

24 February 2009

Mr Bruce Porter
Acting Chairman
Australian Accounting Standards Board
PO Box 204
Collins Street West VIC 8007

Via email: standard@asb.gov.au

Dear Mr Porter

Comments on ED 171 *Consolidated Financial Statements*

Thank you for the opportunity to comment on the AASB Exposure Draft 171 *Consolidated Financial Statements*. CPA Australia, The Institute of Chartered Accountants and the National Institute of Accountants (the Joint Accounting Bodies) have considered the above exposure draft (ED) and our comments follow.

The Joint Accounting Bodies represent over 180,000 professional accountants in Australia. Our members work in diverse roles across public practice, commerce, industry, government, academia throughout Australia and internationally.

Our response to matters on which specific comment is requested is included in the attached Appendix. Also attached is our submission to the IASB which includes our responses to the specific IASB questions for comment.

If you have any questions regarding this submission, please do not hesitate to contact either Mark Shying (CPA Australia) at mark.shying@cpaaustralia.com.au, Kerry Hicks (the Institute) at kerry.hicks@charteredaccountants.com.au or Tom Ravlic (NIA) at tom.ravlic@nia.org.au.

Yours sincerely



Geoff Rankin
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Representatives of the Australian Accounting Profession



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The Institute of
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Appendix – Matters on Which Specific Comment Requested

1. **AASB 127 Consolidated and Separate Financial Statements** applies to for-profit and not-for-profit reporting entities in both the private and public sectors. If approved, the amendments in this Exposure Draft would apply to this broad range of entities. The AASB is also at an early stage of progressing a separate project to address issues specific to control among not-for-profit entities in the public sector that has the potential to give rise to further changes to AASB 127. Accordingly, the AASB would particularly value comments on whether:

(a) there are any regulatory issues or other issues arising in the Australian environment that may affect the implementation of the proposals to these entities, particularly any issues relating to:

- (i) not-for-profit private sector entities; and
- (ii) for-profit public sector entities;

We are not aware of any regulatory issues arising in the Australian environment that may affect the implementation of the proposals.

(b) overall, the proposals would result in financial statements that would be useful to users; and

Overall the proposals would be result in useful financial statements, however as addressed in our comment letter to the IASB, there are certain aspects of the proposals that need improvement.

(c) the proposals are in the best interests of the Australian economy.

The proposals are in the best interests of the Australian economy, however similar to our response to the previous question, some improvements are required to the proposals.

2. **To assist with its ongoing research as part of the AASB's separate longer-term project on control in the public sector, the AASB would value comments on the suitability of the IASB's proposals in a not-for-profit public sector context if some or all of the proposals were to be adopted.**

The definition of control may need some different terminology to apply to the not for profit sector. For the example the use of the word returns may need to be explained to encompass achieving the objectives of the controlling entity (which may include social benefit type objectives) rather than only accessing returns from the controlled entity. Further consideration may need to be given to the situations where the objectives of two or more entities coincide and the implications for determining such a control relationship.

24 February 2009

Sir David Tweedie
International Accounting Standards Board
30 Cannon Street
LONDON EC4M 6XH
United Kingdom

Via "Open to comment" page on www.iasb.org

Dear Sir David

Comments on ED 10 *Consolidated Financial Statements*

Thank you for the opportunity to comment on the IASB Exposure Draft 10 *Consolidated Financial Statements*. CPA Australia, The Institute of Chartered Accountants and the National Institute of Accountants (the Joint Accounting Bodies) have considered the above exposure draft (ED) and our comments follow.

The Joint Accounting Bodies represent over 180,000 professional accountants in Australia. Our members work in diverse roles across public practice, commerce, industry, government, academia throughout Australia and internationally.

General comments

We support the development of a revised standard containing a revised 'principal based' control model to all types of entities. However, we have some fundamental concerns regarding the lack of clarity and guidance provided in the standard and the lack of illustrative examples which are necessary to ensure consistency of application. We recommend field testing of the proposals to better understand the implications, especially in the financial services and property sectors.

We are also concerned that due process has not been adequate on these proposals and would have preferred the IASB to have issued a discussion paper on this topic prepared in conjunction with the United States Financial Accounting Standards Board (FASB). We appreciate that the financial crisis has had a global impact, and that accounting standards require some immediate improvement in this area (the disclosure area in particular). However, a joint project addressing the current issues in both US GAAP and IFRS would result in a permanent global solution, rather than a solution that is likely to change again as US GAAP and IFRS converge in the future.

Further, the linkage that the consolidation model has to investments in associates and joint ventures requires a comprehensive review of these standards (IAS 28 and IAS 31) prior to the consolidation proposals being finalised.

Our response to matters on which specific comment is requested is included in the attached Appendix.

If you have any questions regarding this submission, please do not hesitate to contact Mark Shying (CPA Australia) at mark.shying@cpaaustralia.com.au, Kerry Hicks (the Institute) at kerry.hicks@charteredaccountants.com.au or Tom Ravlic (NIA) at tom.ravlic@nia.org.au.

Yours sincerely



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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 agree with the one model approach and believe that the proposed control definition could be applied to all entities within the scope of IAS 27. However, there still may be some application difficulties for entities within the scope of SIC-12. This one model approach needs better cohesiveness, given that the control definition refers to 'power to direct' which seems contrary to the structured entity definition whose '...activities are not directed...'.

The definition could be better linked to the structured entity definition by including 'predetermine' as follows: "...the power to direct or predetermine the activities of that other entity..."

We would also like bring to the Board's attention the link with the recent IASB discussion paper on the reporting entity and this ED. In our submission dated 1 September 2008, we suggested that the consolidation standard should include guidance on the requirement to present consolidated financial statements and the boundaries of a reporting entity. However, this ED does not include any such guidance. We consider that the current ED is lacking in this regard and therefore suggest this guidance be included.

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

Generally, the control principle appears to be an appropriate basis for consolidation. However, we have two major concerns, as detailed below.

We do not see any need to change the term 'benefits' to 'returns', given there does not seem to have been deficiencies within the current standard using the word 'benefits'. Further we consider the term 'benefits' as more appropriate in a sector neutral environment such as Australia, as well as some other countries in the world.

Secondly, we are concerned about the apparent link between power to direct and returns resulting in difficulties and inconsistencies in application without additional guidance, examples and/or clarification. There are many situations where power to direct and returns may not link and therefore confusion will arise in application of the standard.

For example, some Australian listed companies operate employee benefit trusts (an entity that holds shares to be issued to employees as share-based payments) which they consolidate under SIC 12. In these trusts the employer has the 'power to direct' but the trusts do not 'generate returns for the reporting entity'. Therefore under our reading of the ED these entities would not be controlled and therefore not be consolidated. We question whether this is an appropriate outcome.

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?

The requirements and guidance regarding the assessment of control are considered insufficient to ensure the consistent application of the control definition.

The guidance does not appear to be sufficient to be able to apply professional judgment in areas such as defacto control, participative versus protective rights, agency versus principal relationships and potential voting rights.

For example, similar to the alternative views of Messrs Garnett, Leisenring and Smith, the difference between having control and the ability to control is not clear. An overarching principle is needed to bring together the requirements to ensure consistent application.

Other areas that indicate application difficulties with the current wording in the ED, may include:

- Paragraph 13 which tends to indicate the power and returns are correlated. This is not the case in all situations and therefore may present structuring opportunities
- Paragraphs 23-24 refer to a governing body, which is not defined, but also therefore does not take into consideration that some entities that do not have a governing body.
- Paragraph 28 refers to a dominant shareholder – another term that is not defined and could therefore lead to application difficulties.
- Paragraph 27 refers to one party having more voting rights than any other party – this situation is not easily determined by a party unless legal ownership is such that they can demand the information.

Further, we consider that the concept of a structured entity should be able to be dealt with through the control indicators, rather than tacked on as an adjunct.

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.

Similar to our other comments, the proposals about options and convertible instruments also lack clarity and could be interpreted in different ways.

We understand the proposals indicate that control is possible even if the options held are not currently exercisable. We cannot support this position. We believe that only currently exercisable options are an indicator of control.

Our reasons to support our arguments above include situations whereby the exercise of options is restricted by a time period, in which control could not exist until the relevant condition has been met. Further, option holders are unlikely to be able to immediately direct a company's governing body unless certain legal requirements are met, such as approval of the exercise of the options at the next general meeting. We consider these criteria an important obstacle to the 'power to direct' argument.

Further, paragraph B13(a) seems to indicate that control exists if the entity acts in the interest of the option holder. We do not consider this is an indication of control, unless there is some legal or contractual obligation for the entity to do this under the terms of the option agreement. Straight forward option arrangements do not ordinarily confer rights or powers that enable compulsion.

We also noted that the Basis for Conclusions also tends to assume that a counterparty exists, which is not always the case.

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 commend the Board on considering such a difficult issue. However, we do not think that these proposals are sufficiently clear to apply in practice.

The guidance tends to indicate that 'removal rights' held by a unitholder in relation to a trustee or manager of a fund are not sufficient to overcome the control test. We consider the fact that removal rights exist is an indicator, along with others, that should be considered in a control assessment.

Further, the link to the quantum of fees seems paramount to the assessment. However, in other parts of the consolidation guidance thresholds are not seen as a key criterion. This seems inconsistent and some changes to the wording in the application guidance should be considered. In relation to paragraph B5, given that this is guidance, we would expect that it should read '*...may indicate involvement with an entity...*' i.e. the outcome should be dependant on all the facts and circumstances. We also consider that the assessment of the indicators in paragraph B6 would be difficult to apply in practice.

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 definition of structured entity is not entirely clear and would be assisted through the incorporation of some thoughtful examples that illustrate the outcomes of various structures, or more specifically the key elements or components of a few different structures that lead to different consolidation outcomes.

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 requirements and guidance regarding the assessment of control of a structured entity in paragraphs 30–38 would be better incorporated into paragraphs 12 – 29, as it currently looks like an adjunct to these paragraphs and therefore more likely to result in inconsistent application of the control definition.

Paragraph 33 refers to the correlation between power and variability of returns; however, as discussed in Question 3 there can be circumstances where there isn't a direct correlation. We recommend that guidance and examples are included to assist in assessing control under such circumstances.

In relation to the examples used in paragraphs 32 and 33, we do not think they are particularly useful given that they only consider one factor in determining control, when the proposals require that all facts and circumstances must be considered in determining whether control exists. Some of these examples also introduce terms such as 'significant' and 'more than that of any other party' which can be interpreted differently or imply the use of thresholds, which the basis for conclusions clearly does not support.

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. We do not support an exception to the principle that consolidation is on the basis of control. We do consider that a discussion of risks and rewards is relevant to identifying powers to direct activities. Therefore, we recommend that this discussion is included in the Application Guidance.

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.**

The proposed disclosures appear particularly onerous and may not provide decision useful information. The requirements outlined in the application guidance appear to be more prescriptive than necessary. We appreciate the need for enhanced disclosure in this area given past global events. However, as paragraph 82 of the Framework states, disclosure should not be a substitute for the recognition of an item. We believe that the volume of disclosures proposed in the ED appear to be a substitute for consolidating the structured entity, and may also be seen as a deterrent i.e. entities may prefer to consolidate instead of disclosing information about its unconsolidated entities.

Disclosures in relation to an entity's involvement in structured entities set up and sponsored are unlikely to provide decision useful information and this information will prove difficult to obtain for financial institutions that provide this service to customers as a matter of normal business operations. Further, to require two years of comparative data for such disclosures is even more onerous than a reporting entity is required to disclose in its own financial statements.

We consider that disclosures of unconsolidated entities should focus on the loss and expected loss, and not require the detailed nature of underlying assets and liabilities as described in B44. These disclosures would be more suitably located as part of the risk disclosures in IFRS 7 *Financial Instruments: Disclosures*, than in a consolidation standard that deals with controlled entities. Further, the disclosures required in B38(b) requiring that nature and extent of, and changes in, the market risk, credit risk and liquidity risk are already disclosed as

part of the IFRS 7 disclosures, and to require disclosure for particular subsets of counterparties is highly questionable to have any decision useful information.

- 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.**

We consider that the information sought by reporting entities of unconsolidated structured entities will be difficult or even impossible to reliably obtain for some organisations if there is no legal requirement for the provision of such information to investors generally.

Already there are times when entities have difficulties obtaining sufficient information for IAS 28 disclosures when significant influence exists. These difficulties include situations where the associate reports under a different GAAP (i.e. not IFRS) and where they have a different reporting date. These difficulties of obtaining the information, and consequently auditing any information that can be obtained, will exist also for the disclosures required in this current ED.

- 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.**

Reputational risk, in itself, is not an appropriate basis for consolidation. However, we believe that it is a factor/indicator that needs to be considered when assessing all facts and circumstances of determining whether an entity is controlled.

Recent research has concluded that a link exists in the minds of investors between a structured entity and its sponsor-originator: Landsman, Peasnell and Shakespeare, 'Are Asset Securitizations Sales or Loans?', *The Accounting Review*, 83(5), pp1251-1272 concluded that the stock market treats securitized assets and liabilities as belonging to the sponsor-originator of the structured entity, i.e. the risks and rewards of ownership of the transferred assets reside with the sponsor-originator and not the structured entity. If a sponsor-originator monitors the activities of its structured entity, with the intention of providing assistance if and when required, then we believe that this is an indicator of control. One would anticipate that similar disclosures to that of unconsolidated structured entities should apply in such circumstances.

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

Paragraph B47(b) requires disclosure of why the support was provided – while these disclosures seem adequate, practically the information may be difficult to obtain, as identified in questions above. We consider that B47 should be amended to only apply to situations when the provision of support has lead to, or occurred in the same reporting period as a reassessment to consolidate an entity, previously not consolidated. This information would be available and useful to users of the financial statements. Further, the ED does not define 'support', nor is it discussed in the guidance.

- 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?**

As mentioned earlier, we strongly believe that the Board must as a priority, before the consolidation project is finalised, undertake a comprehensive review of IAS 28, in conjunction with the joint venture project. The principles in accounting for various ownership interests in entities should be made throughout the standards at one point in time, otherwise issues with consistency and application will arise.

The problem paragraphs in IAS 28 appear to be where reference is made to consolidated procedures and concepts underlying the procedures used in accounting for the acquisition of a subsidiary. The measurement models in IAS 28, IAS 27 and IFRS 3 are quite different and therefore the cross referring can create application difficulties.

Other issues identified

- a) The draft illustrative examples seem to focus on illustrating an individual control criterion in isolation of the others rather than consideration of all the facts and circumstances. Therefore we consider these examples should be expanded to show how an entity needs to consider all the indicators as part of an overall assessment of control.
- b) Highlighting that the assessment of control is continuous is very important. However, we feel that given the way that paragraph 16 has been written, there is a risk of consolidation and deconsolidation occurring more than once during an accounting period. This could be explained by including some indicators as to when this should be considered would also be useful, indicators such as change in contract terms, change in extent of involvement, clarity around the word 'cease', etc.
- c) The indicators that highlight the existence of power without a majority of control could be extended to include the fact that the reporting entity can approve and/or make significant changes to the annual budget.
- d) In relation to the definition of subsidiary in Appendix A, there is a footnote referring to silo, which appears to be defined in BC31. We consider that the proposals need to be clearer about the level to which they are applied, i.e. if a silo is considered to be an entity (and therefore a subsidiary) in IFRS, this should be explicitly explained and defined.
- e) The transitional provisions require further clarification. For example, in applying IFRS 3 under paragraph 52:
 - What is the consideration to be used to determine goodwill?
 - Is the 'date of first applying', the first day of the current year or previous year?
 - Are the resulting adjustments from fair valuing the existing interest or discount on bargain purchase recognised in profit or loss or other comprehensive income?