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Sir David Tweedie
Chairman
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
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Dear Sir David,

On behalf of the Austrian Financial Reporting and Auditing Committee (AFRAC), the privately organised standard-setting body for financial reporting and auditing standards in Austria, I appreciate the opportunity to comment on the Exposure Draft (ED) 10 Consolidated Financial Statements. Principal authors of this comment letter were Andreas Rauter, Josef Arminger and Aslan Milla.

General comments

We would like to emphasise that we support the objectives of ED 10. It is a useful approach to combine the principles of the control model and the risk and rewards model: a new concept that includes a definition of control and focuses on variable returns and certain elements of risks and rewards is essential for sound and consistent financial reporting. As such, we support in principle the efforts undertaken in ED 10 to integrate IAS 27 and SIC 12 into a single standard.

However, we are concerned that the provisions of ED 10 in certain circumstances may still result in inconsistent application, e.g., in connection with structured entities, the treatment of options and convertible instruments, and agency relationships.

As a result, ED 10 as drafted may not represent an improvement on existing IFRSs – as long as the principle-based definition of control which is essential for consistent financial reporting is not properly explained and underpinned with clear governance criteria as to what constitutes control.

Specific comments

Q1.- *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?*

Q2. *Is the control principle as articulated in the draft IFRS an appropriate basis for consolidation?*

We understand that a key objective of the project is the development of a single universally applicable principle for consolidation that results in the appropriate entities being consolidated consistently. In general, the proposed control definition could be applied, but we are not sure that it will lead to more coherence than the current definition.

ED 10 requires a parent to have the 'visible' power to direct the activities of its subsidiaries. Sometimes it may be difficult to find visible evidence of a power to direct. We are not sure whether under the new ED 10 all entities will be consolidated in the same way as under IAS 27 and SIC 12.

We are not yet sure how best to achieve this consistency through the use of a single, universally applicable consolidation principle. We think it essential for any proposed single consolidation principle to be thoroughly field-tested in a wide range of jurisdictions before being adopted.

That said, we suggest considering an approach in which control is based either on the enforceable majority of voting rights or otherwise on a specified range of factors such as options, contractual arrangements, risks and rewards (returns) etc. The presence or absence of such factors should be kept under continual review by the reporting entity.

Q3. *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 believe that in some areas such as the discussion of options, contractual arrangements and agents the requirements and guidance regarding the assessment of control have improved the situation. However, we should like to point out that the requirements set out in ED 10 paragraph 30

et seqq. in connection with structured entities and Appendix B9 *et seqq.* in connection with power to direct activities without a majority of the voting rights may lead to inconsistencies in practice.

We also think there is some confusion as to whether it is ‘a power to direct’ or ‘an ability to direct’ that needs to exist. It appears to us that the ED is not clear as to whether the power to determine the strategic operating and financing policies is sufficient to give an entity control of another entity. ED 10 states (in paragraph 22) that “an entity has the power to direct the activities of another entity if it can determine that other entity’s strategic operating and financing policies”. However, it also states (in paragraph 23) that if an entity’s governing body determines that entity’s strategic operating and financing policies and the reporting entity has the power to appoint or remove the members of that governing body that have more than half of that body’s voting rights, then the reporting entity can have the power to direct the activities of the first entity. In other words, having the power to determine that another entity’s strategic operating and financing policies might but might not result in having the power to direct the activities of that other entity. This would be a change from the existing IFRS system.

As discussed in the answer to Questions 1 and 2, we understand the purpose of the Board to be the application of a single concept of control to all types of transactions and relationships (i.e., wholly-owned subsidiaries, subsidiaries with minorities, entities in which less than half of the voting rights are held, and structured entities (previously, special purpose entities)). The definition of a structured entity in ED 10 paragraph 30 as ‘an entity whose activities are restricted to the extent that those activities are not directed as described in paragraphs 23–29’, taken together with paragraphs 26–29 and the guidance contained in Appendix B9 may lead to varied interpretations in practice. We suggest that the definition of a structured entity in paragraph 30 be reconsidered, and that the requirements in paragraphs 26–29 and paragraphs 30 *et seqq.* be made consistent. (Note also our answer to Question 6, below).

Q4. *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 are pleased to see ED 10 addressing the issues of options and convertible instruments. We also agree with the ED’s view that they should both be treated in the same way in assessing power to direct activities without a majority of the voting rights, and that there should be a single principle underlying their treatment. However, we find this part of the ED (paragraph B13) very unclear.

We are not sure whether what this paragraph is saying is that the holding of the options demonstrates that the reporting entity has the power to direct the governing body, or that the fact that the second

entity acts in accordance with the reporting entity's wishes demonstrates the power to direct, or whether there is some other factor that combines to give the reporting entity power to direct activities. We refer to the concern we discussed in our answers to Questions 2 and 3 above, regarding the 'ability to direct activities' or the 'actual exercise of power to direct'. Paragraph BC86 in the Basis for Conclusions (options with an exercise price the same as the fair value of the shares) creates an additional confusion, because it describes a guidance on options and convertibles which should, if considered necessary, be included in the standard or in the application guidance. Nevertheless, we believe that the statement in BC86 is correct.

Q5. *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 with the Board's proposals for situations in which a party holds voting rights directly and on behalf of other parties as an agent. B3 of the application guidance indicates that the agent must use any decision-making ability delegated to it to generate returns 'primarily for the principal'. It is not clear what 'primarily' means, and this needs to be clarified.

We recommend providing guidance as to the principles to be applied in identifying whether a party is acting as an agent, e.g., including a principle that requires an agreement or ongoing relationship, under which the agent must act in accordance with instructions, and where the reporting entity can exercise its power to direct the activities by removing the agent. Explanations given in the Basis for Conclusions (BC88–BC95) should be thoroughly reviewed to determine whether they include important guidance which should appear in the Standard or in the Application guidance.

Q6. *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?*

Q7. *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?*

Q8. *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 are not convinced that a definition of a structured entity should be included in the Standard, because we are aware of the problems that arose in the USA with the notion of a qualifying special purpose vehicle, and the related interpretations.

That issue apart, we also have some concerns about the definition itself. We recognise that the IASB's aim is to ensure that the ED's proposals permit application of the principle of control as defined in the ED to all types of entities. However, the definition of structured entities is merely negative, in terms of the properties defined in paragraphs 23–29, which are all concerned with 'power to direct'. As such, this results in a definition that does not identify the attributes of a structured entity but simply says that a structured entity is everything not already addressed in the ED. We do not think that is very satisfactory.

With regard to the guidance contained in paragraphs 30–38 please see our comments on Question 3 above.

As explained in our general comments and our answer to Question 1, we support the use of a control principle that incorporates some elements of risks and rewards. Although we are not sure yet how best to do this correctly, we believe that the definition of control should cover all situations addressed in IAS 27 and SIC 12 so that the reporting entity could well have control of a structured entity even if the reporting entity's power to direct the activities of the structured entity is not visible. In our opinion the definition of returns and the related guidance correctly addresses risks and rewards. We believe that paragraphs 10 and 11 in particular provide adequate explanation for a reporting entity to understand that returns may, and very often do, involve risks, just as positive returns are rewards.

Q9. *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.*

Q10. *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.*

We support the view that the financial crisis has highlighted a need for better disclosure of the nature of a reporting entity's involvement with structured entities that the reporting entity does not control (and therefore does not consolidate) and the associated risks. In principle, we therefore support the ED's efforts to satisfy this need.

However, although disclosures of off-balance sheet risks are very important, they cannot make up for a failure to consolidate an entity that ought to be consolidated. In our opinion, the emphasis should continue to be on making sure that the consolidation standard is sufficiently robust and consistently applied to ensure that all assets and liabilities – including those of structured entities – are correctly included in the consolidated financial statements where necessary for a true and fair view.

As long as this is achieved, we are not in favour of disclosures about entities that have not been consolidated being designed to enable users to consolidate the entities should they so wish. It is not the function of disclosures to enable management to be “second-guessed” in this way. We are pleased to see that the disclosures proposed do not adopt such an approach.

Although we are broadly in agreement with the general direction of the new disclosures proposed, we are concerned that they seem likely to be voluminous. For example, for unconsolidated structured entities, we think the key disclosures should probably be about the reporting entity’s exposure to the structured entity and the assets and liabilities of the structured entity. While information on exposures to structured entities is always significant, detailed information on structured entities’ assets and liabilities might be relevant only when the reporting entity has a significant exposure to those assets and liabilities through guarantees, junior securities, liquidity facilities, etc. This is likely to be the case when the reporting entity acts as originator or sponsor, or when, even if the role is that of an investor, the risk and rewards acquired are significant relative to the total amount of the risk and rewards involved.

B30–34 include some guidance on disclosure requirements. In these paragraphs both the term “must” (B30) and the term “might” (B33 and B34) are used. We recommend distinguishing clearly between mandatory and voluntary disclosure requirements.

- Q11.** *(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?*

In our opinion reputational risk on its own is not an appropriate basis for consolidation, since it does not satisfy the control criteria.

In our opinion the proposed disclosures in Appendix B B47 are adequate.

Q12. *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 welcome in principle the suggestion that the Board consider the definitions of significant influence and the use of the equity method with a view to revising IAS 28. Although under the present standards – IAS 27, IAS 28 and IFRS 3 – the rules and guidance appear to be very similar in theory, there may be wide divergence in application in practice. However, before deciding whether to change the definition of significant influence or the use of the equity method, the Board should first determine whether there is any real practical problem for users and preparers with the current definition and usage, and/or whether practical improvements could be made that would result in more useful and/or less costly information.

We accept a number of the arguments advanced in paragraphs 27–32 of the Introduction to ED 10 both for and against adding a project on these issues to the Board's active agenda. However, we recommend concentrating on a number of far more pressing issues to which the IASB needs to allocate resources in priority to the work described.

Please do not hesitate to contact me if you wish to discuss any aspect of our comment letter in more detail.

Kind regards,

Romuald Bertl
Chairman