18 January 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 supports the IASB's efforts to address these concerns.

Overall, we agree with the IASB's proposal for an exception to the consolidation principle, because measuring an investment entity's controlled investments at fair value produces more decision-useful information that meets users' needs as it better reflects the entity's business model. We believe that having an exit strategy is a key aspect in the business model of an investment entity and should be one of the criteria to identify an investment entity rather than being described in the application guidance. Furthermore, we do not believe that it is necessary to amendment IAS 28 and restrict the application of the exception to investment entities only, as the existing fair value option in IAS 28 has not raised any concerns in the past.

EFRAG believes that 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 such fair value information would also be relevant in the financial statements of the ultimate parent entity. While we acknowledge the concerns of the IASB and the European Supervisory Authorities (EBA, ESMA and EIOPA) regarding the potential for abuse by permitting such accounting, we believe is addressed by strict investment entity criteria to prevent inappropriate use of the exception. Moreover, to the extent that regulators have specific concerns those would be better addressed as a matter of supervision.

In December 2011, EFRAG sent a letter to the IASB requesting a deferral of the effective dates of IFRS 10, IFRS 11 and IFRS 12. In that letter we noted the concern that some companies might be required to start consolidation under IFRS 10 of investees held by investment entity subsidiaries, but might be forced to adopt investment entity accounting shortly afterwards if the IASB were to change its decision on the 'roll-up' (see our response in paragraph 10 of the Appendix). Constituents have raised this concern again with us as part of the due process for this letter. We therefore recommend that the Board reconsider the effective date of the standards mentioned above.

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 Panagiotis Papadopoulos or me.

Yours sincerely

Françoise Flores
EFRAG Chairman

Appendix

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?

EFRAG's response

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

1 EFRAG supports an exception to the consolidation principle because measuring an investment entity's controlled investments at fair value produces more decision-useful information, as such information reflects the underlying activities of the entity's business model.

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?

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.

2 EFRAG believes 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.

3 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).

4 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 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?

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.

5 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.

6 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?

EFRAG's response

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

7 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.

8 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?

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.

9 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?

EFRAG's response

EFRAG believes that a non-investment entity parent should be required to consolidate its investment entity subsidiaries, but that it should retain the fair value measurement of the controlled entities that are held through those investment entity subsidiaries.

10 EFRAG believes that a non-investment entity parent should be required to consolidate its investment entity subsidiaries, but that it should retain the fair value measurement of the controlled entities that are held through those investment entity subsidiaries (i.e. the parent would 'roll-up' the accounting of its investment entity subsidiary). In our view – and as confirmed by users in the course of our due process – 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.

11 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. We also note that the European Supervisory Authorities (EBA, ESMA and EIOPA) agree with the IASB's position in this respect. EFRAG disagrees with these views for the following reasons:

(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.

(c) We note that anti-abuse issues would be better addressed as a matter of supervision by the regulatory authorities rather than by embedding them in financial reporting.

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?

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.

12 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, such lists of examples are often interpreted as being requirements. Therefore, 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?

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.

13 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.

14 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 impair the usefulness of the financial statements in the year in which these proposals are first adopted.

15 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?

EFRAG's response

We believe that the measurement exemption in IAS 28 should be mandatory for investment entities and voluntary for other venture capital organisations, mutual funds, unit trusts and similar entities, including investment-linked funds.

16 EFRAG favours the alternative approach suggested by the IASB, as it would ensure that investment entities measure all of their investments at fair value, while retaining the IAS 28 exemption for other venture capital organisations, mutual funds, unit trusts and similar entities, including investment-linked insurance funds. We believe that the existing fair value option in IAS 28 is useful and has not raised any concerns in the past. Therefore, we believe that it is not necessary to amend IAS 28 and restrict the application of the exemption to investment entities only.

17 We note that the IASB is currently evaluating, together with National Standard Setters, the impact of the amendments proposed in the ED. EFRAG believes that before finalising the proposals, the IASB should carefully consider the implications of any amendments to IAS 28. In our view, the basis of conclusions in the final standard should provide a clear explanation of those implications.