



Chairman

VIA EMAIL: commentletters@iasb.org

Sir David Tweedie
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30 Cannon Street
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United Kingdom

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Exposure draft – *ED 10 Consolidated Financial Statements*

Dear Sir David

The Basel Committee on Banking Supervision (the Committee) welcomes the opportunity to comment on the International Accounting Standards Board's (IASB's) exposure draft, *ED 10 Consolidated Financial Statements* (ED). The Committee has a strong interest in high quality financial reporting by banks and has carefully analysed the exposure draft noted above.

The Committee respects the IASB's effort to respond expeditiously to the requests of international organisations such as the G20 and the Financial Stability Forum to address weaknesses in accounting and disclosure standards for off-balance-sheet vehicles. The Committee generally supports the notion of a principles-based standard for consolidation that would clearly delineate the controlling entity for all types of entities, including structured entities. However, the Committee has concerns about the lack of clarity around the definition of control, particularly as it relates to structured entities. Several of those concerns align with the issues raised by Messrs Garnett, Leisenring, and Smith in their alternative views as described in your *Basis for Conclusions on Exposure Draft* paper.

The Committee found responding to the ED challenging and necessarily incomplete given that the proposal does not address the closely linked notion of derecognition for assets transferred into structured entities, which is being addressed by the IASB in a separate project and is currently based on the transfer of substantially all risks and rewards. Without clarity on the interaction between derecognition and consolidation, the Committee fears that the IASB will fail to obtain adequate feedback through the public comment process and, thus, may not produce an optimal consolidation standard. Therefore, the Committee encourages the IASB to adjust the comment period for this ED to overlap with the comment period for the upcoming proposal for derecognition.

Of significant concern to the Committee is the possibility that fewer entities will be consolidated under the ED's approach than under current guidance because of the lack of clarity around determining control for structured entities in the proposed control assessment approach. Such a result would be inconsistent with the general findings of the Financial Stability Forum and others indicating that off-balance sheet treatment for certain types of structured finance activities was inappropriate and was a contributing factor to the current financial crisis. The

Committee recommends that the IASB give prominence to the role of risks and rewards in identifying control, particularly with respect to structured entities, to assist in identifying control when power is difficult to assess due to complex structuring or shared power arrangements. The Committee further recommends that the IASB ensure that the useful risks and rewards provisions from the IASB's existing guidance including International Accounting Standard 27: *Consolidated and Separate Financial Statements* (IAS 27) and the Standing Interpretations Committee's Interpretation 12: *Consolidation - Special Purpose Entities* (SIC 12) should be mapped to the proposed standard to ensure that such provisions that would indicate "in substance" control have not been omitted inadvertently. In addition, the Committee recommends that the IASB accelerate efforts to achieve a converged approach with the FASB to produce a comprehensive and consistent standard for structured finance on a worldwide basis since both standard setters are addressing similar issues concurrently.

Due to concerns about the practical applicability of the definition of control, we are unable to conclude that the proposed standard would provide a significant improvement in practice over the IASB's current standards. We encourage the IASB to revisit its own cost-benefit analysis and determine whether the proposed standard provides sufficient guidance around the definition of control, particularly for structured entities, to achieve sufficient consistency in practice and realise the benefits envisioned at the outset of the project.

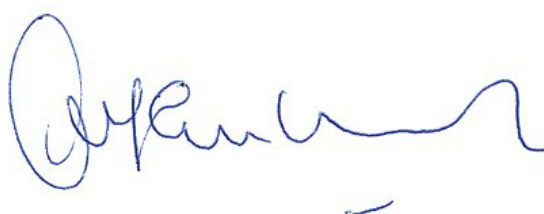
In addition, to minimize the risk of unintended consequences, we recommend that the IASB conduct a field test of the new standard prior to final issuance to determine whether the provisions are likely to be implemented as intended. Based on the results of the field test, additional guidance may be needed for further clarification of the definition of control.

In addition to the concerns above, the Appendix elaborates on the Committee's primary concerns by responding to selected questions posed within the ED.

These comments have been prepared by the Committee's Accounting Task Force, chaired by Sylvie Mathérat, Director of the Banque de France, and have been approved by the Committee. The Committee trusts that you will find its comments useful and constructive.

If you have any questions regarding our comments, please feel free to contact Sylvie Mathérat (+33 1 4292 6579); Arthur Lindo, Chief Accountant, Board of Governors of the Federal Reserve System and Co-Chair of the ATF's Conceptual Framework Issues Subgroup (+1 202 452 2695); Jerry Edwards, Senior Advisor to the ATF and Co-Chair of the ATF's Conceptual Framework Issues Subgroup (+41 61 280 8055); or Xavier-Yves Zanota at the Basel Committee Secretariat (+41 61 280 8613).

Yours sincerely



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Appendix:

Answers to selected questions

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?

We support the notion of a principles-based standard that would apply to all types of entities and we tend to agree that the notion of control can be applied to both structured entities and other entities. However, as expanded upon below, we assert that the notion of risks and rewards and its impact on control is especially important for structured 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. Our concern appears to be shared by the Board Members who expressed the following alternative view in the ED: "The focus on power inherent in this proposal rather than the variance in returns will result in more structuring opportunities than are permitted at present and presumptively fewer entities will be consolidated because power is more easily disguised." Based on our understanding, the IASB intended for risks and rewards to inform the assessment of control through their impact on power and returns. However, especially with respect to structured entities, we found references to risks and rewards concepts to be lacking. The control principle would appear to be a much more appropriate basis for consolidation if it articulated the manner in which risks and rewards could influence the assessment of control. Additionally, the control principle would be more operational if the definition of control were improved to better address the link between power and 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?

In light of the concerns expressed in response to Question 2, we recommend directly incorporating notions of risks and rewards, specifically residual risk as that notion was contained in SIC 12, into the control principle. We also support retaining the notion of the "in substance" circumstances that may indicate a relationship in which an entity controls a structured entity and consequently should consolidate that structured entity as provided in paragraph 10 of SIC 12. We find that such additional guidance would be helpful to assist in making very challenging assessments of structured entities for which power and returns can appear to change hands under certain circumstances or in certain economic environments.

In addition, we are concerned about the practical application of the notion of an agent in the ED. It is unclear at what point a bank's investment in a vehicle like a mutual fund would constitute control in combination with the bank's role as manager of the investment vehicle.

On one hand, it appears that the bank has a combination of power and returns. On the other hand, the bank appears to be an agent asset manager who happens to invest, perhaps temporarily and passively, in the vehicle it manages.

Moreover we consider it necessary to establish clearly under what conditions the actual exercise of control (*de facto* control) prevails on the mere ability to exercise the control (legal control). In the proposed standard there are contradictory provisions. In paragraph 25 it seems possible to demonstrate that the shareholder with the majority of voting rights does not control the entity, “*if another entity has the power to direct the activities of the entity*”. On the other hand in par. 8 it is said that “*a reporting entity need not have exercised its power to direct the activities of an entity to control that entity*”. In order to promote a consistent and meaningful application of general principles, it would be useful to establish a clear hierarchy of cases.

Finally, we suggest that the IASB complement the general principles – which should constitute the logical structure of the proposed standard – with clear guidance that can help preparers (e.g. through the provision of some relative presumptions like in IAS 27 and SIC 12 or through some examples) in applying those principles in challenging situations and could promote a consistent behaviour among entities and, for the same entity, in the time.

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.

Because assessing the relevance of potential voting rights in determining the existence of control is very difficult and could give preparers some room for arbitrage, it would be more effective to lay down in the standard some indications on how to consider those potential voting rights. From this perspective we consider it useful to maintain the well known clause “currently exercisable or convertible”; in the same direction, it would be useful to mention explicitly the ability and the intention of an entity to use those potential 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?

We recommend stressing that only two types of subsidiaries are possible, structured entities and other subsidiaries, to clarify that there is not another type of subsidiary that could be evaluated for consolidation in a different manner.

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?

As noted in the responses above, we recommend directly incorporating the notion of risks and rewards as a qualitative factor relevant to determining control. We agree with the alternative view quoted previously indicating that power can be difficult to determine for structured entities.

Additional application guidance would be useful in supplementing paragraphs 34-36 (activities relating to structured entities) of the draft IFRS. The identification of the key activities that cause the returns to vary and whether a reporting entity has the power to direct

those activities are both important elements in assessing control under the structured entity model. Therefore, we believe that further defining the criteria in determining what are “key” activities would contribute towards the objective of consistent application of the control definition. In addition, while the assessment of control requires judgement and an assessment of all relevant factors, it may be useful to provide a presumption that control rests with a party that bears the most significant risks and rewards attributable to a structured entity.

Question 8: Should the IFRS on consolidated financial statements include a risks and rewards ‘fall back test’? If so what level of variability should be the basis for the test and why?

We do not see the need for a risks and rewards ‘fall back test’ if risks and rewards is directly incorporated into the notion of control as discussed above. In fact, we suggest that a quantitative test could do more harm than good as it would provide an easy target for structuring to achieve a particular accounting outcome.

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 noted that aggregation is addressed throughout the disclosure requirements with specific reference to individual disclosures. We would recommend addressing aggregation from a principles perspective at the beginning of the disclosure requirements. This will permit a reasonable balance providing transparency without resulting in disclosure overload.

We further recommend that the disclosure requirements with respect to reputation risk should be given more prominence in the document by incorporating them into paragraph 48 or by providing a specific subtitle preceding paragraph B47.

Finally, within paragraph B38, we recommend requiring disclosure of high-return entities that are not consolidated to inform the financial statement reader as to how the reporting entity could secure such a high return without having power over the unconsolidated entity. This would be similar in nature to the disclosure required in paragraph B32(c).

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.

We do not view reputational risk by itself being a basis for consolidation. However, as mentioned earlier, we would recommend that reputational risk should be incorporated along with other elements of risks and rewards in the determination of whether one entity controls another. In order to promote a consistent and meaningful application of the risks and rewards approach, it could be useful to introduce in the standard a general presumption that the sponsor (or the primary beneficiary, etc.), being economically responsible for the economic results and performance of the sponsored structured entity, should control this entity, unless it demonstrates and declares in the notes of financial statement that it is not the case (ie it shall not support the structured entity – through credit enhancement, liquidity facility etc. - beyond what is legally due under existing contractual arrangements).

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

As noted in the response to question 9, we recommend that the disclosures required in paragraph B47 should be given more prominence.

Question 12: Do you think 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 relating to IAS 28?

We have not encountered significant practice problems related to the definition of significant influence and the use of the equity method. While we understand the theoretical motivation to conform those items to the new approach for consolidation, we would not place a high priority on such a project at the current time. Perhaps this should be considered as a longer-term convergence project with the FASB.