



Association pour la participation des
entreprises françaises à l'harmonisation
comptable internationale



A F E P

Association Française des Entreprises Privées

IASB
30 Cannon Street
London EC4M 6XH
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Paris, March 19, 2009

Re: ED “*Consolidated financial statements*”

We welcome the opportunity to comment on the IASB exposure draft presenting “*Consolidated Financial Statements*”.

We understand and support IASB’s efforts in bringing as swiftly as possible appropriate response to the legitimate concerns that the financial crisis has highlighted. We observe – as the IASB acknowledges in the introduction and basis for conclusions of the exposure draft - that no major flaw in IFRS consolidation requirements has been identified in the analysis of interrelationships between accounting rules and the financial turmoil, while a need for more detailed disclosures was nonetheless identified.

We derive from our observations that ED10 is attempting to reply to two different sets of concerns:

- First, to make the consolidation standard more robust and easier to apply in practice, by improving the definition of control and providing guidance on the way to apply it. Such improvements are highly desirable, but do not require, in our view, any higher level of priority due to the financial crisis;
- Secondly, to ensure that users of financial statements do get all the information they need in the notes, in order to assess appropriately the entity’s exposure to risks, and this as a matter of relative urgency.

We are highly supportive of the Board’s objective to apply one single consolidation principle to all entities. We support principle-based standards in general and believe that a principle –based approach to consolidation such as pursued by the Board is likely to lead to substantial improvements on the existing combination of IAS 27 and SIC 12.

We support that consolidation be based on the control principle set forth in paragraph 4 of the ED, which should be applied to all forms of entities and regardless of the way such entities are governed. We indeed believe that consolidated financial statements should not reflect the assets and liabilities of an entity whose activities the reporting entity does not have the ability to manage. We therefore believe that the proposed control principle is an improvement, particularly when assessing control over so-called “structured entities”. Indeed SIC 12 has over time be often turned into a “bright line test” on the majority of the risks and rewards, practice leaving aside the “in substance” assessment of control.

However the consultation period has evidenced that the exposure draft was very difficult to read and understand. We believe that the exposure draft needs quite substantial rework before it can turn into a final robust high quality standard on consolidation.

- Although the objective is to assess control for all entities using the same principle, the structure of the standard seems to include two distinct, adjacent sections for different types of entities. The guidance remains partly unclear as to which of the two sets of circumstances it is expected to apply and includes inconsistencies that would, if not removed, impair the quality of judgement of all facts and circumstances and the relevance and consistency of consolidation decisions.
- The emphasis in the control principle on the return element that we welcome is virtually absent from the guidance. Such guidance is however highly needed, particularly in terms of nature, relative weight and significance. Synergies within the group or economies of scale do not play a role in today’s practice, and the impacts of related arrangements remain unclear.
- Some parts of the bases for conclusions would in our view be better included in the standard where they would contribute to the standard’s enhancement. In addition, there is room for further guidance to support consolidation decisions made on the basis of economic substance.
- Illustrative examples should be developed and provided beyond the proposed illustrative guidance. Examples should be selected from both financial institution and corporate most frequent practices.

To be effective, the rework exercise should make the standard and related guidance structured around each of the three components of control as described in BC 42: power, returns and the link between power and returns.

In addition, we believe that some conceptual rationale to support the control principle proposed by the Board is needed and should be made explicit. We had expressed the regret that the DP on “Conceptual Framework – The reporting entity” did not provide such rationale. Such rationale would be helpful to the Board to solve the inconsistencies that remain and potentially solve the divergence of views expressed at the ED stage, for example on potential voting rights or on the ability to direct vs effective power. They would also help in making consolidation decisions in the unavoidable grey areas where the exercise of judgement will continue to prove difficult.

Without the supplementary work that we describe in the two above paragraphs and despite the quality of the approach the Board has adopted, we believe that the final standard would fail being an improvement of the existing IFRS literature. We believe that the work required is inconsistent with the timeframe that was set to respond to the financial crisis pressure, although we believe that it can be achieved before the June 2011 deadline. We therefore conclude that the two sets of concerns referred to above should be decoupled, on the one hand into a revision of IAS 27 and SIC 12, with the objective of improving disclosures as quickly as contemplated and needed, and, on the other hand, into the finalisation of IFRS X later, when all the issues raised in our letter are addressed.

Unless this is done, we believe the Board runs the risk of ending up with weaker requirements than we have at present.

Finally we would encourage the Board to adopt a more principle based approach to disclosures by limiting the disclosure requirements to the principles set forth in paragraph 48 and illustrating the way such objectives could be met as and if needed by the disclosures suggested in B30-B40. We also encourage the Board to coordinate with other standard setting bodies to ensure that supplementary disclosure requirements converge, in terms of content and timing, with the requirements effective in the United States.

We provide detailed comments on the IASB's proposals in the appendix to this letter.

Should you wish any supplementary comment or explanation, please do not hesitate to contact us.

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Appendix to our letter on IASB ED “Consolidated Financial Statements”.
Answers to the specific questions raised in the invitation for comments.

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?

We support the approach that the Board has adopted to bring all entities within the scope of one single standard and adopt one single principle as a basis for consolidation. However the proposals, as they stand, suggest application difficulties in the following areas:

- 1. The assessment of whether the reporting entity has the power to direct the activities of the other entity.*

As indicated in our cover letter, we do not believe that assets and liabilities that the reporting entity does not have the power to manage should be included in the consolidated statement of financial position. Although we agree with the Board that SIC 12 was meant to support the approach that, in substance, a reporting entity had control over another, it has turned in practice to be applied as if it was based on the risks and rewards model. We therefore expect that the future standard would exclude from consolidation all entities whose activities the reporting entity does not have the power to direct. We believe that that would be a desirable outcome for the change in standards.

However we believe that the future standard should ensure that the only entities excluded from consolidation are those that the reporting entity does not have the power to direct. To meet that objective the future standard needs to succeed where SIC 12 has failed, i.e. to ensure that an analysis in substance of control, and more particularly of power being exercised in structured entities, can be achieved in all circumstances. The real challenge of the new standard is to provide a sufficient structured thought process in order to determine whether or not an entity has the power over a structured entity to direct its activities. We do not believe that this is possible without articulating the thought process that preparers need to follow in order to assess whether or not such power exists. We believe that illustrative examples are very useful to that purpose, as they help understanding how the standard is meant to be applied in practice. Consequently we strongly encourage the Board to develop realistic fact patterns (inspired by both financial institution and corporate practices) and illustrate the way such facts should be evaluated in order to assess control.

Paragraphs 31 through 38 provide a series of indicators that are helpful in identifying what party has power over a structured entity’s activities. However, paragraphs 34 and 36 seem to lead to the conclusion that, if a third party that is not acting as an agent of the reporting entity has power to influence the variability of returns the reporting entity gets from the structured entity, the structured entity should not be consolidated. We believe that supplementary guidance is needed to widen the scope of the analysis.

We believe indeed that the variability of returns that depends from the remaining power being exercised in the structured entity should not be assessed, in terms of significance, within the sole boundaries of the structured entity. It should be assessed in the wider context of the entity's operations the structured entity is part of.

2. *The assessment of whether potential voting rights provide power over another entity.*

This issue is dealt with in our answers to questions 2 and 4.

3. *When and how the return component would be met*

This issue is dealt with in our answers to questions 2 and 3

Question 2— Is the control principle as articulated in the draft IFRS an appropriate basis for consolidation?

As indicated in our cover letter we support the control principle as articulated in the draft IFRS. Although we think a major rewrite is necessary, we are confident that, once revised and strengthened, the guidance for applying the control principle proposed in the ED will bring a more robust basis for consolidation than we have at present. We develop what we think needs to be revised in response to the questions that follow.

1. *Clarification of the return component*

We have welcomed the greater emphasis that the control principle is putting on the returns element of control. We do not see, however, that emphasis any further in the rest of the document – beyond the general principles – and therefore believe it is missing. The discussion on potential voting rights, or on dual role as an investor and an agent in particular, are areas where we believe it is missing. We agree with paragraph 11 that returns can be obtained in a variety of ways. However, to conclude that the assets and liabilities of an entity should be reported as part of the assets and liabilities of the reporting entity, the returns should in our view not only be in the form that a parent could get from a subsidiary but also in the amount that a parent could get. We believe that the significance of returns should be analysed as part of the process, although we would agree that any form of “bright line” is not desirable. We also believe that an entity should be consolidated only if the reporting entity is significantly exposed to the variability of the assets and liabilities of the entity. Otherwise some other asset or liability might have to be recognised instead. Finally how to take related arrangements into account remains unclear to us.

2. *Clarification of the current ability to direct the activities of an entity*

We believe also that the proposed control principle is in need of clarification and/or further development. We see some inconsistencies between:

- the “power” to direct the activities being defined as the “ability” to direct the activities, the ability being current or still to be grasped;
- the need to currently assess whether the reporting entity has control.

We agree with the definition of power as the “ability to direct”, if it is intended to capture situations in which a party has the power but decides not to exercise it (a passive shareholder); we disagree that it would encompass situations in which a party can make a decision to grasp the power, i.e. action is needed before the entity has power. Before that action is taken, - and unless that action has no economic substance - a current assessment of control should conclude that the entity does not yet have control (for example in the circumstance of potential voting rights, other facts and circumstances are necessary to indicate that the reporting entity has control).

We believe the application of the control principle is still in a grey area and suggest that the issue be fully clarified in the direction we have indicated.

3. *Clarification of conditions in which power is, or is not, exercised*

Finally we believe that the proposed standard is still in need of clarification. We illustrate below our understanding of the proposals to date to let the IASB staff assess whether the ED is leading to the conclusions intended by the Board.

Let's take the example of a mutual fund in which you have investors and an asset manager whose remuneration is commensurate with the services provided and who cannot be removed in the normal course of operations. Asset and risk management policies have been defined at the outset and formally publicised as part of compliance with investor protection regulations. The only decisions an investor can make are to invest or disinvest money in the fund.

Our understanding of ED10 proposals is as follows:

- the asset manager does not control the fund but is acting as an agent for all investors, although the asset manager cannot be removed, because:
 - o the remuneration received is commensurate with the services provided (the return criterion is not met)
 - o the asset manager is responsible for making decisions in accordance with the defined asset and risk management policies (as the asset manager does not direct the activities, the power criterion is not met)
 - o the asset manager has the duty to act in the interests of all the investors in the fund;
- no single investor can control the fund, even with, say, a 60% interest in it, because:
 - o the investors do not exercise power : asset and risk management policies have been defined and the asset manager cannot be removed (the power criterion is not met)
 - o the only capability left to investors is to disinvest their stakes in the fund.

We would reach the same conclusion if one of the investors in the fund was also responsible for the asset management, whatever its level of interest in the fund. In that case, although the return criterion would be met (investor and asset manager having a dual role), the power criterion would not be met because no financial or strategic policy decision needs to be made (the asset manager's decisions implement a pre-defined policy; the asset manager cannot make any decision to alter policies).

We agree with those conclusions and wish they are intended by the Board.

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 support the objective of the Board to make the future standard's principles more robust. To achieve that objective, we believe that all guidance in the analysis of specific sets of circumstances needs to remain as open as possible, i.e. never indicate what the answer should be, or is likely to be, in particular sets of limited circumstances. Preparers, auditors and enforcers should at all times have to take into account all facts and circumstances to make a principle-based decision of whether to consolidate. As a result, any form of prescriptive or rebuttable presumption should be eliminated. Examples of such guidance in need of review are the following:

- paragraph 33 indicates that the entity that is the most exposed is likely to have power; this could be perceived as a requirement to consolidate, in contradiction with the core principle, even in circumstances where the power to direct the activities would not be – in substance – evidenced;
- descriptions of limited circumstances, such as in B13 (a) and (c), may hinder an analysis in substance taking into account other facts and circumstances;
- B11 brings a rebuttable presumption that may hinder a wider, more comprehensive and more relevant analysis (please refer to our answer to question 5 on how to deal with dual role circumstances).

Notwithstanding the above comments, we are satisfied with the development of additional guidance that is missing in the existing IAS 27. We welcome more particularly the guidance provided on agency relationships and on protective rights. We however perceive the need for further guidance on the two issues below:

- A list of indicators of substantive participating rights would also be useful. The guidance on protective rights is rightfully based on indicators and there also judgement needs to be exercised. Grey areas, however, exist between protective rights and substantive participating rights; consequently both sets of indicators would be valuable to have. If however the Board believes that such supplementary guidance is not necessary, we would recommend that the Board indicates that, when non-controlling interest rights go beyond being protective, no consolidation should arise;

- Supplementary guidance would be helpful to assess the “return” component in making the decision whether to consolidate (without setting, we agree, any form of “bright line”): the significance of the returns that the reporting entity expects, the level of variability of those returns necessary to assess that the power that is still being exercised is to be considered or ignored (see our comment made in response to question 2). We also need further guidance to assess, for example, the following, to exercise judgement on as consistent a basis as possible:
 - o Should we consider absolute returns or exposure to their variability, or both? And if absolute returns have to be considered, on what basis should that be done? Should the returns be considered for all entities on the same basis, i.e. when the entity has more returns than any other investor and those returns are significant to the entity?
 - o §11 indicates that returns can take many different forms. Does any form of return satisfy the return criterion? Is consolidation triggered as soon as the reporting entity gets some form of return, if besides the power criterion is met?
 - o Would the return criterion be met when a reporting entity is exposed to positive returns only, or negative returns only, and not to both positive and negative returns?

Otherwise we believe the guidance has been set at an appropriate level of detail (we comment on the content in the answers to the following questions). Some clarifications would be welcomed though:

- paragraphs B1-B16 are only partially cross-referenced to the standard. As a result, it is difficult to ascertain whether the guidance applies generally or only to some specific situations; we believe clarifications would be welcomed. For example, is B11 supposed to apply to structured entities as well, even though it focuses on the exercise of voting rights?
- we believe the separation between the standard and application guidance could be optimised. The standard should contain only the provisions that apply generally. The first part of the guidance, dealing with identifying what entities need to be consolidated, could be split into various parts (power, returns and the link between the two), and various circumstances assessed in each of those parts. This would solve the existing perceived imbalance that, once principles have been set, they are quickly forgotten and control is assessed from only one of its components, or that there are two sub-parts in the standard, structured entities being dealt with apart.

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.

In our view, holding an option over a convertible instrument that, if exercised, would grant control to the entity is not, by itself, an indicator of control. We agree that the existence of potential voting rights should trigger a close examination of all facts and circumstances in order to determine if potential voting rights, in combination with other facts and circumstances, would indicate control.

We would therefore agree in substance with paragraph B13. However, we disagree with B13 (a) and (c). We believe those paragraphs are too prescriptive and do not allow enough room for judgement. We agree with B13 (b) that describes in our view an application of the principle of substance over form. We would also agree that the existence of potential voting rights associated with evidence that control is being exercised effectively (both power and return criteria being met) should trigger consolidation.

We further disagree with paragraph BC85 for two reasons:

- that paragraph seems to be adding to the application guidance, although bases for conclusions should only explain proposed requirements and not depict other possible situations of application;
- options deeply in the money, as any other option, should be considered in combination with other facts and circumstances to determine whether the holder has control.

Paragraph BC87 raises a supplementary concern. Paragraph B13 remains silent on whether the options that are being considered need to be currently exercisable. The ED has set the principle of continuous reassessment of control. Options, which are not currently exercisable, cannot in our view play any role in the assessment of control at a particular date.

We further note that the whole discussion in the basis for conclusions deals with power only. Returns are mentioned in BC86 in relation to options being exercisable at fair value. We believe that the way the option holder is exposed to returns from the entity should play a role in determining whether it has control of the entity. In many situations, exercising the option will modify the nature and extent of exposure of the holder to returns from the entity, in such a way that consolidation may not be the best depiction of the holder's financial position re the entity.

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.

BC 94 explains that the Board has decided to consider two types of circumstances separately:

- a) reporting entities that are directing activities of entities as agents of other parties;
- b) reporting entities that have been given power by other parties sufficient to have power to direct the activities of that other entity.

We support that distinction and believe it should be maintained. We are satisfied with how circumstances described in a) (agency relationships) have been dealt with in the ED. We have concerns with how circumstances described in b) have been addressed.

1. Agency relationships where the agent is directing the activities of entities: we agree with the guidance on agency relationships, more particularly B5-6 and B8. We wish to emphasise that as described in B5 an agency relationship is characterised by the fiduciary responsibility of the agent to act in the best interests of the principal. We believe that this indicator is key in the identification of an agency relationship. In that perspective, we wish the wording of B7 be clarified to make it clearer that where an agent perceives a performance related fee and as a result directs the activities of the entity for both the best of the principal and its own interests, the agent is not deemed to be in a controlling position, even in dual role circumstances. Otherwise, in circumstances where the fee formula fully reflects the performance of the entity, control might be presumed when it should not be. This is in our view consistent with the conclusion reached in BC93.
2. Entities being given power by other parties: on the basis of BC94, we understand that the rebuttable presumption stated in paragraph B11 intends to deal with this set of circumstances. We have several concerns in relation to B11:
 - a. As indicated in our response to question 3 we disagree that the future standard would include any presumption, so that all facts and circumstances need to be taken into account and judgement needs to be exercised at all times.
 - b. We believe the reasoning of the Board should be reversed, and made consistent with the assessment of a passive controlling party. The reporting entity should be assessed as controlling party in its dual role of investor and representative of the other party only in circumstances where it is not acting in the best interests of that other party and that other party does not have the ability to withdraw the power it has entrusted to the reporting entity. Nonetheless, circumstances where the interests of the two parties are not aligned should invite for close scrutiny.
 - c. The wording in the guidance has given rise to a lot of confusion.

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?

We do not disagree with the definition of a structured entity as presented in paragraph 30 of the draft IFRS. We understand the benefit of having a definition by default designed to ensure that no entity escapes from the scope of consolidation if it should fall into it. However we wonder why that definition is needed. We question whether the set of circumstances (i.e. restricted activities, power exercised by other means than voting rights) is not but just another different set of circumstances where the assessment of power and returns and the link between them may need to be carried out on the basis of a different set of facts and circumstances. In other words we do not think that the future standard should include a separate set of guidance devoted to structured entities.

Defining structured entities draws a parallel with IAS 27 and SIC 12 and tends to diminish the efficiency of having all entities – of all natures – governed by the same control principle. It looks as if there are two different sets of requirements sitting next to each other that do not need to be derived from the same core principle.

We believe the standard would be more efficient if every set of circumstances were described and assessed through the three fundamental elements in the definition of control, the power, the returns and the link between them. This could lead to a different break down of the future standard between general principles and application guidance (please refer to our recommendation in the last paragraph of our answer to question 3).

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 believe that the guidance regarding the assessment of a structured entity is adequate in its detail and content. As indicated in our response to question 3, we would wish that it is made clear whether any part of the application guidance (B1 to B16) is intended to apply to structured entities.

However we recommend – as indicated in our answers to both questions 3 and 6 – not to make the guidance on structured entities a separate section. We believe that the standard will be all the more internally consistent if the guidance is valid for any type of entity. For example, we note that power is defined in §22 as the ability to define strategic operating and financing policies. The ability to perform day-to-day activities is not considered as power. Nevertheless the wording of paragraph 36, in combination with the application of the control principle (power component to be met at all times), seems to suggest that the reporting entity has power only in those circumstances where it implements the predetermined policies directly or through an agency relationship. We believe that the final standard should not leave room for potential divergent interpretations of the power component when applied to different sets of circumstances.

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 a fall back test as described in the body of the question is needed, i.e. a fall back that would be considered to infringe the basic control principle proposed in the standard. We believe that:

- in the absence of any ready conceptual reference, the standard should include, even if detailed in the basis for conclusions only, a detailed rationale of how power and returns interact in the control principle to ensure that the external users benefit from the useful information they need to rely upon;
- on the basis of the above mentioned rationale, guidance should be detailed to identify circumstances where the remaining power in a structured entity does not meet the “power” criterion in the control principle;

- on the basis of the above mentioned rationale, guidance should be detailed to identify circumstances where the “returns” criterion is not met appropriately (the stakes of the reporting entity in the structured entity are too low – or the reporting entity is not exposed to the returns of the assets and liabilities of the entity in full).

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 efforts undertaken by the Board to provide to investors all the information they need on the risks a reporting entity faces in relation to unconsolidated activities. We approve of the determination of the Board not to undermine the consolidation principle – in fact to attempt at making it more robust. We acknowledge that such a decision leaves – rightly – activities in which reporting entities have involvement beyond the boundaries of the reporting entity. We therefore agree that supplementary disclosures are required.

However we believe the disclosures requirements set out in the ED should be revised in two main directions:

- the approach to disclosures should be more principle-based: we believe that B31 should be emphasised as the requirement, whereas all details that may have to be disclosed to have B31 complied with should be listed as possible items of disclosure;
- the Board should take into account that the reporting entity does not have the power to collect some information, mainly those indicated in B44 c). As a result this information should not be part of the list of requirements.

We fully support disclosure requirements intended to assess the extent of non controlling interests in the entity, as well as the impact of restrictions on consolidated assets and liabilities (B35 – 37).

Disclosures intended to describe the basis for control and the impact of those decisions expressed in terms of total assets, liabilities and profit/loss either consolidated or non consolidated seem to us to bring users to second guess management decisions. Disclosures cannot encapsulate all details necessary to understand how a judgement was finally formed and may hence create more uncertainty and questions than providing valuable information content.

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.

To comply with every line of disclosure as described in B43 – B47, specific supplementary reporting would need to be organised and collected from structured entities, although the information may not be necessary to comply with B31.

If these pieces of information are listed as possible items needed to comply with B31, entities may have the relevant information available in one form or another as part of its risk management reporting.

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.

We agree with the Board that reputational risk is no basis for consolidation.

Question 11 (b) – Do you think that the proposed disclosures in paragraph B47 are sufficient? If not, how should they be enhanced?

We do not believe that any specific disclosure is needed in this area. Existing disclosures do already call for information to be provided in business combinations, commitments made (enhanced by the present proposals).

Furthermore, we agree with the Board view in BC 145 that disclosures should not be made on the intention to provide future support to other entities.

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 IAS 28 is in need of improvement, all the more so that the Board intends to extend the equity method to all joint ventures. In this respect, consistently with the comments we made on ED9, joint control and significant influence are quite different in substance, and the IASB needs in our view to rationalise its decisions in terms of usefulness of information to investors before finalising any decision on ED9.

We would welcome clarification of whether the equity method is meant to be a one-line consolidation method (our understanding – the method calls for the elimination of intra-group transactions and other consolidation-type adjustments) or a measurement method. We would also approve of the notion of “significant influence” being clarified. We do not believe that the reference to a level of interests alone is appropriate. We believe that significant influence should be also defined by reference to the degree of rights that an investor can exercise to influence the decisions of the controlling shareholder, consistently with the efforts the Board has developed in ED10 in relation to power.

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