



## COMMITTEE OF EUROPEAN SECURITIES REGULATORS

Stig Enevoldsen  
Chairman  
European Financial  
Reporting Advisory Group  
35 Square de Meeûs  
1000 Brussels  
Belgium

[commentletter@efrag.org](mailto:commentletter@efrag.org)

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### Comments regarding IASB's Exposure Draft ED 10 Consolidated Financial Statements

The Committee of European Securities Regulators (CESR), through its standing committee on financial reporting (CESR-Fin), has considered EFRAG's draft comment letter on IASB Exposure Draft ED 10 Consolidated Financial Statements.

We thank you for this opportunity to comment on your draft letter and are pleased to provide you with the following comments:

1. In general, CESR is supportive of the comment letter prepared by EFRAG.
2. CESR appreciates the efforts being made by the IASB to respond in a timely manner to the comments made by a number of stakeholders, in particular the FSF, regarding the role played by consolidation rules in the development of the financial crisis. In general, CESR supports the objective of a single standard which addresses the various issues relating to consolidation, and which sets out additional disclosures allowing investors to better understand the risks associated with structured entities.
3. CESR, like EFRAG, would support a single consolidation principle. The principle proposed in the ED is that, if a reporting entity has the power to direct the activities of another entity in order to generate returns for the reporting entity, then the reporting entity controls that second entity and should therefore consolidate it. CESR, like EFRAG, also understands that ED 10 is proposing a control-based model that implicitly incorporates some elements of the risks and rewards approach; CESR however would prefer this incorporation to be explicit. Furthermore, CESR is not aware of any major deficiencies arising from the current application of IAS 27 and SIC-12, and therefore is concerned that the application of ED 10 as drafted might result in boundaries being set on the definition of the reporting entity that differ from those that result from the application of the current requirements – more especially leading to less entities being consolidated. CESR feels the ED does not give proper consideration to these consequences.
4. As a result of the above comments, CESR is supportive of EFRAG's suggested solution that the IASB should divide the consolidation project into two halves, addressing the need for improved disclosures in the short term, whilst allowing more time for the design of a single consolidation principle and a comprehensive analysis of its potential consequences. According to the IASB's work program, the consolidation project was to be a joint project with the FASB, however CESR is not aware that an exposure draft covering the general principle of consolidation is currently open for comment in the United States of America. EFRAG's suggested solution would allow the two standard setters time to develop a truly joint approach.



5. CESR is also of the view that field tests should be performed as part of the second phase of the amended project.
6. Finally, CESR notes that many important issues are presented only in the proposed basis for conclusions. If the IASB continues with the project in its current form, CESR would suggest that all elements relating to principles be transferred into the standard itself and those relating to detailed guidance, which will be helpful to users and enforcers, into the appendices.

Our detailed comments are set out in the appendix to this letter. I would be happy to discuss any of these issues further with you.

Yours sincerely,

Chairman of CESR-Fin



## Appendix: Answers to the questions included in the ED

### 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?*

CESR has doubts whether the proposed definition of control could be applied consistently to all entities. See our answers to question 7 for details on the doubts we have regarding structured entities.

### Question 2

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

CESR supports the objective of the ED to improve certain aspects of existing IFRS (IAS 27 and SIC 12) by providing a single consolidation principle.

However CESR believes that the current way the principle is articulated should be clarified. Paragraph 12 states very clearly that both power and returns are to be assessed. Paragraph 21 draws a distinction in how the principle is to be applied based on the type of entity for which the assessment of control is being made. CESR believes that the proposals could make the point more clearly that for entities in the first category, an assessment of both power and returns is required, whereas for those in the second category, the assessment of power is generally not conclusive and therefore more emphasis has to be placed on the returns criterion.

As a final point on this issue, CESR is in favour of including more detail within the principle of control to make it explicit that risks and rewards are incorporated into the concept of control (see also our answer to question 7).

### 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?*

CESR is concerned that definitions and guidance regarding "returns" and "power" may be too general and therefore difficult to apply. The guidance around both concepts should be clarified to ensure consistent application and to clear up inconsistencies that exist in the ED as currently drafted.

- See our answers to questions 4 and 7 for details on the doubts we have for example regarding whether returns can be limited by a cap or a floor.e.g. the potential loss in the case of an option could be considered to have a floor since the loss is limited to the premium paid.
- In addition CESR is concerned that in the case of options there seems to be a significant difference between paragraph B13 which states that options and convertibles, if exercised, may give the power to direct the activities of another entity only if certain criteria are met, as opposed to paragraph BC 87 (and to a lesser extent BC 85) which make it clear that the Board thinks that an option being currently exercisable is not a mandatory criterion for control.

CESR is also puzzled by the wording contained in paragraph 22. Paragraph 4 states that “ 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”.



Whilst according to paragraph 22 "A reporting entity has the power to direct the activities of another entity if it can determine that other entity's strategic operating and financing policies". IAS 27 defines control as the power to govern the financial and operating policies of an entity so as to obtain benefits. Hence the difference between the two versions of the control definition is not obvious and CESR wonders whether there is a need to change the definition in IAS 27 if, in the end, ED 10 simply explains in two steps the same principle as IAS 27 does in only one.

The guidance provided regarding when an entity owns less than a majority of voting rights seems consistent with the way control is otherwise assessed except for the following:

- CESR shares EFRAG's view that the concept of "power to direct the activities" referred to in Paragraphs 21-29 could open the door to structuring opportunities if putting in place formal restrictions can justify the assertion that the reporting entity does not have this power. Consider the case of a patent trust where after the nomination of first trustees the reporting entity no longer has the power to direct the activities of the trust. Such a trust would not be consolidated according to the new requirements of ED 10 whereas the application of SIC-12 would result in its consolidation because the reporting entity is exposed to the full variability of the trust's net income.
- Regarding other contractual agreements, CESR also agrees that Paragraph 17 should indicate more explicitly that the overall effect of all arrangements related to an entity should be taken into account when assessing whether that entity is controlled.

#### **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.*

It seems reasonable to make assessment of the powers attached to options and convertible instruments consistent with that made when a reporting entity has less than a majority of voting rights. However, the guidance provided in paragraph B13<sup>1</sup> is not clear and additional guidance is provided in the Basis for conclusion (BC 81 and BC85-86 in particular). This guidance seems relevant, but is not part of the standard that will be endorsed by the EU. In addition to this:

- According to BC81 an entity is deemed to have control over another if it in fact is controlling that second entity, for example "...if the shareholder that is the counterparty to the option...uses its voting power to act on behalf of the option holder, or if the strategic operating and financing policies are determined according to the wishes of the option holder". This position might conflict with the concept of control contained in BC47 which does not require actual exercise of such power. It could be argued that an entity may currently be using a counterparty's voting power or be determining the strategic operating and financing policies of a second entity but only for as long as the counterparty allows that entity to continue so doing. In such circumstances the entity is merely an "operator" for the counterparty, not a controlling entity. The same confusion seems to arise when de facto control is assessed. An entity may just be an operator in those circumstances where the other shareholders can stop that entity from making decisions with which they do not agree. From a forward-looking perspective, such an entity does not have "unilateral" power, as control is in fact shared with the other shareholders who have de facto "passive" control over the subsidiary. Such issues should be clarified in the subsequent project and before a final standard is issued.
- As underlined in EFRAG's draft comment letter, the link between options / convertible instruments and the power to direct the activities of the issuing entity is not self-evident. Using the example included in BC85, even if a reporting entity owns an option that is

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<sup>1</sup> Paragraph B13 describes three cases where a reporting entity that holds options or convertible instruments has power to direct the activities of another entity: (a) action of the governing body in accordance with the wishes of the reporting entity, (b) the counterparty of the option acts as a agent for the reporting entity and (c) the option gives particular rights.



exercisable for little or no consideration (and therefore benefits from returns on the underlying asset), that option does not per se provide the reporting entity with the power or ability to direct the activities of the underlying asset. This link also seems to be unclear in the case of derivatives which include potential voting rights but which are not options or convertible instruments, such as forwards. Such instruments are not addressed at all in this ED nor is how they should be taken into account in assessing control.

- CESR is concerned that some preparers might view BC85 as establishing a link between the ability to finance the exercise of the option (and indirectly therefore the intention of management) and the power or ability to direct the activities of the underlying asset. CESR fears that if this were the case, the standard would be difficult to enforce and consequently we would suggest that this aspect is clarified further (according to IG8 in IAS 27, financial ability does not influence the assessment).
- BC86 states that an option that is exercisable at fair value does not provide returns to its holder and therefore control is not obtained through the option only. However BC86 does not address the issue of options that are “out of the money” and CESR believes that additional consideration should be given to this issue dealing specifically with the probability that the option will be exercised. For example, if synergies (Par. 11.c) are anticipated by the option holder which have not been factored into the value of the option by the market, should this fact not be taken into account?

#### **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.*

The principles set out in paragraphs BC89-90 (definition of an agent) should be transferred into the standard. CESR agrees with EFRAG’s view that control can be obtained through a contract compelling the agent to act in accordance with the wishes of the reporting entity (and giving the reporting entity the ability to remove the agent).

BC95 deals with situations where the reporting entity has a dual role (principal and agent). The paragraph requires such an entity to exclude the voting rights it holds as an agent from its own only if it can demonstrate that it uses those voting rights solely to act on behalf of others. This requirement should be made compulsory and therefore be included in the standard or one of the appendices.

For those situations where the reporting entity has a dual role with regards to a structured entity, CESR considers additional guidance might be appropriate since BC95 focuses solely on voting rights.

#### **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?*

A definition of the term is useful, not necessarily in order to assess control (which would be based on the single consolidation principle applicable to all entities) but because specific disclosures are required for structured entities in the notes to the financial statements.

However, CESR is concerned about the use in paragraph 30 of the term “restricted activities” which might be misunderstood (“restricted” might be understood as making reference to law and regulations). SIC-12 used the terms “narrow and well-defined objective” (SIC-12.1) and we wonder why these terms are no longer considered appropriate.

#### **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?*

Paragraph 33 states that “a reporting entity is likely to have power to direct the activities of a structured entity if it is exposed to the variability of returns ...” The paragraph seems to mix the concepts of power and returns whereas in paragraphs 12 and 21 they are clearly separate. CESR finds this confusing.

The assessment required by paragraph 31 seems primarily based on the returns from the entity’s activities. The definition of returns is given in paragraph 10: they vary with that entity’s activities and can be positive or negative. This definition might be too general and difficult to distinguish from risks and rewards.

As mentioned in AV8 and AV9, it seems that a focus on risks and rewards is more appropriate than the concept of control when assessing structured entities. CESR agrees with EFRAG’s conclusion that circumstances can arise where any residual power gives only little influence over the variability of returns.

Consequently, CESR fears that a broad notion of power could make any assessment of that power more difficult to enforce and leave room for structuring opportunities: there may be cases in which an entity is fully exposed to the variability of returns but has no remaining power over the structured entity. If the concept of power is to be maintained, then the guidance relating to it should be enhanced, to clarify among other things the differences between protective rights and participating rights.

CESR believes that the concept of returns implicitly incorporates risks and rewards as defined in SIC-12, but both BC 33 and BC 100 clearly indicate that the Board rejected this method of assessment and wanted to break the connection. Consistent with the concerns expressed above, CESR does not agree with this analysis. On the contrary CESR believes an explicit incorporation of the risks and rewards approach into the concept of control would help users.

Furthermore, in assessing the variability of returns, paragraph BC53 appears to put emphasis on the gross amount (“the entity that receives the greatest returns [...] is likely to have the greatest power...”) whereas paragraph 33 states that “a reporting entity is likely to have power to direct the activities of a structured entity if it is exposed to the variability of returns that are potentially significant...”. This lack of a consistent definition is at best confusing.

Notwithstanding the concerns expressed above, CESR believes that the various criteria included in paragraph 31 are indeed relevant and should be contained in a standard on consolidation covering structured entities.

Finally, BC121 describes a situation where a reporting entity does not have the power to control a structured entity but is exposed to the risks associated with it. The Board is of the view that such risks should be disclosed in the reporting entity’s financial statements rather than lead to the consolidation of the structured entity’s assets and liabilities into those financial statements. Based on situations encountered during the financial crisis, CESR is not convinced that this approach will provide useful information to investors. The risk seems high that reporting entities will provide very little information regarding those structured entities on the grounds that they assess the related risks as low, meaning significant changes both in terms of amounts accounted for and disclosures once a problem appears.

#### **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.

A response to question 8 is partly included in our responses to questions 1 & 7. In addition, CESR feels the role and prominence of the risk and rewards fall back test is unclear. When should it be used? Whenever there are doubts concerning the results of the assessment of control?

#### **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.*

CESR agrees that improved disclosures are needed. Paragraph 48 provides a clear indication of the kind of information needed by investors. However, CESR supports EFRAG's comments regarding disclosure requirements.

With regards to B32(c), CESR does not understand how not to require consolidation of a structured entity from which the reporting entity receives returns that are potentially significant [the addition of the terms "to the structured entity" at the end of this paragraph is adding to the confusion] can be consistent with a sound principle for consolidating structured entities.

CESR observed that the text and principle contained in ED 10.B31 is the same as that contained in IFRS 7.B3. The principle in IFRS 7 however is accompanied by Implementation Guidance (paragraphs IG3 -IG6) regarding materiality and the level of disclosures including a requirement to provide additional disclosures (especially by a reference to IAS 1 paragraph 17(c)) if appropriate. This implementation guidance is missing from ED 10. Granted the last element (a requirement to provide additional information) is taken into account in paragraph 50 of ED 10 (and so in the standard itself), however the first element (materiality and level of disclosures) is nowhere mentioned in ED 10. The IASB does not clarify why there are differences in this area between IFRS 7 and ED 10. This raises two questions: why did the IASB create these differences and what is their meaning, if any? CESR recommends that from a legal point of view such differences should be avoided, but if they are necessary, the reasons for them should be made clear in order to prevent misunderstandings.

#### **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.*

CESR does not have enough information at this stage and believes preparers are better placed to provide comments on such matters.

#### **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.*

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

CESR agrees that reputational risk does not per se constitute a relevant criterion for consolidation. The disclosures required in B47 seem appropriate to address the needs of investors.

#### **Question 12**



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*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?*

CESR is not aware that the use of the equity method or the concept of significant influence has caused significant problems in the last months. Therefore, CESR thinks that if a project were to be developed in this area (not that this would seem urgent), it should follow appropriate due process. Our view also takes into account that the conceptual framework project which is currently under way is addressing the reporting entity issue. Once this has been done, IAS 28 may need to be aligned with the new consolidation principles.

**Other comments**

Another reason for CESR's supporting EFRAG's suggestion of taking additional time is that this might allow solutions to be provided for situations which are currently not dealt with by existing standards, but are nonetheless important for listed companies. Such situations, closely related to the consolidation issue, include in particular those where entities join forces and generally have a single governing body but from a legal point of view remain separate. Examples of such situations (relating to companies listed on a Stock Exchange) exist in the Netherlands, in the UK, and in France (dual parent company structures).