



14 December 2010

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

Dear Sir David

### **AOSSG comments on IASB's Project on Consolidated Financial Statements**

The Asian-Oceanian Standard-Setters Group (AOSSG) is pleased to provide comments on the IASB's tentative decisions taken on its project on *Consolidated Financial Statements*. The AOSSG's comments included in this letter are based on the IASB's announced tentative decisions and staff draft of *IFRS X Consolidated Financial Statement* issued by the IASB on 29 September 2010.

The AOSSG currently has 24 member standard-setters from the Asian-Oceanian region: Australia, Brunei, Cambodia, China, Dubai, Hong Kong, India, Indonesia, Iraq, Japan, Kazakhstan, Korea, Macao, Malaysia, Mongolia, Nepal, New Zealand, Pakistan, Philippines, Saudi Arabia, Singapore, Sri Lanka, Thailand, and Uzbekistan.

To the extent feasible, this submission to the IASB reflects in broad terms the collective views of AOSSG members. Individual member standard setters may also choose to make separate submissions that agree or disagree with aspects of this submission. The intention of the AOSSG is to enhance the input to the IASB from the Asian-Oceanian region and not to prevent the IASB from receiving the variety of views that individual member standard setters may hold.

This submission has been reviewed by members of the AOSSG after having been initially developed through the AOSSG's Consolidation Working Group. In developing the submission, individual members of the Working Group sought and considered the views of constituents in AOSSG jurisdictions.

The AOSSG supports the IASB in its effort to develop a single consolidation principle, based on a control model that would be applicable to all types of entities. In general, the AOSSG also supports most of the IASB's tentative decisions on the consolidation project. To achieve the objective, the AOSSG considers that it is critical to have a clearly defined control principle with clear guidance on application.

While in agreement in principle with the definition of control including the concept of a "dominant shareholder" exerting control without a majority of equity interest (the "dominant shareholder approach"), the majority of the AOSSG members are concerned about the

difficulties in obtaining evidence of control that is premised primarily on the relative voting size and level of dispersion of the numerous minority shareholders. The proposal on dominant shareholder approach may potentially result in application inconsistencies and thus, impairing the decision-usefulness of resulting information. These AOSSG members recommend that the consolidation should only apply where there is evidence of effective control currently and there is no evidence that such control might be lost in the foreseeable future.

The majority of the AOSSG members also recommend that the IASB to review its proposed criteria concerning investment entities, specifically on the relevance and appropriateness of pooling of interest and unit ownership as criteria, and to extend the limited scope exception in consolidation to the parent company accounting of investment entities.

However, some AOSSG members have expressed strong support for the consolidation principles as proposed by the staff draft and do not think an exception or exclusion in any circumstances should be provided in the final standard.

The AOSSG notes that the financial crisis has highlighted a need for better disclosure of “off-balance sheet” risks. The AOSSG is supportive of the IASB’s decision to improve such disclosure requirements but would like to emphasise that the requirements should be objective-based, practical and supplement the overall consolidation model.

Our views are expressed in detail under the following specific questions. These questions are identified and developed from the AOSSG Consolidation Working Group’s comments on the overall tentative proposals of the consolidation project:

### **Question 1**

**Do you agree that the general control principles should be applicable to both voting interest entities and structured entities? Do you think that the proposed control definition, requirements and guidance for consolidation work well for structured entities? If not, why not and what additional guidance is needed?**

Yes, the AOSSG agrees that the general control principles should be applicable to both voting interest entities and structured entities. Therefore, the AOSSG supports the staff draft of *IFRS X Consolidated Financial Statement* where the assessment of control for both voting interest and structured entities are based on similar set of control principles.

The AOSSG supports the IASB’s tentative decision that exposure to risks and rewards is an indicator of control as the greater a reporting entity’s exposure, or rights to the variability of returns from its involvement with an investee, the greater the incentive for the reporting entity to obtain rights sufficient to give it power. Therefore, having a large exposure to variability of returns is an indicator that the reporting entity may have power.

One AOSSG member suggests that the risk and rewards test should be a fall back test if power cannot be assessed under the general control principles.

The AOSSG notes that the IASB has tentatively decided that being involved in the design of an investee, alone, is not sufficient to indicate control. However, involvement in the design may indicate that the investor had the opportunity to obtain rights that are sufficient to give it

power over an investee. Some AOSSG members hold the view that the irreversible predetermination of the strategic operating and financing policies that could not be changed or affected by any potential or existing substantive rights, which can also include the actions that must be taken in response to anticipated events or circumstances, is a form of power and therefore, it is recommended that this should be explicitly clarified in the final standard.

## Question 2

**The Board tentatively decided that a reporting entity with less than half of the voting rights in an entity may have the power to direct the activities of that entity considering relevant facts and circumstances. Do you agree with the proposed guidance and do you think that the proposed guidance is sufficient to allow consistent application? If not, why not and what additional guidance is needed?**

Whilst the AOSSG agrees with the IASB's tentative decision that the reporting entity with less than half of the voting rights in an entity that has the rights or potential rights, arising from certain contractual arrangements, to direct those activities of the entity that significantly affect the returns meets the control definition, the majority of the AOSSG members are concerned that it may be difficult to conclude whether a minority shareholder has the power to direct to the activities of the entity if it does not have other legal or contractual arrangements to allow it to do so. However, some of the AOSSG members have expressed strong support for the control principles enunciated in the staff draft and believe that no exception or bright line should be introduced in the final standard.

The IASB introduces the dominant shareholder approach for consolidation in the staff draft. A minority shareholder may have power if it holds significantly more voting rights than any other vote holders or organised group of vote holders, and the other shareholders are widely dispersed. In situations where this is not conclusive, the minority shareholder will need to consider **secondary indicators** such as voting patterns at previous meeting and other additional facts and circumstances<sup>1</sup>. The majority of the AOSSG members believe that the guidance as it is currently provided in the staff draft would result in subjective judgment and inconsistent application in many cases.

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<sup>1</sup> The additional facts and circumstances include indicators such as whether there is any evidence that the investor has power over the investee or there is indication that he has a special relationship with the investee.

An investor has evidence of power if he can appoint or approve the investee's key management personnel, direct the investee to enter into, or veto any changes to significant transactions that affect the investor's returns, dominate either the nominations process for electing the members of the investee's governing body, or the obtaining of proxies from other vote holders; or the investor is a related party of the majority of the members of the investee's governing body, or its key management personnel (*paragraph B14 of the staff draft*).

An investor has more than a passive interest in the investee if the majority of key management personnel are current or previous employees of the investor; the investee's operations are dependent on the investor, a significant portion of the investee's activities either involve or are conducted on behalf of the investor; the investor has an interest in the investee that is disproportionately greater than its voting rights (*paragraph B15 of the staff draft*).

## Concerns and issues with the proposed dominant shareholder approach

The application of the dominant shareholder approach as proposed depends largely on the **primary indicators**- the relative size and dispersion of the remaining vote holders. The majority of the AOSSG members are concerned that this approach is premised on a presumption that a collective group of widely dispersed vote holders will not come together and thwart the votes of a dominant shareholder simply because they are widely dispersed. The AOSSG believes that having more vote holdings compared to the rest does not automatically lead to a permanent ability to direct the activities of an entity, as the remaining vote holders, acting in concert, may still be able to oppose the will of the dominant shareholder. The fact that the remaining non-controlling interests are widely dispersed does not mean that they will not come together to vote in the future.

The AOSSG members are also concerned that the application of the dominant shareholder approach based on historical voting records at previous shareholders meetings may result in consolidation of an entity in one period and deconsolidation in the following period should the voting behavior of shareholders change. This presumption of control based on historical extrapolation should not be equated to actual/real control, and that it would not be sound accounting practice if businesses are required to consolidate simply due to the action/inaction of others. Furthermore, a new reporting entity would not have the historical evidence to determine if it is the dominant shareholder nor would a reporting entity have the historical evidence to determine if it is the dominant shareholder of a new entity. The AOSSG believes that the potential unnecessary volatility created by the dominant shareholder approach would impair the decision-usefulness of financial information.

The majority of the AOSSG members strongly believe that an assessment of control should be based primarily on the relationship between the investor and investee, and that consolidation should apply only where there is **evidence of effective control currently** and **there is no evidence that such control might be lost in the foreseeable future**. These members recommend that the IASB to incorporate the requirement that an investor holding less than half of the voting rights has control over the investee where there is evidence of it directing the activities of that investee that significantly affect returns.

Some of the AOSSG members believe that the secondary indicators with regards to the consideration of evidence of power and special relationship are important and useful indicators for effective control and these AOSSG members believe these indicators are **evidence of effective control** and should not be differentiated from the proposed primary indicators. However, some other AOSSG members think that it is important that the indicators are “ranked” relative to their importance for easy and consistent application. In addition, one AOSSG member believes that the indicators could be further improved by including the assessment of whether the investor has access to the residual assets of the investee and urges the IASB to include it in the final standard.

### (ii) Blurring the line between control and significant influence

In practice, there are many situations in which the minority shareholders may hold voting rights ranging from 20 to 49 percent with the remaining shareholder being widely dispersed. Some of the AOSSG members believe that the dominant shareholder approach as it is currently defined blurs the line between significant influence and control and may

inadvertently result in the consolidation of entities that were previously accounted for as associates.

The AOSSG also notes that the staff draft introduces application examples explaining situations where the minority shareholder holding voting rights of approximately 40 to 49 percent has control over the investee. The majority of the AOSSG believe it is important for the IASB to clarify whether it is its intention to apply the dominant shareholder approach to situations where the voting rights themselves are significant and are closer to the majority holding, which some of the AOSSG members believe should be the case. Otherwise, it is imperative for the IASB to provide clearer guidance and examples to complex situations involving entities having 20 to 30 percent vote holdings in the investees and are currently accounting for these investees as associates, so as to make the application practical, operational and consistent across different entities.

Whilst the majority of the AOSSG members do not object that the IASB's effort to redefine "control", some AOSSG members believe that the current requirements under IAS 27 work well in practice and questions the IASB's decision to review and change the requirements. These members are of the view that the IASB should retain the requirements in the current standard and instead, work on to improve the indicators of control considering the business model of the entities. They also believe as the notion of control is pervasive in many IFRSs, it is imperative for the IASB to do a fundamental and thorough review of the control notion at the conceptual framework level.

### **Question 3**

**The Board has tentatively decided to provide a limited scope exception to consolidation for investment entities.**

**(a) Do you agree with the Board's tentative definition of an investment company? If not, why not?**

**(b) Do you agree with the Board's tentative decision that the controlling party of an investment company is required to consolidate all entities that it controls, including those that are controlled by an investment company subsidiary, unless the controlling party is an investment company itself. If not, why not?**

#### **3(a) Definition of investment entities**

The IASB has tentatively decided to allow a limited scope exception to the normal consolidation basis for investment entities - investment entities may account for investments that they control, as single asset at fair value, with fair value changes recognised in profit or loss. While some AOSSG members do not support an exception to the overall control principle that allows an investment entity to account for its controlled investments at fair value through profit or loss as they believe consolidation should be based on the existence of control and not how the controlled investments are being measured, the majority of the AOSSG members support the IASB's tentative decision as it is believed that the investment information presented on fair value basis would be more relevant and useful to users of an investment entity as these investments are often managed on fair value basis and not integrated into the investment entity's operations.

However, some AOSSG members question the appropriateness of two of the proposed criteria for the definition of an investment entity - (i) the ownership interest in the investment entity must be represented by unit of investments such as shares or partnership interests; and (ii) the investment entity should act on behalf of a group of unrelated investors and the funds of the investment company's owners are pooled to avail the owners of professional investment management. Whilst this group of AOSSG members agree that the more extensive the pooling of funds to avail the owners of professional investment management, the greater the evidence that the entity is investing for current income, capital appreciation, or both and therefore, the greater the need for unit ownership structure so as to allow proportionate share of net assets to be attributed to each unit; it is believed that they represent indicators rather than criteria for the identification and definition of an investment entity.

In the case of a single investment entity or sovereign funds, although the funds are not represented by unit ownership and not pooled together from unrelated investors, the financial objective of the funds is to hold investments in other entities with an expectation of realizing the investment at a profit in the future or to receive investment income. These funds are managed on a fair value basis in accordance with a documented investment strategy and management information is managed on the same basis. It is not clear that the two criteria of unit ownership and pooling of funds are relevant in the assessment of whether these funds or entities qualify as investment entities. The AOSSG recommends the same scope exception to consolidation should be extended to these funds if they meet all remaining proposed criteria.

On the other hand, there are occasions when the investments are actively managed by the investor (i.e. essentially the new definition of control is met even though sometimes the objective of the investor may be to obtain current income and pursue capital appreciation) and the question would then be whether such an investor is an "investment entity". For instance, investments of private equity and venture capital funds controlled by certain investment companies are often classic subsidiaries, actively managed by the investor, for the purpose of generating higher returns that facilitate the distribution of current income as well as capital appreciation. As such, some AOSSG member believes that consolidation, not fair value, is the appropriate accounting treatment. The IASB should therefore consider more fully the implications of the accounting treatment on different arrangements practised by these private equity and venture capital funds and not provide for their exclusion from the scope the ED which is due to be released later this year.

### 3(b) Parent company accounting of an investment entity

No, the majority of the AOSSG members do not agree with the tentative proposal. The AOSSG considers that the measurement basis, regardless of whether it is a subsidiary or parent entity, should be driven primarily by the decision-usefulness of information presented to the users. If it is argued that consolidation at investment company level does not provide useful information to users, the AOSSG is not fully persuaded that such consolidation at parent level would do so.

In addition, the AOSSG members also note that in January 2010, IFRIC has confirmed the IASB's proposed amendment in ED Annual Improvements to IFRS issued in August 2009 that different measurement bases can be applied to portions of an investment in an associate when part of the investment is designated at initial recognition at fair value through profit or loss in accordance with the scope exception in paragraph 1 of IAS 28. For example, a parent entity that has significant influence over an associate through both direct investment and

indirect investment in the associate via a subsidiary, can retain the different measurement bases i.e. equity accounting of its direct investment, and fair value basis accounting of its indirect investment in which its subsidiary accounts for the investments at fair value through profit or loss under the scope exception in paragraph 1 of IAS 28. The IASB does not impose a requirement that the parent company must be an investment entity for it to measure the portion of the investments of the associate at fair value. The measurement basis of the portion of the associate at the subsidiary level is consistently flow through to the consolidated financial statement of the parent entity. This decision seems to contradict the current tentative decision taken by the IASB with regards to the parent company accounting of controlled investment entities.

The IASB should extend the limited scope exception in consolidation to the parent entity such that the parent entity is allowed to retain the measurement basis adopted by its controlled subsidiaries regardless of whether it is an investment entity itself. This is consistent with the overall objective of having such a limited scope exception in the first place. Reversing the fair value measurement basis of the subsidiary's investments and consolidate them at the parent company level would add onerous burden to the parent company and the information presented at the consolidated financial statements will not be decision-useful to the investors.

#### **Question 4**

**Do you think that the Board's proposed disclosure requirements provide decision-useful information? In your opinion, is there any disclosure requirement which should be added to, or removed from, the eventual IFRS?**

The AOSSG understands that the IASB tentatively decided to retain most of its proposed disclosure requirements in the ED 10 issued in December 2008, particularly the disclosure of involvement with structured entities. The AOSSG members wish to highlight that they are not totally convinced by some of the IASB's proposed disclosure requirements.

##### **(i) Disclosure of involvement with structured entities**

The IASB proposed that a reporting entity should disclose information that help users of financial statements to understand the nature of, and changes in, risks associated with the reporting entity's involvement with structured entities.

The AOSSG believes that a reporting entity can be exposed to risks from its involvement with any type of entity, regardless of whether the entity is considered a structured entity. Having different disclosure requirements for voting interest and structured entities would be inconsistent with the IASB's objective of developing a single control model for all entities. The AOSSG also believes that the IASB has not provided a clear definition of structured entity in the ED 10 and such specific disclosure requirement is likely to result in inconsistent interpretation when applied.

In addition, some AOSSG members consider that it is not clear what is meant by "involvement with structured entities" as the scope based on "involvement" is too broad and onerous. For example the definition of an involvement could be interpreted literally to be any involvement with a structured entity, including the provision of administrative tasks or consultancy services or the issue of standardised banking products, such as interest rate swaps.

The AOSSG members do not view that disclosure of such a wide range of activities would be decision-useful to users of financial statements and suggest the IASB limit the scope to **significant** involvement with a structured entity. The IASB should require a reporting entity to provide only **specific** risk disclosures when it has significant involvement with unconsolidated structured entities.

Some of our AOSSG members are also concerned that it might be challenging to obtain the financial information of an unconsolidated structured entity for disclosure given that the reporting entity does not have control over it and the structured entity is not legally required to provide such information. Furthermore, the reporting entity may incur significant costs to meet the disclosure requirements if the unconsolidated structured entity has a different reporting period and reporting framework. Some AOSSG members suggest that if a reporting entity applies the equity method to account for the unconsolidated structured entity as an associate under IAS 28, it should be exempted from disclosing the nature of, and changes in, risks associated with its involvement with structured entities.

(ii) Disclosure of risks from sponsoring or setting up of structured entities

The ED 10 requires that the reporting entity disclose the income from its involvement with the structured entity that it has set up or sponsored and the value of the assets it has transferred to these structured entities at the date of transfer. Whilst the AOSSG agrees with the proposed disclosure, it questions the rationale and appropriateness of requiring the disclosure to be made for the current and preceding two reporting periods and suggest that the disclosure should be made only for the current and one comparative period.

### **Other comments**

Some of our AOSSG members have raised concerns over the accounting treatment where golden shares are held by their governments. For the purpose of protecting national interests, the government may own shares with veto rights and other special privileges in companies that are of strategic national interest. The rights allow the government to veto any resolution of the directors or the shareholders to ensure that such resolutions do not jeopardise the national interest or security of the country, and also to veto any resolution to amend the provisions of the memorandum and articles of associations which affects the rights of the golden share.

There are other situations involving government-owned entities, whether wholly owned or partly owned, where the government seems to be exerting control, but the purpose of such control is not to maximise their share of the returns but rather it is to serve some other national interest. Such other interest can often also be structured in other forms to achieve the same effect, e.g. cheap developmental capital or regulatory oversight. Some members are of the view that control for the purpose of such other interests (other than to maximise shareholder returns) should not be the basis for consolidation, and should be distinguished from control for the purpose of maximising shareholder returns. These AOSSG members believe that the current guidance on such situations in the staff draft is not adequate. It would be helpful to jurisdictions, particularly emerging economies, if the proposed standard on consolidation could include guidance that will stop a social purpose parent entity being consolidated with a for-profit subsidiary entity.

Some members also recommend that the IASB should provide guidance as to the application of the control principles for not-for-profit organisations, particularly on what constitutes "returns" for these organisations as it may be significantly different from for-profit entities.

The AOSSG is keen to play a key role in the development of a global set of high quality financial reporting standards and trusts that the IASB finds our comments helpful in progressing the replacement of consolidation requirements in *IAS 27 Consolidated and Separate Financial Statements* and *SIC-12 Consolidation- Special Purpose Entities*.

If you have any queries regarding any matters in this submission, please contact us.

Yours sincerely



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