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November 3, 2010

Technical Director Financial Accounting Standards Board 401 Merritt 7 P.O. Box 5116 Norwalk, CT 06856-5116

RE: FASB Public Roundtable Meetings on the IASB Staff Draft on Consolidated Financial Statements

Dear Technical Director:

We appreciate the opportunity to respond to the questions included in the agenda for the November 22 FASB public roundtable meetings to discuss the IASB Staff Draft (the Staff Draft) of a forthcoming IFRS on consolidated financial statements that the IASB plans to issue to replace IAS 27, Consolidated and Separate Financial Statements and SIC-12, Consolidation-Special Purpose Entities. Please note that KPMG IFRG Limited previously commented on the IASB Exposure Draft (ED) 10, Consolidated Financial Statements. Our responses to the FASB roundtable agenda questions included below are intended to provide feedback for the Board as it considers what next steps may be appropriate in its consolidation project and do not necessarily represent our views about the IASB's proposals in ED 10 for changes to IFRS consolidation guidance.

Question 1

The Staff Draft provides a single concept of control that is used to evaluate control on a consistent basis for all types of entities (both voting interest entities and variable interest entities). Do you agree that a single-model approach to assess control will provide more consistent financial reporting for all types of entities rather than providing separate models for voting interest entities and variable interest entities? If not, why not?

Yes, we agree that a single-model approach to assess control would provide more consistent financial reporting for all types of entities rather than maintaining separate models for voting interest entities and variable interest entities. Maintaining different models to assess control for voting interest entities and variable interest entities results in added complexity in the accounting literature and creates opportunities for accounting arbitrage. We believe that a properly designed model for identifying a controlling financial interest should be sufficiently flexible to be operational when applied to any type of entity.



Question 2

The Staff Draft does not incorporate the U.S. GAAP concept of a variable interest entity or a structured entity. Rather, the Staff Draft provides that the way in which control is assessed will vary depending on how the activities that significantly affect the entities' returns are directed. For example, how control is assessed will depend on whether the decisions that significantly affect the returns of an entity are made through voting rights. Without an explicit definition of a variable interest entity, do you believe that (ignoring the differences when analyzing decision making relationships and the effect related party arrangements have on the analysis) the Staff Draft will produce the same consolidation conclusions as the recently issued U.S. GAAP guidance for consolidating variable interest entities (FASB Accounting Standards CodificationTM Subtopic 810-10, Consolidation¹)? If not, what are the situations that produce a different conclusion and why? Do you think it is sufficiently clear how to assess power and control for all types of entities in the Staff Draft?

We do not believe the Staff Draft always will produce the same consolidation conclusions as FASB Accounting Standards Update 2009-17, Consolidations (Topic 810): Improvements to Financial Reporting by Enterprises Involved with Variable Interest Entities (ASU 2009-17). The model for identifying a controlling financial interest under the Staff Draft is different from the ASU 2009-17 model for identifying a controlling financial interest in several respects. For example, the Staff Draft model for identifying a controlling financial interest is based on effective (de facto) control, which considers not only the reporting entity's rights but also the likelihood that other parties that could prevent the reporting entity from exercising its rights and thereby prevent the reporting entity from directing the activities that significantly affect the investee's returns (i.e., the relevant activities) will actually do so. This is different than the model in ASU 2009-17 other than with respect to the consideration of kick-out rights and participating rights, and even in the case of such rights ASU 2009-17 contains no likelihood assessment in its model for identifying a controlling financial interest. In addition, the guidance in the Staff Draft is more general than the guidance in ASU 2009-17, and there are fewer application examples to narrow the range of interpretations that may be applied to the general guidance in the Staff Draft than there are in ASU 2009-17. As a result, there may be more diversity in practice under the guidance in the Staff Draft than there is under the guidance in ASU 2009-17. Situations that would produce a different consolidation conclusion under the two models include, but are not limited to, the following:

a) Instances where substantive kick out rights or participating rights are held by more than one party (even if held by a very small number of parties) other than the reporting entity, rather than by a single party that has a unilateral right and ability to exercise them. Under ASU 2009-17, such rights would be disregarded in the analysis of whether the reporting

¹ Originally issued as FASB Statement No. 167, Amendments to FASB Interpretation No. 46(R).



- entity has a controlling financial interest whereas under the Staff Draft they would be taken into consideration in the analysis. Also refer to our responses to Questions 7 and 8.
- b) Instances where the reporting entity holds a forward contract or option to acquire additional voting shares of the investee. Under ASU 2009-17, contracts that are not immediately exercisable (e.g., forward contracts) are not taken into consideration in the evaluation of whether the reporting entity has a controlling financial interest whereas under the Staff Draft they would be taken into consideration in the analysis. In addition, under the model in ASU 2009-17, contracts that are immediately exercisable (e.g., certain purchase options) are evaluated to determine whether they function in substance as a unilaterally-exercisable kick-out right. Typically, unless a purchase option is exercisable for little or no consideration and there is no disincentive for the reporting entity to exercise the option, it would not be considered to be in substance equivalent to a unilaterally-exercisable kick-out right. Conversely, under the Staff Draft, purchase options that require a substantial investment in order to exercise are taken into consideration in the analysis of whether the reporting entity has a controlling financial interest and may result in a conclusion that it does when its other rights would not alone have been sufficient to reach that conclusion. Also refer to our response to Question 6.
- c) Instances where the reporting entity holds a substantial minority of the voting shares of an investee and no other party holds a significant portion of the voting shares. Under ASU 2009-17, the reporting entity would not be deemed to have a controlling financial interest in such circumstances without other rights whereas under the Staff Draft the reporting entity may be deemed to have a controlling financial interest in such circumstances. Also refer to our responses to Questions 3-5.

In addition to the foregoing, it is important to note that there are significant differences between ASU 2009-17 and the Staff Draft in the guidance for determining whether a service provider is acting solely as a fiduciary. In general, these differences appear to result in a greater likelihood that a service provider would not be deemed to have a controlling financial interest under the guidance in the Staff Draft than under the guidance in ASU 2009-17. Also refer to our response to Question 7.

Question 3

The Staff Draft proposes that in order to control an entity, the reporting entity must have the power to direct the activities of that entity². Power is defined as having existing rights that give the reporting entity the current ability to direct the activities that significantly affect the entity's

² A reporting entity controls another entity when the reporting entity has (1) power over the other entity, (2) exposure, or rights to variable returns from their involvement with the other entity, and (3) the ability to use its power over the other entity to affect the amount of the reporting entity's returns.



returns. Do you agree with the control principle as articulated in the Staff Draft? Do you agree that there are situations when a reporting entity can have control of an entity controlled through voting rights with less than a majority of voting rights? Why or why not?

As noted above, the Staff Draft's model for identifying a controlling financial interest is an effective (de facto) control model under which the evaluation looks not only at the reporting entity's rights, but also at the likelihood that the reporting entity will be able to direct the investee's relevant activities even if the reporting entity's rights alone are not sufficient to do so.

As a result, there may be cases where a reporting entity is deemed to have a controlling financial interest under the Staff Draft's model but in fact could be prevented from directing the investee's relevant activities by its other investors. In addition, under the Staff Draft's model, the evaluation of whether the reporting entity has a controlling financial interest could change solely as a result of changes in economic conditions (e.g., when the reporting entity holds a purchase option to acquire voting shares of the investee) or because of transactions by other investors or changes in the way that other investors are expected to behave. We believe a controlling financial interest generally should not be affected by the likelihood that investors other than the reporting entity will behave in a particular way or by economic conditions. If a reporting entity has a controlling financial interest it should be able to direct the investee's relevant activities and we have concerns about the operationality of a model in which other investors' actions or economic circumstances could act as a barrier to the reporting entity doing so. As a result, we believe that a reporting entity that holds less than a majority of the voting rights of an investee generally should not be deemed to have a controlling financial interest in the investee unless the reporting entity either a) has a purchase option to acquire additional voting shares sufficient to give the reporting entity a majority voting interest that is exercisable for little or no consideration and for which there is no disincentive to exercise, or b) has entered into an agreement that either gives it the right to exercise other investors' voting rights or that precludes other investors from exercising their rights such that the reporting entity has the right irrespective of likelihood to direct the investee's relevant activities.

Question 4

The Staff Draft states that if the activities that significantly affect an entity's returns are directed through voting rights, a reporting entity holding less than a majority of the voting rights (assuming no potential voting rights or other contractual rights exist) has power when it can unilaterally direct the activities of the entity that significantly affect the entity's returns. This assessment requires judgment. The Staff Draft provides application guidance to determine when a reporting entity holding less than a majority of the voting rights in an entity controlled through voting rights has power. Specifically, the Staff Draft provides that, in some cases, a determination can be made about whether a reporting entity has power by just considering the



absolute size of the reporting entity's holding of voting rights, the size of its voting rights relative to the size and dispersion of holdings of the other vote holders, the voting patterns at previous shareholders' meetings, and other arrangements. Do you believe that there are circumstances when, considering only these factors, an assessment could be made about whether a reporting entity has power? Why or why not?

We do not believe the factors to consider in the Staff Draft listed above are operational in all cases. Application of the factors in the Staff Draft requires that the reporting entity have access to the information needed to make the assessment of whether it has a controlling financial interest in the investee. The Staff Draft does not provide any further guidance about what to do if the information cannot be obtained and, if it is obtained, how the reporting entity would use the information in its assessment. It is not clear to us why a reporting entity that does not already possess this information or that cannot obtain it would be deemed to have a controlling financial interest in the investee. However, the inclusion of these factors in the Staff Draft provides an opportunity for reporting entities that hold less than a majority of an investee's voting shares but are motivated to consolidate the investee to make a concerted effort to obtain the information and interpret it in a way that would support a conclusion that they have a controlling financial interest in the investee. Reporting entities that are motivated not to consolidate an investee would have the opposite incentive. Consequently, the factors in the Staff Draft appear to carry the risk of making consolidation / non-consolidation in certain circumstances an option rather than a requirement.

Question 5

In other circumstances the Staff Draft provides that additional evidence may be needed in order to conclude that a reporting entity holding less than a majority of the voting rights in an entity controlled through voting rights has power. The Staff Draft includes indicators that may provide additional evidence in these circumstances to assist in determining whether the reporting entity has power. Do you believe that these indicators provide sufficient guidance to conclude that a reporting entity has power in situations where it is unclear as to whether a reporting entity has power solely based on the absolute size of the reporting entity's holding of voting rights, the size of its voting rights relative to the size and dispersion of holdings of the other vote holders, the voting patterns at previous shareholders' meetings, and other arrangements? If not, what additional indicators should be included or which of these indicators should be removed?

The indicators included in the Staff Draft do not provide sufficient guidance without additional information about the relative significance of each indicator (i.e., some type of weighting guidance). Without additional guidance that highlights the importance of each indicator, we believe diversity in practice is likely to arise in the application of the indicators resulting in potentially inconsistent conclusions about whether a reporting entity has a controlling financial



interest. In addition, the indicators describe circumstances in which the reporting entity likely may want, and/or be permitted, to direct the investee's relevant activities but it is not clear that this would be because the reporting entity actually is doing so as a result of its rights rather than merely because the investee's interests are aligned with those of the reporting entity. If the latter, we do not believe consolidation is appropriate – that is, we do not believe consolidation should result simply from coincidence or mutual interest between an investor and an investee.

Question 6

The Staff Draft requires a reporting entity to consider its rights to obtain additional voting rights of another entity, as well as such potential voting rights (options or convertibles, for example) held by other parties, to determine whether the reporting entity has power. Do you believe the guidance in the Staff Draft is appropriate and operational? Specifically, do you believe that the guidance for determining when potential voting rights are considered substantive is operational? If not, what additional guidance would you suggest?

We believe that potential voting rights generally should not be considered in assessing whether the reporting entity has a controlling financial interest because the reporting entity does not yet have those voting rights (that is, they are not currently exercisable). We do not believe the guidance regarding forward contracts is appropriate because there is no possibility for the reporting entity to exercise any additional decision-making rights that it may obtain through such contracts until they settle. We also do not believe purchase options should be considered in the evaluation of whether the reporting entity has a controlling financial interest unless they are equivalent in substance to a substantive unilateral kick-out right. We believe additional guidance for purchase options should be provided that differentiates options that are currently exercisable from those that are not and addresses the circumstances in which they are equivalent in substance to a substantive unilateral kick-out right. As noted in our previous comments, we believe options that are currently exercisable for little or no consideration and for which there is no disincentive to exercise may be equivalent in substance to a substantive unilateral kick-out right if the exercise of the option would give the holder a majority of the investee's voting shares and there are no other agreements that would preclude the holder from exercising its voting rights to direct the investee's relevant activities.

Question 7

When determining whether a reporting entity acts as an agent, the reporting entity must consider the overall relationship between it and other parties involved with the entity, considering the following factors:

- a. The scope of its decision-making authority over the entity
- b. The rights held by other parties



- c. The remuneration the reporting entity is entitled to in the arrangement
- d. The reporting entity's exposure to variability in returns as a result of other interests that it holds in the entity.

Do you believe the guidance related to assessing decision-making arrangements in the Staff Draft is appropriate and operational? Do you believe the Staff Draft would lead to appropriate consolidation conclusions?

The guidance in the Staff Draft about whether a service provider (decision-maker) is acting solely as a fiduciary differs in some important respects from the corresponding guidance in ASU 2009-17. Under ASU 2009-17, there are a number of conditions that all must be met in order for a service provider to be deemed to be acting solely as a fiduciary. The Staff Draft includes most of the ASU 2009-17 conditions governing whether a service provider is acting solely as a fiduciary as factors to consider rather than as conditions that must be met (the exception is that the Staff Draft requires the conditions in ASU 2009-17 on whether the service provider's compensation is commensurate with the service being provided and whether the terms and conditions of the service arrangement are consistent with customary terms and conditions for similar service arrangements negotiated at arm's length to be met in order to conclude that the service provider is acting solely as a fiduciary). The Staff Draft also contains guidance that differs from that in ASU 2009-17 with respect to how to evaluate kick-out rights held by more than one party and the impact of the service provider's exposure to variability in returns of the investee in assessing whether a service provider is acting solely as a fiduciary. In general, these differences appear to result in a greater likelihood that a service provider would be deemed to be acting solely as a fiduciary under the guidance in the Staff Draft than under the guidance in ASU 2009-17.

As we have noted previously (see KPMG comment letter re: Proposed Statement, Amendments to FASB Interpretation No. 46(R) (File Reference No. 1620-100), October 30, 2008), we do not agree with the premise in ASU 2009-17 that a kick-out right cannot be considered substantive if it requires the agreement of multiple parties to exercise it. Accordingly, we believe the Staff Draft's guidance regarding kick-out rights represents an improvement in relation to those provisions of the ASU. However, it is not clear to us that the guidance in the Staff Draft would properly identify all circumstances in which a service provider is acting solely as a fiduciary. Because the principal/agent distinction is crucial to the determination of whether a service provider is acting in a fiduciary capacity, we believe more work needs to be done in this area, including consideration of whether and, if so, how the principal/agent analysis for this purpose should differ from the principal/agent analysis for purposes of revenue recognition. In addition, we believe it would be appropriate for further consideration to be given to the usefulness of consolidated financial statements in circumstances in which the "parent" provides little (or none) of the at-risk investment in the "subsidiary". Based on the guidance in the Staff Draft, it appears that there may be circumstances in which a service provider could be required to



consolidate another entity even though little (or none) of the at-risk investment in the entity is provided by the service provider. It would be helpful for the consideration of this issue to also extend to entities such as limited partnerships.

Question 8

When evaluating a decision-maker's role, rights held by other parties are considered when determining whether a decision-maker is an agent. Specifically, situations in which a single party holds substantive removal rights and can remove the decision-maker without cause, in isolation, would be sufficient to conclude that the decision-maker is an agent. However, if numerous parties hold such rights, those rights would not, in isolation, be conclusive in determining whether a decision-maker is an agent. In such a situation, those rights would be considered together with the other factors included in question 7 above, to determine whether the decision-maker is an agent. Do you believe that removal rights held by numerous parties should be a factor when evaluating whether a decision-maker is an agent? If so, do you agree that it should be one factor but not in and of itself determinative, when evaluating whether a decision-maker is an agent?

As noted in our previous responses, we believe a controlling financial interest generally should not be affected by the likelihood that investors other than the reporting entity will act in a particular way or by economic conditions. If a reporting entity has a controlling financial interest it should be able to direct the investee's relevant activities and the actions of other investors or economic circumstances generally should not create a barrier that would keep the reporting entity from doing so. As a result, we are supportive of a model under which substantive removal rights held by more than one party is a factor that in and of itself can result in a conclusion that a decision- maker is acting solely as a fiduciary or an agent. However, if the model remains one in which such rights would be a factor to consider but not in and of itself determinative, we believe that additional guidance should be provided about how to evaluate those rights so that reporting entities can reach consistent conclusions about whether they hold a controlling financial interest.

Question 9

The Staff Draft requires a reporting entity to reassess whether it controls another entity if facts and circumstances indicate that there are changes to one or more of the three elements of control. Do you believe this principle, and the related guidance in the Staff Draft, is sufficiently clear and operational?



We are fully supportive of a requirement for an ongoing consolidation reassessment when coupled with an appropriate model for identifying a controlling financial interest. However, because the Staff Draft's model for identifying a controlling financial interest is an effective (de facto) control model (under which the evaluation looks not only at the reporting entity's rights, but also at the likelihood that the reporting entity will be able to direct the investee's relevant activities even if the reporting entity's rights alone are not sufficient to do so), the evaluation of whether the reporting entity has a controlling financial interest could change solely as a result of changes in economic conditions or because of transactions by other investors or changes in the way that other investors are expected to behave. As a result, the combination of the reassessment requirement and the Staff Draft's model for identifying a controlling financial interest could require consolidation or deconsolidation even when there has been no change in the reporting entity's rights with respect to the decisions about the investee's relevant activities. As noted previously, we do not agree with that result and we believe that is likely to create a number of operational challenges.

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We look forward to participating in the roundtable meetings to discuss the specifics of these issues in more detail. If you have any questions about our comments or wish to discuss any of the matters addressed herein, please contact Mark Bielstein at (212) 909-5419 or Kimber Bascom at (212) 909-5664.

Sincerely,

