a reporting entity has ‘the power to direct activities’ but has less than the majority of voting rights. It is not clear what degree of influence is meant to be demonstrated by the term ‘dominate’ and what factors would indicate that a shareholder dominates the direction of the activities of an entity.

Directing the activities of an entity

In relation to the definition of control, we suggest that the Board clarifies what is meant by directing the activities of an entity. Paragraph 22 indicates that ‘a reporting entity has the power to direct the activities of another entity if it can determine the other entity’s strategic operating and financing policies.’ Paragraph BC44 confirms that paragraph 22 should be read as indicating that determining the strategic operating and financing policies of an entity is one means of having the power to direct the activities of another entity, but that it is not necessarily the only means by which this power may be obtained. As an example, paragraph BC44 indicates that the power to direct the activities of an entity may also be obtained through contractual arrangements. However, this paragraph does not specify which rights (other than the right to determine the other entity’s strategic operating and financing policies) would need to exist under the contractual arrangement in order for the reporting entity to have the power to direct the activities of the entity. In order to ensure that the concept of ‘directing the activities of an entity’ is appropriately interpreted and applied in practice, the Board should clarify the difference, if any, between directing the activities of an entity and determining an entity’s strategic operating and financing policies. The Board should also clarify how one may exist without the other.

Given that activities of an entity may be predetermined, it would also be important to consider how the concept of directing the activities might apply to such an entity. This will be necessary if the Board retains our later suggestion of not differentiating consolidation of structured entities from that of other entities. Please refer to our response to Question 7 for our views on the matter.

Ability to generate returns

Another significant concept in the proposed definition of control is the ability to generate returns. We understand that the Board intends for the term ‘returns’ to be interpreted broadly. We support such an approach. To ensure that this broad definition is well understood, we suggest that the Standard better illustrates how the ability to generate returns might go beyond purely monetary returns and how it would include the ability of the reporting entity to use another entity to conduct activities that the reporting entity would otherwise carry out itself. For example, would the ability to set up a trust for its employee share ownership plan represent a form of return for the reporting entity? Similarly, if a reporting entity sets up and funds a foundation to do charitable work, would the returns generated by the public profiling of the reporting entity’s name be considered as returns in establishing whether the reporting entity should consolidate the foundation?

As a further matter for clarification, there are ambiguous and contradicting references to the term ‘returns’. While some paragraphs appear to refer to exposure to returns in terms of absolute value, others such as paragraph 11 and 13 appear to refer to exposure to the variability of returns. The ED should clarify the ambiguity: an entity may be exposed to lower returns than other investors in absolute terms but, nonetheless, be the party most exposed to variability of returns (such as an insurance company).

We also note that there appears to be a discrepancy between the importance given to returns in structured entities compared to other entities. The ED implies that for an entity that is not a structured entity, the control definition may be met even if the returns generated for the reporting entity are minimal. If this is correct, it would be important to explain the basis for this difference.

Finally, in order to clarify further what is meant by returns, we suggest that the principle that ‘returns commensurate with the service provided are fees’ rather than returns (currently in paragraph BC54) should be brought into the main body of the Standard. We also provide views on the necessity of establishing a relationship between the ‘power to direct’ and the ability to ‘generate returns’ in our response to Question 7.

Question 3

Are the requirements and guidance regarding the assessment of control sufficient to enable the consistent application of the control definition? If not, why not? What additional guidance is needed or what guidance should be removed?

No, as noted in our response to Question 2, unless the Board establishes clearly whether the control principle is the absolute power to direct the activities of another entity or more broadly the ability to direct these activities, it will be difficult to ensure consistent application of the resulting Standard. We believe the control definition should be based on the concept of power rather than practical ability. Further, the ED highlights the importance of judgement in assessing whether control exists but it fails to provide the guidelines necessary to apply this judgement in certain key circumstances. We have commented on the need for further guidance in our responses to other questions (in particular Questions 4 to 7). In addition, we would like to highlight three other areas that would need to be addressed to ensure consistent application of the Standard.

Participating rights

We believe that additional guidance is required with respect to protective and participating rights. First of all, we note that the definition provided in Appendix A of protective rights (defined as ‘rights [...] that do not give the party control of the entity, nor do they prevent another party from controlling that entity’) is circular. This definition indicates simply that a protective right is not a participating right. Since a participating right is not defined in the ED, the definition of protective right is ineffective. Indeed, while paragraph BC61 implies that all the guidance from EITF 96-16 has been included, we note that the guidance on participating rights provided in the EITF has not been incorporated in the ED. Given the absence of guidance on what is a participating right, it is difficult to understand when a right goes beyond being protective and is instead participating in substance. Further, we find the wording in paragraph B2(a) ambiguous: it indicates that protective rights protect one party by prohibiting the controlling party from making fundamental changes to the activities of an entity. The ED should explain what constitutes a fundamental change. For example, would changes over the strategic operating and financing activities be considered fundamental? If that were the case, these rights would appear to prevent another party from controlling that entity and therefore fail to meet the definition of ‘protective’ rights.

We also believe that the condition in paragraph B2(a)(ii) may have unintended consequences for entities that are regulated by the state (for example, in certain jurisdictions, entities in the utilities industry are subject to strict governmental regulations) and in which the state holds a non-controlling interest. Often, the investment capacities of these entities are extremely supervised and their returns are predetermined. When paragraph B2 is considered along with paragraph 25 in the context of a regulated entity, does this mean that regulated entities will no longer be consolidated?

Consolidation in the absence of the majority of voting rights

We also find the current guidance with respect to consolidation in the absence of the majority of voting rights very broad and subjective. In particular, the Board should clearly establish whether the existence of de facto control must be demonstrated or it can simply be implied because, for example, other shareholders have not organised themselves in the past. Despite the Board’s conclusion in paragraph BC49 that the guidance currently provided in the ED is not inconsistent with the proposed control definition and simply reflects different circumstances, we continue to be concerned that the ED does not clearly establish the distinguishing factor. Accordingly, we believe that this guidance must be revisited and explained in the main body of the Standard. We believe that control may exist in situations where the reporting entity has less than the majority

voting rights over another entity, but only if the reporting entity has a contractual or other legal right to determine the activities of that entity. In particular, 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 by virtue of the fact that the other shareholders are dispersed and not organised. These issues must be addressed in the final Standard if the Board determines that consolidation can result from de facto control.

Guidance in Basis for Conclusions

Finally, we are concerned that the fact that significant guidance is included in the Basis for Conclusions may hinder consistency of application, in particular in those jurisdictions where the Basis for Conclusions is not officially endorsed by the local legislation. We strongly encourage the Board to revisit the structure of the document to ensure that all relevant guidance is included in the Standard, including the Application Guidance.

Question 4

Do you agree with the Board’s proposals regarding options and convertible instruments when assessing control of an entity? If not, please describe in what situations, if any, you think that options or convertible instruments would give the option holder the power to direct the activities of an entity.

No, we do not believe the proposals are sufficiently clear. For options to give the option holder control over another entity they must provide that holder with the power to direct the activities of the other entity even without actual exercise of the options. In other words having the power to exercise must be an effective means of ensuring that the activities are directed according to the holder’s demands. The other party will choose to act in accordance with the demands of the option holder as refusal to comply with the holder’s demands will be futile.

However, paragraph B13(a) appears to imply that an option holder would assess whether it controls an entity simply by determining the percentage of voting rights that it would hold if the options are exercised in the future. We believe that this concept is inconsistent with the existence of actual power.

We also believe that the conclusion regarding options exercisable at fair value in paragraph BC86 needs to be better explained. Paragraph BC86 may be read as indicating that such options do not provide control until exercised because it is only then that the holder has access to returns on the underlying shares. We note that the definition of returns provided in paragraph 11 extends beyond dividends and other distributions. In fact, paragraph 11(c) extends the definition of returns to include a parent’s ability to create synergies with its subsidiary. Therefore, it would appear appropriate that a reporting entity would consider whether its options allow it access to similar synergies. Accordingly, we believe that options may provide control to the holder regardless of their exercise price. However, as stated above, they only do so if they provide the holder with 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.

Paragraph BC81 states *‘for example, the option holder could have power indirectly if the shareholder that is the counterparty to the option agreement uses its voting power to act on behalf of the option holder, or if the strategic operating and financing policies are determined according to the wishes of the option holder.’* The Board should clarify whether this paragraph would apply only in situations where the power is derived from a contractual or other legal agreement or whether it would also apply where, as a matter of practice, the counterparty to the option agreement seeks the wishes of the option holder before exercising its voting rights (and respects

those wishes). We believe this paragraph should only apply where there is a contractual or legal requirement for the counterparty to vote in accordance with the wishes of the option holder.

Also, paragraph B13 presents three circumstances in which ‘*a reporting entity [that] holds options or convertible instruments has the power to direct the activities of another entity*’. Are these circumstances meant as *examples* of situations where holding options permits the reporting entity to control the other entity or are these *the only* three situations where control would arise from holding options or convertible instruments?

Question 5

Do you agree with the Board’s proposals for situations in which a party holds voting rights both directly and on behalf of other parties as an agent? If not, please describe the circumstances in which the proposals would lead to an inappropriate consolidation outcome.

No, we believe that the guidance around principals and agents is very unclear. In particular, we are concerned that the section on remuneration of an agent is open to diverse interpretations. It is our opinion that for an entity to be an agent it must stand ready to comply with any instructions it receives from the principal in the arrangement, for example in respect of voting. Furthermore, we believe that in a genuine agency relationship, the principal will have the right to remove and replace the agent, albeit that it may have to pay a penalty to do so.

We are concerned that the indicators provided in the ED of whether a party is acting in its own interests or on behalf of others will be difficult to apply in practice and that this difficulty may result in an inappropriate and inconsistent consolidation outcome. Accordingly, we believe that additional guidance is necessary to assist preparers in exercising their judgment. The following areas are likely to cause significant difficulties:

- a) What evidence would be appropriate to demonstrate that a party that acts in a dual role does, in fact, act in the best interest of other parties (as specified in paragraph B11)? Paragraph BC95 appears to create a rebuttable presumption that an agent in a dual role would act in its own best interest. Would it be sufficient for the agent to hold a contractual agreement that stipulates that it must act in the best interest of other parties or would there also be a need to show other evidence to that effect? If so, what is the nature of this other evidence?
- b) Where an entity, say entity A, has an investment in a fund (a limited mandate fund) and entity A also holds the controlling interest in the entity acting as the fund manager, how would A’s dual role impact the assessment of whether A controls the fund? Would this be different from the assessment required for agents acting in a dual role? What would be the impact of the percentage of interest held by A in the fund?
- c) What parameters should be used to assess whether fees are representative of the fair value of the services rendered? Because of the variety of existing schemes, we believe that in practice it will often be difficult to assert whether or not fees are reflective of the market price. Also, what weight should be given to the various indicators provided in paragraph B6 when only some of the factors are present?

Also, we note that paragraph B7 appears to indicate that, as soon as an agent is required to act in the best interest of the principal, its fees would be considered to be remuneration for services. However, the notion that a party must act in the best interest of others exists in other arrangements such as those in which a fiduciary responsibility exists (such a responsibility may arise if A owns an interest in B, and A & B have common shareholders). We suggest that the Board should consider how this fiduciary responsibility impacts the evaluation of control and how it differs from the obligation of an agent to act in the best interest of the principal.

Finally, we suggest that the Board ensures that the guidance on the definition of the role of an agent proposed in this ED is consistent with the guidance being developed as part of the annual

improvements project affecting IAS 18. If the two Standards require different guidance, the basis for this difference should be clearly explained.

Question 6

Do you agree with the definition of a structured entity in paragraph 30 of the draft IFRS? If not, how would you describe or define such an entity?

No, we question the need to define the term ‘structured entity’. The definition of structured entity is required in the ED to identify, in paragraph 30, the entities for which control is better identified using specific guidance and to determine the disclosure requirements applicable to involvement of the reporting entity with certain entities. As indicated in our response to Question 1, we do not believe that the guidance provided in paragraphs 30-38 regarding consolidation of structured entities applies only to structured entities. We consider that, if the role of risks and rewards within the control model was better articulated, it would not be necessary to differentiate between entities in applying the consolidation model.

Similarly, as indicated in our response to Question 9, we believe that the need to provide disclosures about entities that are not consolidated should be determined by the exposure of the reporting entity to the different parties with whom it transacts rather than the manner in which these parties are organised.

If the Board determines that it is necessary to retain a definition of structured entity, we disagree with the proposed definition because of its lack of clarity. Currently, a structured entity is more defined by what it *is not*. It would be more useful if the Board explained what a structured entity *is*. Further, we note that the definition provided in paragraph 30 refers to ‘*activities [that] are not directed as described in paragraphs 23-29*’. This implies that control of a structured entity would need to be assessed in accordance with the principles established in paragraphs 31-38 rather than paragraph 22. Because the principle in paragraph 22 (establishing that control is based on the power to direct the activities) may appear to differ from the guidance in paragraphs 31-38, where assessment of control is based on ‘*how returns from the entity’s activities are shared...*’, the relationship between these paragraphs requires further explanation. This remark is consistent with our comment that the Standard should better articulate how risks and rewards are integral to the existence of control.

Finally, we also note that the definition of structured entities appears to indicate that an entity whose activities are not directed by any party is necessarily a structured entity. This may lead to the conclusion that joint ventures and other entities without a controlling party are by definition structured entities. We do not believe that this is the Board’s intention but this aspect of the definition should be clarified. Also, the ED should clarify whether it is possible for an entity to have significant influence in a structured entity and the consequential implications.

Question 7

Are the requirements and guidance regarding the assessment of control of a structured entity in paragraphs 30–38 of the draft IFRS sufficient to enable consistent application of the control definition? If not, why not? What additional guidance is needed?

No, as previously stated, we believe that the requirements and guidance in paragraphs 31-38 should not be applied solely to structured entities, and accordingly we do not believe that the definition of a structured entity in paragraph 30 is necessary.

Whether or not the Board retains our suggestion that paragraphs 31-38 should be applied to all entities, we believe that clarification is required in any case with respect to the guidance in these paragraphs and the related guidance in other sections of the ED.

Firstly, the wording in paragraph 32 is ambiguous and could be read to mean different things. The second sentence states *‘for example, a reporting entity is likely to control a structured entity that has been created to undertake activities that are part of the reporting entity’s ongoing activities [...]. The reporting entity is unlikely to surrender power to direct such structured entity’s activities because of the importance of those activities [...]*’. Some may interpret this to mean that control would normally exist in circumstances such as those described in paragraph 32 but the fact that the entity set up the structured entity, by itself, is not determinative of whether the entity controls the structured entity or not. Alternatively, some may take a different reading to the paragraph and conclude that the fact that the entity set up the structured entity is determinative of control and, in the absence of clear evidence to the contrary, there is a presumption that the reporting entity controls the structured entity. We suggest that the Board clarifies its intent with respect to the situation described in the paragraph.

Secondly, paragraph 33 is similarly ambiguous:

- a) It states *‘a reporting entity is likely to have power to direct the activities of a structured entity if it is exposed to the variability of returns that are potentially significant to the structured entity and the reporting entity’s exposure is more than that of any other party’*. We question whether this establishes a presumption that exposure to the majority (or to the greatest amount) of returns automatically means that the reporting entity controls the structured entity, i.e. that there is a causal link between exposure to returns and control. If this is the case, we are concerned that this conclusion relies solely on a risks and rewards model and is inconsistent with the definition of control as set out in the ED. We would expect that a more appropriate interpretation of the paragraph would be that exposure to the largest variability of the returns is a (strong) indicator that control exists but is not in itself determinative;
- b) Further, it appears contradictory with paragraph BC56 which states that *‘the right to receive return is not a sufficient condition to control’* and paragraph BC121 which states *‘if a reporting entity has no means of directing or managing the activities or assets and liabilities of an entity, it does not have any ability to affect its returns from its involvement with that entity and would not control the entity even though it might be exposed to risks associated with the structured entity’*. We suggest that paragraph 33 should be further explained (in the main body of the Standard) to remove this apparent contradiction;
- c) Also, we note that example 1B of the illustrative examples concludes that the reporting entity is not considered to control the structured entity despite the fact that it is exposed to the first loss protection of 10%, which the example states is considered potentially significant. This conclusion appears to be inconsistent with the guidance provided in paragraph 33. We suggest that the conclusion provided in the example should be further explained.

Thirdly, paragraph 36 states that *‘predetermined policies can give a reporting entity control’* but it fails to clarify how and when control is obtained through predetermined policies. In particular, the paragraph should establish a link between the predetermination of the policies and the on-going entitlement to returns from the entity by the party who established these policies. An example of the ambiguity in this paragraph is as follows: suppose X sets up a vehicle with completely predetermined policies that will generate returns for whoever holds particular notes, and that the notes are initially held by X. Having predetermined the policies, X can be said to have the power to direct the activities. But what if X later sells the notes to Y? Does Y have control or not? On the one hand, one could argue that Y cannot control the vehicle since it was not involved in the predetermination of the policies. On the other hand, others may argue that by having bought the notes from X, Y assumes the role of X and thereby assumes control of the vehicle. This being said, we believe that a party that had, in the past, the power to direct the activities of an entity to generate returns (i.e. that party had control over the entity) and continues to hold the same interest in the entity would not lose control simply by having predetermined the activities of the entity for the remainder to the life of the entity. The situation, however, becomes more ambiguous if the

party that has preset the activities retains only a portion of its initial interest and another party becomes exposed to greater variability in returns.

Finally, we question whether the example in paragraph 37 is appropriate since it is unclear to us that the arrangement described (the purchase of receivables from the reporting entity by a structured entity) would have resulted in derecognition of the receivables by the reporting entity.

Question 8

Should the IFRS on consolidated financial statements include a risks and rewards ‘fall back’ test? If so, what level of variability of returns should be the basis for the test and why? Please state how you would calculate the variability of returns and why you believe it is appropriate to have an exception to the principle that consolidation is on the basis of control.

No, we do not believe that the Standard should include a risks and rewards fall back test. As previously indicated in this letter, we believe that risks and rewards are integral to the control model. Incorporating a separate fall back test would move away from consolidation based on control, which we do not believe is the direction the IASB should be taking.

Disclosure

Question 9

Do the proposed disclosure requirements described in paragraph 23 provide decision-useful information? Please identify any disclosure requirements that you think should be removed from, or added to, the draft IFRS.

We support the requirement to provide better disclosure both on circumstances where significant judgment was used in determining whether to consolidate (or not consolidate) certain entities and on the reporting entity’s ‘off balance sheet’ activities, which we believe relate to the reporting entity’s business risks. The additional information proposed by the ED appears to affect both areas and we suggest that the Board more clearly distinguishes which disclosures are aimed at addressing which areas. Moreover, the guiding principles for the disclosure are not clearly established, giving the impression that voluminous disclosure will be required, the relevance of which is questionable.

Guiding principles for disclosures

It appears that paragraph B31 should be read as providing the guiding principle that the reporting entity should use in establishing what information to disclose. We note that this paragraph rightly indicates that an appropriate balance is required to avoid providing neither insufficient nor excessive information. However we question whether the requirements listed in the subsequent paragraphs respect this principle. To ensure that the spirit of paragraph B31 is met, we encourage the Board to establish clearly the objective of each element of the disclosures and then turning the detailed information that is currently proposed as being required by the ED into suggestions of the information that may allow the reporting entity to meet this objective.

Information related to consolidation

We have identified paragraphs B32-B37 and B48-B49 as relating to the application of the consolidation requirements.

We agree with the principle of providing additional information related to circumstances where the decision whether to consolidate was based on significant judgment. This is consistent with the disclosure on estimates, uncertainties and judgments required by IAS 1. In that respect, we propose the following modifications to the disclosure requirements:

- a) It would be useful for paragraph B32 to include a reminder of this objective and to indicate that it is likely that significant judgement was involved in the circumstances currently listed in (a) to (c) but it may also arise in other circumstances;
- b) Further, we note that paragraph B33 and B34 indicate that the reporting entity would provide information in the aggregate if the circumstances listed in paragraphs B32(a) and (b), respectively, arise. Keeping in the spirit of IAS 1, we believe that it may be more useful if separate disclosure was provided for each entity that is consolidated (or not consolidated) as a result of a decision requiring significant judgement and estimates.

With respect to the other information related to the effect of consolidation, we question the objective of the requirements proposed in paragraph B35 relating to non-controlling interests. It appears to compensate for the decision taken by the Board to adopt an 'entity approach' and provide disclosure to assess what the consolidated financial statements would be like under a 'parent approach'. If this is the only reason for requesting this information, we do not believe that the disclosure in paragraph B35 is relevant.

Information related to business risks

We have identified paragraphs B38-B47 as relating more to disclosure of an entity's business risks rather than issues related to the application of the consolidation requirements.

We support the Board's decision to improve the disclosure required with respect to business risks, such as reputational risk. However, we believe that such improved disclosures may also be appropriate for entities that would not meet the definition of structured entities. Accordingly, we believe that it is the existence of business risks such as reputational risk which triggers the need for improved disclosure rather than the manner in which the entity, or the counterparty to these activities, has been structured.

While we support the objective of improving the disclosure on business risks, we question the need to provide all of the information listed in the ED. As we detail in our response to Question 10, some of the disclosure requirements may be onerous and/or extremely difficult to obtain. Also, we have indicated above, in order to be consistent with the principle established in paragraph B31, the objective should be for the reporting entity to disclose sufficient and appropriate information to provide a meaningful understanding of its exposure to business risks to the users of the financial statements. We are not convinced that this balance has been achieved so far.

Furthermore, we believe that the expanded disclosure requirement related to business risks would be better integrated in another Standard (e.g. IAS 1 or IAS 24) rather than in a Standard on consolidation.

Other comments

We also note that:

- a) While paragraph BC145 indicates that the '*Board decided against requiring disclosures of a reporting entity's intention to provide future support...without a contractual or constructive obligation to do so*', this decision does not appear to have been respected since paragraphs B46(e)(iii) and B47(a) both require that a reporting entity discloses whether it has current intentions to provide support to structured entities;
- b) The ED proposes to impose a tabular format for much of the information required. We believe that the reporting entity should be free to determine the format most suitable to its disclosure.

Question 10

Do you think that reporting entities will, or should, have available the information to meet the disclosure requirements? Please identify those requirements with which you believe it will be difficult for reporting entities to comply, or that are likely to impose significant costs on reporting entities.

No, we believe that preparing the following disclosures would be onerous and/or that the required information would be extremely difficult to obtain:

- a) B32(c): We question whether an entity will always have the information to determine whether returns are significant to the structured entity. We also note that this disclosure appears to be related to the circumstances discussed in paragraph 33. However, whereas paragraph 33 refers to *‘exposed to the variability of returns that are potentially significant’*, paragraph B32(c) refers to *‘receive returns that are potentially significant’*. If these two paragraphs are indeed related, it would be appropriate that they are consistent in referring either to variability of returns or simply to returns.
- b) B37(b): This paragraph appears to require the disclosure of all covenants. This appears very onerous given that IFRS 7 does not require such a disclosure.
- c) B40-B41: To the extent that a reporting entity no longer has any involvement with a structured entity, we believe these disclosures are onerous and we question the relevance of the information. Furthermore, it would be useful to specify whether the disclosure is also meant to be required if the reporting entity is solely acting as agent for another party with respect to the structured entity. Also, would the disclosure in B41(b) apply to all assets transferred to structure entities (including cash contributions) and to assets transferred ‘from’ structured entities and would it cover only transfers in the current period? Finally, we suggest that the Board should explain what it means to ‘sponsor’ an entity as this term may not be widely understood.
- d) B42: The requirement to provide two years of comparative information appears burdensome and inconsistent with the general requirements of IAS 1.
- e) B43-B47 (nature of risks): As a general principle, we do not believe that the disclosures to be provided should be more onerous than the information a structured entity would include in its own financial statements under IFRS.
- f) B44(c) and B46: We believe that this is information that the reporting entity may be unable to obtain.

Also, we believe that the requirements of the following paragraph should be clarified:

- a) B37(a): Is this meant to require disclosure of all protective rights granted to non-controlling interests?

Question 11

(a) Do you think that reputational risk is an appropriate basis for consolidation? If so, please describe how it meets the definition of control and how such a basis of consolidation might work in practice.

(b) Do you think that the proposed disclosures in paragraph B47 are sufficient? If not, how should they be enhanced?

No, we agree that reputational risk is NOT an appropriate basis for consolidation.

We do not believe that this decision implies that additional disclosure is required as a replacement. We do not believe that the disclosure in B47 is appropriate, if appropriate disclosures about business risks are provided.

Also on the topic of reputational risk, BC 39 states that an explicit commitment to support another entity is likely to be a liability that is accounted for in accordance with IAS 37. We question why IAS 39 might not be the applicable Standard for accounting for such a liability.

Question 12

Do you think that the Board should consider the definition of significant influence and the use of the equity method with a view to developing proposals as part of a separate project that might address the concerns raised relating to IAS 28?

Yes, we believe that the Board should undertake a project on the definition of significant influence and the use of the equity method.

Appendix 2

Additional Comments

The following are additional comments and suggested editorial changes we would like the Board to consider in finalising the Standard on Consolidation.

1. Definition of entity

We believe that the Standard should clearly establish the ‘level’ at which the consolidation principles must be applied. In particular, we note that the ED introduces the concept of ‘silo’ as a footnote to the definition of subsidiary included in Appendix A. Since this is not a defined term in IFRS, the definition of silo currently provided in paragraph BC31 should be incorporated in the main body of the Standard. In addition, the Standard should specify the circumstances when it is necessary to silo an entity into various functions. Further, since the concept of separating entities into silos is not addressed in IFRS, it would be important that the Board explains the basis for introducing this concept in the consolidation Standard.

2. Related arrangements

Paragraph 18 of the ED has carried forward the guidance from IAS 27.33, however subparagraph (c) which states *‘[t]he occurrence of one arrangement is dependent on the occurrence of at least one other arrangement’* has been omitted without any rationale provided in the Basis of Conclusions. We believe that this guidance should be retained because in practice this often establishes the link between two arrangements. The guidance in IAS 27.33(c) addresses a condition that is different from the condition addressed in IAS 27.33(a) which refers to *‘entering into one arrangement in contemplation of another’* and accordingly subparagraph (a) cannot be considered to encompass the two conditions.

3. Related parties

Paragraph B12 lists parties that may be identified as acting for a reporting entity. However, in the absence of further guidance on the matter, it is unclear in what context and how this list of examples is meant to be used. In particular, where related parties are acting in concert (or may be acting in concert), how would one identify which party is acting on behalf of the other?

4. Legal supervision

Paragraph 25 indicates that a reporting entity that has more than half of the voting rights of another entity may not have control if that other entity is under ‘legal supervision’. The term legal supervision is not defined or explained. It may be appropriate to revert to the wording currently used in IAS 27.32 that refers to *‘control of a government, court, administrator or regulator’*. Legal supervision could otherwise be interpreted as encompassing the regulatory regimes to which rate-regulated entities are subject.

5. Transitional provisions

Certain aspects of the transitional provisions require clarification. These include:

- a) Paragraph 52 indicates that if adoption of the new Standard results in consolidation of an entity that was not previously consolidated, the deemed acquisition date is

the date of first applying the Standard. Is this the first day of the current year or of the previous year?

- b) Also, if a reporting entity is required to consolidate an entity not previously consolidated, what is the consideration to be used to determine goodwill? Is it the fair value of the interest at the deemed acquisition date?
- c) Further, if consolidating an entity not previously consolidated requires fair valuing the existing interest, would the resulting adjustment be recognised in profit or loss or other comprehensive income (revaluation reserve, opening retained earnings)? The same question would arise if consolidation results in recognition of a gain on a bargain purchase or if deconsolidation of a previously consolidated entity results in a gain or loss.

It may also be useful to include illustrative examples of the application of the transitional provisions.

6. Presentation of options issued by a subsidiary

While this issue does not arise from the changes to the consolidation Standard proposed by this ED, we would like to take the opportunity to bring to the attention of the Board the fact that ambiguity exists on how to apply the guidance in paragraph B19 (or IAS 27.19 in the current Standard): how are options of subsidiaries presented in the statement of changes in equity, i.e. are these part of the non-controlling interest or not, and if not where should they be presented? Also, under this paragraph, if options entitle the holder to certain dividend rights, how should the dividends be presented and allocated?

7. Revised IAS 27

We recommend that the revised IAS 27 is issued as an exposure draft prior to being issued as a revised Standard to ensure that no unintended consequences arise as a result of unexposed amendments.

8. Editorial changes

Paragraph 11 states '*returns generated for a parent can include...*' We suggest that this should be reworded to say '*returns can include...*' The wording in the ED assumes control relationship before this assessment has been made.

Paragraph 16 states '*however, if the reporting entity ceases to receive returns from its involvement with an entity, it does not control that entity.*' We suggest that this should be reworded to state '*however, if the reporting entity ceases to have an entitlement to receive returns from its involvement with an entity, it does not control that entity.*' The wording in the ED could be misinterpreted in circumstances where returns are nil, therefore emphasis should be on changes in entitlement to returns.

In keeping with our suggestion that the definition of structured entities be removed (i.e. that paragraph 30 be deleted), paragraph 31 may then be reworded to read '*some entities are structured so that their activities are restricted and those activities are not directed as described in paragraphs 23 to 29. In such circumstances, when assessing control, it is necessary to ...*'

Appendix A defines ‘control of an entity’ as ‘*the power of a reporting entity to direct activities ...*’. We suggest that the reference to ‘reporting’ entity is unnecessarily restrictive and accordingly we suggest that the definition should be reworded ‘the power of an entity to direct activities ...’

Paragraph B20 and B21 should refer to ‘*financial statements or other financial information*’ rather than only ‘*financial statements*’.

Paragraph B35(c) should refer to ‘*operating segment or, where the entity is scoped out of IFRS 8, the business activity*’

Paragraph B36, relating to the information required when the date of the financial statements of a subsidiary used to prepare consolidated financial statements differs from the date of these consolidated financial statements, is currently in the section on information related to non-controlling interest. A separate header is required for paragraph B36.