

20 March 2009

International Accounting Standards Board  
30 Cannon Street,  
London EC4M 3XH  
United Kingdom

Tower 42  
25 Old Broad Street  
London EC2N 1HQ  
United Kingdom  
t + 44 (0) 20 7382 1770  
f + 44 (0) 20 7382 1771  
[www.c-ebs.org](http://www.c-ebs.org)

Dear Madam, dear Sir

### **Exposure Draft 10 Consolidated Financial Statements**

The Committee of European Banking Supervisors (CEBS), comprised of high level representatives from banking supervisory authorities and central banks of the European Union, welcomes the opportunity to comment on the Exposure Draft on Consolidated Financial Statements.

Banking supervisory authorities and central banks have a strong interest in promoting sound and high quality accounting and disclosure standards for the banking and financial industry, as well as transparent and comparable financial statements that would strengthen market discipline.

CEBS regards the project on consolidated financial statements to be crucial in ensuring that users of financial statements are provided with decision-useful information about consolidated and unconsolidated entities. The availability of this information should enhance transparency and strengthen market discipline mechanisms, which supervisors regard as an important tool to promote international financial stability and to enhance the soundness of the financial system.

CEBS is concerned that fewer structured entities could be consolidated under the proposed approach than under current guidance because of ambiguity in the control model which could lead to structured entities not being consolidated even though there is exposure to economic risks and rewards. CEBS recommends that the IASB gives prominence to the role of risks and rewards in identifying control, particularly with respect to structured entities. In this respect, it will be important to assess how the approach proposed in the present exposure draft interacts with the related approach which is expected to be adopted in the work on Derecognition.

In addition, we consider that a mapping exercise – which would compare how specific cases would be accounted for under existing rules and the proposed standard – should be undertaken. Amongst other things, that would facilitate assessment of the implications of the proposals for traditional subsidiaries.

The comments put forward in this letter and in the related appendix have been coordinated by CEBS's Expert Group on Financial Information (EGFI) chaired by Mr. Didier Elbaum (Deputy Secretary General, Commission Bancaire) - in charge of monitoring any developments in the accounting area and of preparing related CEBS

positions - and in particular by its Subgroup on Accounting under the direction of Ian Michael of the UK FSA. If you have any questions regarding our comments, please contact Mr. Elbaum (+33.1.4292.5801) or Mr. Michael (+ 44.20.7066.7098).

Yours sincerely,

A handwritten signature in black ink, appearing to read 'Kerstin af Jochnick', written in a cursive style.

Kerstin af Jochnick  
Chair, Committee of European Banking Supervisors

## **Appendix**

### **General Comments**

First of all, CEBS notes that this exposure draft is a response to the global financial crisis and the recommendations of the Financial Stability Forum ('FSF') and the G20 who encouraged accounting standard setters to address weaknesses in accounting and disclosure standards for off-balance sheet vehicles by March 31, 2009. CEBS is of the opinion that considering this short time frame, the focus should be on the most pressing issue, i.e. the consolidation of special purpose entities.

CEBS considers that conceptually the objective of trying to develop a control definition that encompasses all entities within the scope of IAS 27 Consolidated and Separate Financial Statements as well as those within the scope of SIC 12 Consolidation-Special Purposes Entities is very welcome.

In this respect we note that the proposed definition of control amend the current requirements when applied to regular entities, notably as regards the assessment of de facto control.

However, we have specific concerns regarding the application of this new definition of control to structured entities. The exposure draft seems to place too much focus on who has the power rather than who has the returns. Indeed, we consider that many details are given on how to assess power but the indicators proposed to assess who has the returns (paragraph 31) are less developed and relevant compared to the ones included in SIC 12. Moreover, this focus on power to the detriment of a risk and rewards test could result in more structuring opportunities and fewer consolidated entities being consolidated because power is easily disguised. This could actually weaken the accounting treatment of Special Purpose Vehicles at the risk of not meeting the FSF and G20 recommendations. For this reason we encourage the IASB to conduct a field test before adopting this new standard.

Against this background, CEBS believes that the scope of the project launched by the IASB, which decided to have a thorough conceptual review of IAS 27 and SIC 12, goes beyond the recommendations of the FSF and the G20. CEBS considers that in the short term, the project should focus on improving the accounting for structured entities, which is the most pressing issue. The broader issue - that is a conceptual review of IAS 27 and the aim to unify the consolidation models in one standard - should be considered following the usual due process. CEBS believes that improvements to SIC 12 should be informed by the experience of the application of SIC 12. In this regard, we do not see any fundamental flaw in the principles of SIC 12 (that includes a "risks and rewards" approach), but we feel that more guidance is needed.

CEBS notes that this is a joint project between IASB and FASB on consolidation and urges the IASB to ensure that global consistency is achieved on this aspect and notably that a similar treatment is applied to special purpose entities under both GAAPs. We also encourage the IASB to avoid potentially inconsistencies with closely related projects such as "Derecognition" and "Conceptual Framework - Phase D: Reporting Entity".

**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?*

CEBS considers that the objective of trying to develop a control definition that encompasses all entities within the scope of IAS 27 as well as those within the scope of SIC 12 is very welcome. However we believe that more guidance is needed in the case of structured entities.

The revised definition of control that requires two components (the power to direct the activities and the right to obtain returns) seems appropriate for regular entities. However we question its appropriateness for structured entities, since many of these entities are on autopilot and it may be difficult to determine who has the power and the ability to benefit from that power.

The impact of the implementation of the proposed draft IFRS in terms of the composition of the banking groups is not clear at this stage and one of CEBS's major concerns is that entities that are currently (properly) consolidated will be unconsolidated under the new regime. For example, the situation described in Example 1B (paragraph B32(c), page 5) leads to no consolidation of the structured entity according to the new exposure draft. This raises significant concerns as we believe that in this case, the entity should be consolidated. The increased emphasis on the notion of "power to direct the activities" at the expense of the concept of "risks and rewards" could result in more structuring opportunities than is permitted at present and may lead to less consolidation of special purpose entities.

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

Control appears to be an appropriate basis for consolidation but we are concerned that it does not incorporate the concept of risks and rewards sufficiently.

CEBS agrees that the control of a subsidiary precludes others from controlling the same subsidiary (cf. paragraph 5), other than in the case of a joint venture where control is shared, but these fall under the scope of IAS 31 *Interests in Joint Ventures*.

Paragraph 11 gives examples of positive and negative returns generated for a parent. CEBS suggests that examples of negative returns could be given more prominence. Also CEBS would welcome more guidance as regards economies of scale and scope or cost savings and notably how to evaluate such returns.

**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?*

We recommend directly incorporating notions of risks and rewards, specifically residual risk as that notion was contained in SIC 12, into the control principle.

CEBS welcomes the fact that the exposure draft clarifies that a reporting entity can control another entity even if it does not have more than half the voting rights, as long as those voting rights are sufficient to give the reporting entity the ability to determine the strategic operating and financing policies (i.e. de facto control).

It is however not clear whether and under what conditions the actual exercise of control (de facto control) prevails over the mere ability to exercise the control (legal control). In the proposed standard there are provisions in paragraphs 25 and 8 which may appear contradictory. In the same line of reasoning CEBS is concerned with regard to the treatment of options or convertible instruments (see following question).

More generally, it would be helpful to complement the general principles with more detailed guidance (presumptions, examples etc) which could assist preparers in appropriately addressing complicated cases.

**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.*

As a general rule, CEBS favours principles-based standards but we are uncertain as to what the Board's proposal will deliver. Notably we are concerned with the fact that some useful guidance could be left in the basis for conclusion which is not part of the standard (e.g. BC 81).

CEBS has concerns regarding the fact that options that are not "currently exercisable" could be considered when assessing control, as these will usually have limited influence on the determination of control at the reporting. This situation does however change if they become exercisable. We tend thus to agree with the dissenting views expressed in AV 3 that it is important to make clear 'if other relevant facts and circumstances' have to be met to give the option holder the power necessary to be in control, that these facts and circumstances are clearly identified.

We are also concerned that the situations described in B 13 a, b and c could be viewed as the only situations where a reporting entity that holds options or convertible instruments has power to direct the activities of another entity. We believe the standard should be principles-based rather than rule-based, and that the specific situations should be presented as examples.

#### **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.*

Whilst the ED does acknowledge the dual agency / principal role in the context of managed funds where the fund manager is both a principal with 'some skin in the game' and an agent, it would be too easy to assert that they are acting in a fiduciary capacity i.e. solely as an agent hence the decision is made to not consolidate.

We feel that the proposals may lead to entities coming off balance sheet where this is not appropriate.

## **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?*

Given the continuing importance of the definition of structured entity both regarding the application of criteria to determine if control exists and the disclosure implications, we believe that more reflection is needed on the proposed definition and CEBS would like to encourage the IASB to develop a more detailed and positive definition and to conduct field testing in that context.

To avoid an entity bypassing the standard entirely it needs to be made clear that an entity must fit into one of the two categories.

## **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?*

We are concerned that control is easy to disguise which could lead to structuring opportunities. We are not convinced that the move away from the risks and rewards model to the proposed model will result in the right consolidation outcome. In our view risks and rewards need to be incorporated into the model to a greater extent than is the case at the moment.

Conceptually we favour the idea of one model for all entities but we think the proposed definition needs improvement and that further work is needed. We also acknowledge that the objective of having one model for all entities may not be achievable, at least in the short term.

## **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.*

As stated above, we would like to incorporate risks and rewards into the principal test for structured entities. However, if the current power model is retained at the very least we support the inclusion of a fall back test. At the same time we acknowledge that a narrow quantitative assessment could provide structuring opportunities to achieve the desired consolidation result.

## **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.*

We broadly support the proposed disclosure requirements but would favour suitable aggregation to ensure sufficient prominence is given to the substantial high risk exposures.

#### **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.*

It can be expected that reporting entities that have in place sound management practices have the information needed to meet the disclosure requirements presented in the ED available. This information should be decision-useful to users to allow proper identification of risks and rewards reporting entity is (or might be) exposed as a result of the involvement, in particular, in structured entities that are not consolidated.

We believe that in a cost-benefit analysis, benefits for the users would be shown to exceed the cost for entities.

#### **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.*

By itself we do not believe the exposure to reputational risk is an appropriate basis for consolidation, however we favour factoring this heavily into the criteria to assess whether the reporting entity has control.

However, we think the Board should consider establishing a presumption that an entity which establishes an SPE controls it, unless it explicitly declares in the notes to the financial statements that its involvement is limited to its contractual exposures, and that it will not grant support beyond what is legally due under contract.

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

Whilst we accept the difficulty of requiring disclosure based on management intent in respect of future support, CEBS considers that the support already provided to unconsolidated structured entities, is useful information to assess possible provision of future support.

We believe this information should be disclosed so users are aware of the possible responsibilities arising to the reporting entity from the support provided to unconsolidated structured entities.

#### **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?*

We believe the standards for joint arrangements and associates should be made consistent with that for consolidation.