Deutsches Rechnungslegungs Standards Committee e.V.
Accounting Standards Committee of Germany
Der Standardisierungsrat

DRSC e. V. • Zimmerstr. 30 • 10969 Berlin

Telefon +49 (0)30 206412-12
Telefax +49 (0)30 206412-15
E-Mail info@drsc.de

Hans Hoogervorst
Chairman of the IASB
30 Cannon Street
London EC4M 6XH
United Kingdom

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Dear Mr Hoogervorst,

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/2011/4, paragraph 2. While we agree with the IASB that the consolidation of entities controlled by such investment entities does not result in decision-useful financial statements, we believe this argument to be true for other entities as well if (1) the only purpose of investing is to earn capital appreciation, investment income (such as dividends or interest), or both, and (2) the entity has the intention (at the date of acquisition) to dispose of that investment. Furthermore, we strongly support retaining the fair value measurement in the consolidated financial statements of a parent entity (any parent entity, including those that are non-investment entities).

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 IASBôs view that under certain circumstances controlled entities should not be consolidated. However, in our view, not only investment entities 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 for any entity.

Therefore, we believe that the exception from the principle of consolidation should not be linked to the specific characteristics of an entity (here: investment entity as defined by the IASB). Instead the exception 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. If an entity acquires an (controlled) investment with the only purpose to obtain capital appreciation, investment income (such as dividends or interest), or both, and as of the date of the acquisition the acquiring company intends to dispose of that investment then the fair value results in more useful information than consolidation of that investment.

While we agree with the IASB that the consolidation of entities controlled by an investment entity does not result in decision-useful financial statements of the investment entity, we believe this argument to be true for other entities as well. To consider a bank, for example: it 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, having a specific exit strategy on how to go about the disposal 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.

The GASB supports the IASBôs suggestion to measure these specific investments in controlled entities at fair value through profit or loss. In line with the IASB we believe the fair value to result in more meaningful information about the entityôs investments in controlled entities. Nevertheless, we believe that the fair value is not necessarily the appropriate measurement base under all circumstances. In some cases ï considering, for example, fair values which need to be determined according to level 3 requirements ï the equity-method could also be an adequate accounting method.

Criteria for determining when an entity is an investment entity (paragraphs 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 the determination of the scope of the exclusion from consolidation. Our suggestion, therefore, is to identify the specific characteristics of an investment in a controlled entity rather than criteria for specific investment entities. Specific characteristics which determine whether such an investment should be exempted from consolidation are (1) the only purpose of investing is ï as defined by the IASB ï to earn capital appreciation, investment income (such as dividends or interest), or both, and (2) the intention (at the date of acquisition) to dispose of that investment.

In our view, all investments that only serve this purpose and are ï as of the day of the acquisition ï intended to be disposed of qualify for being excluded from consolidation.

We acknowledge the different backgrounds of the IASBôs and the GASBôs proposals, i.e. the different initial points for a concept on the exclusion from consolidation. The different initial points are reflected in our comments on the criteria to define the scope of the exemption. Based on our different understanding of the scope of entities that should be excluded from consolidation of certain controlled investments, our view on the criteria in para. 2 of the Exposure Draft differs from that of the IASB.

That being said, the GASB generally agrees with the detailed explanations of the specific investment purpose as laid out by the IASB in B6. However, unlike the application guidance on ñearnings from investmentsò 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 the earnings from that investment would not preclude the entity from the scope of this standard and from measuring that investment at fair value.

Furthermore, our different concept for the scope of an exemption from consolidation does not restrict the exemption from consolidation to entities whose only substantive activities are investing in multiple investments for capital appreciation and investment income (such as dividends or interest), or both. On the contrary, considering our approach the exemption from consolidation can apply to every entity ï with as few as one ñqualifyingò investment. Nevertheless, independent of this particular GASB approach we do not deem the requirement of multiple investments to be relevant under the IASB approach either. Entities could have just one investment but fulfil all other criteria of the IASBôs definition of an investment entity; in these cases a fair value measurement of that one investment would result in more decision-useful information than consolidation of that investment.

A very important criterion to determine whether the exemption from consolidation is applicable for a specific investment, however, is ï under both the IASBôs and GASBôs approach ï the criterion of management and evaluation of these investments, internally and externally, on a fair value basis (para. 2 (e)) as well as the criterion to provide financial information about the investment activities to the investors (para. 2 (f)). The management and publication of financial information on a fair value basis are important indicators that the controlled investment is held for earnings from investments only and is not held to e.g. engage in other activities to strategically exploit the controlled investmentsô assets.

The criterion ñpooling of fundsò on the other hand is not necessary to define the scope of the exemption from consolidation following the GASBôs approach. The characteristic of the investment (intention to dispose and holding the investment for earnings only) does not depend on the entity having investors who are unrelated to the parent (if any), and in aggregate hold a significant ownership interest in the entity.

ôNature of the investment activityô (paragraphs 2(a) and 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 ñsubstantive activities requirementò if it provides (or holds an investment in an entity that provides) ï to a substantive extent ï services that relate only to the investment entityôs own investment activities. While the substantive activities criterion is not relevant within the concept of the GASB as described above, it is a crucial criterion within the IASBôs concept for the exemption from consolidation. Within the IASB concept we do not support the proposed exemption from the requirement to have no substantive activities other than investing. Therefore, we do not agree that entities should qualify as investment entities if they ï to a substantive degree ï provide (or hold an investment that provides) services that relate to its own investment activities or the investment activities of other entities.

Having expressed our rejection of this exception to the IASBôs definition of an investment entity, we would further like to point out a wording issue regarding the phrasing of the relevant paragraph (para. 7 (a)). That paragraph describes the exception to the requirement in paragraph 6 as follows:

> ñIf an investment entity controls an investee that provides services that relate only to the entityôs own investment activities, it shall consolidate that investee (see paragraph B2);ò

This paragraph reads as if an investee that provides those services would not have to be consolidated if the services do not *only* relate to the entityôs 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 entityôs investment activities (and would therefore have to be measured at fair value). The GASB suggests clarifying the wording of this paragraph accordingly.

ôPooling of fundsö (paragraphs 2(b) and 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 (p. 4 et seq.) under the GASB's approach the criterion "pooling of funds" is not necessary to define the scope for the exemption from consolidation. The characteristic of the investment ((1) intention to dispose of the investment and (2) holding the investment for earnings only) does not depend on the entity having investors who are unrelated to the parent (if any), and in aggregate hold a significant ownership interest in the entity.

We also deem this criterion inappropriate within the IASB's concept of defining an investment entity. 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 as 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 exempt certain controlled investments is about this very fact: to allow a fair value measurement, instead of considering by way of consolidation 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 consolidated but measured at fair value. The important criterion does not seem to be the "ownership" of the assets, but how an entity possibly makes use of those assets. If the exemption from consolidation is to be applied, the entity could not exploit the assets for their business operations. Nevertheless, again it is not the ownership over the assets but the purpose of the investment and whether the assets that are "almost all owned" by the entity do in fact serve the business activities of the entity or are held to achieve investment returns only. This issue is addressed by the – as we agree, crucial – criteria of the nature of the investment activity and the business purpose (para. 2 (a) and (b)).

Measurement guidance (paragraphs 6 and 7)

Question 5
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. Investment entities have to ï as laid out in the criterion in para. 2 (e) ï manage all their investments on a fair value basis. To apply 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 (paragraph 8)

Question 6 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 Boardôs concerns?

The GASB strongly disagrees with the IASBôs proposal that if a parent of an investment entity is not itself an investment entity it should be required to consolidate the controlled entities held through subsidiaries that are investment entities. Given that there is a consensus that the measurement at fair value provides more decision-useful information on the level of the investment entity, we do not find the arguments for a consolidation on the level of a parent entity convincing. We believe retaining the investment entity accounting (fair value measurement) in the financial statements of a parent entity to be the more adequate accounting treatment. That includes those parent entities that are non-investment parent entities. Furthermore, this requirement would load undue burden and undue costs on the entities as there will not only be the cost of measuring the investments at fair value but ï in addition ï the cost of consolidating the investment.

We do not concur with the IASBõs conclusion that the ñpotential accounting inconsistencies and possibilities for abuseò (as laid out in BC20) outweigh the benefits of providing more useful information in the parent entityõs consolidated financial statements. Assuming that the fair value measurement of controlled investees applied by the investment entity results in more useful information, it is also likely ï as acknowledged by the IASB (see BC20) ï that retaining this accounting in the consolidated financial statements of the parent entity provides more useful information since the characteristics of that investment have not changed.

The IASB believes that the restriction of the proposed accounting will not be a major concern as ñin most cases, investment entities would have investment entity parentsò (BC20) which would have to apply the fair value measurement. Our experience has led us to believe that there will be a significant number of cases in which the parent entity is not an investment entity itself. Furthermore, a possibly small number of affected entities does not seem to justify dismissing the accounting method that is likely to result in more useful information.

This 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.

Disclosure (paragraphs 9 and 10)

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 for investment entities 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, IFRS 12 and IFRS 13 as particularly helpful. The IASB should explicitly list the required disclosures instead of having each investment entity by itself look up the appropriate disclosure requirements in other standards. Along the same lines we also do not support B20, in which the IASB merely 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 Standard-setting process to identify possible other applicable or even identical disclosure requirements and it is up to the IASB to avoid redundant requirements within the IFRSs (instead of merely pointing out that those might exists and that investment entities should "avoid unnecessary duplication").

Secondly, on a more specific level the GASB does not approve of disclosure ("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. For example, the detailed per-share information requirements lack 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) would be needed to be provided retrospectively. We suggest clarifying this aspect.

Transition (paragraph C2)

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 an retrospective approach. In the past the 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 some disclosure information might not be available for the previous year. Therefore, we suggest to require a retrospective application unless it is impracticable to do so.

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?

Under the assumption that the IASB is to retain its view on the need to define an investment entity rather than considering the purpose of an investment (for any entity) the GASB agrees with the IASBœs proposal to align the wording throughout the IFRSs. We believe it would be adequate to replace any reference to ñventure capital organisations, mutual funds, unit trusts and similar entitiesò with the term ñinvestment entityò. Furthermore, we agree with the measurement exemption being mandatory rather than elective. For one, comparability and therefore the benefit for users of the financial statements is enhanced. At the same time the burden for entities due to the elimination of an option can be expected 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 IASBœs 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 ñinvestment entitiesò) with regards to accounting for investments in associates.

The GASB believes that its concept to rely not on the characteristics of an entity but on the specific characteristics of the investment should be extended to such other accounting requirements. I.e. investments in associates should be measured at fair value through profit or loss not only by investment entities but by an entity that (1) invests in an associate for capital appreciation, investment income (such as dividends or interest), or both, and (2) at the date of the acquisition intents to dispose of this investment. 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, investment income, or both, the fair value measurement provides more decision-useful information than the equity-method.