European Financial Reporting Advisory Group

160. DSR-Sitzung am 27.10.2011

160_03d_110929_EFRAG_DCL_InvEnt

**DRAFT COMMENT LETTER**

**Comments should be sent to commentletters@efrag.org by 27 December 2011**

[xx December 2011]

International Accounting Standards Board
30 Cannon Street
London
EC4M 6XH
United Kingdom

Dear Sir/Madam

**IASB Exposure Draft on *Investment Entities***

On behalf of the European Financial Reporting Advisory Group (EFRAG), I am writing to comment on the Exposure Draft *Investment Entities* (the ED). This letter is intended to contribute to the IASB's due process and does not necessarily indicate the conclusions that would be reached by EFRAG in its capacity as advisor to the European Commission on endorsement of the definitive IFRS on the issues.

EFRAG acknowledges that the accounting for investment entities has been a significant concern expressed on several occasions by the private equity and venture capital industry. EFRAG therefore supports the IASB's efforts to address these concerns.

Overall, we agree with the IASB's proposal for an exception to the consolidation principle on the basis that the measurement of investees controlled by an investment entity at fair value produces more decision useful information than consolidation. However, we have some concerns:

(a) We are not in favour of requiring a parent, which is not an investment entity itself, to consolidate the controlled entities that it holds through subsidiaries that are investment entities.

(b) Whilst we agree with the criteria for determining whether an entity is an investment entity, we believe that the existence of an exit strategy should be placed more prominently; [Note to constituents: We are seeking specific input from constituents on this issue – please see the questions raised in paragraphs 16 and 17 of the Appendix], and

(c) We would encourage the IASB to carry out an impact assessment to understand better the practical implications of any amendments to IAS 28.

Our detailed comments on the ED are set out in the Appendix to this letter.

If you would like further clarification of the points raised in this letter, please do not hesitate to contact Pieter Dekker or me.

Yours sincerely

Françoise Flores
**EFRAG, Chairman**

# Appendix

**Background information to constituents**

1 *IFRS 10* Consolidated Financial Statements *(IFRS 10) requires entities, including investment entities, to consolidate all entities that they control.*

2 *However, IAS 28* Investments in Associates and Joint Ventures *(IAS 28) provides a measurement exemption for investments in associates and joint ventures held by venture capital organisations, mutual funds, unit trusts and similar entities including investment-linked insurance funds. Such entities may elect to measurement investments in those associates and joint ventures at fair value through profit or loss in accordance with IFRS 9* Financial Instruments *(IFRS 9)*

3 *When the IASB issued the exposure draft preceding IFRS 10 in December 2008, many respondents expressed concern that consolidating investees that are controlled by investment entities did not produce decision useful information.*

4 *In previous IASB outreach activities, users from Europe, the United States and Canada had stated that consolidating the underlying assets and liabilities of an investment entity did not provide useful information. Those users preferred that investment entities accounted for the investees that they control at fair value, because investment entities invest to maximise income or capital gains rather than manage the underlying assets and liabilities of their investees.*

**Question 1 – Exclusion of investment entities from consolidation**

**Do you agree that there is a class of entities, commonly thought of as an investment entity in nature should not consolidate controlled entities and instead measure them at fair value through profit or loss? Why or why not?**

**Notes to constituents**

5 *The Exposure Draft* Investment Entities (the ED) *proposes an exception from the requirement in IFRS 10 to consolidate when the parent entity meets the definition of an investment entity (see the criteria below).*

6 *Hence all entities must apply the requirements of IFRS 10 and determine which investees they control, before they can apply the exception to the consolidation requirement.*

7 *Once an entity has determined that it controls an investee, it will need to consider whether or not it meets the criteria for qualifying as an investment entity. If the entity meets those criteria then its investments held in controlled investees must be measured at fair value through profit or loss in accordance with IFRS 9.*

**EFRAG's response**

**EFRAG supports the exception to consolidation because measuring an investment entity controlled investees at fair value results in information that is more decision-useful as it is better aligned with the entity's business model.**

8 EFRAG supports an exception to the consolidation principle because consolidating the underlying assets and liabilities of the controlled investees of an investment entity results in information that is less decision-useful than measurement at fair

value, which is better aligned with the business model underlying the activities of investment entities.

**Question to constituents**

9 Do you believe that rather than applying the exclusion from consolidation at an entity level, individual investments should be excluded from consolidation if they are managed to maximise income or capital gains? If so, please explain why.

10 If you believe the exclusion should be applied at the level of individual investments, which criteria do you believe such investments should meet to qualify for the exclusion in order to make the exception robust?

**Note to constituents**

11 The wording of the remainder of this draft comment letter is predicated on the assumption that the exception is to be applied at the entity level.

**Question 2 – Criteria for determining whether an entity is an investment entity (paragraphs 2 and B1-17)**

**Do you agree that the criteria in this exposure draft are appropriate to identify entities that should be required to measure their investments in controlled entities at fair value through profit or loss? If not, what alternative criteria would you propose, and why are those criteria more appropriate?**

**Notes to constituents**

12 *An entity qualifies as an investment* entity *if <u>all</u> of the following criteria are met:*

(*a*) *The entity's only substantive activities are investing in multiple investments for capital appreciation, investment income (such as dividends or interest), or both ['nature of the investment activity'];*

*(b) The entity makes an explicit commitment to a group of investors that the entity's purpose is investing to earn capital appreciation, investment income (such as dividends or interest), or both ['business purpose'];*

*(c) Ownership in the entity is represented by units of investments, such as shares or partnership interests, to which proportionate shares of net assets is attributed ['unit ownership'];*

*(d) The funds of the entity's investors are pooled so that the investors can benefit from professional investment management. The entity has investors that are unrelated to the parent (if any), and collectively hold a significant ownership interest in the entity ['pooling of funds'];*

*(e) Substantially all of the investments of the entity are managed, and their performance is evaluated, on a fair value basis ['fair value management']; and*

*(f) The entity provides financial information about its investment activities to its investors. The entity can be, but does not need to be, a legal entity.*

**EFRAG's response**

**EFRAG agrees with the criteria for determining whether an entity is an investment entity. However, we believe that the existence of an exit strategy should be placed more prominently.**

13 EFRAG is, in general, not in favour of options that offer entities a free choice between alternative accounting treatments. In addition, we believe that consolidated financial statements provide the most useful form of financial reporting for most types of entities. Therefore, we agree that it is necessary to limit the use of the investment entity exception to those entities for which consolidated financial information would be less decision useful than measurement at fair value.

14 We agree with the criteria that an entity must meet to qualify as an investment entity. However, we believe that having an exit strategy is a key aspect in identifying an investment entity. Therefore, we consider that this should be one of the criteria for identifying an investment entity (i.e. criteria described in paragraph 2 of the ED) rather than being described in the application guidance (paragraph B9 of the ED).

15 When paragraph 2 of the ED refers to 'investment', it is not entirely clear whether this is meant to include just investments controlled by the investment entity. Paragraph B17 and Question 5 in the ED seem to suggest that investment properties and financial assets are also 'investments'. We would recommend that the IASB clarify that the requirement to hold 'multiple investments' in paragraph 2(a) of the ED relates not only to investments in investees that the investment entity controls.

**Question to constituents**

16 The ED sets detailed criteria that an entity must meet in order to qualify as an investment entity, which has given rise to the question whether all of the criteria are necessary. In particular, the need for the criteria in paragraphs 2(a) and 2(d) of the ED and the requirement to have an exit strategy were challenged in the course of EFRAG TEG discussions. Do you believe that all the criteria proposed in the ED are necessary in order to define an investment entity or do you believe that not all of the criteria mentioned above need to be met? If so, please explain and provide examples.

17 Do you believe that the criteria in the ED would prevent entities from applying the exception even though you consider them to be investment entities?

**Question 3 – 'Nature of the investment entity' (paragraphs 2(a) and B1-B6)**

**Should an entity still be eligible to qualify as an investment entity if it provides (or holds an investment in an entity that provides) services that relate to:**

**(a) its own investment activities?**

**(b) the investment activities of entities other than the reporting entity?**

**Why or why not?**

**Notes to constituents**

18 *One of the criteria is that the entity's only substantive activities are investing in multiple investments for capital appreciation, investment income or both. The entity should have no substantive activities other than its investing activities and it should not have any significant assets or liabilities other than those relating to the investing activities, subject to two exceptions:*

*(a) If the investment entity provides (or holds an investment in an entity that provides) services that relate only to the investment entity's own investment activities, even if those activities are substantive, the entity could still meet the substantive activities requirement. If an investment entity controls an investee that provides these services, the investment entity shall consolidate that entity; and*

*(b) Investment entities sometimes make investments that are collateralised by assets unrelated to the investment objectives of the investment entity. If the investment entity controls collateral as a result of defaults related to the investees, holding such assets (and related liabilities) temporarily does not affect the status of the entity as an investment entity, provided that the investment entity did not acquire the investments with the intention of controlling the collateral.*

**EFRAG's response**

**EFRAG believes that if an investment entity provides investment services to its own investment business then this should not affect the investment entity classification.**

19 EFRAG believes that accounting by investment entities should reflect the underlying substance of their business. Therefore, we agree that an investment entity should consolidate all activities related to the management of their portfolio regardless of whether they are carried out by the entity itself or a subsidiary.

20 We agree with the criterion in paragraph 2(a) of the ED, which requires that an investment entity's only substantive activities are investing in multiple investments. Consequently, we believe that an entity that operates a significant business that provides services to entities outside its group would not be an investment entity.

**Question 4 – 'Pooling of funds' (paragraph 2(d) and B14-B16)**

**(a) Should an entity with a single investor unrelated to the fund manager be eligible to qualify as an investment entity? Why or why not?**

**(b) If yes, please describe any structures/examples that in your view should meet this criterion and how would you propose to address the concerns raised by the Board in paragraph BC16?**

**Notes to constituents**

21 *The ED states that an investment entity would typically have significant external investors who are not involved in the management of the investment entity. The Board was concerned that in the absence of such a criterion an investment entity could be inserted into a larger group structure in order to achieve off balance sheet accounting for some assets, while the parent could own almost all of the investment entity.*

22 *The ED therefore proposes that an investment entity should have unrelated investors' (i.e. not related to the parent entity) who collectively hold significant ownership interests in the entity.*

**EFRAG's response**

**EFRAG believes it is appropriate to require that an investment entity has more than one investor.**

23 There are no conceptual reasons why an investment entity that has a single investor could not be an investment entity. However, we appreciate the difficulty that could exist in practice to distinguish between a 'true' investment entity and entities that are set up for other purposes. We believe that an 'investment-type' entity that engages in transactions with other members of their parent's group on terms that are possibly not arm's length should not be eligible for the investment entity exception, because such entity obtains benefits that are not capital appreciation and/or investment income in nature.

24 We consider the fact that an entity has more than one investor to be important as it ensures that the objectives of the investment entity are aligned with those of its investors, rather than just those of its parent. Hence, we believe it is appropriate to require that an investment entity has unrelated investors who collectively hold significant ownership in the entity.

**Question 5 – Measurement guidance (paragraphs 6 and 7)**

**Do you agree that investment entities that hold investment properties should be required to apply the fair value model in IAS 40, and do you agree that the measurement guidance otherwise proposed in the exposure draft need apply to financial assets, as defined in IFRS 9 and IAS 39 *Financial Instruments: Recognition and Measurement*? Why or why not?**

**Notes to constituents**

25 *The ED proposes that the investment entity should measure its investment in controlled entities, associates and joint ventures at fair value through profit or loss in accordance with IFRS 9. Paragraph B17 of the ED requires that the fair value model in IAS 40 be used for any investment property, if such parent entity wanted to qualify for the investment entity exception.*

**EFRAG's response**

**EFRAG agrees that an investment entity that manages substantially all of its investments at fair value should measure investment properties and financial assets at fair value.**

26 A key characteristic of an investment entity is that it manages substantially all of its investments at fair value (paragraph 2(e) of the ED). Accordingly, EFRAG agrees that if this is the case that an investment entity should also apply fair value measurement to asset classes such as investment property and financial assets, to the extent that they are managed with the same purpose and on a fair value basis as well.

**Question 6 – Accounting in the consolidated financial statements of a non-investment parent (paragraph 8)**

**Do you agree that the parent of an investment entity that is not itself an investment entity should be required to consolidate all of its controlled entities including those it holds through subsidiaries that are investment entities? If not, why not and how would you propose to address the Board's concerns?**

**Notes to constituents**

27 *The ED proposes that if the parent of an investment entity is not an investment entity itself, it should be required to consolidate all entities that it controls via the investment entity. That is, the ultimate parent cannot retain the fair value accounting applied by the investment entity that it holds as a subsidiary. The Board thinks that in most cases, investment entities do not have non-investment parents.*

28 *The Board is concerned that if the non-investment parent entity retains the specialised accounting when preparing its consolidated financial statements there would be potential accounting inconsistencies and possibilities for abuse. For instance, concerns were raised if a non-investment entity parent were to issue its own equity instruments to an investee of its investment entity subsidiary.*

29 *A non-investment parent entity of an investment entity would retain the proposed accounting that the investment entity applies to its associates or joint ventures.*

**EFRAG's response**

**EFRAG is not in favour of requiring that a parent, which is not an investment entity itself, to consolidate the controlled entities that it holds through subsidiaries that are investment entities.**

30 EFRAG is not in favour of requiring that a parent, which is not an investment entity itself, should consolidate the controlled entities that it holds through subsidiaries that are investment entities. In our view, if application of the investment entity exception at the subsidiary level results in fair value information that is more decision-useful than consolidated information then – absent important intercompany transactions and relationships – we would expect such fair value information to be relevant in the financial statements of the ultimate parent entity. In addition, the frequent acquisitions and disposals of businesses by an investment entity subsidiary would lead to consolidation of investees for relatively short periods and would affect the decision-usefulness of the consolidated financial statements of the parent.

31 The Board's decision not to allow a non-investment entity parent to retain the accounting of its investment entity subsidiaries was motivated by concerns about potential accounting inconsistencies and possibilities for abuse.

(a) We understand the complications and potential accounting inconsistencies that might arise if a subsidiary that is an investment entity were to hold an equity interest in the ultimate parent or invest in the same investees as the parent. However, we believe that those concerns would be better addressed by modifying the investment entity criteria (e.g. requiring that an investment entity not make such investments) or prescribing the accounting to be applied if such investments did exist (e.g. application of some form of consolidation accounting to those investments).

(b) We do not share the concerns regarding the possibilities for abuse and the potential for off-balance sheet accounting for some assets because:

(i) The criteria in paragraph 2 of the ED, in particular the need for unrelated external investors, prevent entities that are not in substance investment entities from qualifying for the use of the consolidation exception. In other words, only entities that are investment entities in their own right qualify for the exception; and

(ii) The conditions set in paragraph B6 of the ED ensure that the parent cannot obtain benefits other than those from capital appreciation and/or investment income from investees held by an investment entity subsidiary. Consequently, any arrangement between the parent and its investment entity subsidiary that modifies the nature of the investment activity would disqualify the entity from using the consolidation exception.

For these reasons we believe that it is unnecessary to prohibit a non-investment entity parent from retaining the accounting of its investment entity subsidiaries.

**Question 7 – Disclosures (paragraph 9 and 10)**

**(a) Do you agree that it is appropriate to use this disclosure objective for investment entities rather than including additional specific disclosure requirements?**

**(b) Do you agree with the proposed application guidance on information that could satisfy the disclosure objective? If not, why not and what would you propose instead?**

**Notes to constituents**

32 *A parent entity that meets the definition of an investment entity will not be exempt from IFRS 10. Therefore, the disclosure requirements of IFRS 12 would apply. Similarly, an investment entity would measure the controlled investees at fair value in accordance with IFRS 9. Accordingly, the investment entity should also disclose information about the controlled investments in under IFRS 7.*

33 *The disclosure objective in the ED states that an investment entity should provide information to enable users of its financial statements to evaluate the nature and financial effects of the investment activities. To meet this objective the following disclosures are proposed:*

*(a) when an entity's status has changed (i.e. it becomes or ceases to be an investment entity), the entity shall disclose in the notes the change of status and reasons for the change. In addition, an entity that becomes an investment entity shall disclose the effect of the change of status on the financial statements for the period presented, including the effects of the change on the amounts of investments as of the date of the change of status and the related effects on profit or loss and total comprehensive income;*

*(b) whether the investment entity has, during the reporting periods presented, provided financial or other support (explicitly or implicitly) to investees it controls, without having a contractual obligation to do so, including:*

*(i) the type and amount of support provided, including situations in which the investment entity assisted the investee in obtaining financial support, and*

*(ii) the reasons for providing the support.*

*(c) an investment entity shall disclose any current intentions to provide financial or other support to investees it controls, including intentions to assist an investee in obtaining financial support;*

*(d) the nature and extent of any significant restrictions on the ability of controlled investees to transfer funds to the investment entity in the form of cash dividends, or repayment of loans or advances;*

*(e) the investee's name;*

*(f) the investee's country of incorporation or residence; and*

*(g) the proportionate ownership interest in the investee held by the investment entity and, if different, the proportion of voting interest held.*

34 *The ED states that the following are examples of additional disclosures that may be appropriate to meet the disclosure objective (paragraph B19 of the ED):*

*(a) The following per-share information calculated on the basis of a share outstanding throughout each period presented:*

*(i) total assets less total liabilities on a fair value basis at the beginning of the period;*

*(ii) net investment income or loss per share. Net investment income or loss should be divided by the total number of shares outstanding at the reporting date. Other methods, such as dividing net investment income by the average or weighted average number of shares outstanding during the period, are acceptable and may be disclosed in order to meet the disclosure objective.*

*(iii) realised and unrealised gains and losses per share, which are balancing amounts necessary to reconcile the change in fair value per share with the other per-share information presented;*

*(iv) total income from investment operations, which is the sum of net investment income or loss and realised and unrealised gain or loss;*

*(v) distributions to shareholders;*

*(vi) purchase premiums, redemption fees or other capital items;*

*(vii) payments by affiliates (to reimburse the fund for a loss on a portfolio investment, or to reimburse the fund for a loss where a loss-making investment was purchased (typically by a fund adviser) that violated the fund's investment restrictions); and*

*(viii) total assets less total liabilities on a fair value basis at the end of the period.*

*(b) Ratios of expenses and net investment income to average net assets, annualised for periods of less than a year, including the methodology for computing the ratios.*

*(c) Total return, including the methodology for computing the total return.*

(d) *An investment entity that obtains commitments from owners and periodically calls funds under those commitments to make investments discloses the total committed funds of the owners, the year of its formation and the ratio of total contributed funds to total committed funds of the owners.*

35 *To avoid duplication, the ED proposes that an investment entity need not provide the disclosures in these proposals if other IFRSs disclosures require the same information (paragraph B20 of the ED).*

**EFRAG's response**

**EFRAG agrees with the disclosure objective as stated. However, we are concerned about the level of detailed narrative that has been included to explain the objective.**

36 EFRAG agrees with the disclosure objective as stated. However, we are concerned about the level of detailed narrative that has been included to explain the objective:

(a) While the disclosures suggested in paragraph B19 of the ED might be helpful to users of the financial statements, it is unclear how exactly the IASB selected these particular suggested disclosures. In addition, given that such lists of examples are often interpreted as being requirements, we would be in favour of a shorter, more targeted list.

(b) Paragraph B20 of the ED places the onus on the preparer to decide which disclosures in IFRS 7, IFRS 12, IFRS 13 and the disclosure proposals of the ED result in duplication. We believe that it would be more efficient if the IASB, as a standard setter, would carry out this task rather than multiplying the effort by requiring each and every investment entity to do this.

**Question 8 – Transition (paragraph C2)**

**Do you agree with applying the proposals prospectively and the related proposed transition requirements? If not, why not? What transition requirements would you propose instead and why?**

**Notes to constituents**

37 *The ED proposes prospective application for entities that meet the investment entity criteria. Such entities should adjustment their retained earnings at the beginning of the period in which this draft IFRS is applied for the first time.*

38 *The adjustment to retained earnings represents the difference between (a) the carrying amount of the net assets of an entity's controlled investees and (b) the fair value of the investees at the date of first applying the IFRS, plus any changes in the fair value of the investees' net assets previously recognised, and remaining in, accumulated other comprehensive income.*

**EFRAG's response**

**We believe that the requirements should be applied retrospectively, unless impracticable. This would avoid inconsistencies with the transitional provisions of IFRS 10 and result in information that is more comparable.**

39 EFRAG believes that the transition requirements should be consistent with the transitional requirements in IFRS 10 *Consolidated Financial Statements*. That is, if a parent entity no longer consolidates an investee because it meets the criteria of an investment entity it shall apply the requirements retrospectively in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* unless that is impracticable.

40 The proposals for prospective application would result in serious issues regarding the comparability of the current period and the comparative period(s). That is, in the first year of application of the standard, an investment entity would measure its controlled investees at fair value whilst in the comparative period it would consolidate the underlying net assets of its controlled investees. This, in our view, would seriously impairment the usefulness of the financial statements in the year in which these proposals are first adopted.

41 We understand that the Board is concerned about the undue use of hindsight in determining the fair value of investees. However, to qualify for the use of the exception, an investment entity must manage its investments at fair value. Therefore, we believe that investment entities would have collected fair value information contemporaneously and that the risks associated with use of hindsight are limited. Entities that did not meet the investment entity criteria in earlier periods would only be permitted to use the exception prospectively from the date on which they meet those criteria.

**Question 9 – Scope exclusion in IAS 28 (as amended in 2011)**

**(a) Do you agree that IAS 28 should be amended so that the mandatory measurement exemption would apply only to investment entities as defined in the exposure draft? If not, why not?**

**(b) As an alternative, would you agree with an amendment to IAS 28 that would make the measurement exemption mandatory for investment entities as defined in the exposure draft and voluntary for other venture capital organisations, mutual funds, unit trusts and similar entities, including investment-linked insurance funds? Why or why not?**

***Notes to constituents***

42 *IAS 28 provides for a measurement exemption that allows ventures capital organisations, mutual funds, unit trusts and similar entities including investment-linked insurance funds the option to elect irrevocably to measure investments in associates and joint ventures at fair value through profit or loss.*

43 *The ED proposes an amendment to IAS 28 such that:*

*(a) any reference to 'venture capital organisations, mutual funds, unit trusts and similar entities' is replaced with 'investment entity';*

*(b) the measurement option in IAS 28 will be replaced by a measurement exception that will require an investment entity to measure the investments in*

*associates and joint ventures at fair value through profit or loss in accordance with IFRS 9; and*

*(c) a non-investment entity parent of an investment entity shall retain the fair value accounting applied by the investment entity for its associates and joint ventures.*

44 *The Board has indicated that in making its decision to require investment entities to measure its investments in associates and joint ventures, the change should not result in a significant number of entities that currently qualify for the measurement exemption ceasing to qualify.*

**EFRAG's response**

**We would encourage the IASB to carry out an impact assessment to understand better the implications of any amendments to IAS 28.**

45 EFRAG believes that there may be theoretical advantages, in terms of comparability and consistency, to aligning the scope of the measurement exemption in IAS 28 for 'venture capital organisations, mutual funds, unit trusts and similar entities, including investment-linked insurance funds' with that of the investment entity exception. However, whether these theoretical advantages translate into more useful financial reporting in practice is unclear.

46 In particular, there is no explanation in the basis for conclusions of the effects of removing the irrevocable measurement option that currently exists in IAS 28. Furthermore, it is not made clear whether the replacement of any reference to venture capital organisations, mutual funds, unit trusts and similar entities by a reference to 'investment entity' would restrict the use of the applying fair value to investments in associates and joint ventures. Therefore, we would encourage the IASB to carry out an impact assessment to understand better the implications of such change.

47 We do not favour of the alternative approach suggested in Question 9, because:

(a) it is unclear to us what the principle underlying the alternative approach is; and

(b) we believe that an informed decision can only be taken after an impact assessment has been carried out.