

XX March 2009

International Accounting Standards Board  
30 Cannon Street  
London  
EC4M 6XH  
United Kingdom

**DRAFT COMMENT LETTER**

**Comments should be sent to [Commentletter@efrag.org](mailto:Commentletter@efrag.org) by 20 March 2009**

Dear Madam/Sir

On behalf of the European Financial Reporting Advisory Group (EFRAG) I am writing to comment on Exposure Draft 10 *Consolidated Financial Statements* (ED 10 or the ED). This letter is submitted in EFRAG's capacity of contributing to IASB's due process and does not necessarily indicate the conclusions that would be reached in its capacity of advising the European Commission on endorsement of the definitive interpretations/amendments on the issues.

The primary objectives of the ED are:

- (a) to bring together IAS 27 and SIC-12 in a single principle for consolidation that is applied to all entities;
- (b) to enhance the disclosures provided about certain unconsolidated entities; and
- (c) to clarify aspects of existing IFRS that are causing uncertainty currently.

Although the IASB has had a consolidations project on its agenda for some time now, the project has recently been given a much higher priority than hitherto because it is considered to be a financial crisis-related project and all such projects are being given a high priority. We strongly support the IASB in its efforts to address as a matter of priority accounting issues highlighted by or identified as a result of the financial crisis.

In developing the ED, the IASB staff prepared and held informal consultations on a series of draft texts. We commend the IASB for its willingness to try new approaches to try to speed up the process and make it more likely that the eventual ED will be positively received.

Our detailed comments on the ED are set out in the three appendices attached to this letter. The first appendix sets out some general comments on some matters of fundamental importance to the ED, and also summarises some of the comments made later in the appendices. Appendix 2 sets out EFRAG's response to the questions asked in the ED's invitation to comment. Appendix 3 sets out a few more detailed comments. The paragraphs below summarise our main comments:

- We support the objectives of the ED.
- The debate about consolidation models has essentially been one about whether to adopt a control-based model or a risks and rewards-type model. However, we think the approach proposed in the ED blends aspects of the two approaches in a control-based model that incorporates, through its focus on variable returns, elements of a risks and rewards approach. We think this is an imaginative approach and it is one we support in principle.
- However, we are concerned about the actual consolidation principle proposed, because we think it will not always result in the right entities being consolidated and the right ones remaining off-balance sheet. In addition, we also have a number of concerns about the clarity, consistency and/or appropriateness of the ED's material on the control model, the treatment of options and convertible instruments, agency relationships, and reporting entities with dual roles. As a result, our view is that the ED 10 as drafted does not represent an improvement on existing IFRS. Furthermore, we are not convinced the consolidation principle proposed in the ED is an improvement on the principles in existing IFRS.
- We are broadly in agreement with the general direction of the new disclosures proposed, although we are concerned that they seem likely to be voluminous and it is not clear which disclosures are intended to be mandatory and which are not.
- We believe the IASB should divide the consolidation project in two and address the urgent need for enhanced disclosures and greater clarity as a matter of the highest priority. That would allow much-needed additional time to be spent on a single universally-applied consolidation principle, where we believe a more comprehensive analysis and debate is needed on the information needs of users and on how best to meet those needs in terms of consolidations and group reporting entities. It would also allow time for the thorough field-testing that we think is necessary for a new principle of this kind.

We hope you will find these comments useful. If you would like to discuss this letter further, please do not hesitate to contact either me or Michelle Crisp.

Yours sincerely

Stig Enevoldsen  
**EFRAG, Chairman**

## Appendix 1

### Some general comments about the proposals in ED 10

A1.1 Before answering the questions posed in the ED, we would like to make some general comments that we think put our more specific comments in context and also address an overarching issue that is best dealt with here rather than in the responses to each of the questions.

#### We support the objectives of the ED

A1.2 Currently, the requirements that set out which entities should be consolidated by whom are in IAS 27 *Consolidated and Separate Financial Statements* and in an interpretation of IAS 27, SIC-12 *Consolidation—Special Purpose Entities*. We believe these existing requirements work reasonably well. Having said that, there are areas that could be improved. The main ones are that:

- (a) there are different views as to how to treat de facto control;
- (b) there is not enough disclosure about certain entities that are not consolidated; and
- (c) it can be difficult sometimes to draw the line between entities to which IAS 27 should be applied and entities to which SIC-12 should be applied. Underlying this is a conceptual awkwardness, which is that SIC-12 sits rather uncomfortably as an interpretation of IAS 27 because it seems to be based on different principles.

We welcome and support ED 10 because it seems to be designed to make improvements to these aspects of existing IFRS.

A1.3 The consolidations project is being fast-tracked by the IASB. That is because the current financial crisis has highlighted the need for at least some of the issues mentioned above to be addressed as quickly as possible. In particular, the financial crisis has highlighted a need for better disclosures about certain entities that are not consolidated and a need for greater clarity about some aspects of the existing requirements. We welcome and support the IASB's decision to move quickly on these issues.

A1.4 However, we are not convinced it is essential that a single consolidation principle is developed as a matter of high priority. Such a principle would make the existing consolidation requirements 'tidier' and would address some practical issues that arise at the moment, but they are not serious weaknesses in urgent need of elimination. This is a point we will return to later in this appendix.

#### We have concerns about the consolidation principle proposed

*The ED does not discuss whether the proposed new principle will result in the right entities being consolidated*

A1.5 One of the key proposals in the ED is that the current IAS 27 plus SIC-12 model should be replaced by a single standard based on a single, universally-applied consolidation principle. We agree that, in a principle-based set of

standards, the ideal situation would be for there to be only one consolidation principle.

- A1.6 The single, universally-applied consolidation principle proposed in the ED is that, if a reporting entity has the power to direct the activities of a second entity to generate returns for the reporting entity, the reporting entity controls that second entity and therefore shall consolidate it.
- A1.7 The first question we asked ourselves was whether this is the 'right' principle. We think this involves asking whether it would result in the 'right' entities being consolidated, and the right ones remaining off-balance sheet. To answer this question properly, it is necessary to consider the information needs of users and how best to meet those needs. However, this is not an issue that is discussed in the Basis for Conclusions. In many ways it is probably an issue that is best addressed initially at a conceptual level; and indeed some aspects of the issue were discussed in the 2008 Discussion Paper *Preliminary Views on an improved Conceptual Framework for Financial Reporting: The Reporting Entity*. However:
- (a) as we said in our response to that discussion paper, the paper did not discuss the issue in terms of the decision-usefulness of the information provided; and
  - (b) ED 10 was in any case issued before the IASB had an opportunity to consider the comments received in response to the Reporting Entity Discussion Paper.
- A1.8 We are concerned about this because, without such a discussion taking place, we are not sure how the IASB could have concluded that the principle it is proposing is the right one. We understand that, despite the fundamental nature of some of the proposals in the ED, the ED is not seen as involving a fundamental rethink of the existing consolidation standards. Rather, its aim is to tidy up and clarify existing material that is thought to be working reasonably well. However, unless the new consolidation principle results in the same entities being consolidated and the same entities remaining off-balance sheet as under the existing principles—and we do not think it would—it is necessary to evaluate whether the proposed new principle is an improvement on the old ones. The Basis for Conclusions does not seem to do this.
- A1.9 In particular, we think the key differences between the existing consolidation principles and the new one being proposed need to be assessed in terms of the decision-usefulness of the resulting information. For example, our assessment is that the proposed new principle would not result in all the structured entities that are being consolidated currently being consolidated in the future by the same entities (or perhaps even at all) for two main reasons:
- (a) Firstly, the proposed principle focuses on the ability to direct the activities that affect the variability of the returns, regardless of whether that variability is substantive, whether those returns are substantive, and whether the ability to direct is substantive. We think the result is that sometimes the focus of the ED's requirements would be on non-substantive aspects of an entity's relationship with a structured entity.
  - (b) Another reason for some of the differences is the treatment of circumstances in which it is not possible to detect anyone having the

power to direct the activities of a structured entity and the treatment of circumstances in which an entity receives variable returns from a structured entity but has no visible means of managing those variable returns. We think that in those circumstances SIC-12 would sometimes require a particular reporting entity to consolidate the structured entity but the ED would not.

- A1.10 There is another reason why we consider it important to ask whether the proposed new principle would result in the right entities being consolidated and the right ones remaining off-balance sheet. Currently, for structured entities we have a consolidation model that relies on a risks and rewards test so, if one is designing a structure and wish to avoid consolidating it, one needs to ensure that the risks and rewards test will not be met. The new proposals are based on a control model so, if one wishes to avoid consolidation in the future, one needs to ensure that the new control test will not be met. The wording of SIC 12's risks and rewards test and the ED's control test are different, so different structures could be used to avoid consolidation. That means that introducing a new consolidation principle is likely to result in new types of structure being developed.<sup>1</sup> This makes it important that any new consolidation principle is based on a difference in substance that justifies consolidation/non-consolidation. However, that is not an issue that is discussed in the ED.
- A1.11 For all these reasons, we believe it is important that any new consolidation principle is introduced only after a comprehensive evaluation of the implications of the proposed changes. Understanding the implications of the proposed change for the decision-usefulness of the resulting financial information is an essential part of that work (as is field-testing). As our understanding is that a comprehensive evaluation has not been undertaken, we would be concerned about implementing such a change at this time. Our view, as explained more fully below, is that the IASB should split the consolidation project in two and take more time on the part that involves the implementation of a single, universally-applied consolidation principle.

*We are not convinced the proposed principle is right*

- A1.12 For all the above reasons, it is difficult for us to comment on whether the principle proposed in the ED is the right one. However, we believe that, at least for certain types of structured entity, existing IFRS has got it right. As we believe the proposed new principle will not result in the same structured entities being consolidated and remaining off-balance sheet as existing IFRS, it seems to follow that the proposed principle is not right.
- A1.13 In particular, we think that, when a reporting entity is exposed to the risks and rewards arising from a structured entity in the way described in SIC-12, the reporting entity could well have control of the structured entity even if the reporting entity's power to direct the activities of the structured entity is not visible.

*What should the principle be?*

- A1.14 There has been much talk over the years about consolidation models that are based on control and consolidation models that are based on risks and

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<sup>1</sup> This is not accounting abuse; it is simply developing structures that are accounted for differently because they are different in a way that standards treat as substantive.

rewards. The debate has been made more complex by the absence of generally agreed meanings for the terms 'control and 'risks and rewards'. We believe that ED 10 is proposing a control-based model that implicitly incorporates elements of some sort of risk and rewards approach. (That is because the ED requires the reporting entity to have the power to direct the second entity's activities so as to generate variable returns for the reporting entity. As variability implies risk, it could be said that control is the power a reporting entity has to direct the activities of an entity to manage risks and rewards that the reporting entity exposes itself to as a consequence of its relationship with the entity.) We support such an approach, which we see as being in line with the suggestion we made in our comment letter on the IASB Framework Discussion Paper *The Reporting Entity*:

In our view, control on its own, at least in the way defined in the DP, is not sufficient for determining the composition of a group reporting entity. That is partly because we do not think the control notion deals adequately with SPEs. However, it is also because we think users are primarily interested in understanding where an entity's profits and loss might come from and this requires some sort of risk and rewards notion to be used to help determine the reporting entity's boundary.

A1.15 EFRAG notes however that the ED still requires a parent to have the 'visible' power to direct at least some of the activities of its subsidiaries. In our view, sometimes it is difficult to find visible evidence of a power to direct and the ED's attempt to find that visible power is leading it to focus on abilities to direct activities that might sometimes not be substantive. We think that there comes a point where it is simply easier and more reliable to presume the existence of such a power because of the reporting entity's exposure to risks and rewards. As a result, we share the concerns raised by the three dissenting IASB Board members as set out in paragraph AV8 and one of the dissenting members as set out in paragraphs AV9 – AV12.

A1.16 We are not yet sure how best to achieve this through the use of a single, universally-applied consolidation principle; indeed, we are not certain that it is achievable, although that does not mean that we believe the IASB should not try.

A1.17 Our struggle with this issue is making it difficult for us to comment effectively on other aspects of the paper, which is why we have separated the issue and dealt with it first. In appendices 2 and 3 we will assume, in order to be as constructive as possible, that the control principle proposed in the ED is the right one.

### **We do not think the ED as drafted represents an improvement on existing IFRS**

A1.18 In the preceding section we expressed concerns about the consolidation principle proposed in the ED. As will be apparent from our comments in appendix 2, we also have a number of concerns about the clarity and consistency of the control model described in the ED and about the ED's disclosure proposals. Bearing all this in mind, our view is that the ED 10 as drafted does not represent an improvement on existing IFRS.

**We think this project needs to be split into two, with some parts given a very high priority and the other parts progressed at a pace that allows time for further work**

- A1.19 We believe that a number of the concerns we have raised can be dealt with fairly easily by enhancing the clarity of the text and by eliminating certain apparent inconsistencies in the thinking behind some of the proposals. However, some of the concerns are less easily dealt with quickly. For example, we think it is essential that a new consolidation principle is implemented only if it is at least as good as the existing consolidation principles, and we think it will take some time—and more work—to develop such a principle.
- A1.20 As has already been mentioned, the consolidations project is being fast-tracked by the IASB because it is considered to be a financial crisis-related project. However, although we agree that the financial crisis has highlighted a need for certain changes to be made to the existing consolidation and disclosure requirements as a matter of priority, we are not convinced that it is essential that a single consolidation principle is developed as a matter of priority.
- A1.21 For that reason—and bearing in mind the concerns we have about the proposed single consolidation principle—our recommendation is that the IASB divide the project in two and address the urgent need for enhanced disclosures and greater clarity as a matter of the highest priority. That would allow time for more work to be carried out on a single universally-applied consolidation principle, including a consideration of the need for such a principle and the likelihood of being able to find one that meets the information needs of users.

## Appendix 2

### EFRAG's response to the invitation to comment of ED 10 'Consolidated Financial Statements'

#### DEFINITION OF CONTROL

##### Question 1

Do you think that the proposed control definition could be applied to all entities within the scope of IAS 27 as well as those within the scope of SIC-12? If not, what are the application difficulties?

##### Question 2

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

#### Background notes for EFRAG constituents

*ED 10 proposes to replace the consolidation requirements of IAS 27 Consolidated and Separate Financial Statements and SIC-12 Special Purpose Entities. The aim of the ED is to have a single definition of control that can be applied to all entities. As a consequence only the controlling entity model is applied as the basis for consolidation for entities in the ED.*

*The ED contains the following definition of control:*

*A reporting entity controls another entity when the reporting entity has the power to direct the activities of that other entity to generate returns for the reporting entity.*

*The ED states that control is not shared; that is, the power to direct the activities of an entity is held by one entity only. On the other hand, power does not have to be absolute. Protective rights restrict power but do not preclude someone else having control.*

*The definition of control requires an entity to have power to direct the activities of an entity. The IASB as part of its proposals in the ED aims to widen the definition of power from that contained in IAS 27. IAS 27 refers to 'power to govern the financial and operating policies of an entity' the IASB believes that this is just one means of having power.*

*The IASB also aims to widen the definition of returns by providing explicitly that returns can be both positive and negative. The ED also provides, importantly, that returns must vary with the entity's activities.*

*It is explained in the ED that the IASB believes that an entity's ability to affect the performance of the assets of another entity is correlated with its willingness to expose itself to the variability of returns from that entity. In assessing control a reporting entity is, therefore, required to assess both power and returns together.*

## EFRAG's response to questions 1 and 2

### *The objectives of the ED*

- A2.1 It is noted in paragraph 1 of the Introduction to the ED that the main aim of the project is to improve the definition of control and related application guidance so that the control model can be applied to all entities. Paragraph BC12 notes that there is concern that the differing consolidation concepts of IAS 27 and SIC-12 have caused diversity in practice and might be creating structuring opportunities. As a consequence we interpret a key objective of the project as being the development of a single universally-applied principle for consolidation that results in the right entities being consolidated consistently.
- A2.2 We strongly support this objective although, as explained in appendix 1, we do not believe this objective is as urgent as some of the other objectives of the ED. Furthermore, we are not certain that the objective is achievable, because we do not believe the principle proposed is satisfactory but are struggling to suggest how it should be improved.

### *The single universally-applied consolidation principle*

- A2.3 The single universal consolidation principle proposed in the ED is that, if a reporting entity has the power to direct the activities of a second entity to generate returns for the reporting entity, the reporting entity has control of that second entity and shall consolidate it.
- A2.4 Question 1 asks whether this definition of control could be applied to all entities. In appendix 1 we discuss whether the principle proposed would result in an appropriate result were it to be applied to all entities. Appendix 1 also partly answers Question 2. To summarise that discussion:
- (a) we believe that the consolidation principle proposed in the ED would not always result in the right entities being consolidated and the right ones being off-balance sheet.
  - (b) however, we are not sure which approach to suggest instead, and are not even certain that we are right to be concerned about the proposed principle.

In our view what is needed—and what is lacking in this ED—is a thorough analysis of users' information needs in terms of consolidations and group reporting entities and of what principles will be most appropriate in terms of those users needs.

- A2.5 However, in order to be constructive, we will in the remainder of this appendix assume that the ED has proposed the appropriate consolidation principle.

### *Consistency and clarity*

- A2.6 We have a number of concerns about how the ED currently describes and explains the notion of control it is proposing should be applied. In some cases this is just about drafting. However, in some other cases the inconsistencies in the descriptions and explanations seem to be more than that, and cause us to be unsure as to what is being proposed. This issue is discussed further in our response to questions 3 and 7.

*Field-testing*

- A2.7 Not least because of the concerns we have raised in this letter, we think it is essential that any proposed single universally-applied consolidation principle is thoroughly field-tested in a wide range of jurisdictions before being implemented.

## ASSESSING CONTROL

### Question 3

Are the requirements and guidance regarding the assessment of control sufficient to enable the consistent application of the control definition? If not, why not? What additional guidance is needed or what guidance should be removed?

### Question 4

Do you agree with the Board's proposals regarding options and convertible instruments when assessing control of an entity? If not, please describe in what situations, if any, you think that options or convertible instruments would give the option holder the power to direct the activities of an entity.

### Question 5

Do you agree with the Board's proposals for situations in which a party holds voting rights both directly and on behalf of other parties as an agent? If not, please describe the circumstances in which the proposals would lead to an inappropriate consolidation outcome.

## Background notes for EFRAG constituents

### Assessing control

*The ED discusses the link between power and benefits and provides guidance on assessing control. In assessing control a reporting entity considers all relevant facts and circumstances including the terms and conditions of all related arrangements.*

### Power without a majority of the voting rights

*The exposure draft clarifies the IASB's view that a reporting entity that holds less than half of the voting rights in another entity can control that other entity in certain situations. The exposure draft includes application guidance on how to apply the control principle when assessing whether a reporting entity has power to direct the activities of another entity with less than half of the voting rights. This guidance also considers:*

- *options and convertible instruments to obtain voting rights of an entity.*
- *how to assess whether an entity has control if it holds voting rights both directly and on behalf of other parties as an agent.*

## EFRAG's draft response to question 3

A2.8 In order for the requirements and guidance regarding the assessment of control to be sufficient to enable the consistent application of the control definition, it is necessary that they should be clear and unambiguous, and also internally consistent. However:

- (a) we think there is some confusion in the current draft between 'the power to direct' and 'the power to determine the strategic operating and financing policies'.
- (b) 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.

*Relationship between the power to direct and the power to determine the strategic operating and financing policies of an entity*

A2.9 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 a second entity. The ED 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, 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 is a change from existing IFRS. We suspect it might be a drafting error. However, if it is not a drafting error, we believe the ED needs to explain the principle that should be applied to determine whether the reporting entity's power to determine a second entity's strategic operating and financing policies results in the reporting entity having the power to direct the second entity's activities and when it does not.

A2.10 It would also be helpful if it could be made clear:

- (a) when the ED is talking about circumstances in which the reporting entity has the power to direct the second entity's activities and when it is talking about circumstances in which the reporting entity might have the power to direct the second entity's activities.
- (b) why the focus is sometimes on directing the activities of the second entity and sometimes (as in paragraph 27(b)) on determining that entity's strategic operating and financing policies.

*'Power to direct' versus 'ability to direct'*

A2.11 Paragraph 8 of the ED states that "a reporting entity need not have exercised its power to direct the activities of an entity to control that entity". Put another way, to have control of an entity (ie to have the power to direct the activities of an entity) a reporting entity need only have the ability to direct that second entity's activities.

A2.12 Yet, elsewhere in the ED it seems to us the test being described is whether the reporting entity is directing the activities of the second entity. For example, under paragraph 27 a reporting entity is deemed to have the power to direct the activities of a second entity if it in fact directs those activities even though it has less than half of the voting rights (as long as it has more voting rights than any other party). Similarly, the proposed treatment of options and convertibles

seems to focus on whether the reporting entity is in fact directing the activities of the second entity.

- A2.13 We find this confusing because it seems to us that the ED is in places using a test based on whether the reporting entity has the ability to direct the activities and is in other places asking whether the reporting entity is directing those activities. (We note that three dissenting IASB Board members expressed concerns about this in their dissent to the ED (see paragraph AV6).)
- A2.14 Paragraphs BC47 to BC51 argue that the ED is not inconsistent (because the fact patterns are different). Although we are not convinced by those paragraphs, we do think it is plausible that the ED might simply be treating the fact that the reporting entity is directing the activities of the second entity as a demonstration that it has the power to direct that second entity's activities. If that is the case it would be helpful if it were made clear. And, if it is not the case, the ED's approach needs to be reconsidered to ensure there is no uncertainty on such a fundamental point.
- A2.15 We note also that the ED talks from time to time about a reporting entity's ability to direct the activities of another entity.
- (a) We are not sure whether this is intended to be synonymous in all cases with having the power to direct the activities of another entity, but assume that that is not the intention otherwise the same wording would have been used. Similarly, we wondered whether it is intended to be synonymous in all cases with actually directing the activities, but dismissed that possibility for the same reason. It is confusing to have a third notion introduced into what is already a complex set of requirements.
  - (b) In addition, we note it might be difficult for a reporting entity to determine whether (or when) it has the ability to direct the activities of another entity as described in paragraph 27. Sometimes a reporting entity might only be able to make this assessment when it has demonstrated control by voting in an annual general meeting.
  - (c) A reporting entity without a majority of the voting rights might be able to direct the activities of another entity because the other vote holders are disinterested or disorganised. On the other hand, the other vote holders might be very interested and very organised, but content to remain inactive because they agree with the objectives and direction that the reporting entity without a majority of voting rights is pursuing when it casts its votes. In our view these are very different situations, and we are not sure that both amount to control.

#### *Other matters*

- A2.16 In relation to the assessment of control we are concerned that the guidance regarding variability of returns does not discuss the cause of variability or explain that variability is referring to risk. We think it should.
- A2.17 We also think the guidance regarding related arrangements is not clear. We assume that the intention of paragraphs 17 and 18 is to require the assessment of control to take into consideration the combined effect of all arrangements a reporting entity has with the entity. Bearing that in mind, we do not see that the

arrangements themselves need to be related; merely that the reporting entity has a number of arrangements with the same entity.

- (a) We therefore suggest that paragraph 17 should clarify that, when assessing control, the overall effect of all arrangements is taken into consideration.
- (b) We also therefore suggest that references to 'related' should be deleted. That would also mean that the guidance on multiple arrangements in paragraph 18 is not necessary to help in making assessments about the existence of control.

A2.18 If, despite this comment, paragraph 18 is to be retained, we would recommend that its content and language be reviewed to make it more principled and less rules-based.

A2.19 In view of the above comments, we consider that the drafting of the ED in relation to the assessment of control needs to be reviewed to ensure consistency of language and to clarify exactly what the control principle is to be based on.

#### **EFRAG's draft response to question 4**

A2.20 We are pleased to see the ED addressing options and convertible instruments. We also agree with the ED's view that they should be treated in the same way as each other 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 (ie paragraph B13) very unclear.

A2.21 We think the main body of the ED is very clear in saying that a reporting entity should consolidate only those entities it currently controls; in other words, those entities whose activities it currently has the power to direct. We think it follows from this that:

- (a) if a reporting entity holds options and/or convertible instruments to obtain voting rights in a second entity but does not currently have the power to direct the activities of that second entity (although the options and/or convertible instruments if exercised or converted would give it that power), it does not currently have control and should not consolidate the second entity.
- (b) if a reporting entity holds options and/or convertible instruments to obtain voting rights in a second entity, it is possible that the mere fact that it has those options and/or convertible instruments means it has a power to direct the activities of a second entity that it would not have had had it not have had the options and/or convertible instruments. If that is the case, it currently has control and should consolidate the second entity.

The situation described in (a) is relatively straight-forward, so the focus of the material in the ED needs to be on (b), but we think B13 confuses more than it clarifies.

A2.22 For example, paragraph 13(a) talks of the governing body that determines strategic operating and financing policies of an entity (the second entity)

determining those policies in accordance with the wishes of the reporting entity because the reporting entity would, if it exercised its options/converted its convertibles, have sufficient voting rights to determine the second entity's strategic operating and financing policies. We are not sure if this paragraph is saying that the holding of the options demonstrates that the reporting entity has the power to direct the governing body, or the fact that the second entity acts in accordance with the reporting entity's wishes demonstrates the power to direct or if there is some other factor that combines to give the reporting entity power to direct activities.

A2.23 This is related to the concern we discussed earlier regarding the 'ability to direct activities' or the 'actual exercise of power to direct'. We think an entity that does not have the majority of the voting rights can demonstrate its ability to control only where it actually exercises that ability. We think this gives rise to concerns regarding enforceability.

A2.24 The guidance in B13(a) raises some other questions. For example:

- (a) it might be that the governing body acts in accordance with the reporting entity's wishes because the views of the governing body and reporting entity are broadly aligned. We do not think that is control. In our view the issue is whether the governing body would act in accordance with the wishes of the reporting entity even when those views differ from those of the governing body. In this context it might also be useful to provide an explanation of the conceptual difference between the position in B13(a) and the position described in paragraph 27 (where those holding the majority of the voting rights are apathetic, disorganised, or perhaps merely content to let someone with views similar to their own to direct the activities of their company); and
- (b) the relationship between this material and the material on agents is unclear. We think in most respects the governing body will be acting as the reporting entity's agent.

A2.25 A second example of the confusion that the guidance on options and convertibles creates can be found in the additional guidance in paragraphs BC80 - BC86. Before commenting on this, we would like to make it clear that we are totally opposed to the Basis for Conclusions being used to provide guidance. In our view the basis for conclusions should be limited to setting out the IASB's reasoning. We are particularly concerned about this guidance being included in the basis of conclusions because the basis is not endorsed by the EU and hence does not form part of 'IFRS as endorsed by the EU'. This could give rise to inconsistent application of any future standard.

A2.26 Now, turning to the content of paragraphs BC80 - BC86. In our view, the guidance in the paragraphs is clearer and more useful than the guidance provided in the standard and application guidance. However:

- (a) we think the guidance in the paragraphs BC85 and BC86 goes much further than the guidance in the standard and application guidance. ;
- (b) we think the guidance in paragraph BC85 would be more useful were the paragraph expanded to explain that usually having control is more desirable than not having control, so usually an entity would expect to pay something to acquire control. It follows that, if a reporting entity holds

some options that, if exercised, would clearly give it the voting rights it would need to control a second entity and those options could be exercised for little or no cost, this is an indicator that it might already have control.

- (c) we think paragraph BC86 makes an important unstated assumption, which is that the options represent the only link between the two entities. If that is indeed the case, it follows that one needs to consider the return the reporting entity receives on the options to establish whether the return criterion is met. However, if there are other links, what matters is the reporting entity's overall relationship with the second entity (taking the unexercised/unconverted options/convertibles into account).

#### **EFRAG's draft response to question 5**

A2.27 Paragraphs B3 – B8 set out guidance on determining whether an agency arrangement exists and whether a reporting entity has control of a second entity through such an arrangement. Although we do not disagree with the guidance provided, we think the underlying principle or principles are not well articulated.

#### *Removal rights and remuneration of an agent*

A2.28 For example, paragraph B3 provides guidance as to the role of agents. This guidance discusses removal rights and remuneration of an agent. We assume that the purpose of the guidance is to assist in identifying agency relationships; however, this is not explicitly stated.

#### *Identifying whether a party is acting as an agent*

A2.29 Similarly, we have been unable to identify within the guidance the principle to be applied in identifying whether a party is acting as an agent. It appears to us that paragraphs BC89 and BC90 set out the IASB's conclusions on this issue. We recommend developing the material in paragraphs BC89 and BC90 into a principle and including that principle in the standard itself or, if not, in the application guidance.

- (a) We think such a principle might be:

A reporting entity has power to direct activities through the use of an agent where it controls the agent via an agreement or ongoing relationship where the agent must act in accordance with and where the reporting entity can exercise its powers to direct the activities by removing the agent.

- (b) The existing material could then be used to provide guidance on applying the principle. This includes:
  - (i) the terms and conditions that govern the relationship;
  - (ii) the terms and conditions of appointment and the right to replace or remove the agent; and
  - (iii) how the agent is remunerated including whether the remuneration is in accordance with the level of services performed.

A2.30 Paragraph B12's objective is presumably to highlight circumstances in which it is likely that one entity is acting as agent for another. However, we think that in several of the circumstances listed it is just as likely that there will not be an agency relationship as that there will, so we think the paragraph is of limited use and should probably be omitted.

*Reporting entities with dual roles*

A2.31 Paragraph B11 of the application guidance states in effect that, when a reporting entity acts in a dual role and has voting rights in both roles, there should be a rebuttable presumption that the reporting entity uses for its own benefit the voting rights it holds as an agent. That presumption can be rebutted only if the reporting entity can demonstrate that, in using its powers as agent for another party or parties, it is obliged to act in the best interest of those other parties or has implemented policies and procedures that ensure the independence of decision making.

A2.32 Paragraph BC95 explains the rationale for this proposal:

Because the reporting entity has the power sufficient to direct the entity's activities, the Board decided to place the onus on the reporting entity to demonstrate that it does not use the power it has as an agent for its own benefit, rather than the opposite.

A2.33 We have been considering how this requirement and guidance would work in a situation in which a reporting entity both manages (as an agent for others) an investment fund that has say a 49% interest in an entity (the second entity) and also has a direct interest of 2% in that second entity. Under paragraph B11, the reporting entity would be required to proceed as if it had a 51% interest in the second entity unless it could demonstrate that, in using its powers as agent for the investors in the fund, it is obliged to act in the best interest of those investors or has implemented policies and procedures that ensure the independence of decision making. However, as it has a small direct investment in the fund, we do not think it will ever be able to demonstrate that (because it will gain economically from the way in which the fund's activities are directed).

A2.34 Thus, the reporting entity would be required to consolidate the second entity. Although we realise that many situations will not be as clear cut as our example we think our example illustrates a situation in which the second entity should not be consolidated but will be required to do so by the ED (because of the rebuttable presumption). Consequentially we do not think the rebuttable presumption works. We suggest it is removed from the standard.

A2.35 Consider now the position of a reporting entity that manages a mutual fund and also has a small investment of its own in that fund. As the fund manager it has the power to direct the activities of the mutual fund although, as it is managing the fund on behalf of those investing in the fund, it is required to use that power to direct the activities so as to generate returns for those investors. However, the reporting entity is one of those investors, and the variability of those returns will be identical to the variability that the other investors in the funds will get. (The reporting entity will also receive a fund management fee which will often vary depending on the value of the fund, and may even be performance-related.) Bearing all this in mind, would the ED require the reporting entity to consolidate the fund it manages? We think it might, but we also think that the reporting entity should not consolidate the fund. Our view would be different

were the reporting entity's investment in the fund sufficiently large that, when the investors are required to act collectively as a body, the reporting entity exerts a dominant influence over that body.

## STRUCTURED ENTITIES

### Question 6

Do you agree with the definition of a structured entity in paragraph 30 of the draft IFRS? If not, how would you describe or define such an entity?

### Question 7

Are the requirements and guidance regarding the assessment of control of a structured entity in paragraphs 30–38 of the draft IFRS sufficient to enable consistent application of the control definition? If not, why not? What additional guidance is needed?

### Question 8

Should the IFRS on consolidated financial statements include a risks and rewards 'fall back' test? If so, what level of variability of returns should be the basis for the test and why? Please state how you would calculate the variability of returns and why you believe it is appropriate to have an exception to the principle that consolidation is on the basis of control.

## Background notes for EFRAG constituents

*The exposure draft introduces the term 'structured entity'. Special purpose entities referred to in SIC-12 have characteristics similar to structured entities. The ED 10 contains the following definition of a structured entity:*

*An entity whose activities are restricted to the extent that those activities are not directed as described in paragraph 23-29.*

*It is noted in the ED that the IASB decided on this definition of a structured entity because it could not find a single attribute or set of attributes that it considered satisfactorily isolated the types of entities the IASB had in mind.*

*The ED provides that unlike entities that are controlled through a governing body, there is no single, simple test that the Board could identify for assessing control of a structured entity. In assessing control of a structured entity the ED proposes that it is necessary to identify how returns from the entity's activities are shared and how decisions, if any, are made about the activities that affect those returns.*

*It is noted in the ED (paragraph BC110) that power can be more difficult to assess when the activities of an entity are not directed by strategic operating and financing policies on an ongoing basis. However the ED implies that a reporting entity should be able to reach a decision on whether it controls a structured entity by applying the definition of control of an entity. The IASB notes that, in its view, a structured entity is rarely, if ever, set up with entirely predetermined activities.*

## EFRAG's draft response to question 6

A2.36 We are very concerned about any definition of a structured entity being included in the standard because we are aware of the problems that arose in the US with the notion of a qualifying special purpose vehicle. In our view it ought not to be too difficult to amend the draft standard so that the only role

that the definition plays is in determining the types of entity that fall within the scope of particular disclosures. We would be more comfortable with the inclusion of such a definition were its role limited in this way.

A2.37 Putting that issue aside, 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 articulated in the ED to all types of entities. However, we think that this aim has given rise to a definition that does not identify the attributes of a structured entity but rather indicates simply that a structured entity is everything not already addressed in the ED. We do not think that is very satisfactory.

#### **EFRAG's draft response to question 7**

A2.38 As already explained in appendix 1, EFRAG is of the view that the consolidation principle proposed in the ED will result in some structured entities that should be consolidated by a reporting entity not being consolidated by that entity. We will not repeat our reasoning here. Instead, we will focus on other aspects of the proposal.

A2.39 First of all, we believe that underlying what the ED proposes is an assumption that real 'autopilots' do not exist. We are not convinced that is a correct assumption. Furthermore, we suspect that, if the consolidation principle in the ED replaces the existing principle in SIC-12, there will be more real autopilots in the future. A key driver in the detailed design of a structured entity is, and probably always will be, each party's exposure to that structured entity. That exposure is a substantive issue for the parties and is therefore something they take great care to align with their business objectives. SIC-12's focus on risks and rewards recognises that. We think control as it is described in the ED is a less important factor for the parties and as a result there is some flexibility to vary the arrangements if it would result in a different accounting result—which it would under the proposed principle.

A2.40 Secondly, we note that the proposed guidance in the ED for determining the existence of control when a structured entity is involved requires the reporting entity to focus on the variable returns it receives from the structured entity, the activities that give rise to that variability, and which party has the power to direct those activities. This is very different from the test for normal entities, where the focus is on the power to direct the strategic operating and financing policies. We are concerned that the test for structured entities, by focusing on only a limited range of activities, might be giving too much emphasis to relatively insignificant aspects of the relationship between the reporting entity and the structured entity. In our view control is about substantive things.

A2.41 Thirdly, we are concerned that the guidance for the assessment of whether a reporting entity controls a structured entity that is set out in paragraphs 31 to 38 might in practice be applied as a set of rules rather than guidance on application of the control principle. This is because paragraph 31 provides a list for the entity to consider without stating what the objective of the list is. We therefore suggest that:

- (a) the standard should contain a high level description of how the principle of control should be applied to all entities. This description would include the need to assess risk and rewards to determine power to direct activities.

- (b) the material in paragraphs 31 to 38 could then be included in the application guidance.

We believe that restricting the material in the standard to a high-level interpretation of the control principle will result in a more principle-based standard, and that will present less structuring opportunities.

- A2.42 Finally, we are concerned that the IASB's view of how the control principle should be applied to structured entities might not be consistent with some of the assumptions that we believe underlie the standard. We consider that paragraph BC121 provides an interpretation of how the Board considers the control principle should be applied to structured entities. That paragraph states:

If a reporting entity has no means of directing or managing the activities, or assets and liabilities, of an entity, it does not have any ability to affect its returns from its involvement with that entity. In that situation, the reporting entity does not have the power to direct the activities and would not control the entity, even though it might be exposed to risks associated with the structured entity.

In our view, this statement conflicts with the assumptions (that we believe underlie the ED) that power and returns are correlated and that a real autopilot does not exist because power can always be determined. We are confused as to why the IASB considers an entity would expose itself to risk from a structured entity that it does not have the power to control unless those risks and corresponding returns are insignificant. In our view this provides further evidence of our comment in appendix 1 that field testing of the proposals should be undertaken.

### **EFRAG's draft response to question 8**

- A2.43 As we explained in appendix 1 and our response to question one, we support the use of a control principle that incorporates some elements of risks and rewards and we believe the principle ED 10 proposes does that. However, we do not think the principle proposed is quite right. Although we are not sure yet how best to 'make it right', we believe that using some sort of risks and rewards test as a fallback is one possible way forward. That would enable standards to say that, when a reporting entity is exposed to the risks and rewards arising from a structured entity in the way described in SIC-12, the reporting entity could well have control of the structured entity even if the reporting entity's power to direct the activities of the structured entity is not visible. In this regard we draw attention to the alternative view of Mr Smith that an entity that clearly and obviously has the majority of the risks and rewards of a structured entity can easily avoid consolidation by circumventing the power criterion.
- A2.44 We know that there are some commentators who question whether a risks and rewards approach is capable of being applied in a consistent and robust way. However, such a test has been used successfully in IFRS for a number of years and in the UK's FRS 5 for many more years, and our practical experience of those tests makes us believe that the practical implementation issues that concern some people are overstated. We agree though that more guidance would be needed to ensure consistent application.

## DISCLOSURE

### Question 9

Do the proposed disclosure requirements described in paragraph 23 provide decision-useful information? Please identify any disclosure requirements that you think should be removed from, or added to, the draft IFRS.

### Question 10

Do you think that reporting entities will, or should, have available the information to meet the disclosure requirements? Please identify those requirements with which you believe it will be difficult for reporting entities to comply, or that are likely to impose significant costs on reporting entities.

### Background notes for EFRAG constituents

*The IASB proposes to enhance disclosure requirements. The global financial crisis has highlighted a need for better disclosure about the nature of, and risks associated with, a reporting entity's involvement with structured entities that the reporting entity does not control. Such disclosure is often referred to as information about 'off balance sheet' activities.*

*The application guidance to the ED provides a list of disclosures. It is noted in paragraph B31 of the application guidance that an entity decides in the light of circumstances how much detail it should provide.*

*The new areas of disclosures being introduced/improved in the ED are:*

- *decisions regarding the basis of control;*
- *restrictions on consolidated assets and liabilities; and*
- *involvement with unconsolidated structured entities and associated risks.*

*In relation to decisions regarding the basis of control greater disclosure is required of the basis of an entity's assessment and any significant assumptions or judgements when assessing control in certain circumstances.*

*The requirements regarding disclosures on restrictions on consolidated assets and liabilities seek to clarify the requirements in IAS 27 and to propose disclosure of restrictions that are a consequence of assets and liabilities being held by subsidiaries.*

*In relation to involvement with unconsolidated structured entities there are two sets of requirements:*

- *nature and extent of the reporting entity's involvement with structured entities it does not control;*
- *the nature and extent of, and changes in, the market risk (interest rate, prepayment, currency and other price risk), credit risk and liquidity risk from the reporting entity's involvement with structured entities that it does not control.*

*These disclosures are required for non-consolidated entities which the reporting entity has set up or sponsored.*

#### **EFRAG's draft response to question 9**

- A2.45 As paragraph 23 of the invitation to comment notes, the financial crisis has highlighted a need for better disclosure about the nature of, and risks associated with, a reporting entity's involvement with structured entities that the reporting entity does not control (and therefore does not consolidate). We in principle support the ED's efforts to satisfy this need.
- A2.46 However, although disclosures about 'off-balance sheet' risks are important, they cannot make up for a failure to consolidate an entity that should be consolidated. So the emphasis should remain on ensuring that the consolidations standard is sufficiently robust to ensure the boundaries of a reporting entity will be drawn in the right place. We would therefore not have been 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 job 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.
- A2.47 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. Paragraph B46's list of information that might be disclosed is particularly exhausting. There is a risk that if the eventual standard contains long lists of possible disclosures, those lists will become a checklist that is then almost unthinkingly complied with. We think it important that the IASB develops its new disclosure requirements in a way that encourages thoughtful implementation.
- A2.48 For that reason, we like the objective-based nature of the disclosure requirement set out in paragraph 48 of the ED. We also like the principle set out in paragraph B31 that a reporting entity should decide, in the light of circumstances, how much detail it provides to satisfy the requirements of the eventual standard.
- A2.49 However that principle seems inconsistent with the explanation in paragraph B30 that an entity "must" disclose the information set out in paragraphs B32-B49. Confusingly, paragraph B33 talks about the information the disclosures might include. We think the ED needs to be much clearer as to which of the disclosures described are intended to be mandatory and which are intended more to be indicative of the sort of things that could usefully be disclosed should the circumstances demand.
- A2.50 In addition, we think the objectives behind the disclosures (as set out in paragraph 48) are sometimes lost by the time one gets to the application guidance. As a result, we think, in relation to paragraphs B38 to B47, that the proposals in the ED would be clearer were they to refer explicitly to the need to improve disclosures regarding off-balance sheet activities.
- A2.51 We also think the disclosure requirements in paragraphs B40 to B47 are very detailed and could be simplified, especially if the principle in paragraph B31 were emphasised.

A2.52 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. However, we would have thought a good case could be made for the amount of information provided to be differentiated depending on the degree of involvement in the structured entity. Accordingly while information on exposures to structured entities is always significant, detailed information on the 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. That 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/rewards involved.

An alternative to this might be for the eventual standard to state that the information on assets and liabilities described in paragraph 40 of the ED shall be required only when the degree of involvement is judged significant.

A2.53 In our view, much of the information we have mentioned in the preceding paragraph should probably be disclosed even for consolidated structured entities, because of the complexity that is likely to be involved.

#### **EFRAG's draft response to question 10**

A2.54 In relation to the availability of information, our understanding is that some of the disclosures that are being proposed will require alterations to be made to existing reporting systems. This will need to be addressed as part of the transition provisions.

## REPUTATIONAL RISK

### Question 11

- (a) Do you think that reputational risk is an appropriate basis for consolidation? If so, please describe how it meets the definition of control and how such a basis of consolidation might work in practice.
- (b) Do you think that the proposed disclosures in paragraph B47 are sufficient? If not, how should they be enhanced?

### Background notes for EFRAG constituents

*The IASB has also considered reputational risk; reputational risk (in the context of the ED) refers to a reporting entity's implicit commitment to provide support for unconsolidated structured entities without having a contractual or constructive obligation to do so. The IASB has decided that reputational risk is not a basis for consolidation because it reflects management intent. The ED does, however, include new disclosures regarding support provided to unconsolidated structured entities where no contractual or constructive obligation exists.*

### EFrag's draft response to question 11

- A2.55 We are in agreement that the existence of reputational risk is not in itself an appropriate basis for consolidation; an entity should be consolidated only if the reporting entity has the power to direct its activities to generate returns for the reporting entity.
- A2.56 We are generally content with the disclosures that paragraph B47 proposes should be provided if, during the period, the reporting entity provides support that it was not obliged to provide to an entity that at that time it was not consolidating.
- A2.57 However, we think there is an implication that, if a reporting entity provides support to a structured entity, it controls the structured entity. We do not think that is right, because we think there may be circumstances where a reporting entity provides support but there is not a change in its powers and therefore the control definition is not met.

## ACCOUNTING FOR ASSOCIATES AND THE EQUITY METHOD

### Question 12

Do you think that the Board should consider the definition of significant influence and the use of the equity method with a view to developing proposals as part of a separate project that might address the concerns raised relating to IAS 28?

### Background notes for EFRAG constituents

*Paragraphs 27 – 32 of the Introduction to the ED discuss accounting for associates and the equity method. The discussion ends with a question as to whether the IASB should consider the definition of significant influence and the use of the equity method in IAS 28. The IASB notes in the ED that consideration of the requirements in IAS 28, together with the proposals in this exposure draft and the concurrent development of a replacement for IAS 31 Interests in Joint Ventures, would permit the development of a cohesive set of requirements for all investments in entities.*

### EFRAG's draft response to question 12

- A2.58 We believe the IASB should follow an evidence-based approach to its agenda decisions and the scoping of its agenda projects. That would mean that, before deciding whether to change the definition of significant influence or the use of the equity method, it should first determine whether any real practical problem exists for users and/or 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. And, even if it is decided that there is room for improvement, it would mean considering whether the practical improvements are sufficient to justify allocating resources to this work rather than to other inactive projects.
- A2.59 We accept a number of the arguments advanced in paragraphs 27 – 32 of the Introduction to the ED both for and against adding a project on these issues to the Board's active agenda. We accept also that the Board is currently addressing (in various projects) the boundaries of a reporting entity and therefore reconsideration of the principles associated with equity accounting might be timely. We also accept that running some of these projects in parallel could mean that there will be cross-fertilisation of ideas between the projects and that the result could be that they would all develop at a faster pace.
- A2.60 On the other hand, we think that it is the conceptual framework project that must ultimately provide the overriding principles and it is at that level that issues of this kind should initially be explored. We would like to see the relevant parts of that project completed before work of the kind discussed in paragraphs 27 – 32 of the Introduction to the ED is undertaken. We also think there are a number of far more pressing issues that the IASB needs to allocate resource to ahead of the work described, especially as we are not aware of any evidence that suggests the work described is urgent.
- A2.61 Therefore, on balance we think the IASB should not undertake such a project at this time.

### Appendix 3 Some more detailed comments

- A3.1 EFRAG notes that paragraph BC33 states that the IASB has rejected the risks and rewards model as a basis for consolidation. We think it would be useful if the reasons for the rejection of the risk and rewards model were set out in the basis for consolidation.
- A3.2 On agency relationships, the draft standard provides only that a reporting entity can have power by having power to direct an agent on its behalf (paragraph 9). The application guidance then provides that an agent may have the ability to direct activities but that ability is governed by a higher agreement. We consider that an agent does have power to direct activities (rather than the ability); it is simply that empowerment comes from the agreement with the principal.
- A3.3 Paragraph 8 of the ED states that a reporting entity possess the power to direct the activities of another entity by different means, including by having voting rights, by means of contractual arrangements, of a combination of these. Paragraphs 21 to 38 then provide guidance on how to assess whether an entity has power to direct activities. In certain instances these paragraphs appear to contradict themselves. For example:
- (a) Paragraph 22 provides that a reporting entity has the power to direct the activities of another entity if it can determine the other entity's strategic operating and financing policies;
  - (b) Paragraph 23 provides that a reporting entity can have power to direct the activities of another entity by having the power to appoint or remove the members of that entity's governing body that have more than half of the voting rights within that body, if the determination of strategic operating and financing policies is by that body:
  - (c) Paragraph 24 provides that, if the appointment or removal of the members of an entity's governing body is determined by voting rights, a reporting entity with more than half of those voting rights controls that governing body and has power to direct:
  - (d) Paragraph 27 provides that a reporting entity has power to direct where it has more voting rights than any other party and voting rights are sufficient to give the reporting entity the ability to determine the entity's strategic operating and financing policies:

We consider that these inconsistencies should be addressed.

- A3.4 There appears to be an inconsistency between paragraph 23 and 24. The governing body in paragraph 23 does not appear to have the same requirement as the governing body in paragraph 24 in that, while the governing body in paragraph 23 must be the body that determines strategic operating and financing policies, this requirement is not restated in paragraph 24.
- A3.5 We are concerned that the guidance on assessment of the power to direct activities does not clearly explain what 'other arrangements' in paragraph 21 refer to. Although a reference is made to paragraphs 23-29, those paragraphs do not refer to other arrangements that provide an entity with power to direct

activities; they refer to other circumstances in which an entity may have power to direct (or in the case of paragraph 25 where there is no power to direct activities). We note, however, that paragraphs B14 to B16 of the application guidance provide clarification on 'other arrangements'. In our view the standard would be improved if it was referenced to these paragraphs.

- A3.6 We are concerned that the guidance provided on structured entities might not be sufficiently clear to achieve the intended results; namely to ensure that structured entities are consolidated when both the power criterion and the return criterion are met. In particular, while paragraphs 34 to 36 and, to some extent, paragraph 38 describe what IASB has in mind, paragraphs 32 and 33 could be interpreted in a different way.
- (a) Paragraph 32 states that a reporting entity is likely to control a structured entity that has been created to undertake activities that are part of the reporting entity's ongoing activity (such as providing a source of financing for the reporting entity). This paragraph could be interpreted as having a more significant meaning than intended.
  - (b) Paragraph 33 could be interpreted in a way that as long as the entity is exposed to variability of returns of the structured entity, the power criterion is automatically fulfilled. This seems to contradict BC121.
- A3.7 In addition to the above we note that the definition of a structured entity includes the need for the entity's activities to be restricted. We consider that an entity only requires restricted activities where it has predetermined policies. However, if the assumption in the ED (that power can be determined in all circumstances) is correct, whether the entity has restricted activities is irrelevant.
- A3.8 Although paragraph 48 sets out the objectives that the disclosures required by the ED are seeking to achieve, the disclosure objective in paragraph 48(d) is expanded on in paragraph B38. In our view it would be an improvement if all of the disclosure objectives were dealt with in one place; the standard itself.
- A3.9 EFRAG does not support the proposal in paragraph 53 that, if application for the first time of the principles in the ED would result in an entity no longer being consolidated, that change shall be applied prospectively, not retrospectively. In general, EFRAG believes that retrospective application provides much more useful information than prospective application and is therefore to be preferred. Furthermore, where it is difficult to apply a new or amended standard both at short notice and retrospectively, EFRAG's strong preference is to allow a longer lead time, rather than to apply it prospectively. In EFRAG's view the only circumstance in which prospective application is acceptable is when the cost of retrospective application exceeds the benefits. We do not believe that is in the position in this case, so we would prefer retrospective application.
- A3.10 Paragraph B12 is presumably discussing circumstances in which it is likely that one entity is acting as agent for another. However, the paragraph uses the words 'act for' rather than 'act as agent for' and this is causing some confusion.
- A3.11 EFRAG notes that the proposal in paragraph B42 is that a reporting entity shall be required to provide the information described in paragraph B41 about unconsolidated structured entities for the current period and the two preceding periods. We do not understand why this disclosure was being singled out as a

disclosure for which two years of comparatives should be provided, and do not support such an exception being made.

A3.12 Paragraph BC 58 states that “power is not shared with others” and that “only one party controls an entity.” The heading above the paragraph states that “control is not shared”. Yet, as paragraph BC8 goes on to say, “if an entity shares control with other parties, it often has an interest in a joint venture.” In other words, power can be shared with others and more than one party can jointly control another entity; it is just that:

- (a) although several entities might together share control (or jointly control) another entity, that control will not under existing IFRS result in full consolidation of the controlled entity. It can though result in partial consolidation; and
- (b) if one entity has control of a second entity, another entity cannot also have direct control of that second entity. (It will though have indirect control if it controls the first entity.)

We think the ED needs to be clearer on this point.