



ED/2014/2 INVESTMENT ENTITIES: APPLYING THE CONSOLIDATION EXCEPTION

ICAEW welcomes the opportunity to comment on EFRAG's draft comment letter on the International Accounting Standards Board Exposure Draft [ED/2014/2 Investment Entities: Applying the Consolidation Exception – Proposed amendments to IFRS 10 and IAS 28](#) published by the IASB on 11 June. Our responses to the main issues highlighted by EFRAG are set out below. A copy our response to the IASB is attached. Please refer to this response for our detailed views on the IASB's proposals.

This response of 12 August has been prepared on behalf of ICAEW by the Financial Reporting Faculty. Recognised internationally as a leading authority on financial reporting, the faculty, through its Financial Reporting Committee, is responsible for formulating ICAEW policy on financial reporting issues and makes submissions to standard setters and other external bodies on behalf of ICAEW. The faculty provides an extensive range of services to its members including providing practical assistance with common financial reporting problems.

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MAJOR POINTS

Some member states will not benefit from the exemption from preparing consolidated

1. Like EFRAG, we support the proposal to apply the exemption from preparing consolidated financial statements set out in paragraph 4(a) of IFRS 10, to subsidiaries of an investment entity, that are themselves parent entities together with the proposed consequential change to paragraph 17 (d) of IAS 28.
2. However, we note that the proposed change would not have any significant effect in the UK as sections 400 and 401 of the Companies Act 2006 allow an exemption from consolidation only where a parent entity is 'included in consolidated accounts for a larger group' by way of 'full consolidation'. We understand that similar legal constraints also exist in other jurisdictions in the EU and, possibly, beyond.

While we agree that fair value measurement of an investment entity's subsidiaries generally provides the most useful information, we prefer a principles-based approach

3. In common with EFRAG, we agree that fair value measurement of an investment entity's subsidiaries generally provides the most useful information. We are also comfortable with the limited exception for subsidiaries that provide services that relate to the investment entity's investment activities as, in effect, such subsidiaries act as an extension of the investment entity itself.
4. However, unlike EFRAG, we are concerned that the current proposals risk undermining this approach by introducing rules that attempt to firmly define which entities should and should not be consolidated. We do not agree with this approach as it may result in valuable information being obscured. Moreover, it could encourage structuring to obtain a particular accounting outcome. Instead, we encourage the board to develop a principles-based solution that is backed up by indicators to help management apply their judgement and give appropriate disclosures.

We agree that consistent treatment of investment entity investees by non-investment entity investors is preferable

5. In common with EFRAG, we do not believe that it is appropriate for there to be two different methods of equity accounting; one applying to associates and one to joint ventures. Instead, we would prefer a common approach for investment entity associates and joint ventures in the financial statements of non-investment entity investors and therefore urge the board to preserve the investee's accounting not only in the financial statements of investors in associates but also in those of investors in joint ventures.



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MAJOR POINTS

We prefer a principles-based approach

1. We are supportive of the current approach of requiring investment entities to present their investments in subsidiaries at fair value through profit or loss rather than consolidating them. We are also comfortable with the limited exception for subsidiaries that provide services that relate to the investment entity's investment activities as, in effect, such subsidiaries act as an extension of the investment entity itself.
2. However, the board risks undermining this approach by introducing rules that attempt to firmly define which entities should and should not be consolidated. We do not agree with this approach as it may result in valuable information being obscured. Moreover, it could encourage structuring to obtain a particular accounting outcome. In our response to question 2 below we encourage the board to develop a principles-based solution that is backed up by indicators to help management apply their judgement and give appropriate disclosures.

Consistent treatment of investment entity investees by non-investment entity investors

3. We do not believe that it is appropriate for there to be two different methods of equity accounting; one applying to associates and one to joint ventures. Instead, we would prefer a common approach for investment entity associates and joint ventures in the financial statements of non-investment entity investors and therefore urge the board to preserve the investee's accounting not only in the financial statements of investors in associates but also in those of investors in joint ventures. See our response to question 3 below for more details.

Intermediate holding companies set up for tax or regulatory purposes

4. We believe that the current requirement to fair value intermediate holding companies set up for tax or regulatory purposes obscures valuable information about the results of investment entities. While the board has not asked for comments on this matter, we believe that it is closely related to this consultation and therefore urge the board to reconsider its current position. We have therefore appended additional comments on this matter at the end of this letter.

RESPONSES TO SPECIFIC QUESTIONS

Q1: Exemption from preparing consolidated financial statements

The IASB proposes to amend IFRS 10 to confirm that the exemption from preparing consolidated financial statements set out in paragraph 4(a) of IFRS 10 continues to be available to a parent entity that is a subsidiary of an investment entity, even when the investment entity measures its subsidiaries at fair value in accordance with paragraph 31 of IFRS 10. Do you agree with the proposed amendment? Why or why not?

5. We agree with the proposed amendment as requiring entities to prepare consolidated financial statements in such circumstances could result in significant additional costs without commensurate benefits.
6. However, we note that the proposed change would not have any significant effect in the UK as sections 400 and 401 of the Companies Act 2006 allow an exemption from consolidation only where a parent entity is 'included in consolidated accounts for a larger group' by way of 'full consolidation'. We understand that similar legal constraints also exist in other jurisdictions in the EU and, possibly, beyond.

Q2: A subsidiary that provides services that relate to the parent's investment activities

The IASB proposes to amend IFRS 10 to clarify the limited situations in which paragraph 32 applies. The IASB proposes that the requirement for an investment entity to consolidate a subsidiary, instead of measuring it at fair value, applies only to those subsidiaries that act

as an extension of the operations of the investment entity parent, and do not themselves qualify as investment entities. The main purpose of such a subsidiary is to provide support services that relate to the investment entity's investment activities (which may include providing investment-related services to third parties). Do you agree with the proposed amendment? Why or why not?

7. We are supportive of a requirement that investment entities present their investments in subsidiaries that form part of their investment portfolio at fair value through profit or loss rather than consolidating them. We are also supportive of a requirement to consolidate subsidiaries that provide services that relate to the investment entity's investment activities as, in effect, such subsidiaries act as an extension of the investment entity itself.
8. However, the board risks undermining the investment entity exception by introducing rules that attempt to define which entities should and should not be consolidated in a way that could result in the fair value of subsidiaries that form part of an investment portfolio as well as the cost of investment related services being obscured depending on how an investment entity structures its group. We do not agree with this approach. Instead, we would prefer the board to develop a principles-based solution to make it clear that investment entities should present all investments in subsidiaries at fair value through profit and loss except those that are, in substance, an extension of the entity's own activities.
9. We recommend that this principle be backed up with indicators to help preparers identify which subsidiaries are, in substance, an extension of the parent (eg, they provide services to the parent, they exist only to manage the parent's tax, they are managed on a unified basis with the parent or they are not subject to an exit strategy) and which are held as part of the investment activities that allow the parent to qualify as an investment entity (eg, they are managed on a fair value basis, they are subject to an exit strategy, etc.).
10. If our suggested approach is adopted, we would also recommend that disclosures are introduced that require entities to explain how they have applied their judgement when determining which entities to consolidate and which to measure at fair value. This could include a list of those entities that have been consolidated together with an explanation of why they have been treated in that way. Alternatively, a 'comply or explain' approach could be adopted, whereby an explanation is needed only for those subsidiaries that are not measured at fair value.
11. Returning to the board's current proposals, we do not agree with the proposed requirement that an investment entity should fair value even those investment entity subsidiaries that also provide investment related services. We do not believe this assumption is appropriate because subsidiaries that provide such services – regardless of the materiality of those services to the subsidiary's activities – may be acting as an extension of the parent irrespective of whether they are investment entities. Where that is the case, we believe that they should be consolidated.
12. The proposals could also mean that the results of subsidiaries that provide services as an extension of the parent are inappropriately obscured, particularly in those organisations with vertical group structures. Furthermore, the proposals could result in fundamentally different accounting outcomes for groups that are identical in all respects other than their legal structure. This, in turn, could encourage structuring to obtain a particular accounting outcome as illustrated in the example in the appendix to this letter. We do not believe that is appropriate.

Q3: Application of the equity method by a non-investment entity investor to an investment entity investee

The IASB proposes to amend IAS 28 to:

- a) require a non-investment entity investor to retain, when applying the equity method, the fair value measurement applied by an investment entity associate to its interests in subsidiaries; and
- b) clarify that a non-investment entity investor that is a joint venturer in a joint venture that is an investment entity cannot, when applying the equity method, retain the fair value measurement applied by the investment entity joint venture to its interests in subsidiaries.

Do you agree with the proposed amendments? Why or why not?

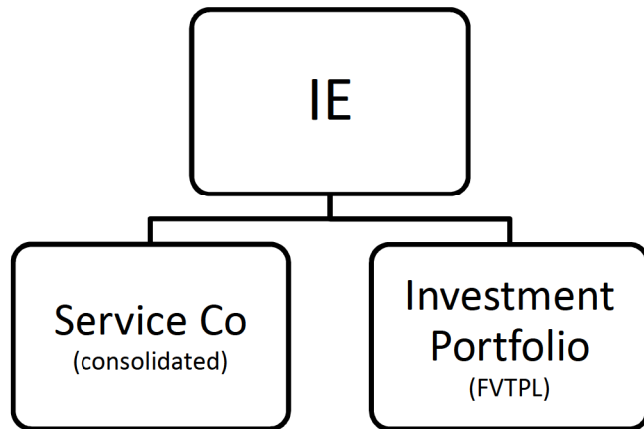
13. We agree with the proposal in respect of the accounting for investment entity associates that are held by non-investment entity investors as it offers a pragmatic solution that provides users of the investor's financial statements with more useful information. We do not, however, agree with the proposal in respect of joint ventures as it could result in significant additional costs without commensurate benefits.
14. The proposals would also require a remeasurement to be undertaken when an investee changes from being an associate to being a joint venture (or vice versa). This appears to be contrary to IAS 28.
15. We do not believe that it is appropriate for there to be two different methods of equity accounting; one applying to associates and one to joint ventures. Instead, we would prefer a common approach for investment entity associates and joint ventures in the financial statements of non-investment entity investors and therefore urge the board to preserve the investee's accounting not only in the financial statements of investors in associates but also in those of investors in joint ventures.

Other comments

16. We believe that the current requirement to fair value intermediate holding companies set up for tax or regulatory purposes obscures valuable information about the results of investment entities. While the board has not asked for comments on this matter, we believe that it is closely related to this consultation and therefore urge the board to reconsider its current position.
17. The current requirements (as set out in BC272 of IFRS 10 and confirmed by the IFRS Interpretations Committee in its March 2014 discussions) require intermediate holding companies that undertake no activities to be carried at fair value through profit or loss. In our experience, investment entities often utilise intermediate holding companies within their structures and many argue that recording them at fair value obscures valuable information about the investments made by the group. For example, if an investee that is held through an intermediate holding company pays a dividend or is disposed of, then the investment entity parent would not record any cash inflow in its consolidated accounts if the holding company was carried at fair value through profit or loss. This can create counter-intuitive results with identical groups providing different results purely because of their structure.
18. Furthermore, we believe that investors are primarily interested in the fair values of and cash flows arising from the underlying portfolio; they are rarely interested in the fair values of intermediate holding companies set up by investment entity parents.
19. Given the range of different structures used by investment entities, we believe that the board's current approach of creating rules about what should or should not be consolidated will neither result in an appropriate outcome nor avoid creating structuring opportunities. As noted above, we would instead encourage the board to develop a principles-based solution that is backed up by indicators to help management apply their judgement and appropriate disclosures.

APPENDIX – STRUCTURING OPPORTUNITIES

Consider an investment entity, IE, which has a wholly owned subsidiary, Service Co, which provides investment related services to it. IE also owns a portfolio of investments. In its financial statements, IE consolidates Service Co and records its portfolio of investments at fair value through profit or loss



Now suppose that IE inserts a new Top Co above itself. Assuming that Top Co qualifies as an investment entity (and we can think of no reason why it would not) then, under the proposals, it would prepare financial statements that showed only its investment in IE recorded at fair value through profit or loss. Service Co would not be consolidated by Top Co meaning that Top Co's accounts would be fundamentally different to the pre-existing IE despite its purpose and investors being identical. We do not believe that is an appropriate outcome.

