EFRAG

European Financial Reporting Advisory Group

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

1 October 2014

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 Exposure Draft (ED/2014/2) *Investment Entities: Applying the Consolidation Exception Proposed amendments to IFRS 10 and IAS 28* (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 supports the first amendment that proposes to amend IFRS 10 *Consolidated Financial Statements* to extend the exception from preparing consolidated financial statements to an intermediate parent that is a subsidiary of an investment entity. We also support the consequential amendments to IAS 28 *Investments in Associates and Joint Ventures*. We explain in the appendix why we conclude differently from a number of our constituents who consider that this will lead to a loss of information for some users of financial statements. We also note that the possible interaction between the proposed amendment and the EU Accounting Directive (2013) needs to be investigated further.

EFRAG disagrees with the second proposal 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. In our view, further work is required to ensure that activities that are extensions of operations of the parent are not subject to fair value measurement if they are undertaken by an investment entity subsidiary.

Finally, 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 (associates and joint ventures). Moreover, we see no conceptual basis for applying the equity method differently to associates and joint ventures in the cases addressed in the ED.

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?

EFRAG's response

EFRAG supports the proposal to clarify that the exemption from preparing consolidated financial statements set out in paragraph 4(a) of IFRS 10 *Consolidated Financial Statements* is available to subsidiaries of an investment entity that are themselves parent entities.

EFRAG supports the proposed consequential change to paragraph 17(d) of IAS 28 *Investments in Associates and Joint Ventures*.

We also note that the possible interaction between the proposed amendment and the EU Accounting Directive (2013) needs to be investigated further.

1 EFRAG supports the proposed amendment. EFRAG agrees that an intermediate parent entity that is a subsidiary of an investment entity should be able to apply 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.

2 As noted in paragraph BC3 of the ED, the current exemption in IFRS 10 was developed from a cost-benefit perspective, on the grounds that the cost of requiring each intermediate parent entity within a group to prepare consolidated financial statements could be burdensome. 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, provides sufficient safeguards for users in relation to the intermediate parent's financial statements. We agree with this reasoning.

3 Similarly, we believe that, from a cost-benefit perspective, the exemption should be available for an intermediate parent entity that is the subsidiary of an investment entity (whether or not it itself is an investment entity) when it meets the criteria in paragraph 4(a)(i)-(iii) of IFRS 10.

4 In most circumstances, EFRAG believes that it is common for providers of finance to such an entity to require consolidated financial statements to be produced as a condition of lending, if it is relevant to that lending decision. Other users such as suppliers or customers tend to have rights restricted to the legal entity and therefore are more concerned about individual financial statements.

5 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 information for users of the investment entity parent's financial statements.

6 Some constituents consider that not having line-by-line consolidated information of the intermediate parent entity will result in a significant loss of information for some users. These constituents believe that the exemption considers the information needs of the investment entity owners only; and that other users of financial statements such as suppliers of finance, and suppliers, customers and employees at the level of the intermediate parent entity; that is a subsidiary of an investment entity, might neither be adequately informed about the financial position and performance of the relevant subsidiary nor have the opportunity to object to the parent not presenting consolidated financial statements. This argument is also applicable to the generally accepted exemption that existed before the changes to IFRS 10 introduced the definition of an 'investment entity' and we indicate above why we think that any loss of information is limited in practice. We therefore continue to believe that the savings for preparers by removing the requirement to prepare sub-group consolidated financial statements outweigh the costs for users of any losses of information as a result of this exemption.

Consequential amendment to IAS 28

7 EFRAG supports this proposed amendment for reasons described above.

8 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.

Interaction with EU Accounting Directive

9 EFRAG notes that the possible interaction between the proposed amendment and the EU Accounting Directive (2013) needs to be investigated further.

10 EFRAG will review the issue and discuss it with the responsible EC units. We will inform the IASB of the outcome of this investigation.

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?

EFRAG's response

EFRAG supports the IASB's efforts to clarify the application of paragraph 32 of IFRS 10. However, we disagree with the proposed amendment.

11 EFRAG supports the IASB's efforts to clarify the application of paragraph 32 of IFRS 10 and address diversity in practice. However, EFRAG disagrees with the proposal to limit the situations where an investment entity parent should consolidate a subsidiary to those subsidiaries that are not investment entities.

12 Whilst we agree that the proposed amendment will result in an appropriate outcome in some cases (for instance, a 'fund of funds' structure), we have learned that in other cases, particularly multi-layer structures such as seen in many private equity arrangements, the proposed amendment will result in a substantial loss of relevant information as significant activities providing investment related services could be incorporated into the single value measurement of that subsidiary.

13 We note that 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). We understand that it is not uncommon for subsidiaries of investment entities to both hold an investment portfolio and provide services that are an extension of the higher level investment entity parent. Furthermore, such subsidiaries may also issue debt on behalf of the group to partly fund the investment portfolio. It follows that information such as total group operating expenses, income from provision of investment related services and gearing levels that is relevant to the economic decisions of investors in the parent investment entity may be lost if key activities are undertaken by a subsidiary that is also an investment entity.

14 Furthermore, the proposed amendment could result in fundamentally different accounting outcomes for groups that are identical in all respects except for their structure.

15 Consistent with our comment letter on ED/2011/4 *Investment Entities*, we continue to believe that accounting by investment entities should reflect the underlying substance of their business. Therefore, we continue to support requiring an investment entity to consolidate all activities related to the management of their portfolio regardless of whether they are carried out by the entity itself or a subsidiary.

16 We therefore do not support the IASB proceeding with this amendment. In our view, an investment entity should consolidate those activities of a subsidiary that acts as an extension of the operations of the parent and measure the activities of a subsidiary that are investments at fair value. It follows that, in our view, additional work is required to develop an approach whereby a subsidiary of an investment entity that undertakes both investment and operational activities can provide relevant information about both types of activity.

17 In the event that the IASB continues with the proposal, we recommend that disclosures are developed that will ensure that users of financial statements obtain the information that is lost through its application by providing consolidated information on all the non-investment entity activities of the investment entity group.

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?

EFRAG's response

In EFRAG's view, fair value measurement of an investment entity's investments 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 basis for applying the equity method 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.

18 EFRAG agrees with the first proposal and disagrees with the second proposal. We support the proposal to 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, even though we do so for different reasons to that explained in the ED.

19 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.

20 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.

21 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.

22 Paragraph BC35 of IFRS 11 *Joint Arrangements* 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 venturer with an interest in an investment entity joint venture provides the most relevant information about the relationship.

23 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 changes 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.

24 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. Even if, in theory, a conceptual difference exists, until now IAS 28 has required the same application of the equity method for all equity-accounted investees. We do not believe that introducing such a distinction for the purpose of this amendment provides any benefit.