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International Accounting Standards Board
30 Cannon Street
London.EC4M 6XH

15 September 2014

Dear Hans

Re: Exposure Draft Investment Entities: Applying the Consolidation Exception (ED/2014/2)

This letter sets out the Financial Reporting Council's (FRC's) comments on the Exposure Draft (ED) Investment Entities: Applying the Consolidation Exception.

The FRC supports the proposal to confirm that the exception from preparing consolidated financial statements is available to a parent entity that it is a subsidiary of an investment entity, even when the investment entity measures its subsidiaries at fair value.

The FRC disagrees with the proposal to limit the situations where an investment entity parent should consolidate a subsidiary providing the parent with investment services to those subsidiaries that are not investment entities.

A subsidiary that is an investment entity may provide investment related services to its parent or third parties, "*even if those activities are substantial to the entity*" (IFRS 10 paragraph B85C). Such subsidiaries may also issue debt on behalf of the group to partly fund its investments, using such leverage to maximise returns to its parent and its parent's ultimate investors. By requiring an investment entity parent to measure such subsidiaries at fair value, information relevant to the economic decisions of investors in the parent (such as total group operating expenses, income from provision of investment related services and gearing levels) will be lost.

The FRC considers that, where a subsidiary acts both as an extension of the operations of the investment entity parent and is an investment entity in its own right, the most relevant information would be presented through consolidation of the subsidiary using a consistent accounting policy for the treatment of its underlying investments, namely measurement at fair value. Such an approach will result in more comparable information across investment entity groups irrespective of where, within the groups, operations are performed or debt issued.

To support this conclusion, we have evidence from our constituents that the IASB's proposal would reduce the transparency of the investments and other operations in investment entity subsidiaries and the usefulness of information to investors.

In our response to the original investment entities exemption consultation, we argued that investment entity subsidiaries should be accounted for in a consistent manner by all ultimate parents be they themselves investment or non-investment entities. We continue to believe this should be the case. This reflected our view that an investor, be it an investment entity itself or not, that invests in an investment entity is interested in the value of the underlying investments of the investment entity, rather than the operational performance of those underlying investments. This is because the investment entity manages its performance on the basis of the fair value of its investments and must have an exit strategy for disposing of them.

This analysis led us to argue that both non-investment entities and investment entities be permitted to fair value investments in investment entities.

However, our analysis of the proposed changes to paragraph 32 of IFRS 10 highlights that the binary distinction between investment and non-investment entities is flawed. Given an investment entity may provide a substantial level of investment services, measuring it at fair value, as if it was *only* a vehicle of holding investments, can omit decision useful information about the efficiency of its investment management services. We now believe a more comprehensive change to the standard should be considered, so as to permit the fair value measurements of the underlying investments to be “rolled up” into the accounts of parent companies, i.e. for investment entities to be consolidated into parent accounts whilst retaining the fair value measurements of the underlying investments. This would then alleviate the need for specific exceptions when equity accounting for interests in associate and joint venture investment entities.

In the absence of such a change, we agree with the IASB’s proposal to require a non-investment entity investor to retain, when applying the equity method, the fair value measurements applied by its investment entity associate to interests in subsidiaries as a pragmatic solution to the problems identified in the current Exposure Draft.

However, we disagree with the IASB’s proposal that a non-investment entity investor should not similarly retain the fair value measurements applied by its investment entity joint venture. Instead, we believe the same pragmatic solution be extended to interests in investment entity joint ventures to ensure that associates and joint ventures continue to be accounted for in the same manner.

Our detailed responses are set out in the appendix to this letter.

Should you have any questions in relation to this letter, please do not hesitate to contact either myself or Jennifer Guest j.guest@frc.org.uk.

Yours sincerely

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APPENDIX – Responses to the questions in the Invitation to Comment section of the Investment Entities ED

Question 1 - 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?

1.1 The FRC supports this proposal as we agree with the IASB that, given the conditions in paragraph 4 for taking the exemption, requiring such a subsidiary to present consolidated financial statements would result in significant additional costs without commensurate benefits. The FRC also supports the proposed consequential change to paragraph 17 (d) of IAS 28.

Question 2 – 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?

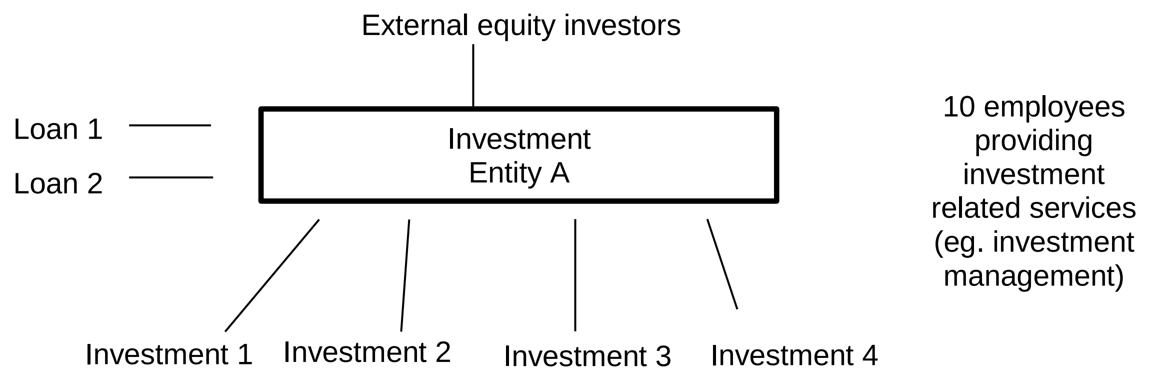
Why or why not?

2 The FRC disagrees with this proposed amendment.

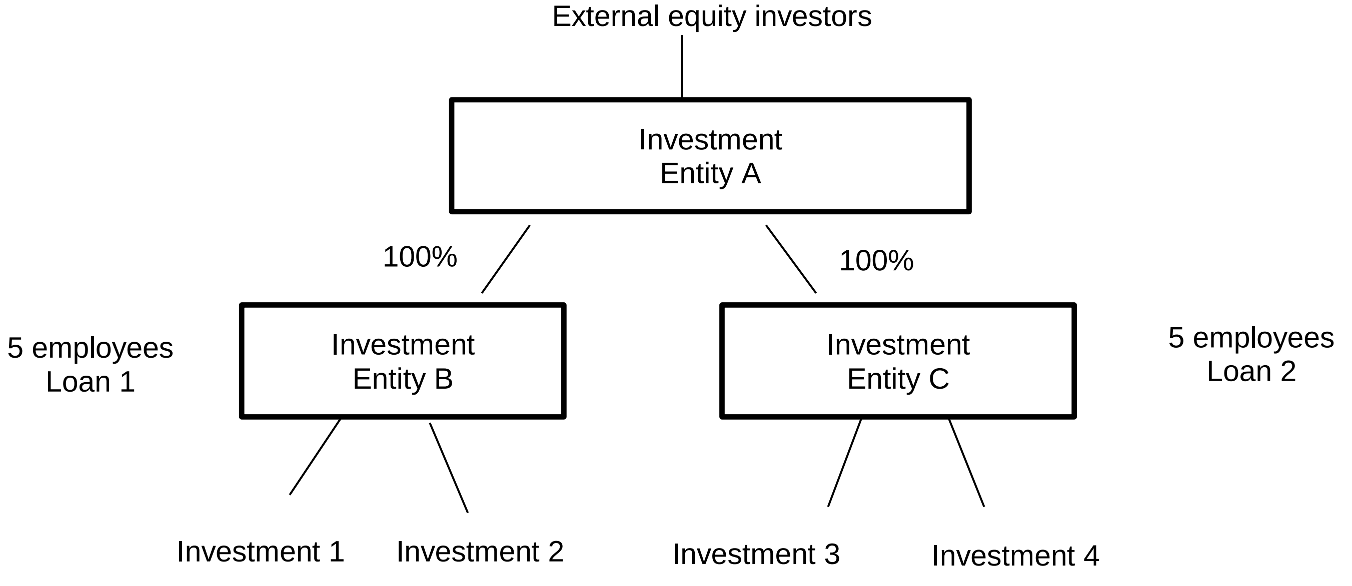
2.1 We are concerned that the limitation proposed will lead to important information that is relevant to the economic decisions of investors being lost and result in situations that are economically identical from an external investor's perspective being presented in different ways, solely due to where within the group transactions are carried out.

2.2 Consider the following example.

Situation 1



Situation 2



2.3 In situation 1, investment entity A raises external equity funds and debt finance (loans 1 and 2). Using the services of 10 employees, it provides investment related services such as investment management and investment support which, in accordance with IFRS 10 paragraph B85C, may be substantial without prohibiting its classification as an investment entity.

2.4 To external equity investors in investment entity A, situation 2 is economically identical despite A having structured, for purely operational and managerial reasons, its investments through two investment entity subsidiaries. The same employees provide the same investment management services, but are now directly employed by the subsidiary companies, and the same debt has been issued.

2.5 If the proposed amendment to paragraph 32 was made, equity investors in A would receive very different information depending on the way its operations were structured. In situation 1, the cost of operations would be clearly presented in the income statement, whilst the balance sheet would show the financial gearing of the company arising from the issuance of external debt and the fair value of the underlying investments 1 to 4. Such information is relevant for understanding the risks faced by entity A and for assessing the efficiency of its operations and the performance of its investments compared to other investment opportunities.

2.6 But in situation 2 only the fair value of the subsidiary investment entities will be presented, with a resulting loss in decision-useful information.

2.7 Supporting this analysis, we have evidence from our constituents that the IASB proposal would reduce the transparency of information in respect of investments, leverage and operational efficiency in investment entity groups and that the absence of such information is not consistent with investors expressed needs.

2.8 In our view, any amendment to paragraph 32 should require an investment entity to consolidate a subsidiary that acts as an extension of the operations of the parent, irrespective of whether the subsidiary is itself an investment entity or not.

2.9 We are not convinced by the arguments in favour of the proposal put forward by the IASB in the Basis of Conclusions to this Exposure Draft because:

(i) they are concerned primarily with the provision of investment related services by a subsidiary to third parties and do not consider the more common situation of providing investment related services to investors and, more specifically, its investment entity parent:

(ii) whilst they correctly conclude that an entity whose *main* purpose is to provide investment related services is unlikely to meet the conditions necessary for classification as an investment entity, they do not reflect the fact that an investment entity may, in accordance with paragraph B85C of IFRS 10, carry out investment related activities that are still *substantial* to it. If such activities are substantial they must presumably be material and information about them decision-useful. If material to a subsidiary, then such information may well be material to the group especially when combined with similar information on other subsidiaries.

2.10 An extension of our proposed solution would be to require consolidation of all investment entity subsidiaries, whilst retaining the fair value measurement of the underlying investments. This will ensure that fair value measurement is applied where it is most useful (i.e. to underlying investments) whilst retaining detailed information on the performance of investment services.

Question 3 - 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?

3.1 We agree with the IASB's proposal to require a non-investment entity investor to retain, when applying the equity method, the fair value measurements applied by its investment entity associate when accounting for interests in subsidiaries.

3.2 We disagree with the IASB's proposal that a non-investment entity should not retain, when applying the equity method, the fair value measurements applied by its investment entity joint venture when accounting for interests in subsidiaries.

3.3 In our response to the consultation on the original investment entities amendment to IFRS 10, we stated that we did not believe a non-investment entity parent should be required to consolidate the subsidiaries of its own investment entity subsidiary. Consistent with that view, we consider that the fair value of an investment entity's subsidiaries provides the most useful information irrespective of whether:

(i) the reporting entity is an investment entity or not; or

(ii) the reporting entity's interest in the investment entity is that of a subsidiary, an associate or a joint venture.

3.4 The view expressed in our earlier response was predicated on the conditions for classification as an investment entity being strengthened, specifically by introducing the condition that an investment entity must have an exit strategy for its investments. The inclusion of this condition is, in our view, sufficient to ensure that investment entities are not a vehicle for abusive practices.

3.5 Therefore, we do not share the IASB's continuing concerns, expressed in BC 280 of IFRS 10 to which the current ED cross-refers, that there is an opportunity for non-investment entities to hold investments through an investment entity subsidiary or joint venture to "hide leverage or loss-making activities". We note, with some irony, that the amendments proposed to paragraph 32 would lead to leverage and information on performance within an investment entity group to be so hidden (see the example set out in our answer to question 2 above).

3.6 The rationale behind the current proposals to permit the retention of fair value measurements when accounting for an associate is a pragmatic one, based specifically on the perceived difficulties of “unwinding” such measurements. If the IASB is unwilling to revisit its previous decisions on the accounting by non-investment entities for their interests in investment entities, we recommend that the same pragmatic solution be applied to joint ventures. In our view, the distinction consistently made in other standards between, on the one hand, control and, on the other, joint control and significant influence should be maintained. In other words, we believe any differences in the application of the equity method should be drawn between interests in investment entities and interests in non-investment entities and not between (some) associates and joint ventures.

3.5 Therefore, in the absence of a more thorough review of the accounting for interests in investment entities, we suggest that proposed paragraph 36B be deleted and proposed paragraph 36A be amended to refer to interests in both investment entity associates and joint ventures so as to require a non-investment entity investor to retain, when applying the equity method, the fair value measurements applied by all such entities.