



## The Stock Exchange of Hong Kong Ltd.

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Mr. Steve Ong  
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Dear Steve,

### **IASB Exposure Draft ED 10 Consolidated Financial Statements – A comprehensive review of off balance sheet risk (“the Paper”)**

I refer to your letter dated 21 January 2009 on the above to our Mr. Paul Chow which has been passed to me for my attention.

We have reviewed the exposure draft and our comments for your consideration are set out below.

#### General approach

Based on paragraph C9 on page 48 of the Paper, we understand that the exposure draft will effectively carve out sections of the current IAS 27 dealing with control to create a new standard that will solely deal with “Consolidated Financial Statements”. The remaining parts of the existing IAS 27 will be retained and will form a separate standard on the presentation of “Separate Financial Statements”, namely, those in respect of the reporting entity itself rather than consolidated financial statements of the reporting entity and its subsidiaries.

We believe this approach is not desirable. It would be preferable and sensible for the guidance in the amended IAS 27 on Consolidated Financial Statements to be incorporated into IFRS 3 “Business Combinations” which deals with the general principle of business combinations. Consolidated financial statements is just one form of presenting financial statements of a business combination which is the subject matter of IFRS 3. We would add that IFRS 3 goes to some length in describing the process of preparing consolidated financial statements and determining goodwill on an acquisition which we note will not be included in the proposed consolidated financial statements standard.

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The proposed standard on consolidated financial statements focuses on clarification of what constitutes “control” and introduces specific disclosure requirements for non-controlled structured entities. We believe that the guidance on control and consolidated financial statements should appear in IFRS 3. By adopting this approach, the IASB would be seen to be moving towards its objective of grouping related guidance on a specific subject matter into a single standard and replacing the current IASs, which were previously issued by its predecessor, the International Accounting Standards Committee, with IFRSs issued by the IASB. The current approach leads to guidance on a specific topic being included in a number of standards and the duplication of disclosure requirements already included in IFRS 3 (e.g. basis of control and disclosure of accounting consequence on the loss of control).

### Structured entities

On the issue of structured entities, we believe that the proposed disclosures appear excessive because of the wide scope of the mandatory disclosures. Under the proposals detailed disclosures are required on all structured entities that the reporting entity does not have control.

We understand that the intent of incorporating such disclosures in the proposed consolidated financial statements standard is to address the concerns on the use of off-balance sheet vehicles which was the subject of SIC 12 “Consolidation – Special Purpose Entities”, that is, structured entities controlled by the reporting entity should be consolidated.

Although we appreciate the objective of the disclosures on “non-controlled” structured entities, inclusion of such requirements in the consolidated financial statement standard appear misplaced. Such disclosure requirements would appear to be more suitable for inclusion in a related party or investment standard as the focus is on the need to disclose exposures and interests in off-balance sheet vehicles over which the reporting entity retains a significant influence and interest but does not have control. We believe the IASB needs to clearly identify conceptually the appropriate accounting treatment for various types of interests in entities a reporting entity may have. In summary, we believe that under the current accounting standards interests in entities or undertakings fall under the following types:-

- Type 1 Dominantly influenced entities or controlled entities - subsidiaries
- Type 2 Jointly influenced entities or jointly controlled entities – joint ventures  
(The current term used is jointly controlled but given the proposal in the exposure draft that there can be only one party that has “control”, the term “joint control” or its meaning will need to be reconsidered.)
- Type 3 Significantly influenced entities – associated companies
- Type 4 Passive investments or interests in entities in which the reporting entity has no influence – trading and other assets



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A non-controlled structured entity, would not fall into Type 1. They however could arguably fall into any of the other three types as the only condition in the Paper is that the reporting entity has no control.

If the proposed disclosures on non-controlled structured entities is adopted the disclosures would be more than those currently required for associates and joint ventures. We would therefore suggest that the proposed disclosure requirements, if retained, should be restricted to structured entities where the reporting entity has joint control or significant influence.

A possible alternative approach that could be considered is that structured entities in which a reporting entity has involvement (irrespective of the level of influence) should be “deemed” or presumed to be controlled by the reporting entity and should be consolidated unless the reporting entity can demonstrate and disclose that it does not have control.

The concept of consolidated financial statements takes the view that an interest in a subsidiary is in substance an interest in a “vehicle” which holds other underlying assets and liabilities. The consolidated financial statements attempt to draw out and disclose these controlled underlying assets and liabilities as these would be reflected in the financial statements of the reporting entity itself in only one line – the cost of the investment in the subsidiary entity. We agree the same principle should apply to structured entities (the vehicle) that are controlled or deemed controlled by the reporting entity.

A key principle discussed in SIC 12 “Consolidation – Special Purpose Entities” was the importance to look at the “*substance of the relationship*” between the reporting entity and a structured entity and whether there is the retention of the risks and rewards of ownership of the assets and liabilities of the structured entity. We believe that this key guidance should be retained in the new standard to reinforce the message that in preparing financial statements, transactions should be accounted for in accordance with their substance and economic reality and not necessarily their legal form. This key concept we note has also been removed from the draft conceptual framework statement which we believe is unfortunate. We believe it should be reinstated as it emphasises the need for preparers of financial statements to look at the spirit and objective of financial reporting to present a set of financial statements that show a true and fair view.

A further alternative approach that could be considered would be for tighter rules on the de-recognition of assets that would prevent the removal of assets from the balance sheet. The issue concerning structured entities and off-balance sheet vehicles falls back to a basic issue of the conceptual framework and the question of what is an “asset”, how an asset should be accounted for, namely, when an asset should be recognised and how it is disclosed and when should it be de-recognised.

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### Separate financial statements of the reporting entity itself

The exposure draft does not mention the proposed position to be taken in respect of separate financial statements of the reporting entity itself. Currently, under IAS 27 the presentation of such statements is optional. As the assets and liabilities attributable to the reporting entity itself would not be evident from consolidated financial statements, we believe that the IASB should reconsider whether the requirement to produce the separate financial statements of the reporting entity itself should be made mandatory and if so, how they should be presented in annual reports to shareholders. Separate financial statements provide useful information, including the performance and financial position of the reporting entity itself which have legal implications (e.g. on the distribution of dividends), and their presentation sometimes highlight possible impairment issues about the carrying value of goodwill and investments in subsidiaries which may not be apparent if only consolidated financial statements are presented. They also provide readers with a better understanding of the parent company in which they hold shares.

### Definition of control

The proposed revised definition of control is as follows:-

*“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 definition could be construed to describe a relationship between just two parties, namely, the “reporting entity” and the “other entity”. By doing so, it could be argued that it does not cover indirect control or interests or returns obtained through control of intermediaries. We therefore suggest that consideration could be given to inserting the words “directly or indirectly” after the word “controls”. We would also suggest the IASB consider replacement of the word “power” with the words “rights or power” as power is usually associated with the holding a formal position (e.g. being on the board of directors) whereas “right” would include the ability to make directions provided through other means, such as by a contract.

An intended purpose of the revised definition is to ensure that only one party can control an entity. We believe this can be re-enforced by the inclusion of “dominant influence” in the term. In future as there will only be one party that can be in “control”, the use of dominant influence may pave the way to adopt a term such as “joint significant influence” to replace the term “joint control” currently used for joint ventures.

It may also be useful to add a phrase to indicate that the “other party” is obliged to act on the instructions and directions given or that the directions can be made without the consent of the other party to indicate that the controlled party is subservient to the controlling party.



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Taking up the above suggestions would result in a definition of control along the following lines:-

*“A reporting entity controls another entity when the reporting entity has the right or power to exert dominant influence (whether directly or indirectly) over the other entity to direct the activities of that other entity, (and the other entity is obliged to act on the instructions and directions given), to generate returns for the reporting entity.”*

The stated intended consequence of the revised definition for control in the Paper is that only one party can control another entity. This will mean that in future business combinations under common control by two or more parties will no longer be possible. If this is the intention, the guidance in paragraph 2(c) of IFRS 3 becomes redundant or needs to be revised to clarify whether two parties can be regarded “collectively” as being one party.

### Assessing control – options and convertibles

The guidance provided in assessing control is useful but we would have reservations to including reference to holding options and convertible instruments as evidence of control. These holdings do not represent immediate rights or powers to direct but are only potential rights that would accrue if, and only if, the options or convertibles are exercised.

Included in the discussion of assessing control is guidance on “structured entities”. There is a possibly of a loophole if the term “entity” is construed narrowly. Another term that may be considered in lieu of “entity” could be the term used in the Companies Ordinance, namely, an “undertaking”. We also note that in the definition of a “subsidiary” referred to on page 49 of the Paper, the previous reference to “including an unincorporated entity such as a partnership” has been removed for some unknown reason. We believe this reference was useful guidance as it made it clear that the word entity has a wider meaning to include unincorporated undertakings.

### Disclosures

We appreciate the intention to prescribe disclosures for “off-balance sheet activities” but have concerns on the scope of the proposed disclosure requirements. As mentioned above, the proposal is that they will apply to all structured entities that the reporting entity does not have control. We believe that this would be too wide and should be restricted to those that the reporting entity does not have control but where the reporting entity retains significant influence over the operations and direction of the structured entity.

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### Reputation risk

We concur that “reputational risk”, as defined, is not an appropriate basis for consolidation. We also believe that where a reporting entity has a commitment to provide support to another entity, even though it does not have a contractual or constructive obligation to do so, it should trigger a need for disclosure (subject to intergroup eliminations) as it represents a commitment and an exposure of the reporting entity which is useful information to readers. However, we suggest that a materiality test should be incorporated so that immaterial disclosures can be omitted. This approach would be similar to the current requirements to disclose contingent liabilities although we note that under paragraph 27 of IAS 37 “Provisions, Contingent Liabilities and Contingent Assets”, a contingent liability need not be disclosed if the possibility of an outflow of resources is remote.

### Risks and rewards fall back test

We believe the test is a useful test and focuses on the second limb of the “control” test which normally requires the reporting entity to have the ability to direct as well as to get returns from the ability to direct. Retaining a financial interest in the activities undertaken by the structured entity looks to the substance of the arrangement, that is, the reporting entity is entitled to share in the returns of the structured entity even though it does not require the reporting entity to actively direct the activities of the structured entity.

On the issue of the variability of returns, a possible measure could be a “majority interest” held by the reporting entity in the output, revenue or net assets of the structured entity. Anything less than a majority interest would appear to indicate an interest but not a controlling or dominant influence over the structured entity.

### Significant influence

We believe that the IASB should seriously reassess the meaning of “significant influence” as the issue of control and significant influence deal with the same issue, namely, how much influence an investor has over the operations of the investee. We believe that “control” is equivalent to what we would describe as “dominant influence”.

### Access to information of non-controlled structured entities

We note that the exposure draft proposes prescribed disclosures for structured entities in which the reporting entity does not control. We believe that a reporting entity’s access information will normally depend on whether it has a significant influence over the other entity. For example, only with significant influence would a reporting entity be able to gain access to information to properly equity account for an investment in an associated company under IAS 28. Its inability to acquire information may be an indication that it does not have significant influence. We believe therefore that information may be

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difficult to obtain if the reporting entity does not have significant influence over the structured entity. The disclosures required under paragraphs B41 to B47 are quite onerous and may lead to practical implementation issues. We believe that disclosures should only be required for structured entities in which the reporting entity has significant influence.

We hope that you find our comments useful. If you require further clarification, please let us know.

Yours sincerely,  
For and on behalf of  
The Stock Exchange of Hong Kong Limited



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