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18 March 2009

By fax 2865 6776 & by post

Mr Steve Ong
Director, Standard Setting
Hong Kong Institute of Certified Public Accountants
37th Floor, Wu Chung House
213 Queen's Road East
Wanchai
Hong Kong

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HKICPA

Dear Mr Ong

HKICPA Consultation Paper on International Accounting Standards Board (IASB) Exposure Draft ED 10 Consolidated Financial Statements – A Comprehensive Review of Off Balance Sheet Risk

Thank you for re-sending to us on 4 March 2009 a copy of your original letter dated 21 January 2009 of which we are unable to trace receipt.

As requested, we would like to provide below our comments on the above Exposure Draft for the consideration of Hong Kong Institute of CPAs:

A. General comments

We support, in principle, the IASB's objective of developing a single consolidation model and enhancing disclosures in respect of structured entities. We believe, however, that the exposure draft needs significant work before it can be issued as a replacement for IAS 27 *Consolidated and Separate Financial Statements* (IAS 27) and SIC 12 *Consolidation - Special Purpose Entities* (SIC 12) which we believe have provided a satisfactory working model for consolidation of 'normal' entities and Special Purpose Entities (SPE).

The "controlling entity model" adopted in the exposure draft needs clearer articulation, particularly in respect of options, de facto control, convertible instruments and agency relationships. In addition, the model as developed in the exposure draft does not appear to provide a clearer and more comprehensive basis for determining control of structured entities than the existing guidance in SIC 12. If a new standard is finalised on the basis of the exposure draft without considerable further development, we are concerned that it could lead to more, rather than less, diversity in practice.

Chairman The Hongkong and Shanghai Banking Corporation Ltd
Vice Chairmen Standard Chartered Bank (Hong Kong) Ltd
Bank of China (Hong Kong) Ltd
Secretary Jennifer Cheung

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As regards the proposed disclosure requirements, we acknowledge the need for enhanced disclosures in relation to structured entities but we consider that the guidance in the exposure draft would lead to extensive but not necessarily useful additional disclosures. Specifically, the lists of possible disclosures included in the Illustrative Examples would likely to be treated as a checklist, resulting in the disclosure of large amounts of information which may be not useful to readers while important information on risks that are probable could be obscured.

Accordingly, we would urge the IASB to re-work the proposed standard and to conduct a thorough consultation on a further draft before finalisation.

B. Responses to specific questions

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

We consider that there is a risk that the proposed control definition may not always result in structured entities being appropriately consolidated. In particular, we are concerned that the proposed definition might lead to more 'structuring' to avoid consolidation than is possible under SIC 12.

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

We agree that the term 'returns' conveys the concept that these can be either negative or positive better than the term 'benefits' in IAS 27 and that this implicitly incorporates elements of the risks and rewards model into the control definition. However, it is not always clear whether it is the majority of absolute returns or the majority of the variability of returns which is the key criterion; paragraph 10 (on page 16) states that returns 'vary with that entity's activity' whilst paragraph 11(b) (on page 17) states returns 'can include' non-variable items such as upfront fees.

The application guidance in relation to the 'power to direct' concept is not clear. For example, in the case of options and convertible instruments the exposure draft indicates that the ability to direct activities should be demonstrated while in the case of a passive shareholder holding the majority of voting rights, the ability to direct activities does not need to be established.

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

We consider that the proposed requirements and guidance are not sufficiently clear to enable consistent, objective application of the control definition, for example, where no entity has the majority of the voting rights.

It is not entirely clear whether the exposure draft is focused on legal control or de facto control and this lack of clarity is likely to lead to diversity in practice.

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

We agree that options and convertible instruments can give an indication of the purpose of an arrangement and that the present and future intentions of parties towards an entity can help with the assessment of control or returns. We are concerned, however that basing the consolidation decision on management intentions would be inconsistent with the approach taken in many other standards. It is not clear to us why options which are not currently exercisable can demonstrate controlling power.

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

We believe that the proposals need to be clarified and that the guidance in respect of agency relationships (which, in itself, is a large topic) needs to be further developed to ensure that the proposals are consistently applied across different entities. Specifically, it is unclear how the guidance on agency relationships would be applied where all or part of the "agent's" remuneration is based on performance.

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

The SIC-12 definition of an SPE identifies a number of attributes that make structured entities different from 'normal' entities. This is useful. The IASB

should consider, if the distinction is still required, including further discussion of what makes structured entities different and how the “controlling entity model” is to be applied to them. If it is considered that the model needs modification for application to structured entities (for example, by applying a risks and rewards test) then a clearer definition and application guidance will be required.

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

We consider that the requirements and guidance set out in the draft standard would not be sufficient to enable decisions on consolidation of some structured entities to be made. It is difficult to see, at present how these decisions can be made without reference to a risks and rewards (or variability of returns) test.

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

We consider that the ‘controlling entity model’ is insufficiently developed in the exposure draft to ensure consolidation of structured entities where control is either dispersed or masked. In the absence of further development of this model to include tests based on variability of returns it is possible that the proposed standard would result in fewer structured entities being consolidated than is presently the case under SIC 12. We doubt that this would be consistent with the IASB’s intentions.

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.**

We acknowledge that disclosure of exposure to and involvement with structured entities should be enhanced. We consider, however, the exposure draft is insufficiently focused to provide useful guidance, for example, on ‘potential significant returns’ (see B32(c) on page 37). In practice, the Illustrative Examples would tend to be treated as a checklist and this will result in disclosure of large amounts of information which is not useful to



users of financial statements while important information on risks that are probable (or, at least not remote) will be obscured.

In particular, the proposed disclosures in relation to unconsolidated structured entities appear to require information on every structured entity that the reporting entity has had dealings with. In our view, the disclosures should be directed at the risks that the reporting entity faces in relation to potential consolidation of structured entities where the risk is probable under reasonably possible circumstances and what those circumstances are and what the financial impact on the reporting entity would be.

- 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.**

There will, in many cases, be immense practical difficulties in obtaining the required information from structured entities that the reporting entity does not control. Reporting periods may be different, the structured entity may report under a different Generally Accepted Accounting Principles (GAAP), and the reporting entity may not have the ability to require the structured entities to provide the information required. We consider that that, as indicated above, the focus of the disclosure should be on the significant risks and reasonably possible circumstances in which the reporting entity might be required to consolidate entities that are presently unconsolidated, together with the financial effects of consolidation.

- 11. (a) Do you think that reputational risk is an appropriate basis for consolidation? If so, please describe how it meets the definition of control and how such a basis of consolidation might work in practice.**

We do not consider that the existence of reputational risk is an appropriate basis for consolidation. The consolidation decision should be taken on the basis of an assessment of the power to direct activities and the exposure to variability of returns.

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

We consider that the proposed disclosures are adequate.



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

We do not consider that it is appropriate at this time to launch a new project to revise IAS 28.

Should you have any questions on our above comments, please feel free to contact our Senior Manager Ms Grace Law at 2521 1880.

Yours sincerely

A handwritten signature in black ink, appearing to read "Jennifer Cheung", is positioned below the "Yours sincerely" text.

Jennifer Cheung
Secretary

c.c. Chief Executive, Hong Kong Monetary Authority