

Attachment to
Deloitte Touch Tohmatsu's comments to the
Financial Crisis Advisory Group's Invitation to Comment dated 10 March 2009

Appendices B-D

Appendix B

Submission to the IASB on the Discussion Paper *Reducing Complexity in Reporting Financial Instruments* dated 19 September 2008



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19 September 2008

Sir David Tweedie, Chairman
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH

Dear Sir David,

Discussion Paper – Reducing Complexity in Reporting Financial Instruments

Deloitte Touche Tohmatsu is pleased to respond to the IASB’s Discussion Paper on Reducing Complexity in Reporting Financial Instruments (“the DP”).

We welcome the IASB’s efforts to improve financial reporting for financial instruments. We believe that current guidance under IFRS is complex and requires significant improvements to reduce the inherent complexity.

However, to meet the goal of improving reporting for financial instruments by reducing complexity it is important that complexity is properly defined and that any change made to existing Standards should not result in a mere shift of complexity from one constituent to another.

In addition, the DP fails to address important areas, notably scope and derecognition, of financial instruments accounting that also fall outside the IASB’s other concurrent projects or, where they are within existing projects, these would be completed only with a significant time lag to the financial instruments project. We believe that guidance on these issues influences the assessments made on the proposals of the DP.

Furthermore, we do not agree with the implicit assumption of the DP that full fair value accounting would be the ultimate improvement to financial instruments accounting. We believe such a conclusion would be premature at this point. We believe that at the moment, amending existing Standards, possibly over a longer period, would be a feasible way to improve financial instruments accounting significantly for all constituents without undue costs or efforts. Below we set out an approach that, whilst still incorporating a mixed measurement attribute model, we believe would represent a significant improvement over the current guidance in IFRS. Our approach also includes a proposal for improving hedge accounting that we consider superior to the existing model in IAS 39 *Financial Instruments: Recognition and Measurement*.

Our detailed responses to the invitation to comment questions are included in the Appendix to this letter.

If you have any questions concerning our comments, please contact Ken Wild in London at +44 (0) 207 007 0907, Andrew Spooner in London at +44 (0) 207 007 0204, or Robert Uhl in Wilton, the United States, at +1 (203) 761-3152.

Sincerely,

A handwritten signature in black ink, appearing to read "Ken Wild", written over a single horizontal line.

Ken Wild
Global IFRS Leader

Appendix:

Section 1 Problems related to measurement

Question 1

Do current requirements for reporting financial instruments, derivative instruments and similar items require significant change to meet the concerns of preparers and their auditors and the needs of users of financial statements? If not, how should the IASB respond to assertions that the current requirements are too complex?

We agree that the current requirements for reporting financial instruments are too complex for all constituents and warrant significant improvement. We support an approach that looks broadly at financial instrument accounting and therefore welcome the DP. However, we believe that the Board should analyse the issue of complexity and weigh competing projects before proceeding with any related project.

We believe that complexity cannot be eliminated and what may appear to be a reduction in complexity on closer analysis may merely transfer complexity from one constituent to another. For example, removing a mixed measurement model through comprehensive use of fair value may reduce complexity for users as it reduces the number of options for classification and thereby improves comparability, but will increase the complexity for preparers and their auditors, particularly when valuing financial instruments that are not actively traded due to the associated subjectivity. Similarly, removing cash flow hedge accounting may appear to reduce complexity for preparers as all derivatives will be fair valued through profit or loss and entities will avoid the burden of designating and monitoring hedge effectiveness, however it would increase complexity as financial results will be less understood as gains/losses on derivatives will be recognised in a different period to the forecasted transaction that is being hedged. In addition, reducing complexity in one area of the financial statements, e.g. decreasing the number of measurement attributes, will increase complexity in another, e.g. fair value measurement and disclosures for instruments that are derived using valuation models. Therefore, in deliberating which approach to pursue the Board must ensure their analysis of complexity is broad.

We note there are competing demands which require the IASB to prioritise its projects. Pursuit of the Memorandum of Understanding with the FASB, response to the credit crisis, and other long-term projects where standards are still required in areas where there is no existing literature, e.g. accounting for insurance contracts, mean that allocation of the Board and staff resources is key. Financial instruments accounting is just one major subject area among many others. Within this subject area the Board has to further address the balance of resources assigned to this project and other pressing issues that are causing genuine application problems today. We acknowledge that the DP excludes derecognition, but this subject is of significant diversity and complexity which has not been alleviated by the IFRIC's and the Board's inability to provide clarification on a series of derecognition issues that were raised with the IFRIC and the Board in 2006. We acknowledge that there is a separate derecognition project but this will not be finalised for some years to come. Similarly, scope is a significant practical issue which is also not part of this project. Determining whether contracts over non-financial items are 'own-use' and therefore are outside the scope of the standards is particularly complex and is of a critical importance to resource intensive industries. We would not want to see scarce resources dedicated to a project on classification and hedge accounting at the expense of these other important issues that ultimately will not be resolved by this project.

The IASB must complete or run concurrently the project on financial statement presentation before implementing a new financial instruments recognition and measurement standard. It would be unreasonable to force an increased use of fair value for financial instruments (and/or removal of the available for sale category) without constituents understanding how performance will be reported under the new presentation model. Equally, the fair value measurement project must also be resolved so constituents know what definition of fair value will be applied. We consider this of particular importance to liabilities where there is concern as to whether it is more appropriate to assume a transfer notion or a settlement notion when determining an exit price fair value.

Section 2 Intermediate approaches to measurement and related problems

Question 2

(a) Should the IASB consider intermediate approaches to address complexity arising from measurement and hedge accounting? Why or why not? If you believe that the IASB should not make any intermediate changes, please answer questions 5 and 6, and the questions set out in Section 3.

Given a choice of full fair value accounting or an “intermediate approach” for financial instruments we favour the latter. We appreciate the term “intermediate approach” is consistent with the IASB’s ultimate ambition for full fair value accounting for financial instruments, but, as noted in our response to Question 8 we do not believe that support of this long-term goal is a precondition to supporting what the IASB refers to as an intermediate approach. Successful application of an intermediate approach, in conjunction with successful application of standards on fair value measurement and financial statement presentation, may best meet the needs of users where a full fair value accounting approach may not. Therefore, our recommendation is to pursue an intermediate approach (our preferred approach is detailed in our response to Question 7) that includes completed standards on fair value measurement and financial statement presentation. After there has been a sustained period of application of these standards that allows the IASB to look back on the standards’ successes and failures, the IASB should then review the long-term ambition of full fair value accounting. Only then do we believe the IASB can fairly judge whether full fair value accounting for financial instruments would provide an improvement to financial reporting and whether that approach is feasible.

(b) Do you agree with the criteria set out in paragraph 2.2? If not, what criteria would you use and why?

We agree with the criteria set out in the DP with the one reservation: paragraph 2.2(b) requires that any future intermediate proposal must not result in an item currently at fair value to be recognised other than fair value. We do not support this criterion as this presumes that fair value for all financial instruments is the only long-term objective and we question this assumption. As described in our response to Question 7, our preferred approach may result in some held long-term debt instruments being classified at amortised cost that currently are classified as available for sale assets.

Question 3

Approach 1 is to amend the existing measurement requirements. How would you suggest existing measurement requirements should be amended? How are your suggestions consistent with the criteria for any proposed intermediate changes as set out in paragraph 2.2?

We are supportive of certain aspects of Approach 1. Our preferred approach is detailed in our response to Question 7.

Question 4

Approach 2 is to replace the existing measurement requirements with a fair value measurement principle with some optional exceptions.

- (a) What restrictions would you suggest on the instruments eligible to be measured at something other than fair value? How are your suggestions consistent with the criteria set out in paragraph 2.2?***
- (b) How should instruments that are not measured at fair value be measured?***
- (c) When should impairment losses be recognised and how should the amount of impairment losses be measured?***
- (d) Where should unrealised gains and losses be recognised on instruments measured at fair value? Why? How are your suggestions consistent with the criteria set out in paragraph 2.2?***
- (e) Should reclassifications be permitted? What types of reclassifications should be permitted and how should they be accounted for? How are your suggestions consistent with the criteria set out in paragraph 2.2?***

We are not supportive of a full fair value approach. Our preferred approach is detailed in our response to Question 7.

Question 5

Approach 3 sets out possible simplifications of hedge accounting.

- (a) Should hedge accounting be eliminated? Why or why not?***
- (b) Should fair value hedge accounting be replaced? Approach 3 sets out three possible approaches to replacing fair value hedge accounting.***
 - (i) Which method(s) should the IASB consider, and why?***
 - (ii) Are there any other methods not discussed that should be considered by the IASB? If so, what are they and how are they consistent with the criteria set out in paragraph 2.2? If you suggest changing measurement requirements under approach 1 or approach 2, please ensure your comments are consistent with your suggested approach to changing measurement requirements.***

We are supportive of certain aspects of Approach 3. Our preferred approach is detailed in our response to Question 7.

Question 6

Section 2 also discusses how the existing hedge accounting models might be simplified. At present, there are several restrictions in the existing hedge accounting models to maintain discipline over when a hedging relationship can qualify for hedge accounting and how the application of the hedge accounting models affects earnings. This section also explains why those restrictions are required.

- (a) What suggestions would you make to the IASB regarding how the existing hedge accounting models could be simplified?**
- (b) Would your suggestions include restrictions that exist today? If not, why are those restrictions unnecessary?**
- (c) Existing hedge accounting requirements could be simplified if partial hedges were not permitted. Should partial hedges be permitted and, if so, why? Please also explain why you believe the benefits of allowing partial hedges justify the complexity.**
- (d) What other comments or suggestions do you have with regard to how hedge accounting might be simplified while maintaining discipline over when a hedging relationship can qualify for hedge accounting and how the application of the hedge accounting models affects earnings?**

Our proposals for simplifying hedge accounting form part of our overall preferred approach as detailed in our response to Question 7.

Question 7

Do you have any other intermediate approaches for the IASB to consider other than those set out in Section 2? If so, what are they and why should the IASB consider them?

Our preferred approach is set out below:

Initial recognition

All financial instruments are initially recognised at fair value. We appreciate that the definition of fair value remains outstanding as it is subject to resolution as part of the IASB's fair value measurement project which, as already stated, we consider must be resolved at the latest before the next stage of this project is effective. A key area to be resolved in the fair value measurement project is whether initial recognition is an entry or exit price and the potential for recognising upfront gains/losses ('day 1 profit or loss'). Our views on these aspects are detailed in our response to the IASB DP on Fair Value Measurement dated 4th May 2007 and therefore are not repeated in this letter.

Classification and subsequent measurement

Only two primary measurement bases for recognised financial assets and financial liabilities are retained: fair value through profit or loss¹ and amortised cost.

Fair value through profit or loss is required for all financial instruments that are *held at fair value*. Held at fair value includes:

¹ As discussed later in more detail 'cost' may be appropriate for unquoted equity investments and therefore can be considered a secondary measurement basis to be potentially applied in certain limited circumstances.

- all derivatives (all changes recognised in profit or loss, except if designated in a cash flow or net investment hedge accounting relationship where the effective portion of the gains or losses must initially be recognised in equity as part of other comprehensive income);
- all equity instruments (subject to a potential cost based exemption for unquoted equity instruments discussed later in this latter); and
- all debt instruments that are not *held at amortised cost*.

Amortised cost is *required* for debt instrument financial *assets* where:

- the cash flows are determinable and variations are due solely to interest rate risk (including non-leveraged inflation) and the issuer's own credit risk²,
- the activities of the reporting entity with respect to those instruments is to realise its return through receipt of contractual cash flows, i.e. a return is generated through continuing investment and not return through sale; and
- the debt instrument is not managed on a fair value basis.

Amortised cost is *required* for debt instrument financial *liabilities* that are not held at fair value, where cash flows are derived solely by interest rate risk (include non-leveraged inflation) and the issuer's own credit risk and are not managed on a fair value basis.

If an instrument meets the criterion for amortised cost the entity can choose to apply a fair value option at initial recognition if there is an accounting mismatch that would result from measuring at amortised cost that can be overcome by applying a fair value option (assume a similar criterion to IAS 39.9).

For debt instruments held at amortised cost an effective interest rate based on expected cash flows will apply (as in the current Standard). Guidance will be required, similar to that contained in IAS 39.AG6/7, to determine over what period cash flows should be discounted in the case where cash flows are derived from a floating interest rate and there is a reset to market rates at specified dates. Similar guidance contained in IAS 39.AG8 would be required for fixed rate debt instruments that are subject to changes in the timing of cash flows due to the existence of prepayment options. Where the effect of discounting is immaterial discounting would not be required as currently permitted by IAS 39. The impairment guidance for debt instruments held for investment (held at amortised cost) would continue to be based on an incurred loss model. We propose that where loan commitments are not in the scope of IAS 39, the impairment should be determined in accordance with IAS 39, not IAS 37 as currently required, so that the determination and measurement of impairment for a loan commitment is consistent with the loan that will be originated from it.

Contracts that may result in the entity buying back own equity by delivering cash or other financial assets for the gross physical receipt of its own equity are currently recognised as a financial liability for the present value of the amount the entity could be required to pay with a corresponding debit in equity. Consistent with our proposal to have only two measurement attributes for financial instruments, amortised cost and fair value, we do not believe it is appropriate to continue with the current treatment in IAS 32 where forward purchase contracts and written puts are effectively split into two, the amount payable, and the shares that may be received under the contract. Assuming there are no other amendments to IAS 32 (i.e. the financial liabilities and equity project is not completed before the completion of an intermediate approach), if the arrangement is a derivative that will be settled by delivering a fixed amount of cash or other financial asset for a fixed number of shares ('fixed-for-fixed'),

² If an instrument is asset-backed with a debt instrument then amortised cost is appropriate only if the debt instrument to which the asset-backed instrument was linked would have been required to be measured at amortised cost had the instrument been held directly by the entity.

the instrument should wholly be classified as an equity instrument, or if not, should be wholly fair valued through profit or loss.³

A comparison of the impact of our proposed approach described above compared to the existing requirements for subsequent measurement is summarised below:

Instrument	Existing treatment	Proposed treatment
Derivatives not in a qualifying hedge accounting relationship and derivatives in a qualifying fair value hedge accounting relationship	FVTPL	FVTPL
Derivatives in a qualifying cash flow or net investment hedging relationship (effective portion)	FV through OCI	FV through OCI
Held for trading (derivatives and non-derivatives) instruments	FVTPL	FVTPL
Non-traded equity investments (quoted in an active market)	FV through OCI (AFS)	FVTPL
Non-traded equity instruments (not quoted in an active market)	FV through OCI (AFS)/Cost	FVTPL/Cost ⁴
Short-term/Long-term receivables/payables (not traded, not subject to the fair value option)	Amortised cost	Amortised cost
Non-derivative assets and liabilities managed on a fair value basis but not traded (without use of the existing IAS 39 fair value option)	FV through OCI (AFS)/Amortised cost (L&R, HTM, Other financial liabilities)	FVTPL
Non-derivative assets and liabilities managed on a fair value basis but not traded (use of the existing IAS 39 fair value option)	FVTPL	FVTPL
Debt instruments held quoted in an active market (not traded and not subject to the fair value option)	FV through OCI (AFS), HTM	Amortised cost
Debt instruments issued (not structured – i.e. not linked to say commodity or equity prices, not traded and not subject to the fair value option)	Amortised cost	Amortised cost
Structured notes, issued or acquired, linked to say commodity prices or equity prices (not traded and not subject to the existing IAS 39 fair value option)	Embedded derivative + debt host contract at amortised cost	FVTPL
Acquired convertible debt (not traded and not subject to the fair	Embedded derivative + debt host contract at amortised	FVTPL

³ We note that in our response to the IASB's Discussion Paper *Financial Instruments with Characteristics of Equity*, we proposed to measure all equity derivatives at fair value through profit or loss (see our letter dated 4th September 2008). However, our proposal is based on the fact that the principles in IAS 32 Financial Instruments: Presentation remain as they are at the moment.

⁴ We believe further assessment is needed to determine whether fair value can be universally applied to unquoted equity instruments and whether the benefits accruing to users will be offset by the lack of reliability and cost to preparers and auditors.

Instrument	Existing treatment	Proposed treatment
value option)	cost	
Held to maturity debt instruments	HTM in entirety or HTM for the debt host contract (plus FVTPL for the embedded derivative)	Will depend. Amortised cost if cash flows are derived from interest rate risk and credit risk and not managed on a fair value basis, otherwise FVTPL
Issued convertible debt that is convertible into own equity instruments (assuming IAS 32 remains unchanged and debt host is not traded or subject to the fair value option)	Debt host at amortised cost plus equity instrument	Debt host at amortised cost plus equity instrument
Derivative that may result in the receipt of a fixed number of equity instruments for the payment of a fixed amount of cash or another financial asset (assuming IAS 32 is retained)	Gross obligation recognised at present value of strike price under option or forward price under forward	Equity
Derivative that will not result in the receipt of a fixed number of equity instruments for the payment of a fixed amount of cash or another financial asset (assuming IAS 32 is retained)	Gross obligation recognised at present value of strike price under option or forward price under forward	FVTPL

We agree with the DP that the most appropriate measurement attribute for all derivatives is fair value. Fair value is the most meaningful attribute as it conveys the potential large variability in contractual cash flows relative to the instrument's little investment.

We believe fair value is the most meaningful measurement attribute for investments in equity investments where the measurement is reliable. Fair value most faithfully reflects the potential variability in expected cash flows that a cost based measurement attribute does not.

We would favour eliminating the available for sale category in conjunction with the completion of a comprehensive financial statement presentation standard as we support gains/losses being recognised in a single performance statement and therefore aim to reduce the amount of items that are currently subject to recycling. This would remove the arbitrary recycling that results for impairment of equity investments when the cumulative decline in fair value is deemed 'significant or prolonged'. This approach can result in significant volatility in income in the period even though the decline in fair value in the period is small relative to the cumulative decline. In addition, different entities apply different thresholds in determining what is significant or prolonged which hinders comparability.

We recognise that as equity instruments have no contractual cash flows the determination of fair value for such instruments may be subject to significant judgement. Where the instrument is quoted in an active market the entity is not required to use its judgement as the collective judgement of the market is used instead. Therefore, in the case where the equity instrument is quoted in an active market fair value is the most meaningful measurement attribute. We believe further work needs to be undertaken by the IASB to determine whether fair value for *all* equity instruments is feasible due to the inherent judgement and greater subjectivity required in determining fair value for equity instruments not traded in active markets where

there is a lack of reliability. The IASB should establish whether a cost measurement attribute with disclosure of why fair value is not reliable is more meaningful to users as opposed to requiring fair value with disclosure as to the potential inadequacies and judgements of the fair value measurement.

We are not supportive of retaining the held to maturity category as currently defined in IAS 39 due to the restrictions placed on initial classification and the prohibition on sale and tainting provisions that arise if there is disposal of more than a significant amount of held to maturity assets. Reclassifying all held to maturity investments due to a sale of some financial assets within the category is an overly disproportionate response. We are also not supportive of retaining the available for sale classification for debt instruments for the same reasons described above for equity instruments as this would further reduce items that would be subject to recycling. In addition to those arguments, removing the category will remove the complexity that arises in requiring separation of the effective interest rate and foreign currency translation on debt instruments classified as available for sale. Also, an existing inconsistency will be removed where impairment amounts on debt instruments held at amortised cost and available for sale differ even though they are based on the same impairment triggers. This inconsistency is exacerbated when comparing different entities as any loan and receivable can be designated under the current standard as available for sale and therefore different entities have different impairment amounts for the same instrument.

Our preference is for certain held debt instruments to be measured at amortised cost if the entity's business model is earning a return on the instrument through passive investments as opposed to trading or purchasing and selling. This may be the case in many financial institutions that originate mortgages and other long-term loans where the intention is to earn a return through the contractual cash flows of the instrument. To the extent a financial institution's intention is to hold to sell, e.g. through securitisation that achieve partial or full derecognition, then the instruments could not be classified as held at amortised cost.

By limiting amortised cost measurement to debt instruments where cash flows are derived from interest rates and the issuer's credit risk the vast majority of guidance on embedded derivatives in financial hybrid arrangements will be removed. We recognise that some guidance will be required on what is a reasonable interest rate and credit risk but we believe this would be relatively simple in comparison to existing embedded derivative guidance. Guidance will still be required on embedded derivatives in non-financial hybrid arrangements under our preferred approach (but also in the case of a full fair value accounting approach) unless the scope of this project was extended to measurement of executory contracts.

We are supportive of retaining a fair value option. IAS 39 currently permits any financial instrument to be designated at fair value through profit or loss at initial recognition if it will substantially reduce an accounting mismatch, is managed on a fair value basis, or includes an embedded derivative that substantially modifies cash flows. Our preferred approach limits the fair value option only to the former because our preferred approach *requires* fair value through profit or loss in the case where financial instruments are managed on a fair value basis and most embedded derivatives in financial instruments that substantially modify cash flows would require the entire financial instrument to be fair valued through profit or loss. We considered whether an entity should be permitted to apply the fair value option after initial recognition and came to the conclusion that in most cases where an entity would wish to apply the election they would also be able to elect for fair value hedge accounting instead. The most prevalent example would be a hedge of interest rate risk of issued or acquired fixed rate debt after initial recognition with an interest rate swap. As our preferred approach also reduces the burden of hedge effectiveness testing (see below) we considered it unlikely that the fair value option would be chosen if fair value hedge accounting was available and

achieved a more preferable accounting outcome. In addition, we noted that permitting a fair value option after initial recognition would potentially allow abuse by allowing an entity to enter into an offsetting instrument to accelerate a gain/loss prior to its disposal but would not be compelled to retain the offsetting instrument. On balance, therefore, we decided to limit the fair value option to initial recognition only.

Reclassifications

Our preference is to limit any opportunities for reclassification. Reclassifying financial instruments into and out of measurement categories after initial recognition creates complexity because of the rules that are needed to limit potential abuse, i.e. cherry-picking.

Applying the *held at fair value* and *held at amortised cost* classification categories at initial recognition will require judgement. Standards should allow the use of judgement to ensure the entity has the ability to provide the most meaningful information to financial statement users. However, it would be detrimental if entities were able to reclassify based on changes in intent which are inherently subjective and may increase complexity and the risk of abuse. In addition, because the criterion for meeting amortised cost measurement is relatively simple, based either on an assessment of the underlying cash flows of the instrument, or based on the entity's business model, we considered it preferable not to create rules on what is or is not deemed an acceptable reclassification.

We are not supportive of allowing an entity that has previously classified a financial instrument as held at fair value to later classify it as held at amortised cost. This will generally only ever be the case for fixed rate debt instruments only as the amortised cost and fair value of floating rate debt instruments is substantially the same (except due to significant changes in credit risk). Measuring fixed rate debt at amortised cost has greatest benefit when applied at initial recognition as that date determines the effective interest rate that will be applied for determining income in future periods. Permitting reclassification of a portfolio of fixed rate debt instruments from held at fair value to held at amortised cost would result in all future income being determined at the date of designation as this will be the date that determines the effective interest rate. We question the relevance of this income measure as well as being concerned that allowing reclassification in such cases may create opportunities for abuse. As an alternative to reclassification an entity may choose to start to disclose the effective interest rate separately from other fair value gains/losses. In addition, an entity may wish to isolate the carrying value of the portfolio on the face of the balance sheet from other held at fair value assets and disclose that it has changed to a hold, rather than a sale strategy.

We are not supportive of allowing an entity that has previously applied held at amortised cost to later unilaterally apply held at fair value. Even if the entity's business model has changed significantly to warrant new assets to be classified as held at fair value going forward we do not consider it appropriate that all existing assets should be reclassified to fair value with the cumulative gain/loss recognised in current period income. Our preference is to not permit reclassification and instead let those assets be derecognised through sale over the passage of time so the proportion of assets measured at amortised cost will fall and be replaced by assets that at initial recognition will be subsequently measured at fair value. An entity may wish to provide supplementary disclosure in this case to explain that initial classification for new assets will differ to past classification due to a change in the business model of the entity.

Financial statement presentation

As previously stated we consider the conclusion of the financial statement presentation project essential before the output of this project is effective. As the success of one standard is

dependent on the other we would hope both could be concluded concurrently. In light of our proposed approach we believe the following proposals may enhance financial statement presentation:

- Consistent with the balance sheet classification the performance statement should distinguish between debt instruments that are held at fair value and those held at amortised cost. This will demonstrate clearly the extent to which earnings are derived from items that are held for investment purposes, i.e. including the earnings effect due to the effective interest rate, foreign currency translation and impairment, and those that are not.
- To the extent an entity wished to separately present the effective interest rate on a debt instrument that is held at fair value (or dividends on an equity instrument held for sale) this would be permitted. However, the effective interest rate would be presented along with other gains/losses on held at fair value items so the effective interest rate on those items at fair value and those that are amortised cost are not mixed up. This should enhance comparability with entities with similar business models.

Below is an example of how our proposed approach could be presented. The performance on assets will be appropriately included in either Investing or Operating depending on the entity's business model. The performance of issued debt will be appropriately included in Financing.

Held at fair value

Trading activities	X	
Equity investments not traded ⁵	X	
Debt instruments not traded ⁶	X	
Derivatives not designated in a qualifying hedge relationship	X	
Hedge ineffectiveness	<u>X</u>	X
Fair value option assets		
• Fair value gains/losses on designated debt instrument	X	
• Fair value gains/losses on derivative	<u>X</u>	
Total gains/losses for assets designated under the fair value option		X

Held at amortised cost

Effective interest rate ⁷	X	
Foreign currency translation	X	
Impairment	<u>X</u>	X

Issued debt at amortised cost

Effective interest rate	X	
Foreign currency translation	<u>X</u>	X

Fair value option liabilities

• Fair value gains/losses on designated debt instruments	X	
• Fair value gains/losses on derivative	<u>X</u>	
Total gains/losses for liabilities designated under the fair value option		X

⁵ Dividends and other fair value gains/losses may be disclosed separately.

⁶ Effective interest rate and other fair value gains/losses may be disclosed separately.

⁷ Disclosure of the fair value adjustment to debt and the associated gain/loss on the derivative may be disclosed separately in the income statement or netted on in the income statement and disclosed separately in the notes.

Hedge accounting - types

To *some* extent hedge accounting is a response to the inadequacies of the existing measurement requirements and therefore full fair value accounting is often cited as the solution that would allow hedge accounting to be eliminated. We believe this solution has limited merit because:

- Net investment hedging is largely a response to the accounting model in IAS 21 *The Effects of Changes in Foreign Exchange Rates*, not IAS 39. There is some complexity associated with recycling the gains/losses of the hedging instrument but this is equally true for recycling the gains/losses on disposal of the foreign operation which is determined by IAS 21. Therefore, irrespective of the outcome of this project and our general concerns about recycling we believe net investment hedging should be retained.
- Cash flow hedge accounting attempts to recognise the gains/losses on a hedging instrument with the timing of the hedged item impacting profit or loss. Unless full fair value accounting introduces the recognition of gains/losses on forecast transactions, which we would not support, there will always be a mismatch in the timing of recognition of gains and losses of the hedged item and hedging instrument which cash flow hedging attempts to overcome. In addition, a comprehensive performance statement (without immediate recognition of gains/losses in equity) will not overcome the demand to recognise gains/losses on a hedging instrument and hedged item in the same period. We believe therefore that there remains a need for cash flow hedge accounting, although we are not in favour of recycling mechanisms in general (see our comments above). Removing cash flow hedge accounting may superficially appear less complex but we believe it is likely to increase complexity and reduce financial statement relevance for financial statement users and preparers.

The arguments in favour of retaining fair value hedge accounting are less compelling than the arguments for retaining cash flow hedging and net investment hedging, however, we believe the arguments at least for now, are persuasive. Fair value hedging introduces a third measurement attribute that is neither fair value nor amortised cost (as it is amortised cost adjusted for fair value movements in the hedged risk). It may appear more simple to remove this measurement attribute as it is a hybrid of fair value and amortised cost accounting but doing so would be a retrograde step when it currently offers entities minimal income statement volatility for highly effective hedges. Fair value hedge accounting is applied mostly for hedging interest rate risk for issued or acquired fixed rate debt. Fair value hedge accounting in these cases allows an entity to get a reasonable accounting match without needing to include credit risk in the fair value measurement of the hedged item. As fair value movements due to credit risk are generally more difficult to value, are less likely to be economically hedged (and if they are hedged they may be hedged by non-derivatives, e.g. purchased financial guarantee contracts), and in the case of own credit risk will result in gains/losses that are more likely to be misunderstood, we believe removing fair value hedge accounting would increase, not reduce, complexity. We recognise that future developments in financial statement presentation may make this argument less compelling and we look forward to revisiting this should that project offer a solution that reduces the need for fair value hedge accounting. In addition, should a mixed measurement model be retained but fair value hedge accounting be removed then consideration will need to be given to the introduction of a fair value option after initial recognition.

The DP includes an alternative method for presenting fair value hedge accounting by deferring gains/losses on the hedging instrument in equity so there is consistency with net investment and cash flow hedging. This approach would have the benefit of treating all gains/losses on hedging instruments consistently and also retaining only two measurement attributes (amortised cost and fair value) instead of a third. However, we propose that such an approach should only be explored if the benefits of any project outweigh the amount of resources that would need to be dedicated to the project. We question whether currently this is the case considering the other financial instrument issues to be resolved as referred to in our response to Question 1.

Hedge accounting – qualification and effectiveness

We also believe the following improvements can be made to the existing hedge accounting requirements:

(i) Qualification

The qualification criteria for hedges of non-financial items should be amended. Currently, an entity cannot hedge a portion of the cash flow variability of an acquisition or sale of a non-financial item. We understand the need for limiting hedges of portions for forecast transactions due to the inherent subjectivity that often exists when determining an identifiable portion of a non-financial item (e.g. the rubber portion of a forecast acquisition of tyres). However, this subjectivity does not apply where the cash flow variability is subject to a contract. For example, if the future acquisition of tyres is subject to a contract, i.e. a firm commitment, where the contract requires the amount paid is variable to a number of factors, for example including changes in the price of rubber, then the rubber price risk should qualify as a hedged risk and the identifiable and measurable component of the cash flow variability that relates to changes in the rubber price should qualify as a hedged item. Equally, the contractually specified inflation-linked portion of cash flows of an operating lease (a non-financial item) should qualify as a hedged risk in the same way as it is possible to hedge contractually specified inflation-linked cash flows of a finance lease (a financial item). In such cases, a portion of the cash flow variability is identifiable and measurable and therefore should be eligible for cash flow hedging. The current Standard does, in our view, unnecessarily prohibit hedge accounting due to the restrictions on hedging portions of non-financial items.

(ii) Hedge effectiveness

The current hedge effectiveness assessment requirements could be simplified without creating the potential for abuse. Currently, the standard is complex for the following reasons:

- The standard requires a continuous prospective assessment of hedge effectiveness at a minimum of each reporting period. When the hedge is highly effective this can be seen as being onerous.
- Different views exist as to whether the prospective test must be quantitative or can be qualitative.
- Different techniques (e.g. dollar-offset, regression, risk-reduction) are used for assessing both prospective and retrospective hedge effectiveness and can lead to different conclusions as to whether a hedge relationship is deemed highly effective, and therefore different accounting treatments.
- Many hedge relationships fail due to the high threshold of ‘highly effective’ with the effect that there is significantly more profit or loss volatility than would be the case if the hedge was deemed effective enough to continue hedge accounting in the period

with recognition of hedge ineffectiveness instead. It could be argued the latter is more representative of the economic gain or loss of the entity.

- The highly effective threshold results in a great number of hedges failure, and therefore deemed termination of hedges due to IAS 39.101(b), with the effect the entity is forced to re-designate, and in many cases, does so on exactly the same basis as the previous hedge relationship. These problems are exacerbated with cash flow hedges because of the need to redefine the hypothetical derivative (see ‘hedge terminations’ below).

An alternative approach that would alleviate many of these issues would be as follows:

1. At inception, perform a qualitative assessment of hedge effectiveness only.
2. Subsequently, perform a retrospective test of hedge effectiveness using the dollar-offset method (quantitative).
3. If the dollar-offset result is deemed ‘effective’ (see below), then the entity maintains hedge accounting for the period and moves on to the next period (start over at step 2), i.e. no need to reassess prospectively.
4. If at those subsequent periods, the dollar-offset result is not effective, there is no hedge accounting in the period. An entity would have to qualitatively assess whether the hedging relationship will be effective in future periods if the same hedge relationship is going to be retained (i.e., consider whether circumstances have changed since inception that would call into question the hedging relationships effectiveness). If proved to be qualitatively effective for future periods, then the existing relationship can continue in future periods.
5. If the dollar-offset result is not effective and the entity cannot qualitatively prove that the relationship will be effective in future periods, then the entity must perform a quantitative prospective assessment. If the entity can quantitatively prove that the relationship is expected to be effective, then it can continue hedge accounting for future periods. If not, then the hedge relationship discontinues.
6. Steps 2-5 are repeated, as necessary, at each period end.

The determination of whether hedge accounting is permitted in the period will be lowered from ‘highly effective’ to merely ‘effective’ which can be considered as more effective than not (i.e. >50% to <200% dollar-offset). This reduction in the threshold will result in less hedge failures and instead show the extent of ineffectiveness in profit or loss. The introduction of a single technique for hedge effectiveness assessment will result in consistency between entities in passing or failing hedge accounting for the same hedge relationship. In addition, by lowering the threshold of the dollar-offset *and* at the same time requiring dollar-offset we expect this will reduce the existing incentive to use regression and other statistical techniques as an alternative to dollar-offset.⁸

(iii) Hedging portions

We continue to be supportive of retaining the hedging of portions for financial items to the extent the portion is identifiable and measurable. As described in (i) above we would also propose to permit cash flow hedging of a non-financial item for a portion where the variability in cash flows of that portion is explicitly identified in a binding contract (i.e. is not forecast).

(iv) Hedge terminations

⁸ We note that in practice the dollar-offset test is often used to support the results of regression anyway.

The Standard currently requires that if there is a hedge failure because hedge effectiveness falls outside the highly effective 80-125% threshold the hedge relationship is deemed to be discontinued. This leads to the anomaly that a new hedge relationship must be documented in the case where the hedged item and hedging instrument are the same as the original hedge which critically for cash flow hedge accounting will result in the reset of the hypothetical derivative. This resetting results in future hedge accounting being ineffective (or potentially so ineffective that the prospective hedge effectiveness test fails and hedge accounting cannot be applied) even when the hedge failure is a result of an isolated or immaterial event (e.g. a 'small numbers problem' where the hedging instrument and hedged item move by small amount but fail the dollar-offset test). We believe this anomaly can be resolved by allowing in the case of a continuous hedge relationship (i.e. no period where hedge accounting does not apply) for the hypothetical derivative not to be reset in the case when the hedge is not highly effective in a period. As long as hedge effectiveness can be demonstrated prospectively the hedge relationship can continue in the same form.

Section 3 A long-term solution—a single measurement method for all types of financial instruments

Question 8

To reduce today's measurement-related problems. Section 3 suggests that the long-term solution is to use a single method to measure all types of financial instruments within the scope of a standard for financial instruments. Do you believe that using a single method to measure all types of financial instruments within the scope of a standard for financial instruments is appropriate? Why or why not? If you do not believe that all types of financial instruments should be measured using only one method in the long term, is there another approach to address measurement-related problems in the long term? If so, what is it?

We believe an intermediary approach as expressed in our response to Question 7 would be beneficial compared to existing standards. We do not believe acceptance of our preferred approach is necessarily a pre-cursor to full fair value accounting for all financial instruments. Further, our preferred approach can only be implemented when there is a completed fair value measurement and reporting financial performance standard. Once this approach and these two new standards have been applied for a reasonable period it will then be possible for the IASB and its constituents to assess whether users have benefited. Only at this point should the IASB then consider whether a full fair value accounting model will be a further improvement to financial reporting which could only be assessed concurrently with a full assessment of the needs of users. We do not necessarily believe our preferred approach as described in our response to Question 7 is necessarily the ultimate solution. By adopting this approach we consider there is a greater chance of knowing in the future whether full fair value accounting would be more meaningful and more importantly whether it would be feasible.

Question 9

Part A of Section 3 suggests that fair value seems to be the only measurement attribute that is appropriate for all types of financial instruments within the scope of a standard for financial instruments.

- (a) **Do you believe that fair value is the only measurement attribute that is appropriate for all types of financial instruments within the scope of a standard for financial instruments?**
- (b) **If not, what measurement attribute other than fair value is appropriate for all types of financial instruments within the scope of a standard for financial instruments? Why do you think that measurement attribute is appropriate for all types of financial instruments within the scope of a standard for financial instruments? Does that measurement attribute reduce today's measurement-related complexity and provide users with information that is necessary to assess the cash flow prospects for all types of financial instruments?**

Our preferred intermediary approach as described in our response to Question 7 is not full fair value accounting and therefore we are not supportive at this stage that fair value is the only meaningful measure.

Even if a full fair value accounting model was introduced we believe as a practical expedient it is reasonable that amortised cost is applied for short-term receivables/payables where their fair value/cash flows are sensitive only to interest rates and credit risk. We recognise that a complexity of this approach is the need to retain an impairment model. However, mandatory fair value measurement of these items would cause preparers to incur a cost (which we recognise will include the need to retain an impairment model) that we believe would exceed the associated benefits.

Question 10

Part B of Section 3 sets out concerns about fair value measurement of financial instruments. Are there any significant concerns about fair value measurement of financial instruments other than those identified in Section 3? If so, what are they and why are they matters for concern?

We agree with the concerns listed in Part B of Section 3. Our comments of the discussion paper on fair value measurement are detailed in our response to you dated 4th May 2007 which is not repeated below. In addition to the concerns raised in that comment letter and this DP we have the following additional comments:

- Future guidance on fair value measurement must clearly distinguish between the 'unit of account' and the 'unit of valuation'. The former is most commonly illustrated with the prohibition on control premiums or block discounts. The latter is a concept that is relevant when fair valuing groups of similar items that when valued as a portfolio have a different valuation dynamic compared to the valuation of single instrument. This is often due to the law of large numbers that is particularly relevant when fair valuing a group of prepayable loans.
- Clarity is needed on the acceptable methods of including the fair valuation of credit risk on a portfolio of derivatives with the same counterparty. This is particularly relevant when multiple derivatives are subject to a master netting arrangement on a portfolio basis. Guidance on the methods of allocating portfolio credit adjustments is

needed as this allocation will be relevant if the IASB requires disclosure of financial instruments by the fair value hierarchy (i.e., Level 1, 2 and 3) and is also relevant in determining hedge effectiveness where fair value changes of the derivative are compared with the fair value changes of the hedged item.

- Should Standards continue to require the disclosure of fair value movements of own credit risk for certain financial liabilities measured as at fair value through profit or loss guidance is needed in how to determine this amount in the case of financial liabilities that are asset-backed, typically issued by consolidated special purpose entities. The current Standard allows an entity to determine the fair value due to credit risk by fair valuing the debt and subtracting the fair valuing movements due to the risk-free interest rate. This method has limited relevance when the valuation of the liabilities are driven by the credit risk of the underlying assets, e.g. in a cash-CDO. In some cases, it could be argued that the credit risk is minimal, as the financial liabilities are only obligated to pay cash flows when received and therefore the credit risk is limited to the non-payment risk within the special purpose entity which is more akin to an operational risk.

Question 11

Part C of Section 3 identifies four issues that the IASB needs to resolve before proposing fair value measurement as a general requirement for all types of financial instruments within the scope of a standard for financial instruments.

- (a) ***Are there other issues that you believe the IASB should address before proposing a general fair value measurement requirement for financial instruments? If so, what are they? How should the IASB address them?***
- (b) ***Are there any issues identified in part C of Section 3 that do not have to be resolved before proposing a general fair value measurement requirement? If so, what are they and why do they not need to be resolved before proposing fair value as a general measurement requirement?***

As stated above we believe fair value measurement and reporting financial performance need to be completed or at least run concurrently with the intermediate approach. We believe these projects should not be deferred until the completion of the long-term objective. In addition, as stated in our response to Question 1 and 12 we believe there are currently considerable application issues with scope, particularly accounting for contracts for non-financial items, which should be addressed.

If full fair value accounting was to be pursued in the long-term we agree completion of a revised disclosure standard would be a pre-requisite as the focus of a disclosure standard would shift more to the assumptions and techniques used in valuation and away from disclosure of fair values and fair value hedge accounting information.

We believe it would be preferable if there was resolution of the project on financial liabilities and equity before introducing a new financial instruments approach though we recognise that whether this is critical will depend on which approach for financial liabilities and equity is adopted. If a Basic Ownership Approach were to be adopted this would result in a greater variety of liabilities being recognised which would raise measurement and financial statement presentation issues for instruments not currently classified as equity (e.g. for derivatives over own equity and many preference shares). If the financial liabilities and equity model adopted was the Ownership-Settlement approach, which is already similar in many respects to IAS 32,

then the need to complete this project before the intermediate approach on reducing complexity would be greatly reduced.

Question 12

Do you have any other comments for the IASB on how it could improve and simplify the accounting for financial instruments?

As already expressed in our response to Question 1 derecognition and scope are both complex areas of accounting for financial instruments and require attention. We note that the former is part of an existing project but the latter is not. The scope requirements of contracts for delivery of non-financial items is critically important for certain sectors, e.g. oil/gas extraction, mining, utilities. There are many entities that have contracts that are subject to the broad definition of net settling, hence are scoped into IAS 39, where the level of net settling is low compared to the total quantity of physical contracts. These entities frequently claim that fair valuing all similar contracts is misleading. Other entities have contracts scoped out of IAS 39 which they believe is misleading but they cannot scope them in. For example, an entity that enters into contracts to sell non-financial items physically at a fixed price in the future, buys at spot and hedges the price differential with derivatives cannot choose to fair value the physical contracts as they are scoped out of scope of IAS 39. Only three paragraphs are included on this subject in existing literature with minimal application or interpretative guidance. We believe the amount of guidance is disproportionately small relative to the importance of this area and also believe that further thought is needed as to whether the guidance is appropriate. Such contracts do not meet the definition of financial instruments but are treated as if they are. As such, we believe that the scoping of these contracts should be subject to a separate project that identifies the practices of 'net-settling' and the IASB reconsiders whether the net settlement criteria is appropriate.

As included in our response to Question 7 we propose that where loan commitments are not in the scope of IAS 39, the impairment should be determined in accordance with IAS 39, not IAS 37 as currently required, so that the determination and measurement of impairment for a loan commitment is consistent with the loan that will be originated from it.

We support the IASB's initiative to undertake a review of the application of IFRS 7 *Financial Instruments: Disclosures*. We note that such a review is in response to the credit crunch and therefore will no doubt be primarily focused on the application by financial institutions. We agree that an analysis of IFRS 7 disclosures is worthwhile but believe that such a review should not be limited to the concerns of financial reporting for financial institutions as IFRS 7 has also been challenging for non-financial institutions. The main areas that should be considered are:

- Liquidity risk:

We believe there is an imbalance between information on liquidity risk management and the mandatory disclosures on providing undiscounted cash flow information. A disproportionate amount of disclosure is dedicated to disclosing undiscounted cash flows on derivative and non-derivative financial liabilities. This partly reflects that the primary focus in IFRS 7.37 is on undiscounted cash flow information based on a worst-case scenario with a secondary requirement as to how an entity manages those cash flows. A disconnect arises as entities manage their liquidity risk on an expected cash flow basis. In addition, disclosing undiscounted cash flows for derivative

liabilities requires a disproportionate amount of effort compared to the benefit to users. A number of problems continue to recur across all sectors:

- providing undiscounted cash flows on held for trading items is of little perceived benefit;
- how to disclose adequately cash inflows on derivative liabilities (e.g. gross settled forwards/swaps);
- how to include the cash flows of an embedded derivative that are settled through settlement of the hybrid contract;
- whether financial liabilities that are exclusively share settled should be included in the maturity analysis.

We understand the IASB will consider some proposals in September 2008 as to how liquidity risk disclosures can be improved to be made more meaningful. We would welcome such a change.

- Credit risk:

The requirement to show the maximum exposure to credit risk excludes any right of offset. Because IAS 32 does not permit offset where there is not the right and intention to offset then master netting arrangements that force offset in the case of default are ignored for the purposes of providing the maximum exposure to credit risk. The outcome is a maximum exposure to credit risk greater than the actual credit risk that would result if there was a credit event. This is misleading. Consideration should be given to allowing the maximum exposure to credit risk to include the effects of master netting arrangements.

- Fair value:

We note the draft best practice guidance on disclosures (and measurement) recommended by the IASB's *Expert Advisory Panel on Valuing Financial Instruments in Markets that are no Longer Active*. The draft version includes similar disclosures to IFRS 7 on disaggregating fair values between Level 1, 2 and 3 fair valuation measurements. We would support greater analysis of fair values between those measured at fair value in active markets and those measured using a valuation technique. We understand the IASB will consider potentially including some of these best practice disclosures as part of an amended IFRS 7 and we look forward to further dialogue with you on any proposals.

Appendix C

Submission to the IASB on the ED 10 *Consolidated Financial Statements* dated 20 March 2009

Sir David Tweedie, Chairman
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20 March 2009

Dear Sir David,

Exposure Draft ED 10 Consolidated Financial Statements

Deloitte Touche Tohmatsu is pleased to respond to the International Accounting Standards Board's (the IASB's) *Exposure Draft ED 10 Consolidated Financial Statements* (referred to as the 'exposure draft' or 'ED').

We recognise the importance of this project and fully support the objectives of issuing a single Standard for consolidation and improving the disclosure requirements relating to consolidated and unconsolidated entities. Furthermore, we believe that applying a single definition of control to all entities is the appropriate basis for the consolidation model.

However, the principles underlying the consolidation model proposed in the ED are not well established and the guidance within the ED is ambiguous and inconsistent in a number of fundamental areas, not least of which in the failure to distinguish between 'power to control' and 'ability to control'. Without a clear definition of control, the resulting Standard will be difficult to interpret and apply on a consistent basis. As a consequence, the financial statements of groups will be less, not more, comparable and understandable. We do not believe that the ED in its current form is an improvement on existing IFRSs.

It is crucial that the Board responds on a timely basis to the global financial crisis and the recommendations of the Financial Stability Forum. We therefore believe that improved disclosure requirements should be issued as swiftly as possible. We are providing comments on specific aspects of the proposed disclosure requirements later in this letter. However, further work, including appropriate field testing, is required to adequately address concerns about the consolidation model itself. Once the results of such additional work has been analysed, we believe that the consolidation Standard should be re-exposed.

We are also concerned that this ED is not the result of joint efforts between the IASB and the FASB. We strongly encourage collaboration between the two Boards on the topic of consolidation with the goal of issuance of a converged Standard.

Our detailed comments and answers to your questions on the exposure draft along with other comments and suggested editorial changes are included in the Appendices to this letter.

If you have any questions concerning our comments, please contact Ken Wild in London at +44 (0)20 7007 0907.

Yours sincerely,

A handwritten signature in black ink, appearing to read "Ken Wild", written over a single horizontal line.

Ken Wild
Global IFRS Leader

Appendix 1

Response to questions on ED 10 Consolidated Financial Statements

Control

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?

No, we do not think that the proposed control definition could be applied to all entities as the two elements of the definition – ‘power to direct activities’ and generation of ‘returns’ are not clearly explained within the ED. In order to develop a clear definition of control, the ED should first establish the core principle underlying the preparation of consolidated financial statements. The ED currently explains *how* consolidated financial statements should be prepared (i.e. by grouping entities that are under the control of the parent) rather than the more fundamental issue of *why* consolidated financial statements should be prepared, i.e. the purpose of consolidated financial statements. We would expect this core principle to be consistent with the principles proposed by the Board in its Discussion Paper *Preliminary Views on an improved Conceptual Framework for Financial Reporting*. Once an appropriate core principle has been established, the definition of control can be developed. An appropriate definition of control would be one that can be applied to all entities in order to determine which entities should be consolidated by reference to the core principle, i.e. are the appropriate boundaries drawn around the reporting entity.

Further, consolidation is one of the building blocks that ensure that the financial statements of a group reporting entity ultimately present all of the assets and liabilities controlled directly and indirectly by the entity. It is therefore important that the consolidation Standard be developed using principles that are consistent with those used elsewhere in IFRS, in particular those used in the Conceptual Framework and in the revenue recognition and derecognition (future) Standards. For example, it is important that the consolidation Standard does not require consolidation of assets (or liabilities) that need to be derecognised under the derecognition Standard. Because of the various on-going projects affecting these fundamental principles, we encourage the Board to take the time to ensure that the final Standards will form a cohesive set of principles.

We support use of the control model as a basis for the consolidation model, recognising however that such a control model must necessarily incorporate concepts of risks and rewards. It is difficult to conceive that control can exist if the controlling party is not also the recipient of risks and rewards arising from the controlled entity. However, at present, the ED expands on the notion of risks and rewards principally in relation to ‘structured entities’. This may lead some to believe that this notion is relevant only to structured entities and that the Board has developed a ‘model within a model’ specific to structured entities. We do not believe that this is the case, nor should it be. In order to rectify the situation, one of the key aspects of the definition of control that needs to be improved is the articulation of the manner in which risks and rewards are integral to control, in particular the interaction between the ‘power to direct the activities’ of an entity and ‘exposure to risks and rewards’ of that entity as the two elements that yield control. In some entities, such as the ‘traditional’ operating entities, control can readily be established by determining who directs the activities of the entity. In other entities, exposure to risks and rewards provides an unambiguous indication of the party that controls the entity. This would be the case, for example, for entities established by the reporting entity clearly for its own benefit. In both cases, identification of the controlling party is easy because there is no contradiction between the indicators of the power to direct the activities of the entity and those related to risks and rewards from the entity.

However, between these two ends of the spectrum there exists a variety of entities for which the identification of the controlling party is not straight forward because indicators of control may point in different directions. This would be the case, for example, when several parties participate in the establishment of an entity, each with its own objectives and specific exposure to risks and rewards. In order to ensure appropriate and consistent consolidation of these entities, it is necessary for the Standard to establish clearly the relationship between the ‘power to direct’ and ‘exposure to risks and rewards’ and the balance between these two elements that may sometimes appear to contradict each other. In addition to improving the consistency of the control model, we believe that such an approach would also have the merit of avoiding recreating the main flaw within the existing IFRS on consolidation: identifying which particular guidance on consolidation applies to an entity, with the result that certain entities that should be consolidated inadvertently fall through the gap because it is unclear whether they are within the scope of IAS 27, SIC 12 or neither.

Question 2

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

No, we do not agree that the control principle as articulated in the ED provides an appropriate basis for consolidation, as we do not believe that control has been defined clearly. At a basic level, the guidance seems to imply that ‘ability’ to control is synonymous with ‘power’ to control. We do not believe this to be the case. We understand the concept of ‘power’ in this context to be an absolute right to direct the activities of another entity (in the sense that it is a right which cannot be taken away by others), whereas ‘ability’ is only the opportunity to do so currently.

Power

The ED defines control as ‘power to direct the activities’ of another entity. However, the guidance explains that ‘power to direct’ is the ability to do so in practice. Practical ability is a subset of power but is not equal to power. It therefore follows that, while power must incorporate the concept of practical ability, practical ability alone is not sufficient to provide an entity with power to direct the activities of another entity. This lack of clarity is illustrated by the guidance on de facto control and voting rights. For example, paragraph 28 indicates that the dominant shareholder may have control over an entity by virtue of the fact that the other shareholders are dispersed and not organised in such a way that they can actively cooperate (de facto control). While an unorganised and dispersed shareholder group may permit a dominant shareholder to make decisions over the activities of an entity at a particular point in time, in the absence of factors that give the dominant shareholder an unconditional power to direct activities, this does not equate to control by the dominant shareholder. Nothing prevents the other dispersed shareholders from voting jointly against any decision which they do not support, i.e. at any time they can take away the ability of the dominant shareholder to direct the entity’s activities. This is particularly true since in practice the majority of dispersed shareholders are institutional investors. We are concerned that, unless the position of the Board with respect to the defining factor (i.e. present power to control or present ability to control) is clearly expressed, the resulting Standard will be difficult to interpret. We believe control should be defined as the current power to direct the activities of an entity, whether by means of voting rights or other arrangements. In particular we do not believe that the control determination should be based solely on the actions (or absence of actions) of others.

The ambiguity inherent in the proposed guidance on control is increased by the fact that the ED uses various terms, such as ‘power’, ‘right’ and ‘ability’, apparently interchangeably. As stated above, we do not believe that these terms are synonymous. The Board should ensure

that consistent terms are used to refer to the same concept and that all key terms are clearly defined.

Further, paragraph B9 (a) uses the term ‘dominate’ to describe situations where a reporting entity has ‘the power to direct activities’ but has less than the majority of voting rights. It is not clear what degree of influence is meant to be demonstrated by the term ‘dominate’ and what factors would indicate that a shareholder dominates the direction of the activities of an entity.

Directing the activities of an entity

In relation to the definition of control, we suggest that the Board clarifies what is meant by directing the activities of an entity. Paragraph 22 indicates that ‘a reporting entity has the power to direct the activities of another entity if it can determine the other entity’s strategic operating and financing policies.’ Paragraph BC44 confirms that paragraph 22 should be read as indicating that determining the strategic operating and financing policies of an entity is one means of having the power to direct the activities of another entity, but that it is not necessarily the only means by which this power may be obtained. As an example, paragraph BC44 indicates that the power to direct the activities of an entity may also be obtained through contractual arrangements. However, this paragraph does not specify which rights (other than the right to determine the other entity’s strategic operating and financing policies) would need to exist under the contractual arrangement in order for the reporting entity to have the power to direct the activities of the entity. In order to ensure that the concept of ‘directing the activities of an entity’ is appropriately interpreted and applied in practice, the Board should clarify the difference, if any, between directing the activities of an entity and determining an entity’s strategic operating and financing policies. The Board should also clarify how one may exist without the other.

Given that activities of an entity may be predetermined, it would also be important to consider how the concept of directing the activities might apply to such an entity. This will be necessary if the Board retains our later suggestion of not differentiating consolidation of structured entities from that of other entities. Please refer to our response to Question 7 for our views on the matter.

Ability to generate returns

Another significant concept in the proposed definition of control is the ability to generate returns. We understand that the Board intends for the term ‘returns’ to be interpreted broadly. We support such an approach. To ensure that this broad definition is well understood, we suggest that the Standard better illustrates how the ability to generate returns might go beyond purely monetary returns and how it would include the ability of the reporting entity to use another entity to conduct activities that the reporting entity would otherwise carry out itself. For example, would the ability to set up a trust for its employee share ownership plan represent a form of return for the reporting entity? Similarly, if a reporting entity sets up and funds a foundation to do charitable work, would the returns generated by the public profiling of the reporting entity’s name be considered as returns in establishing whether the reporting entity should consolidate the foundation?

As a further matter for clarification, there are ambiguous and contradicting references to the term ‘returns’. While some paragraphs appear to refer to exposure to returns in terms of absolute value, others such as paragraph 11 and 13 appear to refer to exposure to the variability of returns. The ED should clarify the ambiguity: an entity may be exposed to lower returns than other investors in absolute terms but, nonetheless, be the party most exposed to variability of returns (such as an insurance company).

We also note that there appears to be a discrepancy between the importance given to returns in structured entities compared to other entities. The ED implies that for an entity that is not a structured entity, the control definition may be met even if the returns generated for the reporting entity are minimal. If this is correct, it would be important to explain the basis for this difference.

Finally, in order to clarify further what is meant by returns, we suggest that the principle that ‘returns commensurate with the service provided are fees’ rather than returns (currently in paragraph BC54) should be brought into the main body of the Standard. We also provide views on the necessity of establishing a relationship between the ‘power to direct’ and the ability to ‘generate returns’ in our response 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?

No, as noted in our response to Question 2, unless the Board establishes clearly whether the control principle is the absolute power to direct the activities of another entity or more broadly the ability to direct these activities, it will be difficult to ensure consistent application of the resulting Standard. We believe the control definition should be based on the concept of power rather than practical ability. Further, the ED highlights the importance of judgement in assessing whether control exists but it fails to provide the guidelines necessary to apply this judgement in certain key circumstances. We have commented on the need for further guidance in our responses to other questions (in particular Questions 4 to 7). In addition, we would like to highlight three other areas that would need to be addressed to ensure consistent application of the Standard.

Participating rights

We believe that additional guidance is required with respect to protective and participating rights. First of all, we note that the definition provided in Appendix A of protective rights (defined as ‘rights [...] that do not give the party control of the entity, nor do they prevent another party from controlling that entity’) is circular. This definition indicates simply that a protective right is not a participating right. Since a participating right is not defined in the ED, the definition of protective right is ineffective. Indeed, while paragraph BC61 implies that all the guidance from EITF 96-16 has been included, we note that the guidance on participating rights provided in the EITF has not been incorporated in the ED. Given the absence of guidance on what is a participating right, it is difficult to understand when a right goes beyond being protective and is instead participating in substance. Further, we find the wording in paragraph B2(a) ambiguous: it indicates that protective rights protect one party by prohibiting the controlling party from making fundamental changes to the activities of an entity. The ED should explain what constitutes a fundamental change. For example, would changes over the strategic operating and financing activities be considered fundamental? If that were the case, these rights would appear to prevent another party from controlling that entity and therefore fail to meet the definition of ‘protective’ rights.

We also believe that the condition in paragraph B2(a)(ii) may have unintended consequences for entities that are regulated by the state (for example, in certain jurisdictions, entities in the utilities industry are subject to strict governmental regulations) and in which the state holds a non-controlling interest. Often, the investment capacities of these entities are extremely supervised and their returns are predetermined. When paragraph B2 is considered along with

paragraph 25 in the context of a regulated entity, does this mean that regulated entities will no longer be consolidated?

Consolidation in the absence of the majority of voting rights

We also find the current guidance with respect to consolidation in the absence of the majority of voting rights very broad and subjective. In particular, the Board should clearly establish whether the existence of de facto control must be demonstrated or it can simply be implied because, for example, other shareholders have not organised themselves in the past. Despite the Board's conclusion in paragraph BC49 that the guidance currently provided in the ED is not inconsistent with the proposed control definition and simply reflects different circumstances, we continue to be concerned that the ED does not clearly establish the distinguishing factor. Accordingly, we believe that this guidance must be revisited and explained in the main body of the Standard. We believe that control may exist in situations where the reporting entity has less than the majority voting rights over another entity, but only if the reporting entity has a contractual or other legal right to determine the activities of that entity. In particular, we do not believe that ownership of a large percentage of the shares in an entity (that entitles the reporting entity to less than the majority of the voting rights) would allow the reporting entity to control that entity simply by virtue of the fact that the other shareholders are dispersed and not organised. These issues must be addressed in the final Standard if the Board determines that consolidation can result from de facto control.

Guidance in Basis for Conclusions

Finally, we are concerned that the fact that significant guidance is included in the Basis for Conclusions may hinder consistency of application, in particular in those jurisdictions where the Basis for Conclusions is not officially endorsed by the local legislation. We strongly encourage the Board to revisit the structure of the document to ensure that all relevant guidance is included in the Standard, including the Application Guidance.

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.

No, we do not believe the proposals are sufficiently clear. For options to give the option holder control over another entity they must provide that holder with the power to direct the activities of the other entity even without actual exercise of the options. In other words having the power to exercise must be an effective means of ensuring that the activities are directed according to the holder's demands. The other party will choose to act in accordance with the demands of the option holder as refusal to comply with the holder's demands will be futile.

However, paragraph B13(a) appears to imply that an option holder would assess whether it controls an entity simply by determining the percentage of voting rights that it would hold if the options are exercised in the future. We believe that this concept is inconsistent with the existence of actual power.

We also believe that the conclusion regarding options exercisable at fair value in paragraph BC86 needs to be better explained. Paragraph BC86 may be read as indicating that such options do not provide control until exercised because it is only then that the holder has access to returns on the underlying shares. We note that the definition of returns provided in paragraph 11 extends beyond dividends and other distributions. In fact, paragraph 11(c)

extends the definition of returns to include a parent's ability to create synergies with its subsidiary. Therefore, it would appear appropriate that a reporting entity would consider whether its options allow it access to similar synergies. Accordingly, we believe that options may provide control to the holder regardless of their exercise price. However, as stated above, they only do so if they provide the holder with current effective means of directing the activities of the entity to generate returns (in the broad sense) for the option holder, even in the absence of actual exercise, because other shareholders do not have any realistic prospect of doing something other than what the option holder desires.

Paragraph BC81 states '*for example, the option holder could have power indirectly if the shareholder that is the counterparty to the option agreement 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.*' The Board should clarify whether this paragraph would apply only in situations where the power is derived from a contractual or other legal agreement or whether it would also apply where, as a matter of practice, the counterparty to the option agreement seeks the wishes of the option holder before exercising its voting rights (and respects those wishes). We believe this paragraph should only apply where there is a contractual or legal requirement for the counterparty to vote in accordance with the wishes of the option holder.

Also, paragraph B13 presents three circumstances in which '*a reporting entity [that] holds options or convertible instruments has the power to direct the activities of another entity*'. Are these circumstances meant as *examples* of situations where holding options permits the reporting entity to control the other entity or are these *the only* three situations where control would arise from holding options or convertible instruments?

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.

No, we believe that the guidance around principals and agents is very unclear. In particular, we are concerned that the section on remuneration of an agent is open to diverse interpretations. It is our opinion that for an entity to be an agent it must stand ready to comply with any instructions it receives from the principal in the arrangement, for example in respect of voting. Furthermore, we believe that in a genuine agency relationship, the principal will have the right to remove and replace the agent, albeit that it may have to pay a penalty to do so.

We are concerned that the indicators provided in the ED of whether a party is acting in its own interests or on behalf of others will be difficult to apply in practice and that this difficulty may result in an inappropriate and inconsistent consolidation outcome. Accordingly, we believe that additional guidance is necessary to assist preparers in exercising their judgment. The following areas are likely to cause significant difficulties:

- a) What evidence would be appropriate to demonstrate that a party that acts in a dual role does, in fact, act in the best interest of other parties (as specified in paragraph B11)? Paragraph BC95 appears to create a rebuttable presumption that an agent in a dual role would act in its own best interest. Would it be sufficient for the agent to hold a contractual agreement that stipulates that it must act in the best interest of other parties or would there also be a need to show other evidence to that effect? If so, what is the nature of this other evidence?
- b) Where an entity, say entity A, has an investment in a fund (a limited mandate fund) and entity A also holds the controlling interest in the entity acting as the fund manager, how would A's dual role impact the assessment of whether A controls the

- fund? Would this be different from the assessment required for agents acting in a dual role? What would be the impact of the percentage of interest held by A in the fund?
- c) What parameters should be used to assess whether fees are representative of the fair value of the services rendered? Because of the variety of existing schemes, we believe that in practice it will often be difficult to assert whether or not fees are reflective of the market price. Also, what weight should be given to the various indicators provided in paragraph B6 when only some of the factors are present?

Also, we note that paragraph B7 appears to indicate that, as soon as an agent is required to act in the best interest of the principal, its fees would be considered to be remuneration for services. However, the notion that a party must act in the best interest of others exists in other arrangements such as those in which a fiduciary responsibility exists (such a responsibility may arise if A owns an interest in B, and A & B have common shareholders). We suggest that the Board should consider how this fiduciary responsibility impacts the evaluation of control and how it differs from the obligation of an agent to act in the best interest of the principal.

Finally, we suggest that the Board ensures that the guidance on the definition of the role of an agent proposed in this ED is consistent with the guidance being developed as part of the annual improvements project affecting IAS 18. If the two Standards require different guidance, the basis for this difference should be clearly explained.

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?

No, we question the need to define the term ‘structured entity’. The definition of structured entity is required in the ED to identify, in paragraph 30, the entities for which control is better identified using specific guidance and to determine the disclosure requirements applicable to involvement of the reporting entity with certain entities. As indicated in our response to Question 1, we do not believe that the guidance provided in paragraphs 30-38 regarding consolidation of structured entities applies only to structured entities. We consider that, if the role of risks and rewards within the control model was better articulated, it would not be necessary to differentiate between entities in applying the consolidation model.

Similarly, as indicated in our response to Question 9, we believe that the need to provide disclosures about entities that are not consolidated should be determined by the exposure of the reporting entity to the different parties with whom it transacts rather than the manner in which these parties are organised.

If the Board determines that it is necessary to retain a definition of structured entity, we disagree with the proposed definition because of its lack of clarity. Currently, a structured entity is more defined by what it *is not*. It would be more useful if the Board explained what a structured entity *is*. Further, we note that the definition provided in paragraph 30 refers to ‘*activities [that] are not directed as described in paragraphs 23-29*’. This implies that control of a structured entity would need to be assessed in accordance with the principles established in paragraphs 31-38 rather than paragraph 22. Because the principle in paragraph 22 (establishing that control is based on the power to direct the activities) may appear to differ from the guidance in paragraphs 31-38, where assessment of control is based on ‘*how returns from the entity’s activities are shared...*’, the relationship between these paragraphs requires further explanation. This remark is consistent with our comment that the Standard should better articulate how risks and rewards are integral to the existence of control.

Finally, we also note that the definition of structured entities appears to indicate that an entity whose activities are not directed by any party is necessarily a structured entity. This may lead to the conclusion that joint ventures and other entities without a controlling party are by definition structured entities. We do not believe that this is the Board's intention but this aspect of the definition should be clarified. Also, the ED should clarify whether it is possible for an entity to have significant influence in a structured entity and the consequential implications.

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?

No, as previously stated, we believe that the requirements and guidance in paragraphs 31-38 should not be applied solely to structured entities, and accordingly we do not believe that the definition of a structured entity in paragraph 30 is necessary.

Whether or not the Board retains our suggestion that paragraphs 31-38 should be applied to all entities, we believe that clarification is required in any case with respect to the guidance in these paragraphs and the related guidance in other sections of the ED.

Firstly, the wording in paragraph 32 is ambiguous and could be read to mean different things. The second sentence states '*for example, a reporting entity is likely to control a structured entity that has been created to undertake activities that are part of the reporting entity's ongoing activities [...]. The reporting entity is unlikely to surrender power to direct such structured entity's activities because of the importance of those activities [...]*'. Some may interpret this to mean that control would normally exist in circumstances such as those described in paragraph 32 but the fact that the entity set up the structured entity, by itself, is not determinative of whether the entity controls the structured entity or not. Alternatively, some may take a different reading to the paragraph and conclude that the fact that the entity set up the structured entity is determinative of control and, in the absence of clear evidence to the contrary, there is a presumption that the reporting entity controls the structured entity. We suggest that the Board clarifies its intent with respect to the situation described in the paragraph.

Secondly, paragraph 33 is similarly ambiguous:

- a) It states '*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 to the structured entity and the reporting entity's exposure is more than that of any other party*'. We question whether this establishes a presumption that exposure to the majority (or to the greatest amount) of returns automatically means that the reporting entity controls the structured entity, i.e. that there is a causal link between exposure to returns and control. If this is the case, we are concerned that this conclusion relies solely on a risks and rewards model and is inconsistent with the definition of control as set out in the ED. We would expect that a more appropriate interpretation of the paragraph would be that exposure to the largest variability of the returns is a (strong) indicator that control exists but is not in itself determinative;
- b) Further, it appears contradictory with paragraph BC56 which states that '*the right to receive return is not a sufficient condition to control*' and paragraph BC121 which states '*if a reporting entity has no means of directing or managing the activities or assets and liabilities of an entity, it does not have any ability to affect its returns from its involvement with that entity and would not control the entity even though it might be exposed to risks associated with the structured entity*'. We suggest that paragraph 33 should be further explained (in the main body of the Standard) to remove this apparent contradiction;

- c) Also, we note that example 1B of the illustrative examples concludes that the reporting entity is not considered to control the structured entity despite the fact that it is exposed to the first loss protection of 10%, which the example states is considered potentially significant. This conclusion appears to be inconsistent with the guidance provided in paragraph 33. We suggest that the conclusion provided in the example should be further explained.

Thirdly, paragraph 36 states that *'predetermined policies can give a reporting entity control'* but it fails to clarify how and when control is obtained through predetermined policies. In particular, the paragraph should establish a link between the predetermination of the policies and the on-going entitlement to returns from the entity by the party who established these policies. An example of the ambiguity in this paragraph is as follows: suppose X sets up a vehicle with completely predetermined policies that will generate returns for whoever holds particular notes, and that the notes are initially held by X. Having predetermined the policies, X can be said to have the power to direct the activities. But what if X later sells the notes to Y? Does Y have control or not? On the one hand, one could argue that Y cannot control the vehicle since it was not involved in the predetermination of the policies. On the other hand, others may argue that by having bought the notes from X, Y assumes the role of X and thereby assumes control of the vehicle. This being said, we believe that a party that had, in the past, the power to direct the activities of an entity to generate returns (i.e. that party had control over the entity) and continues to hold the same interest in the entity would not lose control simply by having predetermined the activities of the entity for the remainder to the life of the entity. The situation, however, becomes more ambiguous if the party that has preset the activities retains only a portion of its initial interest and another party becomes exposed to greater variability in returns.

Finally, we question whether the example in paragraph 37 is appropriate since it is unclear to us that the arrangement described (the purchase of receivables from the reporting entity by a structured entity) would have resulted in derecognition of the receivables by the reporting entity.

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.

No, we do not believe that the Standard should include a risks and rewards fall back test. As previously indicated in this letter, we believe that risks and rewards are integral to the control model. Incorporating a separate fall back test would move away from consolidation based on control, which we do not believe is the direction the IASB should be taking.

Disclosure

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 support the requirement to provide better disclosure both on circumstances where significant judgment was used in determining whether to consolidate (or not consolidate) certain entities and on the reporting entity's 'off balance sheet' activities, which we believe relate to the reporting entity's business risks. The additional information proposed by the ED appears to affect both areas and we suggest that the Board more clearly distinguishes which

disclosures are aimed at addressing which areas. Moreover, the guiding principles for the disclosure are not clearly established, giving the impression that voluminous disclosure will be required, the relevance of which is questionable.

Guiding principles for disclosures

It appears that paragraph B31 should be read as providing the guiding principle that the reporting entity should use in establishing what information to disclose. We note that this paragraph rightly indicates that an appropriate balance is required to avoid providing neither insufficient nor excessive information. However we question whether the requirements listed in the subsequent paragraphs respect this principle. To ensure that the spirit of paragraph B31 is met, we encourage the Board to establish clearly the objective of each element of the disclosures and then turning the detailed information that is currently proposed as being required by the ED into suggestions of the information that may allow the reporting entity to meet this objective.

Information related to consolidation

We have identified paragraphs B32-B37 and B48-B49 as relating to the application of the consolidation requirements.

We agree with the principle of providing additional information related to circumstances where the decision whether to consolidate was based on significant judgment. This is consistent with the disclosure on estimates, uncertainties and judgments required by IAS 1.

In that respect, we propose the following modifications to the disclosure requirements:

- a) It would be useful for paragraph B32 to include a reminder of this objective and to indicate that it is likely that significant judgement was involved in the circumstances currently listed in (a) to (c) but it may also arise in other circumstances;
- b) Further, we note that paragraph B33 and B34 indicate that the reporting entity would provide information in the aggregate if the circumstances listed in paragraphs B32(a) and (b), respectively, arise. Keeping in the spirit of IAS 1, we believe that it may be more useful if separate disclosure was provided for each entity that is consolidated (or not consolidated) as a result of a decision requiring significant judgement and estimates.

With respect to the other information related to the effect of consolidation, we question the objective of the requirements proposed in paragraph B35 relating to non-controlling interests. It appears to compensate for the decision taken by the Board to adopt an 'entity approach' and provide disclosure to assess what the consolidated financial statements would be like under a 'parent approach'. If this is the only reason for requesting this information, we do not believe that the disclosure in paragraph B35 is relevant.

Information related to business risks

We have identified paragraphs B38-B47 as relating more to disclosure of an entity's business risks rather than issues related to the application of the consolidation requirements.

We support the Board's decision to improve the disclosure required with respect to business risks, such as reputational risk. However, we believe that such improved disclosures may also be appropriate for entities that would not meet the definition of structured entities. Accordingly, we believe that it is the existence of business risks such as reputational risk which triggers the need for improved disclosure rather than the manner in which the entity, or the counterparty to these activities, has been structured.

While we support the objective of improving the disclosure on business risks, we question the need to provide all of the information listed in the ED. As we detail in our response to Question 10, some of the disclosure requirements may be onerous and/or extremely difficult to obtain. Also, we have indicated above, in order to be consistent with the principle established in paragraph B31, the objective should be for the reporting entity to disclose sufficient and appropriate information to provide a meaningful understanding of its exposure to business risks to the users of the financial statements. We are not convinced that this balance has been achieved so far.

Furthermore, we believe that the expanded disclosure requirement related to business risks would be better integrated in another Standard (e.g. IAS 1 or IAS 24) rather than in a Standard on consolidation.

Other comments

We also note that:

- a) While paragraph BC145 indicates that the *'Board decided against requiring disclosures of a reporting entity's intention to provide future support...without a contractual or constructive obligation to do so'*, this decision does not appear to have been respected since paragraphs B46(e)(iii) and B47(a) both require that a reporting entity discloses whether it has current intentions to provide support to structured entities;
- b) The ED proposes to impose a tabular format for much of the information required. We believe that the reporting entity should be free to determine the format most suitable to its disclosure.

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.

No, we believe that preparing the following disclosures would be onerous and/or that the required information would be extremely difficult to obtain:

- a) B32(c): We question whether an entity will always have the information to determine whether returns are significant to the structured entity. We also note that this disclosure appears to be related to the circumstances discussed in paragraph 33. However, whereas paragraph 33 refers to *'exposed to the variability of returns that are potentially significant'*, paragraph B32(c) refers to *'receive returns that are potentially significant'*. If these two paragraphs are indeed related, it would be appropriate that they are consistent in referring either to variability of returns or simply to returns.
- b) B37(b): This paragraph appears to require the disclosure of all covenants. This appears very onerous given that IFRS 7 does not require such a disclosure.
- c) B40-B41: To the extent that a reporting entity no longer has any involvement with a structured entity, we believe these disclosures are onerous and we question the relevance of the information. Furthermore, it would be useful to specify whether the disclosure is also meant to be required if the reporting entity is solely acting as agent for another party with respect to the structured entity. Also, would the disclosure in B41(b) apply to all assets transferred to structure entities (including cash contributions) and to assets transferred 'from' structured entities and would it cover only transfers in the current period? Finally, we suggest that the Board should

explain what it means to ‘sponsor’ an entity as this term may not be widely understood.

- d) B42: The requirement to provide two years of comparative information appears burdensome and inconsistent with the general requirements of IAS 1.
- e) B43-B47 (nature of risks): As a general principle, we do not believe that the disclosures to be provided should be more onerous than the information a structured entity would include in its own financial statements under IFRS.
- f) B44(c) and B46: We believe that this is information that the reporting entity may be unable to obtain.

Also, we believe that the requirements of the following paragraph should be clarified:

- a) B37(a): Is this meant to require disclosure of all protective rights granted to non-controlling interests?

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?**

No, we agree that reputational risk is NOT an appropriate basis for consolidation.

We do not believe that this decision implies that additional disclosure is required as a replacement. We do not believe that the disclosure in B47 is appropriate, if appropriate disclosures about business risks are provided.

Also on the topic of reputational risk, BC 39 states that an explicit commitment to support another entity is likely to be a liability that is accounted for in accordance with IAS 37. We question why IAS 39 might not be the applicable Standard for accounting for such a liability.

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?

Yes, we believe that the Board should undertake a project on the definition of significant influence and the use of the equity method.

Appendix 2

Additional Comments

The following are additional comments and suggested editorial changes we would like the Board to consider in finalising the Standard on Consolidation.

1. Definition of entity

We believe that the Standard should clearly establish the ‘level’ at which the consolidation principles must be applied. In particular, we note that the ED introduces the concept of ‘silo’ as a footnote to the definition of subsidiary included in Appendix A. Since this is not a defined term in IFRS, the definition of silo currently provided in paragraph BC31 should be incorporated in the main body of the Standard. In addition, the Standard should specify the circumstances when it is necessary to silo an entity into various functions. Further, since the concept of separating entities into silos is not addressed in IFRS, it would be important that the Board explains the basis for introducing this concept in the consolidation Standard.

2. Related arrangements

Paragraph 18 of the ED has carried forward the guidance from IAS 27.33, however subparagraph (c) which states *‘[t]he occurrence of one arrangement is dependent on the occurrence of at least one other arrangement’* has been omitted without any rationale provided in the Basis of Conclusions. We believe that this guidance should be retained because in practice this often establishes the link between two arrangements. The guidance in IAS 27.33(c) addresses a condition that is different from the condition addressed in IAS 27.33(a) which refers to *‘entering into one arrangement in contemplation of another’* and accordingly subparagraph (a) cannot be considered to encompass the two conditions.

3. Related parties

Paragraph B12 lists parties that may be identified as acting for a reporting entity. However, in the absence of further guidance on the matter, it is unclear in what context and how this list of examples is meant to be used. In particular, where related parties are acting in concert (or may be acting in concert), how would one identify which party is acting on behalf of the other?

4. Legal supervision

Paragraph 25 indicates that a reporting entity that has more than half of the voting rights of another entity may not have control if that other entity is under ‘legal supervision’. The term legal supervision is not defined or explained. It may be appropriate to revert to the wording currently used in IAS 27.32 that refers to *‘control of a government, court, administrator or regulator’*. Legal supervision could otherwise be interpreted as encompassing the regulatory regimes to which rate-regulated entities are subject.

5. Transitional provisions

Certain aspects of the transitional provisions require clarification. These include:

- a) Paragraph 52 indicates that if adoption of the new Standard results in consolidation of an entity that was not previously consolidated, the deemed acquisition date is the date of first applying the Standard. Is this the first day of the current year or of the previous year?
- b) Also, if a reporting entity is required to consolidate an entity not previously consolidated, what is the consideration to be used to determine goodwill? Is it the fair value of the interest at the deemed acquisition date?
- c) Further, if consolidating an entity not previously consolidated requires fair valuing the existing interest, would the resulting adjustment be recognised in profit or loss or other comprehensive income (revaluation reserve, opening retained earnings)? The same question would arise if consolidation results in recognition of a gain on a bargain purchase or if deconsolidation of a previously consolidated entity results in a gain or loss.

It may also be useful to include illustrative examples of the application of the transitional provisions.

6. Presentation of options issued by a subsidiary

While this issue does not arise from the changes to the consolidation Standard proposed by this ED, we would like to take the opportunity to bring to the attention of the Board the fact that ambiguity exists on how to apply the guidance in paragraph B19 (or IAS 27.19 in the current Standard): how are options of subsidiaries presented in the statement of changes in equity, i.e. are these part of the non-controlling interest or not, and if not where should they be presented? Also, under this paragraph, if options entitle the holder to certain dividend rights, how should the dividends be presented and allocated?

7. Revised IAS 27

We recommend that the revised IAS 27 is issued as an exposure draft prior to being issued as a revised Standard to ensure that no unintended consequences arise as a result of unexposed amendments.

8. Editorial changes

Paragraph 11 states '*returns generated for a parent can include...*' We suggest that this should be reworded to say '*returns can include...*' The wording in the ED assumes control relationship before this assessment has been made.

Paragraph 16 states '*however, if the reporting entity ceases to receive returns from its involvement with an entity, it does not control that entity.*' We suggest that this should be reworded to state '*however, if the reporting entity ceases to have an entitlement to receive returns from its involvement with an entity, it does not control that entity.*' The wording in the ED could be misinterpreted in circumstances where returns are nil, therefore emphasis should be on changes in entitlement to returns.

In keeping with our suggestion that the definition of structured entities be removed (i.e. that paragraph 30 be deleted), paragraph 31 may then be reworded to read '*some entities are structured so that their activities are restricted and those activities are not directed as described in paragraphs 23 to 29. In such circumstances, when assessing control, it is necessary to ...*'

Appendix A defines 'control of an entity' as '*the power of a reporting entity to direct activities ...*'. We suggest that the reference to 'reporting' entity is unnecessarily restrictive and accordingly we suggest that the definition should be reworded 'the power of an entity to direct activities ...'

Paragraph B20 and B21 should refer to '*financial statements or other financial information*' rather than only '*financial statements*'.

Paragraph B35(c) should refer to '*operating segment or, where the entity is scoped out of IFRS 8, the business activity*'

Paragraph B36, relating to the information required when the date of the financial statements of a subsidiary used to prepare consolidated financial statements differs from the date of these consolidated financial statements, is currently in the section on information related to non-controlling interest. A separate header is required for paragraph B36.

Appendix D

Submission to the IASC Foundation Trustees on the Invitation to Comment *Review of the Constitution: Identifying Issues for Part 2 of the Review* dated 31 March 2009

Mr Gerrit Zalm, Chairman
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31 March 2009

Dear Mr Zalm

**Review of the IASCF Constitution:
Identifying Issues for Part 2 of the Review**

Deloitte Touche Tohmatsu is pleased to provide comments to the IASC Foundation Trustees on their discussion document *Review of the Constitution: Identifying Issues for Part 2 of the Review* issued in December 2008.

In our view, the IASCF Constitution should identify the principles of governance and oversight of the IASCF and the IASB. It should be relatively short and allow the various components of the IASCF a necessary degree of operational flexibility. This operational flexibility has allowed the IASB to react quickly to crises (e.g., that in October 2008). Were the Constitution to be overly detailed, this ability to act with agility might be compromised.

However, we have identified areas within the Constitution where we see the need for change: to align the IASCF Constitution and the IASB *Framework*; to require that IFRS be based on clear principles; and to clarify certain aspects of the IASCF's governance.

Many of our comments encourage the IASB and the Trustees to enhance the documentation of operational aspects of their activities. Within the constitutional framework, the IASB and the IFRIC have voluntarily documented their operational practices in their respective Due Process Handbooks, to which they adhere generally and the SAC developed its own 'Terms of Reference and Operating Procedures'. We believe that the IASB should amend its *Due Process Handbook* to give constituents an opportunity to comment on the IASB's agenda and relative priorities; to be required to conduct field tests when a proposal would change current practice in an untested way; and to require more rigorous reconsideration of a principle in light of substantial unorchestrated opposition.

Many of the criticisms being levelled at the IASCF and the Trustees in particular stem from a lack of transparency and understanding around what they do and how they do it. We

encourage the Trustees to prepare a document that explains their operating procedures and how they exercise their oversight functions.

If you have any questions concerning our comments, please contact Ken Wild in London at +44 (0)20 7007 0907.

Yours sincerely

A handwritten signature in black ink, appearing to read "Ken Wild", written over a horizontal line.

Ken Wild
Global IFRS Leader

Objectives of the organisation

1 *The Constitution defines the organisation's primary objective in the following manner:*

to develop, in the public interest, a single set of high quality, understandable and enforceable global accounting standards that require high quality, transparent and comparable information in financial statements and other financial reporting to help participants in the world's capital markets and other users make economic decisions

In fulfilling that objective, the organisation is

to take account of, as appropriate, the special needs of small and medium-sized entities and emerging economies

Does the emphasis on helping 'participants in the world's capital markets and other users make economic decisions', with consideration of 'the special needs of small and medium-sized entities and emerging economies', remain appropriate?

We believe that the objective remains appropriate, but that the Trustees should take the opportunity to align the objectives of the organisation as expressed in the Constitution as far as possible with the objective of general purpose financial reporting as it is expressed in the IASB's proposed *Framework*. Although any change to the IASCF Constitution should use the words in the final version of Chapter 1 of the *Framework*, using the words in the May 2008 Exposure Draft of *An Improved Conceptual Framework for Financial Reporting* the Objective would be:

to develop, in the public interest, a single set of high quality, understandable and enforceable global financial reporting ~~accounting~~ standards that require high quality, transparent and comparable information in financial statements and other financial reporting to help present and potential equity investors, lenders, creditors and other participants in the world's capital markets ~~and other users~~ make economic decisions in their capacity as capital providers.

And that, in discharging this responsibility, the IASB should

take account of, as appropriate, the special needs of private entities [or however the IASB refers to the 'SME project' in the final Standard] ~~small and medium-sized entities~~ and emerging economies.

In suggesting these changes, we wish to emphasise that the world's capital markets include public and private capital markets; both of which seem to have similar (although not identical) information requirements. That is, the user of the financial statements may be different between public and private capital markets, but the objective of financial reporting remains the same: to provide high-quality, transparent and comparable financial information about the reporting entity that is useful to present and potential equity investors, lenders, creditors and other capital market participants in making economic decisions in their capacity as capital providers.

The disclosure requirements in public capital markets are usually thought to be more extensive than for private ones, but this is an issue already being addressed by the IASB in its IFRS for non-publicly accountable entities project.

Is 'emerging economies' the correct term?

We believe that there is some misunderstanding of the term 'emerging economies'. Sometimes, the term is used (e.g., the FTSE Emerging Markets Index and the Morgan Stanley Emerging Markets Index) to refer to large second-tier economies such as Argentina, Brazil, Chile, China, India, Russia, South Africa and Taiwan. We question whether economies of this size are those contemplated in objective 2(c), or whether the intention is to highlight the needs of the one hundred or more smaller 'developing countries' and 'economies in

transition'. If the intention is to address the latter, we suggest modifying objective 2(c) to refer to 'developing countries and economies in transition', which is the term used by the United Nations' Intergovernmental Working Group of Experts on International Standards on Accounting and Reporting (ISAR). We note that the Constitution refers to 'emerging markets' in paragraph 37(f) and recommend that whatever term is used in paragraph 2(c) should also be used in 37(f).

How might the IASCF and the IASB implement objective 2(c)?

Referring to the 'special needs of emerging economies' in the objectives of the organisation raises expectations among constituents. Objective 2(c) refers back to objectives (a) and (b), which are to develop high quality standards and promote their use and rigorous application. We believe that the forthcoming IFRS for Private Entities will help enhance access to capital by companies, regardless of size, in developing countries and economies in transition. We believe that the IASCF's programme to develop comprehensive training materials to accompany the IFRS for Private Entities and make them available without charge in multiple languages will help bring about use and rigorous application of the standard.

At the same time, we also believe that the main challenges in developing countries and economies in transition are a lack of capacity and experience in many different aspects of the financial reporting infrastructure generally, such as accounting education and training, support materials and software in local languages, effective enforcement of standards, an professional accountancy body that complies with the obligations that IFAC imposes on its members, and experienced, effective external auditors. Building capacity in these areas is, for the most part, beyond the remit of the IASCF and the IASB. But in our view they are closely related to what is intended by the inclusion of 'emerging economies' in objective 2(c).

While we support clarifying objective 2(c), we believe that the intention expressed remains appropriate and should not be deleted from the Constitution. However, it is important that the IASCF and the IASB and their constituents have a clear understanding of what is intended by that objective and that constituents have realistic expectations of what the IASCF and the IASB can and cannot do to achieve it.

- 2 *In the opinion of the Trustees, the commitment to drafting standards based upon clear principles remains vitally important and should be enshrined in the Constitution. Should the Constitution make specific reference to the emphasis on a principle-based approach?*

We agree that the IASCF Constitution should require that the IASB should develop financial reporting standards that are based on 'clear principles' i.e., the objective of the IFRS. These principles must be explained clearly in each IFRS. We would use the phrase 'clear principles' in the Constitution in preference to 'principles-based', for which there is no consensus on what that phrase means. The Constitution should not be overly-prescriptive on what should be implied by 'clear principles', but it could comment as follows:

Financial reporting standards are based on clear principles that result in financial reporting information that is a faithful presentation of economic reality and is responsive to users' needs for clarity and transparency. In addition, such standards will be consistent with a clear Conceptual Framework; will be based on an appropriately-defined scope that addresses a broad area of accounting; are written in clear, concise and plain language; and allow for the reasonable and appropriate use of professional judgement.

We acknowledge that any IFRS based on clear principles will be accompanied by application guidance, but we would expect that this would be kept to a minimum and illustrate the principles rather than detailed examples of particular facts and circumstances. Extensive application guidance is often an indicator that the principle in the standards is not as clear as it should be.

If the Trustees incorporate a ‘clear principles’ requirement in the Constitution, the IASB should be asked to amend its *Due Process Handbook* to accommodate and elaborate on how it implements the requirement in practice – in accordance with its usual period for public comments. This will help to ensure that there is consensus among the IASB’s constituents about (i) what ‘financial reporting standards based on clear principles’ means in practice; and (ii) that how the IASB expects to achieve that objective in practice is appropriate and accepted.

3 *The Constitution and the IASB’s Framework place priority on developing financial reporting standards for listed companies. During the previous review of the Constitution some commentators recommended that the IASB should develop financial reporting standards for not-for-profit entities and the public sector. The Trustees and the IASB have limited their focus primarily to financial reporting by private sector companies, partly because of the need to set clear priorities in the early years of the organisation. The Trustees would appreciate views on this point and indeed whether the IASB should extend its remit beyond the current focus of the organisation.*

We believe that it is important to clarify that financial reporting by not-for-profit entities and public sector entities are potentially very different and that any discussion should not address these two sectors as if they were necessarily the same or faced the same issues.

The IASB’s primary function at present is ‘private sector’ financial reporting standards. We believe that this responsibility remains appropriate and should not change at this time. At present, we are uncertain whether any of the IASB members has significant experience in the public sector and thus whether the IASB has the appropriate skills to set both public- and private sector financial reporting standards. We believe that, in the medium-term at least, there are many issues requiring attention in private sector financial reporting and the IASB should not have the constitutional distraction of having to address public sector issues.

Currently the International Public Sector Accounting Standards Board, which operates under the auspices of the International Federation of Accountants, issues International Public Sector Accounting Standards. In setting these standards, the IPSASB ‘considers and makes use of’ International Financial Reporting Standards as well as pronouncements from other sources with an over-arching objective that IPSAS are consistent with IFRS ‘to the extent those pronouncements are applicable and appropriate to the public sector’ (IPSASB *Interim Terms of Reference*, 10). There is a high degree of cooperation between the IASB and IPSASB and the respective staff members. This should be encouraged to continue (see below, Q4).

In due course, although not as a current priority, the IASB should address issues in financial reporting by not-for-profit entities. There are some specialist areas (e.g. non-reciprocal transactions/ contributions; accounting for collections, heritage assets, etc; and financial statement presentation in the lack of an ownership structure).

- 4 *There are other organisations that establish standards that are either based upon or have a close relationship with IFRSs. The IASC Foundation already recognises the need to have close collaboration with accounting standard-setting bodies. Should the Constitution be amended to allow for the possibility of closer collaboration with a wider range of organisations, whose objectives are compatible with the IASC Foundation's objectives? If so, should there be any defined limitations?*

We note that nothing in the Constitution prohibits the IASB from cooperating or collaborating with any other body with a legitimate interest in financial reporting standards. Indeed, we have seen and support the IASB's outreach not only to financial reporting standard-setters and regional bodies that are closely involved in financial reporting standards, such as the European Financial Reporting Advisory Group, but also to standard-setters that operate in areas that are complimentary to financial reporting, such as the International Valuation Standards Committee and the UN ECE and CRIRSCO groups on the measurement of oil and gas reserves.

This *collaboration* contributes to the success of IFRS as a global reporting language, but we think that it is an operational aspect of standard-setting. If the Trustees think that it is important to document willingness or an undertaking to enter into such cooperation, it should ask the IASB to amend their *Due Process Handbook* how this might be done while preserving the Board's operational transparency.

Governance of the organisation

- 5 *The first part of the review of the Constitution proposed the establishment a formal link to a Monitoring Group. Under this arrangement, the governance of the organisation would still primarily rest with the Trustees. Although the first part of the review has not yet been completed, the Trustees would welcome views on whether the language of Section 3 should be modified to reflect more accurately the creation of the Monitoring Group and its proposed role.*

We note that the IASC Foundation Trustees announced the completion of Phase I of the Constitution review on 29 January 2009. Included in that announcement was the formation of the Monitoring Group and the publication of the Terms of Reference agreed between the IASCF and the Monitoring Group Members and Observer.

We believe that the IASC Foundation Constitution should be amended to reiterate the principles recited in paragraphs 5 and 4 of the Memorandum of Understanding, for example:

Governance of the IASC Foundation

- 3 The governance of the IASC Foundation shall rest with the Trustees. In discharging this responsibility, the Trustees shall collaborate with the IASCF Monitoring Board in the manner specified in the 'Memorandum of Understanding to strengthen the institutional framework of the IASCF' dated [dd mmm 2009] (cf MoU paragraph 4). That MoU does not alter the terms of the relationship between the Trustees and the IASB, neither does it alter the Trustees' responsibilities as described in this Constitution (cf MoU paragraph 5). ~~and such other governing organs as may be appointed by the Trustees in accordance with the provisions of this Constitution.~~ The Trustees shall use their best endeavours to ensure that the requirements of this Constitution are observed; however, they are empowered to make minor variations in the interest of feasibility of operation if such variations are agreed by 75 per cent of all the Trustees.

Trustees

- 6 *The Trustees are appointed according to a largely fixed geographical distribution. Is such a fixed distribution appropriate, or does the current distribution need review?*

In our view the mandatory geographical apportionment at the Trustee level is, and continues to be appropriate.

However, it would be useful to all constituents to understand the basis for the apportionment, for example, whether it is based on national or regional GDP or securities markets' capitalisation or other indicators. In our view, the formula for the apportionment should be fixed but the actual distribution should be flexible and should be reviewed from time to time.

- 7 *Sections 13 and 15 set out the responsibilities of the Trustees. The intention of these provisions is to protect the independence of the standard-setting process while ensuring sufficient due process and consultation—the fundamental operating principle of the organisation. In addition to these constitutional provisions, the Trustees have taken steps to enhance their oversight function over the IASB and other IASC Foundation activities. The Trustees would welcome comments on Sections 13 and 15, and more generally on the effectiveness of their oversight activities.*

Funding the organisation (paragraph 13(a))

While noting the progress highlighted in the Trustees' press release of 29 January 2009, we share the concern of others about the progress of funding arrangements (paragraph 13(a)). See also our response to Q8.

Operating procedures for the Trustees (paragraph 13(b))

The IASCF's standard-setting components (IASB and IFRIC) have developed and issued documents that explain what they do and how they do it (their *Due Process Handbooks*). The Standards Advisory Council has a similar document in their *Terms of Reference and Operating Procedures*. We are concerned that the operations of the Trustees (paragraph 13(b)) are not well understood and that some of the stress on the organisation stems from this lack of understanding. Consequently, we would encourage the Trustees to document their operating procedures in a manner similar to the IASB, IFRIC and SAC.

Open meetings (paragraph 13(f))

While we note that there are public sessions at meetings of the IASCF Trustees (paragraph 13(f)), we would encourage more sessions to be opened to the public and for better observer resources to be provided. (Again, the IASB, IFRIC and SAC provide very detailed resources to Observers, which are very helpful to Observers and others to understand those discussions and to ensure better and more accurate communication with constituents.)

Oversight of the IASB

Before we can comment on the "effectiveness of the Trustees' oversight activities of the IASB" (paragraph 15), it would be helpful for us to understand how the Trustees undertake this exercise and the criteria they employ. Therefore, once again we encourage the Trustees to document their operating procedures and to include in that document the criteria against which they assess the effectiveness of the IASB.

Standards Advisory Council

We note the appointment of the reconstituted Standards Advisory Council in February 2009 and support the inclusion of members as representatives of constituencies on the Council. We think that this group has the potential to be very useful to the IASB, provided that it is seen as an effective conduit for an *exchange* of views between constituents and the IASB.

Consequently, we recommend that, as part of its responsibility to monitor the effectiveness of the IASB, the Trustees develop criteria that will allow them to assess how effectively the IASB engages with and responds to the Standards Advisory Council.

- 8 *The Trustees are responsible for ensuring the financing of the IASC Foundation and the IASB. Since the completion of the previous review of the Constitution, the Trustees have made progress towards the establishment of a broad-based funding system that helps to ensure the independence and sustainability of the standard-setting process. However, the Trustees have no authority to impose a funding system on users of IFRSs. The Trustees would welcome comments on the progress and the future of the organisation's financing.*

We are firmly in favour of a principle that those parties who use the IASC Foundation 'works' (IFRS and related documents) should bear the burden of funding the IASC Foundation's standard-setting activities. We believe that this is best left in the hands of local financial market regulators, who in turn should be responsible for raising the money from their constituents, including but not necessarily limited to preparer companies. We also stress that the method of funding should maintain *and be seen to maintain* the independence of the IASB from national and regional governments, the accounting profession and individual preparer entities.

Insofar as they support this approach to funding the IASCF, we support the principles already established by the Trustees: that the funding should be broad-based; compelling; open-ended; and country-specific.

International Accounting Standards Board

- 9 *Commentators have raised issues related to the IASB's agenda-setting process. The Constitution gives the IASB 'full discretion in developing and pursuing its technical agenda'. The Trustees have regularly reaffirmed that position as an essential element of preserving the independence of the standard-setting process. However, they would welcome views on the IASB's agenda-setting process and would appreciate it if, in setting out views, respondents would discuss any potential impact on the IASB's independence.*

We note that, in the United States, the FASB and the Financial Accounting Standards Advisory Council undertake an annual survey of the FASB's constituents on the FASB's technical agenda. This survey has a high degree of credibility both at the FASB and with constituents. In particular the survey assists the FASB in identifying trends in financial reporting, which in turn assists them in making resource allocations as appropriate.

In the past, the IASB has not been particularly successful in developing communications with constituents with respect to how it determines its technical agenda and assigns relative priorities. We encourage the IASB, SAC and the Trustees to give constituents an opportunity to comment on the IASB's agenda and relative priorities. Part of the Trustees' oversight responsibilities would be to determine how the IASB uses the input it receives; how it communicates to those who participate in the survey about how it has used those responses; and how its resource allocation decisions and priorities were influenced by the feedback it received.

The IASB must have the discretion to make changes to its technical agenda without excessive

interference; however we agree that it would be appropriate for the Trustees to review specifically the exercise of that discretion as part of its annual review. The Board needs the ability to be flexible, while in normal circumstances maintaining its wide consultation with constituents, the SAC and others.

Some constituents are of a view that the agenda has been too heavily focused on convergence with US GAAP and ‘esoteric’ conceptual issues for several years. While many of the IASB’s projects are part of the Memorandum of Understanding with the FASB, the IASB has also undertaken projects that have been responsive to requests from Europe, New Zealand, China and Canada. Their consultation has increased, as has the quality of the documentation supporting agenda proposals.

The regular review of the technical agenda that occurs during public IASB sessions, which more recently have been accompanied by a thorough assessment developed by the senior staff, are very useful documents for regular followers of the IASB. However, they are not documents designed to arrest the public’s attention. Consequently, we are concerned that the perception that some constituents are more important than others remains and the IASB should improve how it communicates its agenda-setting decisions to its constituents.

10 *The Constitution describes the principles and elements of required due process for the IASB. The IASB’s procedures are set out in more detail in the IASB Due Process Handbook. If respondents do not believe the procedures laid out in the Constitution are sufficient, what should be added? If respondents believe that the procedures require too much time, what part of the existing procedures should be shortened or eliminated? The Trustees would also welcome comments on recent enhancements in the IASB’s due process (such as post-implementation reviews, feedback statements, and effect analyses) and on the IASB Due Process Handbook.*

In general, the procedures in the IASB’s Due Process Handbook (and the IFRIC equivalent) are satisfactory and sufficiently flexible to permit the effective discharge of the IASB’s standard-setting responsibilities, however there are areas in which the IASB’s due process could be enhanced further.

We support the IASB’s self-imposed decision to issue a discussion document for all significant new topics. However, there is some concern that, by including their ‘preliminary views’, there is a perception that the IASB is stifling debate or inviting constituents to join a conversation already in progress. These constituents would prefer to see discussion papers present the issues and possible approaches in as neutral a fashion as possible. On the other hand, we acknowledge that if a particular alternative has been included in the discussion document for reasons of completeness, but has little likelihood of forming the basis of an IFRS, the IASB should be honest with its constituents at as early a stage as possible.

We believe that one way in which the IASB could enhance its due process would be to require a substantive redeliberation of a preliminary view if there is a *substantial un-orchestrated* level of opposition to a principle. The IASB would need to debate why so many constituents were opposed to the IASB proposal. Nor should they ignore opposition on conceptual grounds: often opposition is based on practical considerations that the IASB may not have deliberated.

The IASB should also be encouraged to conduct field tests when their proposals are controversial or change existing practice in an *untested* manner. These field tests should be conducted in a variety of jurisdictions to demonstrate that the proposal is a substantively better treatment than any other.

We would also encourage the Board to make a preliminary assessment of the practical and cost/ benefit consequences of a particular approach before committing itself to that approach.

Finally, we wish to support the views of many constituents expressed in public and in correspondence with the IASB that any changes to IFRS must be accompanied by an

opportunity to comment on such proposals. While we acknowledge the extraordinary circumstances of October 2008, if it is to maintain its reputation as the global independent private-sector financial reporting standard setter, the IASB should ensure that some period for comment (normally a minimum of 30 days) be offered for all standard-setting activities. The Trustees should not permit the IASB to bypass its due process in response to pressure from any region or jurisdiction. This is an operational aspect of standard-setting and is best documented in the IASB's Due Process Handbook. (See also our comments on Q11.)

11 *Should a separate 'fast track' procedure be created for changes in IFRSs in cases of great urgency? What elements should be part of a 'fast track' procedure?*

We do not support creating a separate 'fast track' procedure for changes to IFRS.

In extraordinary times, the FASB due process provides for shortening the "normal" comment period, and this has been enacted for some of the recent projects associated with the credit crisis. While recognising the urgency of those projects, we commend the balance shown by the FASB to continue to ensure some period for comment rather than overriding its due process. We note that the IASB's Due Process Handbook (paragraphs 97-98) also provides for very short comment periods without having to obtain an explicit permission of the IASB Foundation Trustees. However, we think that the Due Process Handbook should be amended to acknowledge that comment periods shorter than 30 days could be used in particularly extreme circumstances. While we acknowledge the extraordinary circumstances of October 2008, if the IASB is to maintain its reputation as the global independent private-sector financial reporting standard setter, the IASB should not bypass its due process in response to pressure from any region or jurisdiction.

Standards Advisory Council

12 *Are the current procedures and composition, in terms of numbers and professional backgrounds, of the Standards Advisory Council (SAC) satisfactory? Is the SAC able to accomplish its objectives as defined in Section 38?*

Comments on the composition must await the appointment of the 'new' SAC, but as this will be the third time the SAC has been restructured in seven years, its record as a troublesome group for which to define the appropriate membership and role is well known.

The SAC can be very effective in bringing to light different views on financial reporting issues and as such, provides valuable input to the IASB's agenda-setting and technical deliberations. In particular, we support the inclusion of members as representatives of constituencies on the Council.

We have noted elsewhere in this response ways in which the IASB might work with the SAC more effectively and discuss in a meaningful way with it why the IASB intends to act or has acted in a particular way, how it has taken some views of the SAC into account and why it disagreed with others. This would help to make the SAC more in the nature of 'insiders' and better able to act in their ambassadorial role (see paragraph 2 of the SAC's Terms of Reference).

13 *Are there elements of the terms of reference of the SAC that should be changed?*

We believe that the SAC's terms of reference as defined in paragraph 38 of the Constitution and elaborated in the SAC's *Terms of Reference and Operating Procedures* are appropriate.

Other issues

14 *Should the Trustees consider any other issues as part of this stage of their review of the Constitution?*

Paragraphs 24 and 41 of the Constitution provide that the IASB Chairman shall also be the CEO of the IASC Foundation. Given the very heavy technical workload of the IASB Chairman (including travel to meet with constituents), we recommend that the Foundation and the standard-setting activities be separated completely by appointing a CEO of the IASCF, one who is not a member of the IASB or the IASB/ IFRIC staff.

In addition, paragraph 43 refers to specific roles within the IASCF (director of operations and commercial director). We see no reason why some senior roles should be named and others not. We recommend that this paragraph be deleted or made more generic.