Jonathan Faull
Director General
European Commission
Directorate General for the Internal Market
1049 Brussels

18 February 2013

Dear Mr Faull

Adoption of *Investment Entities (Amendments to IFRS 10, IFRS 12 and IAS 27)*

Based on the requirements of the Regulation (EC) No 1606/2002 of the European Parliament and of the Council on the application of international accounting standards we are pleased to provide our opinion on the *Investment Entities (Amendments to IFRS 10, IFRS 12 and IAS 27)* ('the Amendments'), which were issued by the IASB on 31 October 2012. It was issued as an Exposure Draft in August 2011 and EFRAG commented on that draft.

The Amendments define an investment entity and introduce an exception to consolidating particular subsidiaries for investment entities. These amendments require an investment entity to measure those subsidiaries at fair value through profit or loss in accordance with IFRS 9 Financial Instruments in its consolidated and separate financial statements. The amendments also introduce new disclosure requirements for investment entities in IFRS 12 and IAS 27.

The Amendments become effective for annual periods beginning on or after 1 January 2014. Earlier application is permitted, however entities shall disclose that fact and apply all the amendments at the same time.

EFRAG has carried out an evaluation of the Amendments. As part of that process, EFRAG issued its initial assessment for public comment and, when finalising its advice and the content of this letter, it took the comments received in response into account. EFRAG's evaluation is based on input from standard setters, market participants and other interested parties, and its discussions of technical matters are open to the public.

EFRAG supports the Amendments and has concluded that they meet the requirements of the Regulation (EC) No 1606/2002 of the European Parliament and of the Council on the application of international accounting standards in that they:

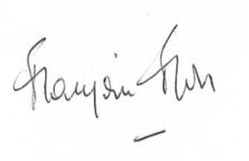
- are not contrary to the principle of 'true and fair view' set out in Article 16(3) of Council Directive 83/349/EEC and Article 2(3) of Council Directive 78/660/EEC; and

- meet the criteria of understandability, relevance, reliability and comparability required of the financial information needed for making economic decisions and assessing the stewardship of management.

For the reasons given above, EFRAG is not aware of any reason to believe that it is not conducive to the European public good to adopt the Amendments and, accordingly, EFRAG recommends their adoption. EFRAG's reasoning is explained in the attached 'Appendix – Basis for Conclusions'.

On behalf of EFRAG, I should be happy to discuss our advice with you, other officials of the EU Commission or the Accounting Regulatory Committee as you may wish.

Yours sincerely,



Françoise Flores
EFRAG Chairman

APPENDIX
BASIS FOR CONCLUSIONS

This appendix sets out the basis for the conclusions reached, and for the recommendation made, by EFRAG on the Investment Entities (Amendments to IFRS 10, IFRS 12 and IAS 27) ('the Amendments').

In its comment letters to the IASB, EFRAG points out that such letters are submitted in EFRAG's capacity of contributing to the IASB's due process. They do not necessarily indicate the conclusions that would be reached by EFRAG in its capacity of advising the European Commission on endorsement of the definitive IFRS in the European Union and European Economic Area.

In the latter capacity, EFRAG's role is to make a recommendation about endorsement based on its assessment of the final IFRS or Interpretation against the technical criteria for the European endorsement, as currently defined. These are explicit criteria which have been designed specifically for application in the endorsement process, and therefore the conclusions reached on endorsement may be different from those arrived at by EFRAG in developing its comments on proposed IFRSs or Interpretations. Another reason for a different is that EFRAG's thinking may evolve.

Does the accounting that results from the application of Amendments meet the technical criteria for EU endorsement?

1 EFRAG has considered whether *Consolidated Financial Statements, Disclosure of Interests in Other Entities and Separate Financial Statements: Investment Entities (Amendments to IFRS 10, IFRS 12 and IAS 27)* ('the Amendments') meet the technical requirements of the European Parliament and of the Council on the application of international accounting standards, as set out in Regulation (EC) No 1606/2002, in other words that the Amendments:

   (a) are not contrary to the principle of 'true and fair view' set out in Article 16(3) of Council Directive 83/349/EEC and Article 2(3) of Council Directive 78/660/EEC; and

   (b) meet the criteria of understandability, relevance, reliability and comparability required of the financial information needed for making economic decisions and assessing the stewardship of management.

   EFRAG also considered, based only on evidence brought to its attention by constituents, whether it would be not conducive to the European public good to adopt the Amendments.

2 In performing its assessment, EFRAG focused on the impact of the new elements introduced by the Amendments.

   (a) Definition of an investment entity and guidance on the typical characteristics displayed by an investment entity.

   (b) Exception to consolidation.

   (c) Measurement at fair value.

(d) Accounting for subsidiaries of investment entities in the separate financial statements.

3 Elements (a), (b) and (c) have been assessed together as a single amendment in this Appendix, while element (d) has been assessed separately.

4 The Amendments also introduce consequential amendments to other IFRSs. In EFRAG's view, the consequential amendments are straightforward and do not raise any new concerns. For this reason, these are not discussed specifically in this appendix. However, EFRAG notes that the consequential amendments to IFRS 9 have not been assessed and will be considered together with the related requirements in IFRS 9.

5 Furthermore, EFRAG observes that the transitional provisions included in the Amendments are consistent with the transition requirements in IFRS 10 as amended in June 2012, and do not introduce any new concerns. Therefore they are not discussed specifically in the appendix.

Qualification and measurement of an investment entity: exception from consolidation

Relevance

6 Information is relevant when it influences the economic decisions of users by helping them evaluate past, present or future events or by confirming or correcting their past evaluations.

7 EFRAG considered whether these Amendments would result in the provision of relevant information – in other words, information that has predictive value, confirmatory value or both – or whether it would result in the omission of relevant information.

<u>Definition and typical characteristics of an investment entity</u>

8 The definition of an investment entity comprises three essential elements that focus on the business purpose of an entity – that is whether it (a) obtains funds from investors and (b) commits to its investor(s) its business purpose is to provide investment management services and invest funds *solely* for returns from capital appreciation, investment income, or both, and (c) measures and evaluates the performance of substantially all of its investments on a fair value basis.

9 Given its business purpose in the definition, an investment entity should not hold its investments indefinitely, and we therefore agree that such an entity would need an exit strategy for its investments to reflect this objective. Furthermore, the Amendments provide a series of characteristics that are regarded to be typical of an investment entity, and should be considered (although not mandatory) when determining whether an entity qualifies as an investment entity. EFRAG agrees with this approach as it encourages an entity to consider all facts and circumstances about how it operates, its ownership structure and how it manages its investments, when assessing whether it qualifies as an investment entity.

10 EFRAG believes that the typical characteristics of an investment entity set out in the Amendments are intended to support the definition of an investment, and at the same time allow an entity to exercise a degree of judgement in order to consider relevant facts and circumstances in making the assessment. We support this principles-based approach, and the focus on the business model of an entity and its

core activities, without the rigidness of having to meet a set of predefined qualification criteria.

11 The provision of investment-related services or activities to third parties or investors by a subsidiary of an entity, does not disqualify that entity from being an investment entity even if the investment-related services are substantial. Instead, the Amendments require the investment entity to consolidate that subsidiary. EFRAG agrees with this requirement as it will ensure that relevant information is not omitted as a result of an investment entity having one or more subsidiaries that provide investment-related services.

<u>Exception to consolidation</u>

12 Under the Amendments, entities that meet the definition of an investment entity will not consolidate their investments in subsidiaries. However, this exception is not extended to a parent of an investment entity that is not itself an investment entity.

13 EFRAG generally believes that a reporting entity should not differentiate between types of entities when applying the control model of consolidation in IFRS 10 *Consolidated Financial Statements*. However, EFRAG notes that the Amendments respond to the concerns of users of financial statements, who expressed support for a consolidation exception for subsidiaries of investment entities, and argued that their interests are best served by having a single line measurement basis based on fair value, instead of consolidation of subsidiaries of investment entities.

14 However, some constituents are concerned that the Amendments should have permitted further entities to benefit from the exception and therefore omit relevant information being provided to users. These constituents disagree with an "entity-based" approach to the exception to consolidation, and believe that the exception should be provided at the asset (investment) level, based on certain characteristics of an investment held by an entity, rather than the other way round. In their view, limiting the use of the exemption to consolidation by investment entities is a missed opportunity as it does not allow a non-investment parent entity to provide relevant information in its consolidated accounts.

15 Although these constituents acknowledge the IASB's concerns about potential abuses that could arise from extending the exception to non-investment entity parents – for example by holding subsidiaries directly or indirectly through an investment entity an entity could obscure leverage or loss-making activities – they believe the IASB could have tried to resolve potential anti-abuse issues by requiring the exception to be provided at a lower asset level, as explained in the paragraph above.

16 Although EFRAG acknowledges the above concerns, we believe that limiting the use of the exception to investment entities as defined under the Amendments, does not affect the relevance of information produced by those entities, and therefore should not preclude the information provided under the Amendments from meeting the relevance criterion.

<u>Fair value measurement</u>

17 EFRAG believes that when an entity invests only for capital appreciation or investment income, rather than to manage the underlying assets and liabilities of its investees (i.e. the investee is the unit-of-account), fair value provides relevant information as it reflects the underlying substance of the activities of the entity and

how it is managed, rather than of the operations of the investee. The relevant cash flows relating to these activities are those of the investment entity itself. Consolidating the cash flows of a subsidiary of an investment entity may hinder users' ability to predict the cash flows that are relevant information to users.

18 EFRAG considered whether the loss of consolidation under IFRS 10, would have a negative impact on relevance because certain key information would not be provided to users. EFRAG notes that IFRS 12 *Disclosure of Interests in Other Entities* requires investment entities to provide qualitative and quantitative information about the nature and risks of its interest in the investees that it does not consolidate.

19 We agree that for entities that meet the definition of an investment entity fair value provides relevant information for these entities.

<u>Conclusion</u>

20 For the above reasons, EFRAG's assessment is that the Amendments satisfy the relevance criterion.

Reliability

21 EFRAG also considered the reliability of the information that will be provided by applying these Amendments. Information has the quality of reliability when it is free from material error and bias and can be depended upon by users to represent faithfully what it either purports to represent or could reasonably be expected to represent, and is complete within the bounds of materiality and cost.

22 There are a number of aspects to the notion of reliability: freedom from material error and bias, faithful representation, and completeness.

<u>Definition and typical characteristics of an investment entity</u>

23 EFRAG acknowledges that consideration of the facts and circumstances in which the business model of an entity operates will involve a degree of judgement which might, if applied incorrectly, have a negative impact on the reliability of information provided.

24 However, in our view, the definition and the guidance on the typical characteristics of an investment entity should be helpful to address concerns on consistent application of the definition, which may affect reliability of information. Furthermore, we believe that the disclosures required by IFRS 12 will assist users in understanding the assumptions made by management and help mitigate the reliability concerns that might arise from the degree of judgement exercised.

<u>Fair value measurement</u>

25 To meet the definition of an investment entity, an entity must also demonstrate that fair value is the primary measurement attribute used to evaluate the performance of its investments, both internally and externally. Consequently, we believe that fair value information would already be available for most investments entities, because they already measure substantially all of their investments at fair value.

26 Furthermore, we believe that IFRS 13 *Fair Value Measurement* provides appropriate guidance to ensure that fair values will be reliable. In developing its endorsement advice on IFRS 13, EFRAG concluded that IFRS 13 does not cause

any significant issues in relation to reliability of information about assets or liabilities subject to fair value measurement or disclosure requirements, and satisfies the reliability criterion.

Conclusion

27 For the above reasons, EFRAG's assessment is that the Amendments satisfy the reliability criterion.

Comparability

28 The notion of comparability requires that like items and events are accounted for in a consistent way through time and by different entities, and that unlike items and events should be accounted for differently.

29 EFRAG has considered whether the Amendments result in transactions that are:

(a) economically similar being accounted for differently; or

(b) transactions that are economically different being accounted for as if they are similar.

Definition and typical characteristics of an investment entity

30 In EFRAG's view, the reference to the business purpose in the definition of an investment entity ensures that entities with the same business models are accounted in the same way, and therefore producing information that is comparable between investment entities.

Exception to consolidation

31 An investment entity's control of an investment in a subsidiary may change from one reporting period to the next, as an investment entity is likely to buy and sell investments or parts of investments on a frequent basis. Without the exception to consolidation, an investment entity would be required to consolidate an investment in one period and deconsolidate it in another period. EFRAG believes that requiring a consistent measurement basis to report its investments in subsidiaries will ensure that investment entities produce comparable information.

32 Under the fair value measurement option in existing IAS 28, an entity (that is considered to be a venture capital organisation or a similar entity) may elect to measure its investments in associates and joint ventures at fair value under IFRS 9 *Financial Instruments*. The Amendments will result in subsidiaries held by investment entities being measured at fair value, and therefore creating a consistent measurement attribute for all investments held by entities that are considered to be investment entities or similar.

33 Some believe that the Amendments will result in information that is not comparable in the following cases:

(a) when similar transactions might be presented differently between entities across different industries when the definition of an investment entity is not met.

(b) when different measurement bases are being applied for the same investment in a subsidiary, depending on whether that investment is reported at a non-investment entity parent level or investment entity subsidiary level.

34 These constituents argue that the above concerns arise because (a) the exception to consolidation focuses on the business model and core activities of an entity, rather than the individual investments (assets) it holds and (b) because the Amendments prohibit a parent entity, that is not an investment entity itself, from retaining the measurement basis of its investment entity subsidiary's investments in its consolidated accounts.

35 The Amendments focus on financial reporting of "investment entities" and achieving comparability of information for those entities. EFRAG acknowledges that limiting the use of the exception to investment entities will result in reporting of different information in the situations explained in paragraph 33 (a) and (b) above. In EFRAG's view, the business model of an investment entity as defined by the Amendments is economically different from that of entities (including parent entities) that hold and manage investments as part of a broader set of business objectives. Given that the activities of investments entities are not directly comparable to those of other entities holding investments, EFRAG believes that this difference in reporting does not adversely affect comparability.

Conclusion

36 Therefore, EFRAG's assessment is that the Amendments satisfy the comparability criterion.

Understandability

37 The notion of understandability requires that the financial information provided should be readily understandable by users with a reasonable knowledge of business and economic activity and accounting and the willingness to study the information with reasonable diligence.

38 Although there are a number of aspects to the notion of 'understandability', EFRAG notes that most of the aspects are covered by the discussion above about relevance, reliability and comparability.

39 As a result, EFRAG is of the view that the main additional issue it needs to consider, in assessing whether the information resulting from the application of the Amendments is understandable, is whether that information will be unduly complex.

40 EFRAG notes that the exception to consolidation has been introduced to address the concerns of the users who argued that fair value information about the investment entity's investments is the most understandable information for their analysis.

41 The Amendments will result in different measurement bases being used for the same investment depending on whether the investment is reported at a non-investment entity parent level or investment entity subsidiary level. Some disagree with this approach, and believe that having a different measurement bases for the same investments could create complexities for users.

42 In EFRAG's view, having a different measurement basis for subsidiaries of investment entities should not increase complexity in understanding the information,

as both consolidation and fair value accounting are well understood by users of financial statements.

43 For the above reason, EFRAG believes that the exception to consolidation will not introduce any new complexities that may impair understandability. Furthermore, the requirement of IFRS 12 to disclose significant judgements and assumptions made in determining whether an entity qualifies as an investment entity will ensure that the information produced under the Amendments is understandable to users, as it will enable them to better understand the financial information provided

44 Therefore, EFRAG's overall assessment is that the Amendments satisfy the understandability criterion.

Accounting for investments in subsidiaries in the separate financial statements of an investment entity

45 Under existing IFRSs, interests in subsidiaries are accounted for at cost or at fair value in accordance with IFRS 9 regardless of the nature of the parent entity.

46 In addition, currently IAS 27 *Consolidated and Separate Financial Statements* does not require a parent entity to disclose the information required in IFRS 12 relating to investment entities in its separate accounts.

47 The Amendments require the investments of the investment entity to be accounted for in the separate financial statements in the same manner as they are accounted for in the consolidated financial statements – at fair value through profit and loss under IFRS 9.

Relevance

48 Information is relevant when it influences the economic decisions of users by helping them evaluate past, present or future events or by confirming or correcting their past evaluations.

49 EFRAG considered whether these Amendments would result in the provision of relevant information – in other words, information that has predictive value, confirmatory value or both – or whether it would result in the omission of relevant information.

50 As described above, in its assessment on the accounting in the consolidated financial statements of investment entities, EFRAG concluded that a fair value measurement basis for investments in subsidiaries held by investment entities will provide relevant information for investment entities. In EFRAG's view, it is equally relevant information if an investment entity measures those same subsidiaries also at fair value through profit or loss in its separate financial statements.

51 For the above reasons, EFRAG's assessment is that the Amendments satisfy the relevance criterion in the separate financial statements of an investment entity.

Reliability

52 EFRAG also considered the reliability of the information that will be provided by applying these Amendments. Information has the quality of reliability when it is free from material error and bias and can be depended upon by users to represent faithfully what it either purports to represent or could reasonably be expected to represent, and is complete within the bounds of materiality and cost.

53 There are a number of aspects to the notion of reliability: freedom from material error and bias, faithful representation, and completeness.

54 The Amendments remove the cost measurement option in existing IAS 27 and require an investment entity to measure its investments in subsidiaries in its separate financial statements in the same way as in its consolidated accounts – at fair value. Therefore, in our view, the Amendments do not raise significant concerns about reliability.

Comparability

55 The notion of comparability requires that like items and events are accounted for in a consistent way through time and by different entities, and that unlike items and events should be accounted for differently.

56 EFRAG has considered whether the Amendments result in transactions that are:

(a) economically similar being accounted for differently; or

(b) transactions that are economically different being accounted for as if they are similar.

57 In EFRAG's view, the Amendments will result in economically similar entities being accounted for in the same way, regardless of whether they are presented in the separate or the consolidated financial statements. This ensures comparability of information for the same entities reporting their activities in the separate financial statements.

58 Some constituents believe that there is no difference between investment entities and other entities when preparing separate financial statements, and therefore there is no reason to require different accounting.

59 However, EFRAG believes that to the extent that an entity is an investment entity as defined by the Amendments that fact should be taken into account, including when preparing its separate financial statements, so that users can benefit from comparable information.

60 For the above reasons, EFRAG's assessment is that the Amendments satisfy the comparability criterion.

Understandability

61 The notion of understandability requires that the financial information provided should be readily understandable by users with a reasonable knowledge of business and economic activity and accounting and the willingness to study the information with reasonable diligence.

62 Although there are a number of aspects to the notion of 'understandability', EFRAG notes that most of the aspects are covered by the discussion above about relevance, reliability and comparability.

63 As a result, EFRAG is of the view that the main additional issue it needs to consider, in assessing whether the information resulting from the application of the Amendments is understandable, is whether that information will be unduly complex.

64 In EFRAG's view, the requirements in the Amendments do not introduce any new complexities in the separate financial statements that may impair understandability and the Amendments satisfy the understandability criterion.

True and fair

65 EFRAG has concluded that the information resulting from the application of the Amendments would not be contrary to the true and fair view principle.

European public good

66 EFRAG is not aware of any reason to believe that it is not conducive to the European public good to adopt the Amendments.

Conclusion

67 For the reasons set out above, EFRAG has concluded that the Amendments satisfy the technical criteria for EU endorsement and EFRAG should therefore recommend their endorsement.