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**Sent electronically through the IASB Website ([www.iasb.org](http://www.iasb.org))**

25 March 2009

International Accounting Standards Board  
30 Cannon Street  
London EC4M 6XH  
United Kingdom

Dear Sirs,

**[IASB Exposure Draft ED 10 Consolidated Financial Statements](#)**

The Hong Kong Institute of Certified Public Accountants is the only body authorised by law to promulgate financial reporting, auditing and ethical standards for professional accountants in Hong Kong. We welcome the opportunity to provide you with our comments on the captioned Exposure Draft. Our responses to the questions raised in your Exposure Draft are set out in the Appendix for your consideration.

We support the IASB in its effort to give the consolidation project a higher priority as a result of the financial crisis, and support the development of a principle-based standard based on control and applicable to all types of entities. However, we have concerns with the Exposure Draft in relation to:

- The lack of clarity and guidance provided on the application of the proposed control principle. Specifically the need to clarify certain aspects with additional application guidance in areas such as:
  - the ability to influence the actions of others through voting rights exercisable in the future (eg options and convertibles); and
  - the principal-agent relationship in circumstances where the reporting entity has dual roles (agent and principal).
- Two different sets of criteria in assessing control of normal entities (paragraphs 21-29) and structured entities (paragraphs 30 – 38). This dichotomy may result in practical implementation difficulties and a different consolidation and disclosure result depending on which category of entity you fall into, which would give rise to structuring opportunities; and
- Voluminous disclosures that may obscure important information in the financial statements. We therefore believe that a general principle behind these disclosures should be established (for both structured and non-structured entities) that requires disclosures to be made to the extent they are necessary to obtain an understanding of the risks to the reporting entity arising from its off-balance sheet arrangements.



Hong Kong Institute of  
**Certified Public Accountants**  
香港會計師公會

If you have any questions on our comments, please do not hesitate to contact me at [ong@hkiipa.org.hk](mailto:ong@hkiipa.org.hk).

Yours faithfully,

A handwritten signature in black ink that reads 'Steve Ong'. The signature is written in a cursive, flowing style.

Steve Ong, FCA, FCPA  
Director, Standard Setting Department

SOMC/ac



## **Hong Kong Institute of CPAs**

### **Comments on the IASB Exposure Draft ED 10 *Consolidated Financial Statements***

#### **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?**

#### **Question 2**

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

Our responses cover both Questions 1 and 2.

We support the objective of the Exposure Draft of developing a single, universally applied consolidation principle based on control.

The proposed definition that links power to direct and variable returns when identifying who controls an entity is consistent with the existing definition and in theory an acceptable definition. However, we have concerns that the guidance supporting that definition is not adequately developed in some areas, not clearly articulated in others, and requires additional guidance material elsewhere.

It is unclear in the ED what is meant in the definition of control by 'returns'. In some parts of the ED returns themselves are sufficient without regard to size or variability. In other parts variability of returns is suggested to be important, and elsewhere still correlation of size of returns to power is suggested to be required, implying that the control model retains at least some elements of a risks and rewards analysis. In our view the exposure of the reporting entity to variability in returns may be relevant in determining control, as an entity that has exposure to significant variability in returns would often retain a mechanism allowing it to take control over key decisions in the event of poor performance (for example step-in rights). However, it would be an indicator of control through other means rather than a primary factor in its own right.

With regards to power and activities it is not clear how to evaluate different activities conducted by an entity. There may be situations where different reporting entities control different activities and there is no guidance over which activities within an entity are the important ones with regard to control. Given the link in the control definition between power and returns we would suggest it is the activities that create the variability of an entity's returns that are important when considering who controls that entity. We support the inclusion of a focus on the substance of the relationship between the reporting entity and the subject entity in the proposed definition of control.

The ED proposes that all entities are categorised as either structured entities or non-structured, each with its own indicators of control. Establishing this dichotomy increases the ability to structure transactions to either meet or avoid the structured entity definition and hence apply one set of indicators or the other. We believe that the same definition of control should therefore be applied to all entities; the structured



entity guidance in paragraphs 31 to 38 is considered useful to the assessment of control for all entities, whether structured or not.

### **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?**

We consider the requirements and guidance regarding the assessment of control are insufficient to ensure the consistent application of the control definition. We share the alternative views of Messrs Garnett, Leisenring and Smith that the difference between having control and the ability to control is not clear.

Paragraph 8 of the ED states that “a reporting entity need not have exercised its power to direct the activities of an entity to control that entity”. In other areas in the ED, a reporting entity is deemed to have the power to direct the activities of another entity if it actually exercises its power to direct the activities. For example, paragraph 27(b) states that “a reporting entity with less than half of the voting rights has the power to direct the activities of another entity if the reporting entity’s voting rights are sufficient to give the reporting entity the ability to determine the entity’s strategic operating and financing policies”.

We therefore consider that an overarching principle should be developed, or more clearly articulated within the standard, to ensure consistent application. In particular, we believe that control is assessed at the balance sheet date, but that the assessment takes into account the substance of the relationship between reporting entity and reporting entity, such as the actions that the reporting entity is able to undertake, and the influence that those potential actions may have on the activities of the subject entity today.

We also believe that the guidance for entities that have a dual agent and principal role should be clarified, as further explained in our response to question 5.

### **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.**

We agree that consideration of options and convertible instruments are relevant to determining the substance of the relationship between the reporting entity and the subject entity and whether or not this gives rise to control. We also agree with the removal of the current presumption in IAS 27 that presently exercisable options or convertible instruments give rise to control of the holder, as well as the removal of the requirement for such options or convertible instruments to be presently exercisable.



Also we agree that options and convertible instruments need to be assessed in the context of other factors such as the cost and other consequences of exercising the options.

However, similar to our comments in Question 3, we consider the guidance regarding options and convertible instruments is both insufficient and internally inconsistent. We believe this will create confusion to users, allow for abuse of the standard, and be inconsistently applied in practice. For example, it is unclear as to how the Board considers options to allow control if it is not through the current potential to remove control from others.

Another example of the confusion can be found in paragraph B13(a). This states that the reporting entity has control over another entity if the governing body of that other entity determines strategic operating and financing policies in accordance with the wishes of the reporting entity. It then further explains that this might be the case if, for example, the reporting entity currently has voting rights and would, if it exercised its options or converted its convertibles, have sufficient voting rights to determine the entity's strategic operating and financing policies. We are not clear whether the principle behind the example is that the holding of the options/convertibles demonstrates that the reporting entity has the power to direct the governing body, or whether control is considered to exist only if the entity is currently acting in the interests of that option holder. It is also not clear whether or not it is determinative that the reporting entity already has some voting rights in addition to the options/convertibles.

#### **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.**

We agree that principal-agent issue is an important area that needs to be addressed in the Consolidation project, particularly for the investment management industry. However, we have concerns that the proposals as drafted have not been sufficiently developed to allow for consistent application in practice, as they do not clearly articulate how control should be assessed in agency and dual role relationships, including outside the investment management industry.

In particular, paragraphs B11 and BC 95 state that, when a reporting entity acts in a dual role and has voting rights in both roles, it should exclude the voting rights it holds as an agent from its assessment of control if it can demonstrate it uses them to act on behalf of others. Theoretically a fund manager who is also an investor would therefore only consider the votes it holds as an investor because its activities as a fund manager are on behalf of the investors. However, in practice it would be difficult to demonstrate that it is obliged to act in the best interests of those independent investors since the fund manager is one of those investors, and returns the fund manager gets will be identical to those of the other investors. In other words, acting in the fund manager's own best interests will frequently result in the same decisions as would be made if the fund manager were acting on behalf of the other investors. In such circumstances, it is unclear how the fund manager should interpret B11 i.e. is the fund manager entitled to exclude the other voting interests as it is acting in the common best interest of all



investors or is it required to include the other investors' holdings because its own best interests coincide with theirs and therefore he is unable to demonstrate that he acts only in the best interests of the other parties? It is also unclear whether the extent of the fund manager's own holdings is relevant under B11: for example would the conclusion under B11 be different if the fund manager holds only 5% compared to if it holds 20% of the fund, with all other facts concerning the investment mandate remaining equal? Also, would the conclusion be different if the fund manager's fees contained a variable element based on the performance of the fund? Again, we find that B11 is insufficient as a basis for identifying control in a dual-role situation.

We suggest that further clarification within the application guidance such as what other facts and circumstances or indicators of an agency relationship should be considered in the assessing control should be included in order to reduce the extent of diversity in practice in this area. Removal rights relating to the fund manager are also important, and should be expressly considered in the guidance, but must be carefully considered to determine whether they are substantive.

### **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?**

The inclusion of a definition of two different types of entities is troublesome for two reasons. Firstly it negates the idea of one model of control. If control is the principle then it should be equally applicable to all entities, and indicators of control should be equally applicable to all entities. If certain indicators are considered inappropriate for one or other of the two types of entities we would question whether they are the correct indicators to include.

Secondly having two distinct definitions of entities requires a decision to be made as to which bucket the specific entity falls into. In reality there would appear to be a continuum of entities from a normal operating entity governed by its board of directors who are duly elected by the vote holders, through to a plain vanilla repackaging structure with minimal equity, no board of directors, and minimal decisions to be made. Forcing this continuum into two distinct buckets will always be difficult and may encourage arbitrage.

### **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?**

We do not support the separation of entities into two categories with different requirements applied to determine control (non-structured entities in paragraphs 21-29 and structured entities in paragraphs 30 – 38).

We note that the proposed guidance in the Exposure Draft requires the reporting entity to focus on the variable returns it received from the structured entities in determining



the existence of control instead of to focus on the power to direct the strategic operating and financing policies for normal entities, which appears to be similar to the current risks and rewards approach in SIC-12. We do not agree with a model that maintains a 'power' criterion for some entities, and a 'risks and rewards' criterion for others. We believe that there should be an explicit requirement to consider all relevant factors, including the substance of the relationship with the subject entity, in a balanced judgment to arrive at a decision regarding control.

### **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.**

We do not think that the risks and rewards model should be included as a "fall back" test. Rather we consider that variability of returns may be an indicator in assessing other aspects of the power criterion. For example, an entity would not normally subject itself to the majority of such variability without a mechanism by which it could influence the key decisions giving rise to the variability (eg step-in rights).

### **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.**

As has been demonstrated in aftermath of the current financial crisis, there is a need for enhanced disclosure regarding off-balance sheet arrangements. While we agree that some additional information is required, we are concerned that the current proposals seem to be voluminous. We think the disclosure requirements in paragraphs B40 to B47 are very detailed and could be simplified by stating clearly which of the disclosures are intended to be mandatory and which are intended more to be indicative of the sort of things that could usefully be disclosed should the circumstances demand. In order to achieve this, we would support the application of a general principle that the reporting entity should disclose information to the extent it is necessary to obtain an understanding of the risks to the reporting entity arising from its off-balance sheet arrangements. We believe that this principle should be applied to all entities, whether structured or not.





### **Question 10**

**Do you think that reporting entities will, or should, have available 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.**

We believe that there will always be a practical problem with regard to the availability of information concerning entities that the reporting entity does not control. In addition, financial systems and processes currently in use are unlikely to support the disclosures that are being proposed. A risk-focused approach to disclosure, based on the general principle set out in Question 9, is more likely to result in the disclosure of information to which the reporting entity already has access.

### **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?**

We concur that “reputational risk”, as defined, is not an appropriate basis for consolidation. However, past actions of an entity may establish a valid expectation in third parties that the reporting entity intends to provide support to entities that it has involvement with, in which case we believe that appropriate disclosure should be made.

### **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?**

We believe that the IASB should reassess the meaning of “significant influence” as part of a comprehensive project regarding the use of the equity method. We also suggest that any changes to accounting for joint arrangements should be delayed, pending the outcome of any project on the equity method.

### **Other comments**

We note that in the definition of a “subsidiary” referred to on pg 49 of the Paper, the previous reference to “including an unincorporated entity such as a partnership” has been removed. We believe this reference was useful guidance as it made it clear that the word “entity” has a wider meaning to include unincorporated undertakings.