EFRAG

European Financial Reporting Advisory Group

Draft Comment Letter

Comments should be submitted by 5 September 2014 to
commentletters@efrag.org

[Date]

International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

Dear Sir/Madam,

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

On behalf of the European Financial Reporting Advisory Group (EFRAG), I am writing to comment on the proposed amendments to IFRS 10 *Consolidated Financial Statements* and IAS 28 *Investments in Associates and Joint Ventures* named Exposure Draft *Investment Entities: Applying the Consolidation Exception* (ED/2014/2), published by the IASB on 11 June 2014 (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 definitive IFRS in the European Union and European Economic Area.

EFRAG welcomes the proposed amendments to IFRS 10 and IAS 28 and agrees that the addressed issues needed clarification. We support the clarification that the exemption from presenting consolidated financial statements is available to intermediate parent whose only subsidiaries are investment entities. We also support the clarification that the exception to fair valuation of a subsidiary only applies to subsidiaries that act as an extension of the operations of the investment entity parent, and do not themselves qualify as investment entities.

EFRAG agrees with the proposal that a non-investment entity investor retains, when applying the equity method, the fair value measurement applied by an investment entity associate to its interests in subsidiaries. However, EFRAG has different reasons for supporting this proposal. These same reasons lead EFRAG to disagree with the proposal 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.

Our detailed comments and responses to the questions in the ED are set out in the Appendix to this letter.

If you would like to discuss our comments further, please do not hesitate to contact Isabel Batista, Robert Stojek or me.

Yours faithfully,

Françoise Flores
EFRAG Chairman

APPENDIX

EFRAG's responses to the questions raised in the Exposure Draft

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?

Notes to EFRAG's constituents

1 *In October 2012 the IASB published* Investment Entities: Applying the Consolidation Exception *Proposed Amendments to IFRS 10 and IAS 28) to provide an exception to the requirements in IFRS 10* Consolidated Financial Statements *for investment entities.*

2 *Paragraph 4(a) of IFRS 10 provides an exemption from presenting consolidated financial statements for a parent entity that meets specified criteria. One criterion is that its ultimate or any intermediate parent produces consolidated financial statements that are available for public use and comply with IFRS. The other three criteria are:*

(a) it is a wholly-owned subsidiary or a partially-owned subsidiary of another entity and all its other owners, including those not otherwise entitled to vote, have been informed about, and do not object to, the parent not presenting consolidated financial statements, it has not issued any public debt, its shares are not listed, and its minority shareholders do not require the consolidated financial statements;

(b) its debt or equity instruments are not traded in a public market; and

(c) it did not file, nor is it in the process of filing, its financial statements with a securities commission or other regulatory organisation for the purpose of issuing any class of instruments in a public market.

3 *The issue is whether an intermediate parent can use the exemption from preparing consolidated financial statements if it is reflected at fair value in its investment entity parent's financial statements.*

4 *At the time of developing the investment entities amendments, the IASB did not amend the requirement of paragraph 4(a) of IFRS 10 to reflect a situation when the ultimate parent (and every intermediate parent, if any) is not required to produce consolidated financial statements because it follows the paragraph 4(c) exemption*, *which states that an investment need not present consolidated financial statements if it is required, in accordance with paragraph 31 of IFRS 10, to measure all of its subsidiaries at fair value through profit or loss.*

5 *The ED confirms that the exemption from preparing consolidated financial statements set out in paragraph 4(a) of IFRS 10 is 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.*

6 The ED also proposes a consequential amendment to paragraph 17(d) of IAS 28 to exempt entities from applying the equity method to its investment in an associate or a joint venture if the ultimate or any intermediate parent of the entity produces financial statements available for public use that comply with IFRSs, including the requirements of IFRS 10 to consolidate subsidiaries or to measure them at fair value. In essence this proposed amendment aligns the "consolidation" exemption in paragraph 4(a) with the corresponding exemption in IAS 28.

EFRAG's response

EFRAG supports 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.

EFRAG also supports the proposed consequential change to paragraph 17 (d) of IAS 28.

7 EFRAG supports the proposed amendment and agrees that an intermediate parent entity that is a subsidiary of an investment entity should be able to use the exemption in paragraph 4(a) of IFRS 10, even when the investment entity parent measures its subsidiaries at fair value in accordance with paragraph 31 of IFRS 10. In such cases, the investment entity parent presents separate financial statements as its own financial statements in accordance with paragraph 8A of IAS 27 *Separate Financial Statements*.

8 Some acknowledge that not having line-by-line consolidated information of the parent entity subsidiary being made available at a higher group level, may appear like a loss of information for users of the financial statement of that parent entity subsidiary. Indeed, some argue that in principle a non-investment entity parent ought to produce consolidated financial statements in cases when those consolidated financial statements are not available higher up in the group, for whatever reason.

9 However, we believe that when an investment entity parent measures its subsidiaries at fair value, these subsidiaries have been appropriately represented within the parent entity's financial statements in accordance with the requirements of IFRS 10 that apply to investment entities, and thus that parent entity provides useful information. Consequently, should one of those subsidiaries itself be an intermediate parent, the intermediate parent should be able to benefit from the exemption from preparing consolidated accounts that is available to other intermediate parents by paragraph 4(a) of IFRS 10.

10 Also, as noted in paragraph BC3 of the ED, the purpose of the current exemption in paragraph 4(a) of IFRS 10 was previously developed from a cost-benefit perspective, given that the cost of requiring each intermediate parent entity within a group to prepare consolidated financial statements could be burdensome in cases in which the conditions in paragraph 4(a) are met. In such cases, the IASB considered that the combination of information available in the consolidated financial statements of the higher level parent, together with the conditions in paragraph 4 of IFRS 10, provide sufficient safeguards for users in relation to the intermediate parent's accounts. We agree with this reasoning.

11 Similarly, we believe that, from a cost-benefit perspective, the exemption should be available for an intermediate parent entity that is not an investment entity in situations when it meets the criteria in paragraph 4(a)(i-iii) of IFRS 10. The exemption will reduce the costs for the intermediate parent entity in preparing and

presenting its financial statements which is in line with the objective of the exemption in paragraph 4(a) of IFRS 10.

12 As noted in paragraph BC4 of the ED, the carrying amounts of interests in subsidiaries of an investment entity parent are supplemented by the combination of information provided by the disclosures required by IFRS 12 *Disclosure of Interests in Other Entities*, IFRS 7 *Financial Instruments: Disclosures* and IFRS 13 *Fair Value Measurement.* These Standards provide relevant and adequate measures for users of investment entity parent's financial statements.

Consequential amendment to IAS 28

13 The ED also proposes consequential amendments to IAS 28. It proposes to exempt entities from applying the equity method to its investment in an associate or a joint venture if the ultimate or any intermediate parent of the entity produces financial statements available for public use that comply with IFRSs, including the requirements of IFRS 10 to consolidate subsidiaries or to measure them at fair value. EFRAG supports this proposed amendment.

14 EFRAG believes that the ED proposes a consistent application of the exemptions from both consolidating the subsidiaries and from applying the equity method to the investments when the relevant criteria are met.

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?

Notes to EFRAG's constituents

15 Paragraph 31 of IFRS 10 requires an investment entity to measure its investments in subsidiaries at fair value, except when paragraph 32 of IFRS 10 applies. Paragraph 32 requires an investment entity to consolidate a subsidiary that provides services that relate to the investment entity's investment activities.

16 When a subsidiary of an investment entity itself meets the definition of an investment entity and, additionally, provides services that relate to the parent's investment activities, the wording in paragraph 32 is unclear as to whether the investment entity parent should measure that investment entity subsidiary at fair value or consolidate it.

17 The ED proposes to clarify that the requirement for an investment entity to consolidate a subsidiary under paragraph 32 of IFRS 10, 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.

18 The main purpose of such a subsidiary is to provide support services that relate to the investment entity's investment activities and may include providing investment-related services to third parties. Therefore, the provision of these services does not preclude an entity from qualifying as an investment entity under IFRS 10.

EFRAG's response

EFRAG agrees that fair value measurement of an investment entity's subsidiaries provides the most useful information. We therefore agree that the "exception" to fair value measurement in paragraph 32 of IFRS 10 should apply 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.

19 The investment entity exception in paragraph 31 of IFRS 10 does not preclude an entity that provides investment-related services from being an investment entity. Paragraph 32 of IFRS 10 provides, however, a limited exception of this principle for those subsidiaries that provide investment-related services, by requiring those subsidiaries to be consolidated by an investment entity parent.

20 The question is how an investment entity parent should account for a subsidiary that is both an investment entity and provides investment-related services.

21 EFRAG agrees with the proposal that the requirement for an investment entity to consolidate a subsidiary, instead of measuring it at fair value, should apply 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. In case the subsidiary is an investment entity, the principle in IFRS 10 – to measure all of its subsidiaries at fair value - should apply.

22 We note that the IASB, when re-deliberating the ED *Investment Entities* amendments to IFRS 10*,* considered extending the scope of the "exception" in paragraph 32 of IFRS 10 to wholly-owned investment entity subsidiaries created for legal, tax or regulatory purposes. As explained in paragraph BC9(a) of the ED, the IASB concluded that there is no conceptual basis for distinguishing between different investment entity subsidiaries and that it would be very difficult to distinguish between an investment entity subsidiary formed for a specific legal, tax or regulatory purpose and those that are set up for other business reasons. We support the IASB's original decision.

23 In EFRAG's view, if an entity qualifies as an investment entity, its business purpose would be to invest funds solely for returns from capital appreciation, investment income or both. This means that performing investment-related services that support the investment entity parent's investment activities cannot be the main activity of that subsidiary. If performing investment-related services is its main activity, that subsidiary entity is unlikely to meet the definition of an investment entity under IFRS 10.

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?

Notes to EFRAG's constituents

24 Paragraph 33 of IFRS 10 explicitly requires a non-investment entity parent of an investment entity to 'unwind' the fair value accounting of its investment entity subsidiaries and to consolidate all subsidiaries in the group.

25 IAS 28, however, does not contain an equivalent explicit statement related to the application of the equity method by a non-investment entity investor for its investments in joint ventures or associates that are investment entities. Instead, paragraphs 35-36 of IAS 28 require the use of uniform accounting policies when accounting for joint ventures or associates.

26 It should be noted that under the equity method, the non-investment entity investor recognises its share in the investee's comprehensive income. This entity is required to develop the consolidated financial statements in respect of the investee's subsidiaries to arrive at the adjusted consolidated profit. This exercise requires obtaining additional information about financial position and operating performance of the investee's subsidiaries. If the non-investment entity investor is allowed to retain in its financial statements the fair value measurement of its investee associate, it would recognise the share in fair value movements of the investee's subsidiaries.

27 The ED, in regard to IAS 28:

(a) *provides relief to a non-investment entity investor by requiring it to retain, when applying the equity method, the fair value measurement applied by an investment entity associate to its interests in subsidiaries; and*

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

EFRAG's response

In EFRAG's view, fair value measurement of an investment entity's subsidiaries provides the most useful information and should be retained by a non-investment entity investor when applying the equity method to its investment entity investees.

Moreover, we see no conceptual reason to require that the equity method is applied differently to associates and joint ventures in the cases addressed in the ED.

We support, therefore, the proposal regarding the application of the equity method by a non-investment entity investor to its investment entity associate, but for a different reason than is stated in the ED.

We disagree with the IASB's proposal regarding the application of the equity method by a non-investment entity joint venturer to its investment entity joint venture.

28 EFRAG notes that in accordance with existing requirements of paragraphs 35 and 36 of IAS 28, the financial statements of a non-investment entity investor with an interest in an investment entity associate, or a non-investment entity joint venturer with an interest in an investment entity joint venture should be prepared using uniform accounting policies for like transactions and events in similar circumstances. Therefore, we acknowledge that the investment entity associate or joint venture entity would normally be required to consolidate its subsidiaries into its financial statements prior to the equity method being applied by the investor.

29 EFRAG notes also that, in contrast to paragraph 33 of IFRS 10, paragraphs 35 and 36 of IAS 28 do not contain an explicit requirement to "unwind" fair value accounting of investment entity subsidiaries when accounting for investment entity itself using the equity method. We therefore agree with the IASB's decision that this should be clarified.

30 In paragraph BC19 of the ED, the IASB notes that it is conceptually consistent with the requirements of IFRS 10 for a non-investment entity parent to consolidate subsidiaries held through an investment entity subsidiary (i.e. the non-investment entity parent cannot retain the fair value measurement). However, we do not believe that IAS 28 should mirror IFRS 10 in this respect. We believe that fair value measurement should be retained for the purpose of applying the equity method by a non-investment entity investor/joint venturer, as explained below.

31 Paragraph BC35 of IFRS 11 and the disclosure requirements in IFRS 12 support our view in stating that the unit of account of a joint arrangement is the activity that two or more parties have agreed to control jointly (that is, the unit of account is the joint venture itself not the individual assets and liabilities that would be reflected in a full consolidation) and the summarised disclosures required under IFRS 12 for joint ventures are prepared on a "full basis" rather than reflecting the investor's specific level of interest in the joint venture (on the basis that this provides more decision-useful information). In our view, it follows that consistency with IFRS 10 should not be the most important consideration. Instead, we conclude that retaining fair value measurement in the financial statements of a joint venture with an interest in a joint venture provides the most relevant information about the relationship.

32 In addition, paragraph BC41 of IFRS 11 recognises that joint control and significant influence are different but nonetheless concludes that the equity method is best suited for both joint venturers to account for their interest in a joint venture as well as for an investor to account for its interest in an associate. In this specific case, therefore, introducing a differential application of the equity method would not be aligned with the underlying view in IFRS 11. Consequently, the share of profit or loss, comprehensive income and change in net assets that is reflected through the equity method should be determined on the same basis regardless of whether the underlying entity is an associate or a joint venture.

33 We therefore disagree that the IASB should reach different conclusions for the application of the equity method by an investor in an investment entity associate or joint venture. This is on conceptual grounds, and not for reasons of cost or difficulty in implementation, even though these reasons are themselves valid.