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Hans Hoogervorst
Chairman of the IASB
30 Cannon Street
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Berlin, 30 November 2011

Dear Hans,

Exposure Draft ED/2011/4 *Investment Entities*

On behalf of the German Accounting Standards Board (GASB) I am writing to respond to the IASB's Exposure Draft *Investment Entities*. The GASB welcomes the discussion of an exemption from consolidation and we therefore appreciate the opportunity to comment on the IASB's proposals.

The GASB generally supports an exemption from consolidation for certain investments. However, we suggest focussing on the specific characteristics of the investment instead of linking the exemption to "investment entities" as defined in the ED para. 2. We agree with the IASB that the consolidation of entities controlled by such investment entities results in financial statements being less decision-useful compared to if those entities were measured at fair value. Beyond that we believe this argument to be also valid for other entities if

(1) the only purpose of investing is to earn capital appreciation, or investment income (such as dividends or interest), or both,
(2) the entity has the intention (at the date of acquisition) to dispose of that investment, and
(3) all of the investments are managed and evaluated on a fair value basis.

Furthermore, we strongly support retaining the fair value measurement in the consolidated financial statements of a parent entity and regardless of whether this is an investment entity or not.

Please find our detailed comments on the questions raised in the invitation to comment in the appendix to this letter. If you would like to discuss any aspect of our comments further, please do not hesitate to contact me.

Yours sincerely,

Liesel Knorr
President

Appendix

Exclusion of investment entities from consolidation

Question 1 Do you agree that there is a class of entities, commonly thought of as an investment entity in nature, that should not consolidate controlled entities and instead measure them at fair value through profit or loss? Why or why not?

The GASB agrees with the IASB's view that under certain circumstances controlled entities should not be consolidated. However, in our view, not only investment entities should benefit from being excluded from consolidating their controlled investments.

Under certain conditions the measurement of a controlled investment at fair value instead of consolidation could result in more decision-useful information. Therefore, we believe that the exemption from the principle of consolidation should not be linked to the specific characteristics of an entity (i.e. investment entity as defined by the IASB). Instead, the exemption should be linked to the specific economic substance of a particular investment made by any entity. Whether the consolidation of a controlled investment results in more decision-useful information than fair value measurement does not depend on the characteristics of the acquiring entity but on the characteristics of the investment, i.e. the purpose of the acquisition of a controlled entity.

To consider an example: A bank acquires an investment in an entity which it then controls. The example further assumes that the bank acquired the investment for the sole purpose of obtaining capital appreciation and already at the date of the acquisition of the controlled investment the bank has the intention to dispose of that investment in the future (e.g. in two years), having a specific exit strategy on how to dispose of that investment. As is the case for investment entities, the consolidation of this controlled entity by the bank does not result in decision-useful information because of the specific characteristics of that investment.

We finally like to mention that, in line with the IASB, we believe the fair value to generally result in more meaningful information about the entity's investment in a controlled entity. Nevertheless, we believe that the fair value is not necessarily the appropriate measurement base under all circumstances. In some cases – e.g. less reliable fair values – the equity-method could also be an adequate accounting method.

Criteria for determining when an entity is an investment entity (paras. 2 and B1-B17)

Question 2

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?

As explained in our answer to question 1, the GASB does not believe the link to specific characteristics of an entity to be appropriate for determining the scope of the exemption from consolidation. Our suggestion, therefore, is to identify specific characteristics of an investment in a controlled entity rather than specific investment entities. Specific characteristics which determine whether such an investment should be excluded from consolidation are

(1) the only purpose of investing is – as defined by the IASB – to earn capital appreciation, or investment income (such as dividends or interest), or both,

(2) the entity has the intention (at the date of acquisition) to dispose of that investment, and

(3) all of the investments are managed and evaluated on a fair value basis.

In our view, all investments fulfilling these criteria would qualify for being excluded from consolidation.

We acknowledge the different backgrounds of the IASB's and the GASB's proposals, i.e. the different initial points of a concept for the exemption from consolidation. That being said, the GASB generally agrees with the detailed explanations of the specific investment purpose as laid out in para. B6. However, unlike the application guidance on "earnings from investments" suggests we believe that it should be possible for the investing entity to engage in some strategic decisions, such as decision over management contracts or restructuring of the controlled investment. These activities typically aim at increasing the capital appreciation and thereby increasing the chances for a financially successful disposal of that investment. Hence, a strategic involvement that would only aim at increasing earnings from that investment should not preclude the entity from the scope of this exemption.

Furthermore, our different concept for the scope of this exemption does not restrict the exemption from consolidation to entities whose only substantive activities are investing in multiple investments for capital appreciation, or investment income (such as dividends or interest), or both. On the contrary, considering our approach the exemption from consolidation could apply to any entity – with as few as one "qualifying" investment. Nevertheless, we do not deem the requirement of multiple investments to be relevant under any approach. Entities having just one investment but fulfilling all other criteria of the IASB's definition of an investment entity should qualify for a fair value measurement of that investment.

Another important criterion to determine whether the exemption from consolidation is applicable is managing and evaluating all of the investments on a fair value basis (para. 2(e)) as well as providing financial information about the investment activities to the investors (para. 2(f)). Both are important indicators that the controlled investment is held only for maximising earnings and not for engaging in its activities or strategically integrating it into the operations of the controlling entity.

Finally, the criterion "pooling of funds" is not necessary to define the scope of an exemption from consolidation following the GASB's approach. The characteristics of the investment do not depend on the entity having investors who are unrelated to the parent (if any), and thus holding a significant ownership interest in the entity.

'Nature of the investment activity' (paras. 2(a), B1-B6)

Question 3

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?

According to para. B2, an entity can still meet the "substantive activities" requirement if it provides (or holds an investment in an entity that provides) – to a substantive extent – services that relate only to the investment entity's own investment activities. Within the GASB's concept which is based on the specific characteristics of the investment rather than on the investment entity, the substantive activities criterion is not relevant.

However, it is a crucial criterion within the IASB's concept. Even within the IASB concept, we do not support the requirement of not having substantive activities as proposed. Rather, we prefer entities qualifying as investment entities even if they – to a substantive degree – provide (or hold an investment that provides) services that relate to its own investment activities or the investment activities of other entities.

In the context of this issue, we would further like to point out a wording issue in para. 7(a): *"If an investment entity controls an investee that provides services that relate only to the entity's own investment activities, it shall consolidate that investee (see paragraph B2)".* It reads as if an investee that provides those services is excluded from being consolidated if the services do not *only* relate to the entity's own investment activities. As a consequence one could conclude that the requirement to consolidate that investee (instead of measuring the investee at fair value) depended on providing the services *only* to the reporting entity. However, what we believe is meant is that the requirement to *only* provide services to the reporting entity is part of the definition of the investment entity. If an investment entity is constituted (i.e. the requirements of the definition are fulfilled because services are provided *only* to the reporting entity) the investee will have to be consolidated; there is no case in which an investee could provide services that relate only in part to the entity's investment activities (and would therefore have to be measured at fair value). The GASB suggests clarifying the wording of this paragraph accordingly.

'Pooling of funds' (paras. 2(b), B14-B16)

Question 4

(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 you would propose to address the concerns raised by the Board in paragraph BC16?

As mentioned in our answer to question 2, under the GASB's approach the criterion "pooling of funds" is not necessary.

Within the IASB's concept of defining an investment entity, we deem this criterion inappropriate. To our understanding the requirement to have external investors who in aggregate hold a significant ownership interest in the entity does not relate to the Board's concern expressed in BC16. The IASB is concerned that an investment entity could be inserted into a larger corporate structure in order to achieve off balance sheet accounting for some assets, while the parent could own almost all of that investment entity. However, the concept to exclude certain controlled investments is about this very fact: to allow fair value measurement of, rather than consolidating, all assets and liabilities which are owned (to a large part) by an entity. A "significant" share of external investors does not prevent the assets – owned to a large part, but not fully, by the entity – from being measured at fair value instead of being consolidated. The important criterion is not the "ownership" of the assets, but how an entity intends to make use of those assets. This is sufficiently addressed by the criteria of the nature of the investment activity and the business purpose (para. 2(a),(b)), which we consider crucial. We do not deem the anti-abuse argument cited in the ED a valid argument; in any event, requiring multiple external investors will not solve any potential misuse issue.

Measurement guidance

> Question 5
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> 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 only to financial assets, as defined in IFRS 9 and IAS 39 *Financial Instruments: Recognition and Measurement*? Why or why not?

The GASB agrees that investment entities which hold investment properties should be required to apply the fair value model in IAS 40. As laid out in para. 2(e), investment entities have to manage all of their investments on a fair value basis. Applying the fair value model to investment properties is a consequent amendment of this requirement ensuring a continuous management on a fair value basis.

We also agree that the other measurement guidance applies to financial assets only.

Accounting in the consolidated financial statements of a non-investment entity parent

> Question 6
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> 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?

The GASB strongly disagrees with the IASB's proposal that if a parent of an investment entity is not itself an investment entity it is required to consolidate the controlled entities held through subsidiaries that are investment entities themselves. Given a consensus that fair value measurement on the level of the investment entity provides more decision-useful information, we do not find the arguments for a consolidation on the level of a parent entity convincing. We believe retaining the investment entity accounting to be the more adequate accounting treatment also on the parent entity level and regardless of whether the parent entity is an investment entity or not. Besides, our proposal would avoid undue burden and undue costs of consolidating the investment that is not consolidated on the subsidiary level. Finally, we note that current US-GAAP as well as the recently published FASB ED would require a non-investment parent entity to retain the investment entity accounting in its consolidated financial statements.

We do not concur with the IASB's conclusion that the "potential accounting inconsistencies and possibilities for abuse" (as laid out in BC20) outweigh the benefits of providing more decision-useful information in the parent entity's consolidated financial statements. Assuming that the fair value measurement applied by the investment entity results in more decision-useful information, it is also likely – as acknowledged by the IASB (see BC20) – that retaining this accounting provides more decision-useful information on the parent entity level too, since the characteristics of that (controlled) investment are identical.

We do not agree, either, with the IASB that "in most cases, investment entities would have investment entity parents" (BC20). It has been brought to our attention that there will be a significant number of cases in which the parent entity is not an investment entity itself (e.g. banks or corporations with venture capital activities). Furthermore, a possibly small number of affected entities does not seem to justify dismissing the accounting method that is likely to result in more decision-useful information. Considering the costs and benefits, retaining the fair value measurement would entail the measurement exercise once whereas not retaining would add gathering information for and processing consolidation entries. The IASB's proposal is also inconsistent with the requirement that parents of investment entities would retain the accounting applied for the associates or joint arrangements of the investment entity.

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 (IASB model) or the investing criteria (GASB model) (e.g. introducing a further criterion scoping out these investments).

Disclosure

Question 7

(a) Do you agree that it is appropriate to use a 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?

The GASB generally agrees with the disclosure objective as laid out in para. 9. However, we do not find the specific disclosure requirements in para. 10 and B18 et seq. convincing.

Firstly, we do not deem a general requirement for investment entities to apply IFRS 7, 12 and 13 being particularly helpful. The IASB should explicitly list the required disclosures in the proposed standard instead of having each investment entity look up the appropriate disclosure requirements in other standards. Along the same lines we also do not support B20, in which the IASB points out that investment entities do "not need to apply disclosure requirements of this [draft] IFRS if other IFRSs require disclosure of the same information." To our understanding it is part of the Standardsetting process to identify possible corresponding or even identical disclosure requirements, and finally to avoid redundant requirements within the IFRSs.

Secondly, on a more specific level, the GASB does not support disclosures ("examples") regarding (detailed) per-share information (see B19). It seems that these disclosure requirements stem from similar requirements under US-GAAP, which might be helpful from a convergence point of view. However, they lack a conceptual integration into the IFRSs, i.e. a conceptual connection to IAS 33 (in order to align the otherwise differing calculation method on which the per-share information are based, e.g. for B19(a)(ii)).

Furthermore, it is not apparent in the requirements whether disclosures on the effect of a change of status on the financial statements of the entity (that has become an investment entity) need to be provided retrospectively. We suggest clarifying this aspect.

Transition

Question 8

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?

Contrary to the IASB's proposal, the GASB supports retrospective application. In the past entities have most likely managed their controlled investments on a fair value basis. Therefore, the information will be available in the entities. However, we acknowledge that retrospective application would mean reintroducing eliminated intra-group balances, transactions, income and expenses in case of consolidation in the past; furthermore some disclosure information might not be available for the previous year. Therefore, we suggest requiring retrospective application if practicable.

Scope exclusion in IAS 28 (as amended in 2011)

Question 9

(a) Do you agree that IAS 28 should be amended so that the 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?

Assuming the IASB is to retain its view on the need to define an investment entity rather than considering the specific characteristics of an investment (for any entity), the GASB agrees with the IASB's proposal to align the wording throughout the IFRSs. We believe it would be adequate to replace any reference to "venture capital organisations, mutual funds, unit trusts and similar entities" with the term "investment entity".

Furthermore, we agree with the measurement exemption being mandatory rather than elective as comparability and therefore the benefit for users of the financial statements would be enhanced. In addition, the (potential) burden for entities due to the elimination of an option ought to be limited as the fair value measurement used to be mandatory until the recent amendment of IAS 28.

Other issues: extension of the GASB concept to investments in associates

Under the GASB concept as laid out in this comment letter the exemption from consolidation does not depend on the specific characteristics of an entity (i.e. in line with the IASB's definition of an investment entity) but on the specific characteristics of the investment (made by any entity). There are other accounting requirements that depend on the specific characteristics of an entity, for example different accounting requirements for venture capital organisations, mutual funds, unit trusts and similar entities (suggested to be replaced by the term "investment entities") with regards to accounting for investments in associates.

The GASB believes that its concept should be extended to such other accounting requirements. In particular, investments in associates should be measured at fair value through profit or loss not only by investment entities but by any entity that (1) invests in an associate for capital appreciation, or investment income (such as dividends or interest), or both, (2) at the date of the acquisition intends to dispose of that investment and (3) manages and evaluates this investment on a fair value basis. If entities do not have any other relationship with an associate and are not engaged in any other activities other than for the purpose of capital appreciation, or investment income, or both, the fair value measurement provides more decision-useful information than the equity-method.