

Staff Paper

Project **Consolidation**
Topic **Disclosures – Scope**

Introduction

1. At the 1 June 2010 board meeting, the Board tentatively decided that a reporting entity should disclose information that helps users of financial statements understand the nature of, and changes in, the risks associated with the reporting entity's involvement with structured entities. At that meeting the staff proposed that a reporting entity would provide those disclosures for all structured entities that the reporting entity has an involvement with.
2. The Board asked the staff to conduct further research on the following issues:
 - (a) Some board members noted that a reporting entity can be exposed to the same risks from its involvement with all types of entities. Therefore, they questioned why the final disclosure standard should contain particular disclosure requirements for a reporting entity's risk exposure from its involvement with structured entities, but not for other entities.
 - (b) Some Board members also expressed concerns that, even if the disclosure requirement applied only to structured entities, the proposed scope of the disclosure requirements might be broader than the scope of the comparable disclosure requirements in US GAAP and impose excessive costs on preparers of financial statements. In addition, those Board members asked the staff to investigate the appropriateness of the scope of the disclosure requirements in US GAAP.

This paper has been prepared by the technical staff of the IFRS Foundation for discussion at a public meeting of the IASB.

The views expressed in this paper are those of the staff preparing the paper. They do not purport to represent the views of any individual members of the IASB.

Comments made in relation to the application of an IFRS do not purport to be acceptable or unacceptable application of that IFRS—only the IFRS Interpretations Committee or the IASB can make such a determination.

The tentative decisions made by the IASB at its public meetings are reported in *IASB Update*. Official pronouncements of the IASB, including Discussion Papers, Exposure Drafts, IFRSs and Interpretations are published only after it has completed its full due process, including appropriate public consultation and formal voting procedures.

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- (c) Some Board members asked the staff to investigate whether the proposed risk disclosures for a reporting entity's involvement with structured entities should be included in IFRS 7 *Financial Instruments: Disclosures*, rather than in a comprehensive disclosure standard for a reporting entity's involvement with other entities.
3. This agenda paper:
- (a) discusses whether the proposed disclosure requirements should apply to all entities or only to structured entities;
 - (b) investigates whether the scope of the proposed disclosure requirements is appropriate by:
 - (i) reviewing the experiences of preparers and users relating to the scope of the similar disclosure requirements in US GAAP; and
 - (ii) comparing the scope of the US GAAP disclosure requirements with the scope of the disclosure requirements proposed in the joint consolidation project.
4. The Appendix reproduces excerpts from Agenda Paper 6B of the Board meeting in February 2010, which addressed the issue of whether the proposed disclosure requirements should be incorporated into IFRS 7.

Should the risk disclosures apply to all entities?

5. The staff agrees that the same types of risks that the disclosure requirements in ED 10 were intended to address can arise from a reporting entity's involvement with other types of entities and that it may be appropriate to develop risk disclosures that apply to a reporting entity's involvement with all types of entities. However, developing such a disclosure requirement is currently outside the scope of the consolidations project. In addition, such disclosure requirements were not exposed in ED 10 and the staff is concerned that the development of risk disclosure requirements for all entities might significantly delay the finalisation of the proposals in ED10. In our view, risk disclosures for

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a reporting entity's involvement with entities in general should be discussed separately, rather than in the current consolidations project.

6. When the IASB proposed specific risk disclosures for a reporting entity's involvement with structured entities in ED10, the IASB intended to provide a timely response to particular information needs identified in the financial crisis. During the financial crisis, users and regulators had expressed concerns about the lack of disclosures related to investment and securitisation activities that a reporting entity conducts through structured entities. They asked the IASB to introduce specific risk disclosures for a reporting entity's involvement with structured entities, as those involvements have exposed reporting entities in the past to high risks. The proposed disclosure requirements in ED 10 were intended to meet those requests.
7. Addressing disclosures for structured entities would also be an opportunity to align the IFRS disclosure requirements and the US GAAP requirements. In December 2008, FASB Staff Position FAS 140-4 and FIN 46(R)-8 *Disclosures by Public Entities (Enterprises) about Transfers of Financial Assets and Interests in Variable Interest Entities* introduced disclosures for a reporting entity's involvement with variable interest entities that are similar to those discussed in the joint consolidation project. The FASB subsequently included those disclosure requirements in the Statement No. 167 amendments to ASC Topic 810.
8. We recommend that, in order to respond to the particular information needs identified in the financial crisis, the Board affirm that a reporting entity should provide information about its risk exposure from its involvement with structured entities. The Board could separately consider whether to integrate the disclosure requirement into a more general risk disclosure relating to a reporting entity's involvement with all types of entities.

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Question 1 for the Board

Does the Board agree to limit the risk disclosures developed in the current consolidation project to structured entities?

Is the scope of the risk disclosures appropriate?

9. If the Board affirms that a reporting entity should disclose information about the reporting entity's risk exposure from its involvement with structured entities, a question arises as to whether the scope of the proposed disclosure requirements should apply to particular involvements with structured entities, rather than all forms of involvement.
10. As a first step of our analysis, we sought the feedback of selected US constituents on the scope of the comparable US GAAP disclosure requirements. Subtopic 810-10 contains disclosure requirements for variable interest entities that are similar to those proposed in the consolidation project. In particular, paragraph 810-10-50-2AA states that one of the principal objectives of the disclosures is to provide financial statement users with an understanding of the nature of, and changes in, the risks associated with an enterprise's involvement with a variable interest entity. The disclosure requirements became effective for reporting periods that ended after December 15, 2008.
11. US constituents generally agreed with the scope of the disclosure requirements. Users of financial statements thought that the revised disclosure requirements provided them with an appropriate degree of detail. Preparers and accountants thought that the disclosure requirements allow reporting entities to focus on presenting information that is considered relevant for users of financial statements.
12. During our discussions, constituents noted that (1) the requirement in paragraph 810-10-50-10 that an enterprise shall determine, in light of the facts and circumstances, how much detail it must provide to satisfy the requirements in Subtopic 810-10 and (2) the aggregation guidance in paragraph 810-10-50-9,

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provided sufficient flexibility for preparers to determine the extent of disclosures to provide. In addition, the concept of materiality which underpins the disclosure requirements also affects the extent of the disclosure provided. The IASB and FASB have agreed in the conceptual framework project on a definition of materiality, according to which information is material if omitting it or misstating it could influence decisions that users make on the basis of a specific reporting entity's financial information.

13. In a second step, the staff has compared the scope of the proposed disclosure requirements for structured entities to the scope of the disclosure requirements in Subtopic 810-10. We have identified the following potential scoping differences:
- (a) the difference in the definitions of a variable interest entity and a structured entity;
 - (b) the difference in the definitions of involvement compared to a variable interest; and
 - (c) specific requirements to limit the extent of the disclosures.

Variable interest entity vs. structured entity

14. The disclosure requirements in Subtopic 810-10 apply to variable interest entities. A variable interest entity is an entity for which by design:
- (a) the total equity investment at risk is not sufficient to permit the entity to finance its activities without additional subordinated financial support provided by any parties, including equity holders; or
 - (b) a group of equity holders of the equity investment at risk lack particular characteristics; for example, the power through voting rights or similar rights to direct the activities of an entity that most significantly impact the entity's economic performance.
15. At their March 2010 meeting, the Board has agreed that a description of a structured entity should be included in the final disclosure standard. That description would incorporate some of the factors that describe a variable

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interest entity in US GAAP, but the description would not include all of the current guidance related to determining if an entity is a VIE that is in Subtopic 810-10. However, we do not expect that as a consequence of the tentative decision, there would be a significant difference between those entities currently considered variable interest entities under US GAAP and those considered structured entities.

Variable Interest vs. Involvement

16. The proposed disclosures require that the reporting entity has an ‘involvement’ with a structured entity. Although the term ‘involvement’ is not defined in US GAAP, we understand that US constituents generally interpret involvement as having a variable interest in the variable interest entity (VIE).
17. A variable interest is defined as a contractual, ownership or other pecuniary interest in an entity that changes with changes in the fair value of the variable interest entity’s net assets exclusive of variable interests. To meet the definition of a variable interest, an instrument must absorb variability, in the sense that it reduces the exposure of the entity to risks that cause variability. In contrast, if an instrument creates variability, in the sense that it exposes the entity to risks that will increase expected variability, the instrument is not a variable interest.
18. To illustrate, assume that a VIE holds a loan portfolio. The VIE obtains a credit default swap from the reporting entity to protect the variable interest entity from the default of interest and principal payments of the loans. The reporting entity has a variable interest in the VIE because the credit default swap absorbs variability.
19. In contrast, assume that a VIE holds government debt and issues debt linked to corporate risk. The VIE enters into a total return swap with the reporting entity that exchanges the income stream from the government debt with that of corporate bonds. The reporting entity does not have a variable interest in the VIE because the total return swap creates variability, rather than absorbs it.
20. Appendix A of ED10 states that an involvement with a structured entity includes both contractual and non-contractual involvement that exposes the reporting

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entity to variability of returns of the structured entity. Involvement includes the holding of equity or debt instruments, as well as other forms of involvement such as the provision of funding, liquidity support, credit enhancement, guarantees, and asset management services. We believe that ‘returns’ should be understood as the variability that a reporting entity has rights, or is exposed, to resulting from the performance of the entity in which the reporting entity has an involvement.

21. While not identical, we believe that the concepts of variable interest and involvement in an entity cover a similar scope of instruments. A reporting entity will normally be exposed to positive or negative returns *from the performance of the entity in which it has the involvement* through its involvement with instruments that absorb variability, such as equity or debt instruments of the variable interest entity/structured entity. On the other hand, instruments that create variability (such as the total return swap in the example in paragraph 19 above), would normally not expose the reporting entity *to returns resulting from the performance of that entity*. Although we intend to emphasise this distinction in the application guidance, we would not include the extensive guidance in Subtopic 810-10 related to determining if an interest is a variable interest. However, we would not expect significant scope differences between the US GAAP disclosure requirements and the proposed disclosure requirements arising from the different definitions of involvement.

Specific disclosure requirements to limit the extent of the disclosures

22. It is proposed that the final disclosure requirements will contain all requirements that US constituents considered to be useful in determining the extent of disclosures to provide. In particular, the final consolidation standard will contain a statement similar to that in paragraph 810-10-50-10, according to which a reporting entity decides in the light of the facts and circumstances, how much detail it must provide to satisfy the disclosure objectives. The final consolidation standard will also provide guidance on how the information required to be disclosed could be aggregated.

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23. Neither Subtopic 810-10 nor ED10 state explicitly that to trigger the disclosure requirements a reporting entity's involvement with a structured entity must be material or significant. However, as for all disclosures, the concept of materiality would apply to both the disclosure requirements in Subtopic 810-10 and ED10. The IASB and FASB have agreed in the conceptual framework project that the same definition of materiality should apply to IFRSs and US GAAP.

Staff recommendation and question for the Board

24. We recommend that the Board affirm the scope of the disclosure requirements proposed in ED10, according to which a reporting entity must provide risk disclosures when the reporting entity has a contractual or non-contractual involvement with a structured entity that exposes the reporting entity to variability of returns of the structured entity. In our view, the proposed scope is similar to the scope of the comparable disclosure requirements in US GAAP, which have generally been supported by US constituents.

Question 2 for the Board

Does the Board agree that a reporting entity shall provide risk disclosures for both contractual and non-contractual involvements that expose the reporting entity to variability of returns of the structured entity?

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Appendix

The following paragraphs reproduce the staff analysis in Agenda Paper 6B of the February 2010 Board meeting.

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

1. IFRS 7.31 requires a reporting entity to disclose information that enables users of its financial statements to evaluate the nature and extent of risks arising from financial instruments to which the entity is exposed at the end of the reporting period. Paragraph 48(d) of ED 10 proposes that a reporting entity discloses information that enables users of its financial statements to evaluate the nature of, and risks associated with, the reporting entity's involvement with structured entities that the reporting entity does not control.
2. We agree with respondents that both requirements will often result in disclosure of the same underlying risks. What is different is how the disclosure requirements describe a reporting entity's risk exposure. IFRS 7 requires qualitative and quantitative disclosures about the credit, liquidity, market and other risks associated with financial instruments. ED 10 adopts a different perspective and requires the reporting entity to disclose its total risk exposure from its involvement with a structured entity.
3. We believe that information under both perspectives assists users of financial statements in their analysis of a reporting entity's risk exposure; the disclosures in IFRS 7 by identifying those financial instruments that create risk; and the disclosures in ED 10 by providing:
 - (a) information about the extent of a reporting entity's transactions with particular counterparties;
 - (b) information about the financial position of those counterparties; and
 - (c) a description of all relevant terms of a particular transaction.

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

4. SFAS No. 167 *Amendments to FASB Interpretation No. 46(R)* requires, among others, disclosures about risks from an enterprise's involvement with unconsolidated variable interest entities. In December 2008, the FASB has issued a staff position which requires that those disclosures are already applied for the first reporting period ending after December 15, 2008. Therefore, many U.S. preparers already apply disclosure requirements similar to those proposed in ED 10.
5. We have contacted a number of users of financial statements in the U.S. and asked them whether they considered the new disclosures to be helpful. Users generally acknowledged that there was only limited time to gain experience with the new disclosures and that therefore their view of particular disclosure requirements might change in the future. However, all users confirmed that the new disclosures provided them with information that was not previously available to them, but which they considered to be important for a thorough understanding of a reporting entity's risk exposure.
6. Many users referred also to the recent financial crisis and emphasised that a better understanding of a reporting entity's involvement with unconsolidated structured entities might have helped to identify earlier the extent of risks taken by reporting entities. Therefore, all users agreed that the new disclosures had significantly improved the quality of financial reporting and strongly encouraged the IASB to require similar disclosures for IFRS preparers.
7. In light of the positive feedback from users of financial statements, we recommend that the Board affirm that a reporting entity should disclose information that enables users of its financial statements to evaluate the nature of, and risks associated with, the reporting entity's involvement with structured entities that the reporting entity does not control.

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

Where should the disclosures be located?

9. Should the Board follow the staff recommendation and affirm that a reporting entity must disclose information about its risk exposure from its involvement with structured entities, a question arises where those disclosure requirements should be located: in a combined disclosure standard for involvement with other entities or in IFRS 7.
10. Many respondents to ED 10 suggested that the disclosures should be integrated in IFRS 7. IFRS 7 contains disclosure requirements for risks from financial instruments. Therefore, if the Board would integrate the disclosures proposed in ED 10 into IFRS 7, all risk disclosures would be located in one place. We also note that the *Derecognition* exposure draft proposes disclosures for the derecognition of financial assets and liabilities that follow similar principles to the proposals in ED 10. Therefore, some of the proposed disclosures in ED 10 could be combined with the proposals in that ED.
11. However, we are concerned about scoping issues that would arise under such an approach. IFRS 7 deals with risks from financial instruments only. Many of the risks addressed in ED 10 will stem from financial instruments, but other risks would be related to non-financial assets and liabilities. For example, IAS 39.2(h) excludes particular loan commitments from the scope of IAS 39

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Financial Instruments: Recognition and Measurement and states that those commitments should be accounted for in accordance with IAS 37. In order to provide risk disclosures for risks from non-financial assets and liabilities:

- (a) The Board could amend the scope of the risk disclosures in IFRS 7 to apply to all assets and liabilities. We believe that such an approach would require a broader review of how the risk disclosures in IFRS 7 would apply to non-financial assets and liabilities. As part of this process we would need to investigate whether particular assets and liabilities, for example pension liabilities, warrant further changes to the risk disclosures in IFRS 7 and ED 10. We are concerned that such a project would be impossible to complete on a timely basis.
 - (b) Alternatively, the Board could amend IAS 37 and other IFRSs to require risk disclosures similar to those that would be incorporated into IFRS 7. We do not recommend such an approach because it would duplicate the same disclosure requirements in different standards.
12. A further scoping issue arises from the fact that IFRS 7 requires risk disclosures for all financial instruments. In contrast, we do not believe that the Board should require a reporting entity to provide the disclosures in ED 10 for risk exposures from any type of financial instrument. ED 10 requires risk disclosures only when the reporting entity has an involvement with an unconsolidated structured entity. In our view, this condition would apply to some, but not all financial instruments that are within the scope of IFRS 7 (At the March meeting we will discuss further the meaning of “involvement with a structured entity”).
 13. Therefore, the risk disclosures for a reporting entity’s involvement with unconsolidated structured entities require a different scope from that of the other risk disclosures in IFRS 7. We are concerned that the different scope of the disclosures would effectively lead to a “standard within the standard” rather than to create a comprehensive risk disclosure standard.
 14. In our view, a better approach would be to integrate the proposed disclosures about a reporting entity’s risks from its involvement with unconsolidated

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structured entities into a combined disclosure standard for involvement with other entities. Such a combined disclosure standard would contain, in addition to the disclosures for unconsolidated structured entities, disclosure requirements for subsidiaries, joint arrangements and associates. We believe that the arguments in agenda paper 6A can be extended to the disclosures for unconsolidated structured entities. In particular, we believe that integrating the risk disclosures into the combined disclosure standard would improve the clarity of the disclosure requirements for a reporting entity's involvement with other entities that is not in the scope of IAS 39/IFRS 9 and reinforce the consistent application of those requirements.

In February 2010 the Board tentatively affirmed the proposal in ED10 that a reporting entity should disclose information that enables users of its financial statements to evaluate the nature of, and risks associated with, structured entities that the reporting entity does not control. The disclosure would be integrated within the comprehensive disclosure standard for a reporting entity's involvement with other entities.