FRC

Accounting Standards Board

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Françoise Flores
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Email: commentletter@efrag.org

15 December 2011

Dear Françoise

EFRAG's Draft Comment Letter on the IASB Exposure Draft (ED) 'Investment Entities'

I am writing on behalf of the UK Accounting Standards Board (ASB) in response to EFRAG's Draft Comment Letter (DCL) on the IASB's ED 'Investment Entities'.

The ASB has responded to the IASB and a copy of our response is attached. As you will see from the attached letter, the ASB supports the IASB's proposals for an exception for investment entities to the consolidation principle and hence is broadly in agreement with the EFRAG draft comment letter (DCL).

In common with EFRAG, the ASB also expresses some significant concerns with the level of detail of the ED. Some of the ASB's concerns are similar to those of EFRAG; however some of them differ, and these are highlighted in the appendix, together with the ASB's answers to the questions to constituents raised in the DCL.

One issue which does not arise in the response to the questions is the issue of insurance funds being excluded from the definition of an investment entity. The ASB is concerned with this implication of the proposals and consider that insurance funds should fall within the definition of an investment entity.

Should you wish us to expand on any aspect of this response, please contact me or Jennifer Guest j.guest@frc-asb.org.uk

Yours sincerely

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Appendix 1 – ASB response to the EFRAG DCL response to ED 'Investment Entities'

Responses to the questions in the Appendix to the EFRAG DCL

Questions to constituents in relation to Question 1 of the ED (paragraphs 9-1 of the Appendix to the EFRAG DCL)

The ASB response to the EFRAG questions to constituents in paragraphs 9 and 10 of the DCL which relates to **Question 1** in the ED 'Investment Entities'; are: No
Question 2 (paragraphs 12 – 15 of the EFRAG DCL)

Whilst the ASB is in agreement with the EFRAG comments in paragraphs 13 and 14 of the DCL; we have identified further suggestions for amendments to the criterion (d), (e) and (f). (Please see the ASB's response to the IASB, Question 2)

Questions to constituents in relation to Question 2 of the ED (paragraphs 16-17 of the Appendix to the EFRAG DCL)

The ASB response to the EFRAG questions to constituents in paragraphs 16 and 17 of the DCL which relates to Question 2 in the ED 'Investment Entities'; are:

16 We consider that criteria are necessary to establish qualification as an investment entity. Whilst we have issues with some of the criteria (please see our response to the IASB) we consider that criteria should determine eligibility.

17 We consider that some of the criteria in the ED would prevent some entities from being able to apply the exemption; however if the criteria are correct they should not exclude investment entities from applying the exemption.

Question 4 (paragraphs 21 – 24 of the EFRAG DCL)

The ASB does not agree with the proposed restriction to entities with more than one investor. As explained in our response to the IASB, there are no conceptual reasons why a single investor could not be an investment entity. Whilst we appreciate the practical difficulties to distinguish between a true investment entity and entities set up for other purposes, we consider an entity with a single investor unrelated to the fund manager should be eligible to qualify as an investment entity. There are number of instances where funds as a single investor exist. The most common is where a fund is established with a seed investor, where the fund manager seeks to build up a track record before marketing the fund to new investors. Other examples exist where, for strategic reasons, a fund has been set up for a single investor, but where it is one of a number of funds managed in parallel by a fund manager. There are also examples where funds have been established with a single investor where, that investor is either a nominee for a number of other investors, or where the fund is part of a structured product offered by a financial institution, where the institution is the shareholder in the fund. The institution offers investment products to multiple investors whereby the institution delivers returns to those investors through its holding in the fund.

It is unclear why having a single investor should exclude a fund from the definition of investment entity, especially when it is unrelated to the fund manager, if it meets all other criteria. Therefore we consider this restriction should be excluded. A suggestion for rewording of 2(d) is as follows: 'The entity has, *or is available to*, investors that are unrelated to the parent…'

Question 7 (paragraph 32 -36 of the EFRAG DCL)

Whilst we are in agreement with the issues EFRAG raises in paragraph 36, we would highlight that, where EFRAG says in (a) 'it is unclear how exactly the IASB has selected these particular disclosures'; the disclosures are taken from US GAAP.

Question 8 (paragraph 39 - 41 of the EFRAG DCL)

The ASB agrees with the IASB that it would be impractical to require investment entities to apply the proposals retrospectively. The ASB is inclined to consider that this has to be weighed up with relevance – in order to go back 3 years, hindsight would have to be applied to get retrospective figures and on balance we consider that the IASB are correct to state that the proposals should be applied prospectively.

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15 December 2011

Dear Michael

IFRS ED 'Investment Entities'

This letter sets out the Accounting Standards Board's (ASB) comments on the Exposure Draft (ED) '*Investment Entities*'.

The ASB is in general agreement with the principle behind the proposals and supports the IASB on issuing this ED which proposes to exempt investment entities from consolidation. It has been a long held view of the ASB that the sector's requirements merit treatment that reflects their business model and we are aware of a number of our constituents who will be pleased that the IASB is seeking to address their concerns. The ASB's answers to the questions in the Invitation to Comment are set out in the appendix to this letter.

The ASB, however has some significant concerns with the detail of the proposals in the ED. Our main concern is that the structure of an entity should not drive the accounting. The ASB agrees with the principle that investments should be accounted for in line with the way they are being managed but does not agree with the requirements for the entity to take a particular form in order to be eligible for the proposed exemption. The reporting entity (the parent) should not have to consolidate subsidiaries of the investment entity, if the subsidiaries of the investment entity are exempt from consolidation by the investment entity and the investment entity meets the definition of the ED. (See our answer to Question 6 in the appendix).

Its other concerns can be summarised as follows:

- A general concern that the definition of an investment entity excludes insurance funds which we consider should fall within the definition of an investment entity;
- The criteria to identify investment entities should also include a requirement that they should have an exit strategy; a number of the criteria in the ED are also in need of some refinement (Question 2);
- There are no conceptual reasons why a single investor could not be an investment entity (Question 4);
- Concern with the level of detail used to explain the disclosure objective (Question 7) and;

- The ASB considers that the rationale for amending IAS 28 should be better explained in the Basis for Conclusions as the ED provides no commentary on how the existing exemption in IAS 28 'Joint Ventures' is functioning and, why its scope is in need of amendment. The proposals in the ED will ensure that the scope of the exemption in IAS 28 is more restrictive than at present and we believe that the IASB has not made the case for this (Question 9).

Please find attached, as an appendix to this document, our detailed responses to the invitation to comment questions.

Should you wish us to expand on any aspect of this response, please contact me or Jennifer Guest j.guest@frc-asb.org.uk

Yours sincerely

Roger Marshall
Chairman
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RESPONSE TO SPECIFIC QUESTIONS IN THE ED 'INVESTMENT ENTITIES'

1.1 *This Appendix sets out the ASB's responses to the questions set out in the exposure draft's Invitation to Comment.*

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 that should not consolidate controlled entities and instead measure them at fair value through profit or loss? Why or why not?

We are in agreement that investment entities should be excluded from the requirement to consolidate controlled investments but, that a requirement for them to measure investments at fair value through profit and loss is most suitable. In our view this treatment best represents investment entities' business purpose, how they are managed and better meets the needs of users.

Question 2 – Criteria for determining when an entity is an investment entity (paragraphs 2 and B1-B17)

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 the profit or loss? If not, what alternative criteria would you propose, and why are those criteria more appropriate?

Our main suggestion is that there should be an additional criterion which relates to the existence of an exit strategy as this is a key aspect of identifying an investment entity. Whilst we recognise that exit strategy is mentioned in the application guidance (paragraph B9), we consider that it should be part of the criteria in the standard. We propose that the requirement should be for an 'exit strategy' which should encompass sale on wind up of a limited life vehicle. We propose insertion of the following: 'The exemption should not be made available to an entity that does not intend to sell its investments and, the entity must have an exit strategy.'

Regarding the criteria proposed in paragraph 2 of the ED, we have comments that relate to criterion (a), (d), (e) and (f):

Criteria 2 (a) needs clarification to establish that the requirement to hold 'multiple investments', relates to investments in investees that the parent controls. We suggest 'investing in multiple investments (that the investment entity controls) for capital appreciation.'
Where criteria (d) refers to the 'entity's investors and 'significant ownership interest in the entity' – it should be clear that the ED means investment entity

and not the other entity (parent). It is important not to confuse the terms. A suggestion for rewording of 2(d) is as follows: 'The entity has, or is available to, investors that are unrelated to the parent…'

Criteria (f) should be changed – If it is irrelevant if an entity is legal or not, then why have it as a criterion. Surely the important issue here is the one raised in BC18 which relates to conveying financial information. We suggest the following wording; 'An investment entity must report financial information about its investing activities to its investors even if it is not a separate legal entity.'

Question 3 – Nature of the investment activity (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?

The ASB agrees with the criterion in paragraph 2 (a) of the ED (subject to clarification – see our response to question 2 above). Therefore we agree that if an entity provides or holds an investment in an entity that provides services that relate to: (a) its own investment activities; it should be eligible to qualify for the exemption. However we consider that the wording of B6 is confusing. The last paragraph of B6 should be re-phrased to: 'The following are not investment entities'. Furthermore B6 (a) and (e) amount to the same; but since (e) is a better explanation of why an entity would not be an investment entity; we suggest deleting (a).

Question 4 – Pooling of Funds (paragraphs 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 structure/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.

The ASB agrees that there are no conceptual reasons why a single investor could not be an investment entity. Whilst we appreciate the practical difficulties to distinguish between a true investment entity and entities set up for other purposes, we consider an entity with a single investor unrelated to the fund manager should be eligible to qualify as an investment entity. There are number of instances where funds as a single investor exist. The most common is where a fund is established with a seed investor, where the fund manager seeks to build up a track record before marketing the fund to new investors. Other examples exist where, for strategic reasons, a fund has been set up for a single investor, but where it is one of a number of funds managed in parallel by a fund manager. There are also examples where funds have been established with a single investor where, that investor is either a nominee for a number of other investors, or where the fund is part of a structured product offered by a financial institution, where the institution is the shareholder in the fund. The institution offers investment products to multiple investors whereby the institution delivers returns to those investors through its holding in the fund.

It is unclear why having a single investor should exclude a fund from the definition of investment entity, especially when it is unrelated to the fund manager, if it meets all other criteria. Therefore we consider this restriction should be excluded. A suggestion for rewording of 2(d) is as follows: 'The entity has, *or is available to*, investors that are unrelated to the parent…'

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 only to financial assets, as defined in IFRS 9 and IAS 39 *Financial Instruments*? Why or why not?

The ASB agrees with the extension of the exemption to investment properties; however we consider that the guidance on this issue should be brought forward to the standard. Extending the exemption to investment entities that hold investment properties could raise an issue where an investment entity controls another entity that holds investment properties.

Question 6 – Accounting in the consolidated financial statement of a non-investment entity 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?

The ASB does not agree. In its view, if the entity controlled (by a non-fund parent) is itself an investment entity, as defined by the ED, then it should not have to consolidate any subsidiaries that the fund itself has been exempt from consolidating. In our view, this is a better accounting solution. We also note that this treatment would be allowed under US GAAP and so consistency would also be achieved.

We disagree with the IASB's view that there are few non-investment parents. Seed investors (see response to Q4) would meet the definition of a parent. Long-term insurance entities often own fund management companies that manage the insurer's assets using investment entities. If the insurer is required to consolidate it will be overstating total assets and implying that an obligation exists between the insurer and the unrelated investors of the investment entity; when in reality the insurer is using the investment entity to back their liabilities to policy holders.

We consider that the reporting entity (the parent) should not have to consolidate subsidiaries of the investment entity, if the investment entity is exempt from consolidation and the investment entity meets the definition of the ED.

Where an investment entity might be considered to hold a 'controlling interest' in a subsidiary, it is relevant that, given the investment decisions would be made by a 'third party' asset manager, an investment entity investing in another investment entity is not doing so to exert control but rather to gain exposure to the risk/return of that subsidiary. We expect fair value information to be more relevant in the financial statements of the parent because it demonstrates their ability to cover their liabilities. Whilst we have sympathy for the IASB's concerns expressed in the preceding paragraph to the question; we consider that an existence of a legitimate exit strategy (see out answer to Question 2) is sufficient to ensure that investment entities are not the vehicle for abusive practices.

Question 7 – Disclosure (paragraphs 9 and 10)

(a) Do you agree that it is appropriate to use this disclosure objective for investment entities rather than including additional specific disclosures 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 ASB agrees with the disclosure objective. However, we are concerned with the level of detail used to explain the objective.

Paragraph B18(c) could be problematic if the investee is an open-ended fund because the investment entity will not know the number of investees units in issue (as it changes frequently, possibly every day).

Whilst we recognise that the disclosures listed in paragraph B19 are suggestions, we are concerned that they could be viewed as being requirements, which may not be appropriate in all circumstances. For example (vii) is not relevant in jurisdictions such as the UK or Ireland. What evidence does the IASB have that payments are made in this fashion? In the UK there are strict rules (set by the Financial Services Authority, FSA) governing such payments. Similarly, in Ireland, regulatory notice Undertakings for Collective Investment in Transferable Securities (UCITS 4.5), paragraph 6 & 7 and NU Notice 7.12 paragraph 6 & 7 relate to this issue.

Paragraph B20 places the onus on preparers to check they are not duplicating other disclosure they may have. There is a risk that preparers will err on the side of caution when considering clients disclosures leading to an unnecessary and long list of disclosures. In our view, the IASB should provide specific disclosure requirements for investment entities that are relevant to the economic decisions of the investor.

Lastly, there may still be a gap in disclosures for fund of funds. It is unclear if current disclosure requirements adequately capture the disclosures needed for investors in a feeder fund so as to understand the investments and risks associated with the master fund e.g. disclosure of investments and risk leverage.

Question 8 – Transition (paragraphs 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?

The ASB agrees with the IASB that it would be impractical to require investment entities to apply the proposals retrospectively. The ASB is inclined to consider that this has to be weighed up with relevance – in order to go back 3 years, hindsight would have to be applied to get retrospective figures and on balance we consider that the IASB is correct to state that the proposals should be applied prospectively.

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 tr5usts and similar entities, including investment-linked insurance funds? Why or why not?

The ASB considers that the rationale for amending IAS 28 should be better explained in the Basis for Conclusions as the ED provides no commentary on how the existing exemption in IAS 28 'Joint Ventures' is functioning and, why its scope is in need of amendment. The proposals in the ED will ensure that the scope of the exemption in IAS 28 is more restrictive than at present and the IASB has not made the case for this.

The ASB considers that whilst consistency of definitions between standards is of paramount importance, importing the proposed definition of an investment entity into IAS 28 without detailing the consequences is unacceptable.

With regards to entities which may be affected by these proposals, since investment funds would typically meet the proposed criteria for being an investment entity this proposal should not be problematic. However, for those entities that may not meet the definition of investment entities e.g. some venture capital funds, the option of being able to voluntary adopt the exemption would be preferred. Therefore alternative (b) in the question is preferable.