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25 March 2009

Dear Bruce

**Exposure Draft ED 171 *Consolidated Financial Statements***

I am enclosing a copy of the PricewaterhouseCoopers response to the International Accounting Standards Board's Exposure Draft ED 10 *Consolidated Financial Statements*. The letter reflects the views of the PricewaterhouseCoopers network of firms and as such includes our own comments on the matters raised in the Exposure Draft.

We are not aware of any issues that could affect the implementation of the proposals for for-profit public sector entities. However, because the revised definition of control focuses on the generation of returns, it may need to be supplemented by further guidance to facilitate it being applied by not-for-profit private and public sector entities. The Australian Accounting Standards Board will need to accelerate its work on control in the public sector when the revised standard is issued.

Subject to our concerns about the disclosures proposed in ED 171, as expressed in our submission to the IASB, the proposals would result in financial statements that would be useful to users. We are not aware of anything that would indicate that the proposals in ED 171 are not in the best interests of the Australian economy.

We would welcome the opportunity to discuss our views at your convenience. Please contact me on (03) 8603 3868 if you would like to discuss this further.

Yours sincerely

A handwritten signature in cursive script that reads 'Jan McCahey'.

Jan McCahey  
Partner  
Assurance

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

20 March 2009

Dear Sir David

## **Exposure Draft ED 10 Consolidated Financial Statements**

We are responding to your invitation to comment on the above draft IFRS on behalf of PricewaterhouseCoopers.

Following consultation with members of the PricewaterhouseCoopers network of firms, this response summarises the views of member firms who commented on this exposure draft. "PricewaterhouseCoopers" refers to the network of member firms of PricewaterhouseCoopers International Limited, each of which is a separate and independent legal entity.

We welcome the opportunity to comment on the Board's proposals on this important topic. We recognise the significant efforts that the Board is making to respond to current economic events and the requests of the Financial Stability Forum. We support the Board's proposed changes to the consolidation requirements of IFRS, but we have two significant areas of concern. First, changes in the consolidation requirements must be coherent with any revisions to the de-recognition framework. A single principles based framework for consolidation and de-recognition would improve the transparency and consistency of financial reporting. Second, whilst we support a single control based model for consolidation, we have substantive comments on the proposed guidance, as explained in this letter and attachment.

### **Definition of control**

We do not believe that the proposed definition of control is sufficiently well explained; it is ambiguous about whether the 'power to direct' is assessed as of the balance sheet date or as of some other date. The Board could enhance the proposed definition of control by focusing more on the substance of the relationship between the reporting entity and the subject entity. The power to direct the activities of the subject entity needs to be better articulated. A reporting entity may possess that power by different means, including:

- past actions (such as the establishment of the subject entity, the pre-determination of the scope of its activities and decision-making such that the reporting entity, in substance, has the power to direct the activities of the subject entity),
- current voting rights,
- the ability of the reporting entity to affect the actions of others because of the existence of rights that it can exercise in the future (such as rights granted through options and convertible instruments), and
- rights to act in the future (such as rights that may be triggered upon the occurrence of certain events of default).

All of these actions and rights need to be assessed to determine whether the reporting entity has the power to direct the activities of the subject entity at the balance sheet date. These various means must be considered to inform the decision as to whether the reporting entity presently has the power (or the ability to affect the actions of others) to direct the subject entity's activities.

### **Structured entity**

We do not support the concept of structured entity and the categorisation of all entities as either structured or not. We do not support a control model that is based on creating two categories of entity and then assessing control differently for each of the categories. We believe that the forced categorisation creates potential arbitrage between a structured and a non-structured entity because of the consequences of classification as a structured entity. However, much of the guidance on the assessment of control for structured entities is very useful and should be applicable to the assessment of the substance of the relationship between the reporting entity and any entity.

### **Agent/principal**

We believe that inclusion of the concept of agent/principal, particularly for the investment management industry, could be helpful to a robust assessment of control. However, we believe that this guidance needs to be strengthened and expanded. Evaluating whether a reporting entity with dual roles can act only in its capacity as an agent is a difficult task. We believe that the single control model can be expanded, as explained above, to make the evaluation of agency-type relationships operational. A single model for control, incorporating the Board's proposed guidance around structured entities, could be applied in agency-type relationships.

### **Disclosure**

We do not believe that the proposed disclosure requirements of the draft IFRS are appropriately defined or risk focused. For example, we do not agree that disclosures regarding unconsolidated entities should only be provided for structured entities as we do not support a distinction between structured and non-structured entities. The disclosure requirements should apply to all entities. The disclosure requirements should be more risk focused, and the population subject to the additional disclosure requirements should be better targeted so as not to overwhelm users of financial statements with voluminous information that may obscure the most critical information.

We suggest that there should be a principle for disclosures. The principle could be used by preparers of financial statements to provide appropriate and risk focused disclosures. The principle should be applied to all unconsolidated entities that the reporting entity has significant involvement with.

The following principle might be considered:

"An entity should disclose information to the extent that it is necessary for an understanding of the effect that its 'off-balance sheet arrangements' have or may have on its financial condition, profit or loss, liquidity and capital resources."

Our responses to the specific questions in the exposure draft are attached in Attachment A to this letter. If you have any questions on the content of this letter, please do not hesitate to contact Richard Keys, PwC Global Chief Accountant (+44 20 7212 4555), or Mary Dolson (+44 20 7804 2930).

Yours faithfully

*PricewaterhouseCoopers LLP*

PricewaterhouseCoopers LLP

**Attachment A      Response to Detailed Questions**

**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 a seamless single definition and assessment process to drive decisions on consolidation. The proposed single definition of control as expanded in paragraphs 4-11 of the draft IFRS is an improvement on existing guidance. We support a single model for consolidation based on control, including the power to direct activities and access to returns. However, we suggest broadening the proposed definition of control and related guidance as explained in the following paragraphs and as discussed in our cover letter. Further, we do not support the dichotomy created between structured entities and all other entities (described as non-structured in this letter).

Control is described as the power to direct the activities of an entity to generate returns for the reporting entity and requires continuous assessment. However, there are contradictory indications in the draft IFRS as to whether control is assessed in the present context (what an entity has the power to do today), or an expanded context that might include what the entity will have the power to do in the future or what an entity has done in the past.

We believe that control is assessed as of the current date but the decision must consider broadly the substance of the relationship between the reporting entity and the subject entity. For example, the reporting entity may have options or the sole ability to amend the scope of decisions of another entity (the subject entity). That ability of the reporting entity will impact those directing the activities today of a subject entity and that impact should be considered when assessing control. Actions that the reporting entity has taken in the past may also be relevant to assessing control, such as the predetermination of the scope of activities of the subject entity, should also be considered.

The exposure of the reporting entity to variability in returns is also relevant to determining control; a reporting entity is unlikely to accept a significant variability in returns without the ability to affect the decisions that influence those returns.

The control decision should also consider the history of the reporting entity's relationship with the subject entity. For example, the subject entity may be a full operating entity with a majority of dispersed shareholders. The reporting entity may have demonstrated the ability to appoint the majority of members of governance bodies and senior management, thus an ability today to direct the financial and operating policies of the subject entity. This may result in a determination that the substance of the relationship between the reporting and the subject entity is one of control.

The draft IFRS proposes that all entities are either structured entities or not. Forcing all entities into one of two categories and then requiring substantial disclosures about all entities within the structured entity category has the effect of increasing the arbitrage between the categories. Thus there is pressure to avoid the structured entity category. There will be some circumstances where a non-structured entity has, appropriately, not been consolidated. Disclosures about the reporting entity's involvement with that unconsolidated non-structured entity might be relevant to a proper understanding of the associated risks. However, the draft IFRS does not require disclosure of risks to which the reporting entity is exposed arising from its involvement with unconsolidated non-structured entities.

We find much of the structured entity guidance is useful to the assessment of control and should be retained. We suggest that it should be revised to be more broadly applicable to determination of control for all entities, whether structured or non-structured. The draft IFRS seems to discourage or prevent the guidance set out in paragraphs 31 to 38 being used to determine the controlling party of a non-structured entity. A single set of risk focused disclosures should be required for any entity that falls within the scope for disclosures. (See our response to Q9).

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

We support a single model for consolidation based on control and agree that an entity should consolidate its assets, liabilities, equity, income, expenses and cash flows with those of the entities that it controls. The principle expressed in paragraph 4 of the draft IFRS is a significant step forward from the current consolidation guidance. However, we believe that the concepts of power to direct activities combined with returns and how these might be evaluated in different situations need further development. Our main concerns and suggestions are articulated in our response to Q1 above.

**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 have specific concerns with the guidance and requirements where these appear to be in conflict with the principle of the draft IFRS or indeed with other elements of the guidance within the draft IFRS.

The guidance could be improved as follows:

- Clarify that control is assessed as of a point in time but that the assessment should consider the substance of the relationship between the reporting entity and the subject entity.
- The assessment of control should include consideration of the actions that the reporting entity is able to undertake and the influence that those potential actions may have on those directing the activities of the subject entity today.
- Clarify the guidance for entities that hold a dual agent and principal role. The principle behind the guidance in this area is not clear. We expand our comments in our answer to question 5 below.
- Remove the distinction between structured and non-structured entities.

**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 is 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. The existence of options or other convertible instruments may enable the reporting entity to affect the actions of those directing the activities of the subject entity. We also agree with the removal of the current presumption in IAS 27 that presently exercisable options or convertible instruments give control to the holder. Options and convertible instruments need to be assessed within the context of other factors such as the consequences of exercising the options (for example, the cost and potential undesirable consequences from taking control) and the influence that the reporting entity has over the subject entity as a result of the options.

**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 including the concept of an agent, acting on behalf of the principals, is an important step forward in improving how consolidation decisions are made and explained, particularly for the investment management industry. However, we do not believe that the proposed guidance clearly articulates how control should be assessed in agency and dual role relationships, including outside the investment management industry. It is important that guidance for reporting entities acting as agents should not conflict with the principles and other guidance in the draft IFRS. We describe some potential practical problems with the draft guidance and offer suggestions to improve the agent and principal guidance and align it more closely with a single control model.

Potential practical difficulties

Paragraph 9 of the draft IFRS describes a relationship between a reporting entity and an agent employed to act on its behalf. This is a simple scenario in which the guidance in paragraph 9 and B3-B8 can be easily applied. However, this simple scenario rarely exists in practice, or if it does the assessment of control is straightforward. By contrast, the guidance in the draft IFRS becomes more challenging to apply when considering, for example, how the investment management industry functions with a diverse group of principals (the investors) rather than with a single principal. The investment manager may have established the investment vehicle, developed its investment mandate and sought out the individual investors. The investment decisions may be more or less limited as the types of assets the pooled fund can be invested in are specified. The investment manager, or parties related to the investment manager, may also hold interests in the pooled fund and may be the largest single investor.

The investment manager may earn performance based fees and also have a 'carried interest' in addition to the asset management fee. A carried interest looks much more like a residual or equity type return because it may be determined on wind up or when the significant assets of the fund have been realised. We agree that removal rights are important and many investment managers today would consider the existence of removal rights when assessing if they control funds that they manage. Removal rights, however, must be carefully considered to determine if they are substantive.

The proposed guidance may create opportunities for structuring to avoid consolidation in other situations. A reporting entity that has exposure to returns of the subject entity may be able to use the "agent" status to avoid consolidation despite the reporting entity's significant powers to direct the activities of the subject entity. For example, a reporting entity that both originates and services mortgages, may transfer mortgages into a structured entity that issues notes of varying seniority and retain a portion of the residual interest of the entity, whilst also servicing the mortgages. The reporting entity may have a duty to act, by contract, in the best interest of the principals (i.e., the note holders and all those with residual interest). The originator/servicer can assert that its servicing duties are performed in the capacity of an agent and it would not be deemed to control the subject entity. Asserting its status as agent to avoid consolidation that might otherwise be required does not appear to be an appropriate outcome.

Suggestions to improve the agent/principal guidance

Evaluating whether a reporting entity with dual roles can act only in its capacity as an agent is a difficult task. We believe that the single control model can be expanded to make the evaluation of agency-type relationships operational. A single model for control, that incorporates the Board's proposed guidance around structured entities, could be applied in agency-type relationships,

outlined as follows:

- consider first whether the reporting entity, that may be acting as an agent, has to power to direct the activities of the subject entity (before considering removal rights);
- then assess the substance of any removal rights; and finally
- determine whether the reporting entity has exposure to the returns of the subject entity.

Each of these is further discussed below.

Does the reporting entity (which may be an agent) have the power to direct the activities of the subject entity? The criteria in paragraph 31 of the draft IFRS<sup>1</sup> are relevant when evaluating whether the reporting entity has the power to direct. This should be a broad evaluation considering the existence of legal protection and remedies available to investors, the governance arrangements of the entity and the legal and statutory environment in which the entity operates among other factors. This evaluation considers the consequences of the decisions made in establishing the subject entity and the regulatory environment in which it operates. These will influence the initial conclusion as to whether the reporting entity has the power to direct. For example, a subject entity established by another party or subject to restrictions imposed by regulatory authorities may have such a narrow range of decision making that the reporting entity has very limited powers and therefore would not be deemed to have the power to direct.

The existence of substantive removal rights may overcome the initial conclusion as to the reporting entity's power to direct the activities of the subject entity. The ability of others to remove the reporting entity from its capacity as a service provider/decision maker indicates an agency relationship, not a control relationship. The removal rights must be substantive; that is there can be no significant practical barriers to the exercise of the rights.

Finally, is the reporting entity exposed to the returns of the subject entity? The reporting entity may have a direct interest in the subject entity (residual interest, fund units, partnership interests, beneficial interests) or be exposed to returns through the fees it receives. The reporting entity should look at the entirety of its returns, including fees and other interests, to determine whether it is exposed to the variability in returns of the subject entity and whether those returns are potentially significant.

**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 support a control model that is based on creating two categories of entity and then assessing control differently for each of the categories. We believe that the draft IFRS is overly reliant on this dichotomy and that the forced categorisation creates arbitrage opportunities between a structured and a non-structured entity because of the consequences of classification as a structured entity. We support a seamless single definition and assessment process to drive decisions on consolidation.

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<sup>1</sup> Those criteria include: the purpose and design of the subject entity, the activities of the subject entity, related arrangements and the reporting entity's ability to change the restrictions or predetermined strategic operating and financing policies.

**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. The discussion contained in paragraphs 31 to 38 of the draft IFRS is useful in assessing control in situations where the controlling party is not readily apparent. The draft IFRS implies that the guidance is only applied to structured entities. The guidance should be applicable to all entities in a control model based on a single definition and assessment process.

Further, we believe that there should be an explicit requirement to consider all relevant factors in a balanced judgement to arrive at a decision on control. We also believe that a requirement to consider the substance of the relationship between the reporting entity and the subject entity would assist in making the determination of control for entities where the decision making capability is restricted.

**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 support the inclusion of a risks and rewards fall back test with a quantified assessment of the variability of returns. The US experience with FIN 46 more than adequately demonstrates the limitations of this approach. Inclusion of an independent risk and rewards test would create another control assessment (non-structured entities, structured entities and those entities where significant judgement is required). This will increase complexity and reduce the transparency of financial reporting.

A robust definition and assessment of control, applied to all entities, would eliminate the need for a fall back test.

**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 disclosure requirements appear lengthy and voluminous. Paragraph B31 requires judgment to determine the detail that should be presented but the following paragraphs (B32-B49) appear to mandate that all disclosures be given (“the reporting entity shall disclose...”). Consequently, the proposed disclosure requirements seem to be a ‘shopping list’ of information that if included in the financial statements would encourage users and regulators to ‘second guess’ the consolidation decisions made by management as well as obscure relevant information with an excess of detail. Also, the broad scope of the disclosures resulting from ‘involvement with’ a structured entity as currently identified may be onerous, particularly for financial institutions.

We suggest that there should be a principle for disclosures. The principle could be used by preparers of financial statements to provide appropriate and risk focused disclosures to be included in the audited financial statements. The principle should be applied to all unconsolidated entities that the reporting entity has established, sponsored or has significant involvement with.

The following principle might be considered:

“An entity should disclose information to the extent that it is necessary for an understanding of the effect that its ‘off-balance sheet arrangements’ have or may have on its financial condition, profit or loss, liquidity and capital resources.”

A principle that focused on off-balance sheet arrangements would mean that disclosures would be less likely to duplicate those required by other standards such as IFRS 7.

**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.**

The disclosure requirements set out in the draft IFRS may prove onerous for some reporting entities particularly as they relate to unconsolidated entities where the reporting entity has involvement or significant influence. Involvement or significant influence does not convey control and some of the information may be difficult for entities to obtain. However, entities that have significant risk exposure to an unconsolidated entity would be expected to have sufficient information to comply with the requirements. A risk-focused approach to disclosure should require disclosure of information that an entity would be reasonably expected to have access to. We understand that there are significant system and process issues that would be associated with collecting the data that is required by the draft IFRS.

**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 do not see that reputational risk, on its own, is a sufficient basis for consolidation decisions. Recent events indicate that reputational risk is a secondary consideration and may be driven more by a desire to enhance a reporting entity's reputation for future marketing purposes rather than indicating a control relationship. We see that an entity's past actions may be an important factor in considering the substance of the relationship between the reporting entity and the subject entity. A reporting entity's past actions, supporting similar subject entities, may have established a pattern of activity that should be considered when assessing whether it should consolidate a subject entity.

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

We believe that the definition of 'support' should be clarified and then linked to an overall principle to determine appropriate and relevant disclosures.

**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 support a separate comprehensive project that would examine the use and application of the equity method. We further suggest that any changes to accounting for joint arrangements should be delayed, pending the outcome of any project on the equity method.