Consolidated Financial Statements

ED 10

A response by

CFA Society of the UK

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About CFA Society of the UK

The CFA Society of the UK (CFA UK) represents the interests of more than 8,000 leading members of the UK investment profession. The society, which was founded in 1955, is one of the largest member societies of CFA Institute and is committed to leading the development of the investment profession through the promotion of the highest ethical standards and through the provision of continuing education, advocacy, information and career support on behalf of its members.

CFA UK supports the CFA, Associate (ASIP) and IMC designations. Most members hold either the Chartered Financial Analyst (CFA), or Associate designation. CFA Institute is best known for developing and administering the CFA curriculum and examinations and issuing the CFA Charter. CFA Institute's mission is to lead the investment profession globally by setting the highest standards of ethics, education and professional excellence.

Most CFA UK members also belong to the CFA Institute and reaffirm annually their adherence to its Code of Ethics and Standards of Professional Conduct. Both CFA UK and CFA Institute are committed to providing members with a wide range of continuing education opportunities. All members are encouraged to undertake ongoing post-qualification continuing education.

CFA UK is the awarding body for the IMC, the benchmark entry-level qualification for those working in investment management in the UK. The examination is accredited by the Qualifications and Curriculum Authority (QCA) and is designated a recommended examination by the Financial Services Skills Council (FSSC) for the purposes of the Financial Services Authority's training and competence requirements. The IMC is held by more than 15,000 investment professionals.

About this response

The society welcomes the Board's interest in revising the control definition applicable under IAS 27 and SIC 12 in order to apply the same control criteria to all legal entities and to improve disclosure requirements.

The society shares the Board's belief that the proposals to introduce control as a single criterion for consolidation of all entities, as well as the clarification of the control definition and related application guidance, are likely to benefit both users and preparers of financial statements by providing more principles-based and consistent requirements. This should lead to more consistent application of the consolidation requirements, which would benefit users of financial statements by providing more comparable information. Nevertheless, as the society has pointed out in previous responses to the Board, there is a tendency at present to demand greater disclosure in all areas. The volume of material already disclosed is substantial. It is important for users, preparers and standards-setters to focus on the quality and potential use of disclosures and not simply to seek additional disclosures for their own sake.

The society acknowledges the benefit of the consistent application of a controlling entity model. However, the society is concerned that the definition of control will, in some circumstances (control via equity instruments; structured entities), require judgment in its application that might lead to variable application. Notwithstanding this concern, we share the Board's belief that this approach is preferable to a prescriptive approach (such as that within FIN 46(R)) because the publication of 'bright line' requirements tends to make it easier to structure entities in a way that evades the principles implicit in the standard.

While the society appreciates the Board's efforts to address the issue of control of structured entities, we believe that the focus on these entities within the ED is too great. Not only has the current crisis revealed 'parent company' responsibility for structured entities and severely curtailed issuance, but if the definition and the principles underlying the guidance are encompassing, there is no need to provide such an emphasis about a particular type of entity in the standard.

The society also notes the concern of some investment managers and asset owners regarding the removal of investment company exclusion from the standard. Their argument is that consolidation should not be required because they manage those investments on a net basis and, in their view, presenting the underlying assets and liabilities of their investments is misleading and uninformative. The society accepts the Board's counter-argument, but suggests that this issue be closely watched to ensure that the standard does not have unintended and unanticipated consequences.

Last, the society notes that the revised standard's concentration on which structures and instruments should be included within it has meant that insufficient guidance has been provided on how consolidation should practically be achieved. For instance, it is not clear how non-controlling interests might be consolidated. Where an entity consolidates another entity where it has 'power to direct activities without a majority of the voting rights' or has done so on the basis of 'returns', there is a significant lack of guidance on how this should be accounted for. The standard should address the presentation of minority interest where entities are consolidated and the parent either holds no equity or an equity share that is

significantly less in proportion when compared to the returns it receives from the consolidated entity.

Q1

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?

The society believes that the proposed control definition could be applied to all entities within the scope of IAS 27 and SIC-12. However, we are concerned that the guidance on the definition might not be sufficient [see our response to Q3].

We support the Board's decision to replace 'benefits' with 'returns'.

The society would welcome clarification of paragraph 16 which requires that not receiving a return for the time-being means that an entity would need to be deconsolidated. We understand this to intend that control (and so consolidation) unwinds when the right to receive a return ends, rather than that there should be deconsolidation simply when the return from time to time happens to be zero. We believe that it would be helpful for the IASB to make this intention clear.

Q2

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

Yes.

Q3

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?

While the society is broadly supportive of the Board's new definition of control and of the principles relating to the assessment of control, we are concerned that the degree of judgment required to assess control – particularly where the reporting entity does not hold the majority of the voting rights – might lead to inconsistent application.

It seems that, at face value, the definition of control might be too narrow to capture circumstances in which control is either latent or hidden, hence the detail on how control might a) be exercised by the holder of a minority stake or b) rebound on the originator of a structured entity. This leads to some difficult judgments eg paragraph 27 of the draft IFRS suggests that a reporting entity with a minority shareholding might be regarded as holding the power to direct if (a) it holds more shares than any other party <u>and</u> (b) the holding is sufficient to allow it to determine the entity's strategic operating and financial policies. How is it possible for a reporting entity to know if (b) holds without testing this thesis?

It would be better to try to make the standard simpler by emphasising the underlying logic – as in the basis for conclusions. The more difficult the judgment, the more critical are the disclosures on the tests that have determined the outcome. It is worth remembering that the main thing that users wish to know is the company's potential exposure to losses/liabilities. If these are not captured by this standard then we would look to other standards that govern reporting of related party relationships and investments.

Q4

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.

Our understanding is that certain circumstances, such as those described in paragraph B13, are explicitly considered to provide control, but that further examples might also be considered to provide the option holder with the power to direct an entity – as set out in the basis for conclusions. It is obviously a concern that the assessment of control in relation to options and convertibles might require delicate judgment and that judgment might not be applied consistently.

Q5

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.

We agree with the Board's proposals.

Q6

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?

The society acknowledges the difficulty in defining structured entities and accepts the need to move away from the definition used in SIC-12 in order to avoid inadvertent referencing of the risks and rewards model of consolidation. However, it does not seem satisfactory simply to describe a structured entity as an entity that has non-typical control characteristics. This is not a principles-based approach. While this might provide a good way to capture such entities for consolidation purposes, the definition is clumsy, does not reflect the market's view of what a structured entity (which is better captured by SC-12) is and might result in poor outcomes. It isn't hard to imagine a situation where an entity that the market would regard as a structured entity is not defined that way by the standard, while an entity that the market does not consider to be structured is so defined. Such outcomes diminish confidence in standards.

The definition of control, as amplified to deal with latent power and potential exposure to variable returns, should be sufficient to capture all entities for which the parent has ultimate responsibility.

Q7

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?

The society supports the Board's decision to avoid bright lines and to apply the principle of power and returns in assessing control for consolidation purposes. Similarly, the society shares the view that it will prove difficult on occasion to determine where power really lies. AV8 suggests that it may prove that power is more easily disguised than returns and that the focus on power might lead to more structuring opportunities and less consolidation of structured entities. The society recommends that the guidance be taken as drafted, but that the effectiveness of the guidance be reviewed at an appropriate time following the implementation of the revised standard.

Q8

Should the IFRS on consolidated financial instruments include a risks and rewards fallback 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.

The standard should not initially include a risk and reward fallback test for structured entities as exceptions to the standard might diminish confidence in it and sow confusion over the model being used. However, should a review of the standard determine that guidance on the consolidation of structured entities has not proved effective, then it might be necessary to introduce additional fallback tests referring to risks and rewards.

Q9

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.

The society believes that users would value the disclosure requirements described in paragraph 23.

Q10

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.

This is one for the preparers. As with other regulatory changes, they should be subject to a cost-benefit analysis.

Q11

- *(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 as 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?*

(a) No
(b) Yes, though we believe that the disclosures might better be located as an amendment to IFRS 7.

Q12

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 the proposals as part of a separate project that might address the concerns raised relating to IAS 28?

If control is redefined then there must be knock-on effects on such areas as derecognition (we know this is in the pipeline) and investments in associates, which covers significant influence and equity accounting. So it would seem logical to review IAS 28 and any other standard that refers to interests short of control. The aim is presumably to ensure that the financial reports capture the parent company's exposure to all entities that may materially affect its performance, and that the standards concerned are consistent.