Project **Consolidation**

Topic **Disclosures – Unconsolidated structured entities**

Introduction

1. ED 10 *Consolidated Financial Statements* contains disclosure requirements for both subsidiaries and unconsolidated structured entities. Respondents generally agreed that additional disclosures about subsidiaries would assist users in their understanding of consolidated financial statements. However, many respondents questioned the Board's basis to require disclosures about the nature of, and risks associated with, the reporting entity's involvement with structured entities that the reporting entity does not control.

2. The purpose of this paper is to analyse whether a reporting entity should disclose information about its risk exposure from involvement with unconsolidated entities and, if so, whether the disclosures should be required for structured entities only. We will discuss amendments to specific disclosure requirements for unconsolidated entities at the Board meeting in March 2010.

Respondents' comments

3. Virtually all respondents to ED 10 thought that the recent financial crisis highlighted the need for improved disclosures about a reporting entity's risk from off-balance sheet transactions. However, respondents expressed different views on how those risks should be disclosed. Some respondents agreed with the approach proposed in ED 10 and argued that a reporting entity should disclose the risks from its involvement with unconsolidated structured entities.

Other respondents disagreed with the proposals in ED 10 for the following reasons.

Disclosures cannot replace consolidation

4. Many suspected that the Board had included the proposed disclosures as a "safety-net" because it was concerned that some structured entities might fail the consolidation criteria in ED 10, even though consolidation would be appropriate. Those respondents urged the Board to develop robust consolidation principles rather than to try to compensate for the lack of consolidation through disclosures. They referred to paragraph 82 of the conceptual framework, which states that items that satisfy the recognition criteria should be recognised in the balance sheet or income statement. The failure to recognise such items is not rectified by disclosure of the accounting policies used nor by notes or explanatory material.

Duplication of existing disclosures

5. Many respondents questioned why there was a need to disclose information about the nature of, and risks associated with, a reporting entity's involvement with structured entities that the reporting entity does not control, in addition to the disclosure requirements in IFRS 7 *Financial Instruments: Disclosures*. IFRS 7 requires an entity to disclose qualitative and quantitative information about risks from financial instruments. Those respondents argued that the proposals in ED 10 require disclosures about the counterparties of financial instruments to which the disclosure requirements in IFRS 7 already apply. Therefore, they believed that the proposals in ED 10 duplicate the risk disclosures in IFRS 7.

6. Other respondents assumed that a reporting entity's involvement with unconsolidated structured entities would normally meet the definition of significant influence. As a consequence, the disclosure requirements in IAS 28 *Investments in Associates* would apply. Those respondents believed that some

of the proposals in ED 10 would duplicate the disclosure requirements for associates.

7. Respondents suggested two approaches as to how the Board could avoid duplicating disclosures:

   (a) Some respondents recommended that the Board should not finalise the disclosure proposals in ED 10, but, rather, focus on improving the disclosure requirements in IFRS 7.

   (b) Other respondents asked the Board to exempt a reporting entity from the disclosure requirements in ED 10, when other IFRSs require the reporting entity to disclose the same information.

Location of the requirements

8. Some respondents questioned whether disclosure requirements for unconsolidated structured entities should be incorporated into a standard that deals with consolidated financial statements. Those respondents were concerned that if a reporting entity should not prepare consolidated financial statements, it might not be aware or question the applicability of disclosure requirements for unconsolidated structured entities that are located in a standard that deals with consolidated financial statements. Therefore, they suggested that disclosures about unconsolidated entities should be included in one or more of the following standards: IFRS 7, IAS 1 *Presentation of Financial Statements*, IAS 24 *Related Party Disclosures* or IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*.

9. *Staff comment: We believe that this issue would be addressed by the staff recommendation in agenda paper 6A to issue a combined disclosure standard for a reporting entity's involvement with other entities that is outside the scope of IAS 39/IFRS 9.*

Separate Financial Statements

10. One respondent asked the Board to clarify whether the disclosure requirements for unconsolidated structured entities would also apply to separate financial statements.

Staff Analysis

11. The staff agrees with those respondents who emphasise that disclosures about unconsolidated structured entities cannot replace robust consolidation requirements. The disclosures in ED 10 were never intended to compensate for weaknesses in the control definition. In our view, the current deliberation of the control definition and its application to particular facts and circumstances highlights the Board's and the staff's determination to develop appropriate and robust consolidation criteria. In contrast, the disclosure requirements focus on a reporting entity's risk exposure from its involvement with structured entities that it rightfully does not consolidate because it does not control them.

12. The following paragraphs discuss:

    (a) whether the Board should require a reporting entity to disclose, in addition to the disclosures in IFRS 7, information about the counterparties of its risk exposures;

    (b) whether the disclosures should be integrated into IFRS 7 or a combined disclosure standard for a reporting entity's involvement with other entities; and

    (c) whether the disclosures should also apply to separate financial statements.

Should a reporting entity disclose information about the counterparties of its risk exposures?

13. IFRS 7.31 requires a reporting entity to disclose information that enables users of its financial statements to evaluate the nature and extent of risks arising from financial instruments to which the entity is exposed at the end of the reporting

period. Paragraph 48(d) of ED 10 proposes that a reporting entity discloses information that enables users of its financial statements to evaluate the nature of, and risks associated with, the reporting entity's involvement with structured entities that the reporting entity does not control.

14. We agree with respondents that both requirements will often result in disclosure of the same underlying risks. What is different is how the disclosure requirements describe a reporting entity's risk exposure. IFRS 7 requires qualitative and quantitative disclosures about the credit, liquidity, market and other risks associated with financial instruments. ED 10 adopts a different perspective and requires the reporting entity to disclose its total risk exposure from its involvement with a structured entity.

15. We believe that information under both perspectives assists users of financial statements in their analysis of a reporting entity's risk exposure; the disclosures in IFRS 7 by identifying those financial instruments that create risk; and the disclosures in ED 10 by providing:

    (a) information about the extent of a reporting entity's transactions with particular counterparties;

    (b) information about the financial position of those counterparties; and

    (c) a description of all relevant terms of a particular transaction.

    In our view, the disclosures proposed in ED 10, assist users of financial statements to identify concentrations of risk exposures and support their estimate of the likelihood that a particular default event might occur. Therefore, we believe that the disclosures in IFRS 7 and ED 10 are not redundant, but complement each other.

16. SFAS No. 167 *Amendments to FASB Interpretation No. 46(R)* requires, among others, disclosures about risks from an enterprise's involvement with unconsolidated variable interest entities. In December 2008, the FASB has issued a staff position which requires that those disclosures are already applied for the first reporting period ending after December 15, 2008. Therefore, many

U.S. preparers already apply disclosure requirements similar to those proposed in ED 10.

17. We have contacted a number of users of financial statements in the U.S. and asked them whether they considered the new disclosures to be helpful. Users generally acknowledged that there was only limited time to gain experience with the new disclosures and that therefore their view of particular disclosure requirements might change in the future. However, all users confirmed that the new disclosures provided them with information that was not previously available to them, but which they considered to be important for a thorough understanding of a reporting entity's risk exposure.

18. Many users referred also to the recent financial crisis and emphasised that a better understanding of a reporting entity's involvement with unconsolidated structured entities might have helped to identify earlier the extent of risks taken by reporting entities. Therefore, all users agreed that the new disclosures had significantly improved the quality of financial reporting and strongly encouraged the IASB to require similar disclosures for IFRS preparers.

19. In light of the positive feedback from users of financial statements, we recommend that the Board affirm that a reporting entity should disclose information that enables users of its financial statements to evaluate the nature of, and risks associated with, the reporting entity's involvement with structured entities that the reporting entity does not control.

20. We believe that there is only limited direct overlap between the proposed disclosures in ED 10 and the disclosure requirements in other standards, such as IFRS 7. Nonetheless, we agree with respondents that a reporting entity should not be required to disclose the same information twice. Therefore, we recommend that the Board clarify that, if the proposed disclosures should require a reporting entity to disclose information that is also required by other IFRSs, the reporting entity could cross-reference to that information, rather than to present the same information twice. We note that SFAS No. 167 and the related FASB Staff Position contain a similar requirement. In our view, this has

not negatively affected the clarity of the disclosures provided in accordance with U.S. GAAP.

Where should the disclosures be located?

21. Should the Board follow the staff recommendation and affirm that a reporting entity must disclose information about its risk exposure from its involvement with structured entities, a question arises where those disclosure requirements should be located: in a combined disclosure standard for involvement with other entities or in IFRS 7.

22. Many respondents to ED 10 suggested that the disclosures should be integrated in IFRS 7. IFRS 7 contains disclosures requirements for risks from financial instruments. Therefore, if the Board would integrate the disclosures proposed in ED 10 into IFRS 7, all risk disclosures would be located in one place. We also note that the *Derecognition* exposure draft proposes disclosures for the derecognition of financial assets and liabilities that follow similar principles to the proposals in ED 10. Therefore, some of the proposed disclosures in ED 10 could be combined with the proposals in that ED.

23. However, we are concerned about scoping issues that would arise under such an approach. IFRS 7 deals with risks from financial instruments only. Many of the risks addressed in ED 10 will stem from financial instruments, but other risks would be related to non-financial assets and liabilities. For example, IAS 39.2(h) excludes particular loan commitments from the scope of IAS 39 *Financial Instruments: Recognition and Measurement* and states that those commitments should be accounted for in accordance with IAS 37. In order to provide risk disclosures for risks from non-financial assets and liabilities:

    (a) The Board could amend the scope of the risk disclosures in IFRS 7 to apply to all assets and liabilities. We believe that such an approach would require a broader review of how the risk disclosures in IFRS 7 would apply to non-financial assets and liabilities. As part of this process we would need to investigate whether particular assets and liabilities, for example pension liabilities, warrant further changes to the risk disclosures in IFRS 7 and ED 10. We are concerned that such a project would be impossible to complete on a timely basis.

(b) Alternatively, the Board could amend IAS 37 and other IFRSs to require risk disclosures similar to those that would be incorporated into IFRS 7. We do not recommend such an approach because it would duplicate the same disclosure requirements in different standards.

24. A further scoping issue arises from the fact that IFRS 7 requires risk disclosures for all financial instruments. In contrast, we do not believe that the Board should require a reporting entity to provide the disclosures in ED 10 for risk exposures from any type of financial instrument. ED 10 requires risk disclosures only when the reporting entity has an involvement with an unconsolidated structured entity. In our view, this condition would apply to some, but not all financial instruments that are within the scope of IFRS 7 (At the March meeting we will discuss further the meaning of "involvement with a structured entity").

25. Therefore, the risk disclosures for a reporting entity's involvement with unconsolidated structured entities require a different scope from that of the other risk disclosures in IFRS 7. We are concerned that the different scope of the disclosures would effectively lead to a "standard within the standard" rather than to create a comprehensive risk disclosure standard.

26. In our view, a better approach would be to integrate the proposed disclosures about a reporting entity's risks from its involvement with unconsolidated structured entities into a combined disclosure standard for involvement with other entities. Such a combined disclosure standard would contain, in addition to the disclosures for unconsolidated structured entities, disclosure requirements for subsidiaries, joint arrangements and associates. We believe that the arguments in agenda paper 6A can be extended to the disclosures for unconsolidated structured entities. In particular, we believe that integrating the risk disclosures into the combined disclosure standard would improve the clarity of the disclosure requirements for a reporting entity's involvement with other

entities that is not in the scope of IAS 39/IFRS 9 and reinforce the consistent application of those requirements.

Should the Board require similar disclosures for separate financial statements?

27. We agree with the respondent who argued that there would be merit in considering what risk disclosures should be required in a reporting entity's separate financial statements. However, we note that accounting and disclosure issues related to separate financial statements are currently outside of the project scope. We are concerned that consideration of those issues could delay the publication of a final consolidation standard.

28. Therefore, we recommend that the Board postpone a discussion of whether the risk disclosures for a reporting entity's involvement with unconsolidated structured entities should also apply to separate financial statements until the Board addresses the accounting and disclosure issues related to separate financial statements in a separate project.

Questions for the Board
(1) Does the Board agree with the staff recommendation that a reporting entity should disclose information that enables users of its financial statements to evaluate the nature of, and risks associated with, structured entities that the reporting entity does not control? If not, why? (2) Does the Board agree with the staff recommendation that the disclosures should be integrated into the proposed combined disclosure standard for a reporting entity's involvement with other entities (see agenda paper 6A)? If not, should the disclosures be integrated into IFRS 7? (3) Does the Board wish to address disclosures for separate financial statements as part of this project?