A F E P

Association Française des Entreprises Privées

Mr. Alan Teixeira,
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Activities,
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30 Cannon Street
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Paris, 17 December, 2010

Dear Mr. Teixeira,

"IFRS X Consolidated Financial Statements" – Comments regarding the staff draft posted on the IASB website

We are writing to share with you some comments about the above mentioned staff draft. We realise, of course, that the IASB has completed its deliberations on this topic, and therefore our comments are, for the most part, related to the drafting and how this could be improved to facilitate understanding and application of what is required.

Status of staff drafts

Before dealing with these comments, we would like to raise some general concerns on the status of this document and other staff drafts.

We note that "staff drafts" are increasingly being used by the staff to conduct its outreach activities and in something akin to a "fatal-flaw" review. While we fully support all actions undertaken to improve the quality of proposals and gather more input from all stakeholders, we wonder how these documents fit in to the IASB due process since no formal invitation to comment has been considered necessary. In order to ensure the utmost transparency in the standard-setting process and to avoid any misunderstanding, we think that the IASB ought to define clearly the role of such documents in its due process handbook.

Principal comments on IFRS X

Moving onto the matter of the consolidation standard, we would first of all like to congratulate the staff on their efforts in making this draft a much clearer and more structured document than the exposure draft (ED10). Indeed we note that the proposed standard and its related guidance are now well structured around each of the three control components and they are no longer divided into two distinct and adjacent sections for two different types of entities.

Nonetheless, despite all these improvements, we are not sure that the draft standard will guarantee that preparers are able to reach the correct conclusion in assessing control. Furthermore, in some cases, the conclusion reached may be accurate in terms of its compliance with the standard but may not be relevant in the information it provides. We elaborate on these matters in the Appendix, where we provide some illustrative examples.

We are quite disagreeably surprised by the new transitional provisions, as we fully shared the conclusion reached in the basis for conclusion of the exposure draft: "retrospective application might prove extremely difficult, if not impossible". We believe that the arguments stated in paragraphs ED10.BC150 and ED10.BC151 are still valid and we disagree with the retrospective application required in the staff draft. We understand the need for comparability across reporting periods but we believe that a <u>limited retrospective</u> application is the only transitional method that can reasonably be mandated.

Moreover, we think it is important that the final standard clearly specifies which version of IFRS 3 the entity should apply if full retrospective application is permitted or required: the revised IFRS 3 (2008) version or the former IFRS 3 (2004) as the new one should only be applied prospectively to new business combinations.

Finally, we are not convinced that the apparent plethora of application guidance which has been added to that originally included in the ED will actually facilitate the understanding of the future standard. Indeed, since this guidance is an integral part of the standard all the considerations it raises will have to be taken into account by the entity. However, since the draft does not provide a clear hierarchy of how the individual elements should be weighted in the decision about control, management judgment will be called into play extensively and we fear that it may lead to the conclusion that control is deemed to exist when this is not relevant or appropriate

Our members would be happy to discuss these matters further with you. Should you require any supplementary comment or explanation, please do not hesitate to contact us.

Yours sincerely,

ACTEO	AFEP	MEDEF
Patrice MARTEAU Chairman	**Alexandre TESSIER** Director General	**Agnès LEPINAY** Director of economic and financial affairs

Appendix –illustrative examples and main concerns

ASSESSING CONTROL - POWER

Paragraph B10 – application example: We do not find this example helpful in assessing control in similar circumstances as it is neither conclusive nor understandable. It appears to be an example of facts to consider but does not indicate how a conclusion should be reached. However, it does illustrate perfectly the difficulties entities will face when applying the new standard.

In addition, we do not clearly see the frontier between this forthcoming standard on consolidated financial statements and the future standard on joint control. In this particular example, if both investors have the same power over all the strategic decisions, we understand that such cooperation would be dealt with in ED9 and the investee would probably be accounted for under the equity method.

However, in the situation that each of both investors has an exclusive power on specific decisions during a specific phase, does it mean that the entity will be controlled at first by investor 1 and then by the investor 2 when the next phase begins? It could actually be considered that during phase 1, Investor 1 has the current ability to direct activities that are currently affecting the most significantly its returns. Thus, we are not sure we understand the conclusion “the investor responsible for the manufacturing phase could have the power over the investee even before that phase begins”. Does this mean that we should assess which of both investors has the most power on an ongoing basis?

Please also note that the same word “investors” is used in both this staff draft and in ED 9 but with a different meaning. We believe it could be misleading.

Furthermore, the frontier between this staff draft and IAS 28 “Investments in associates” is also unclear.

- Paragraph IAS 28.6 states that if an investor holds less than 20 per cent of the voting power of the investee, it is presumed that the investor does not have a significant influence, unless such influence can be clearly demonstrated. A substantial or a majority ownership by another investor does not necessarily preclude an investor from having a significant influence.

- An equivalent rebuttable presumption based on a threshold exists in current IAS 27 (paragraph 13) but no longer exists in the forthcoming standard. Our interpretation is therefore, that, even with less than 20 per cent of the voting right, the investor will have to assess whether or not he controls the entity. This implicit requirement appears to us to be potentially very onerous and we think that the standard should provide some guidance about how far an entity should go in order to demonstrate that it does not have control when it holds less than 50% of the voting rights.

POTENTIAL VOTING RIGHTS

We are also particularly concerned that changes in the valuation of instruments that give rights to potential voting rights (i.e. when they move from in or out of the money) could impact consolidation conclusions from period to period (refer to paragraph B19). Indeed, including such quantitative criteria may lead to variability in the scope of consolidation, making the preparation and understanding of financial statements more complex.

Furthermore, the link between substantive criteria as defined in paragraph B18 in reference to the practical ability to exercise the right, and the reference to the exercise or conversion price in paragraph B19(a) is not very obvious, as we believe that a price out ofthe money does not systematically impair the practical ability to exercise the right.

In this context, factors like economic or other barriers (paragraph B19(b)) and the need for agreement from other parties (paragraph B19 (c)) seem much more relevant to determine whether rights are substantive or not. Thus, the reference to a market price should only be a secondary criterion in the overall analysis of control.

THE PURPOSE AND DESIGN OF AN INVESTEE

B49 specifies that "an investor may have an explicit or implicit commitment to ensure that an investee continues to operate as designed. Such a commitment may increase the investor's exposure to the variability of returns and, thus, the likelihood that it has power."

We are unclear about the potential implications of that paragraph regarding "implicit" commitments. We note in BC18 that "the Board concluded that, when assessing control, reputational risk is a factor to consider along with other facts and circumstances". However the Board also added "it is not an indicator of power in its own right, but may increase an investor's incentive to secure rights that give the investor the power". We believe that the Board decision is not strictly reflected in B49. This paragraph appears less balanced and is likely to lead to the inadvertent consolidation of entities. It would represent a major change in comparison to ED 10 where "the Board concluded that reputational risk is not a sufficient basis for consolidation because it reflects only management's intention" (ED 10 BC 38). We fully support the former ED 10 view and we have strong concerns about the fact that this change was not discussed with preparers and users of financial statements.

DELEGATED POWER

A. *Dual role situations in regulated funds (reporting entity both investor and asset manager)*

We strongly regret that the principle developed in ED 10 - paragraph B11 is no longer included in the staff draft. We believe that a reporting entity should be assessed as a controlling party in its dual role of investor and asset manager only in the circumstances when it is not acting in the best interests of the other investors and the other investors do not have the ability to withdraw the power they have entrusted to the reporting entity.

We strongly supported the staff's proposal presented in the staff paper 3B of May 2010 that was to consider a decision-maker as "an agent when its decision-making authority is restricted as follows:

- the decision-maker must operate an entity according to narrowly defined operating and financing policies, that are enforced by law or regulation, to ensure that the entity is operated in the best interests of all investors,

- the decision-maker is unable to change the parameters within which it operates."

Indeed, in the specific case of regulated funds, we believe that the reporting entity (both asset manager and investor) cannot use the assets of the fund for its own activities and must act in the best interests of all investors equally (the different parties, including the reporting entity, have common and convergent interests; when there is a conflict of interest, all investors are treated equally and that the agent cannot favour the interest of the reporting entity as investor). The reporting entity is only at risk in respect of the shares it owns, which are already reflected on the balance sheet, and is not entitled to any return in respect of the shares held by a third party, other than a normal investment management fee. Given the predetermined nature of the fund's investment options and operations the reporting entity does not have the power to direct activities in order to achieve a disproportionate return for itself, and hence our analysis is that consolidation should not be required.

Therefore, when an investor in a fund, whatever the level of its investment, has no unconditional unilateral right to remove the investment manager, no ability to change the restrictions or predetermined strategic policies of a fund, and, more broadly, no other way, as an investor (but excluding its power as asset manager acting in the best interests of investors), to direct or influence the activities, he cannot have control over the fund.

Potential implications of the current staff draft:

Referring only to the general agency guidance for assessing control will lead to diversity in treatments that will not contribute to the objective of comparability of the consolidated financial statements between the different groups.

At this stage, for regulated mutual funds, we have no idea whether there will be a common interpretation of the new principles (in particular considering paragraph B68) on the question of the level of exposure / rights beyond which control will be considered to be obtained by a reporting entity acting both as asset manager and investor.

We noted that BC104 specifies that "if such a decision-maker receives a return that is insignificant or varies insignificantly, most would be comfortable in concluding that the decision-maker uses any decision-making authority delegated to it to generate returns for others". However, this indicator is not included in the proposed standard itself and therefore, is likely not to be taken into consideration.

The following examples illustrate the difficulty of the control assessment:

- a regulated fund is held (first case: 60%; second case: 30%) by an investor A , however managed by an unaffiliated asset manager. Who should consolidate in the case where the asset manager holds an interest in the fund (first case: 30%; second case: 10%) but less than the investor A?

- a regulated fund has been set up by an asset manager with 100% seed money, whilst the fund units are subsequently sold to external investors. At the end of year 1, the % held by the asset manager is 90%, in year 2, it decreases to 60%, in year 3 to 30%, in year 4 to 5% and in year 5 to 0%. Is consolidation required by the fund manager during each or some of these periods?

In these examples, we assume that there are no substantive kick-out rights or similar rights provided to investors and that the remuneration of the fund manager (that includes performance fees) is considered as normal (on the basis of the paragraph B63 assessment).

As a result, we are still unclear about the potential changes in the scope of consolidation implied by the future new general guidance.

B. *Substantive removal rights*

B57 states that “if a small number of parties hold substantive rights to remove a decision-maker, that factor would receive a greater weighting (increasing the likelihood that the decision-maker is an agent) than if a large number of parties hold such rights.”

For **limited partnerships**, a current policy is to consider that the general partner cannot control the entity in practice when unrelated limited partners can freely decide with a simple majority vote to remove him without cause. Indeed, in this case, removal rights are currently considered as substantive. We are unclear about the implications of the future standard.

C. *Remuneration*

B65 specifies that “Remuneration that exposes a decision-maker to variability of returns does not, in isolation, preclude the entity from being an agent if the remuneration aligns the returns of the decision-maker with those of other interest holders. However, remuneration that exposes a decision-maker to returns that vary differently from those of other interest holders may indicate that the decision-maker is not an agent.”

We are unclear how the wording used in that paragraph (“vary differently”, “aligns”) should be interpreted, in particular in the case of performance fees (that, by definition, are not proportionate) even if they are widely used and that their level is normal and commonly applied by actors on the market. If the interpretation is too narrow, many decision-makers are likely to be considered as principals in application of this paragraph. We don't think that it was the objective of the Board decisions.

Conclusion

The absence of specific agency guidance for regulated funds, the possible narrow interpretations of the guidance on removal rights and decision-maker's remunerations are likely to lead to an inadvertent significant increase in the number of funds requiring consolidation. It would result in grossed up balance sheets with a resulting lack of focus on the relevant aspects of the financial statements. The consolidated balance sheet would mix the share of assets belonging to third parties (on which the reporting entity has no risk) with the share of assets belonging to the reporting entity. We believe that the financial statements of the reporting entity should reflect only the investment held in the regulated fund. By reflecting this economic position, the financial statements would provide better decision useful information for investors.