04 January 2012

Our ref: ICAEW Rep 02/12

Your ref: ED/2011/4

Hans Hoogervorst
Chairman
International Accounting Standards Board
30 Cannon Street
London
EC4M 6XH

Dear Hans

ED/2011/4 *Investment Entities*

ICAEW is pleased to respond to your request for comments on ED/2011/4 *Investment Entities*.

Please contact me should you wish to discuss any of the points raised in the attached response.

Yours sincerely

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ICAEW REP 02/12

ICAEW REPRESENTATION

ED/2011/4 INVESTMENT ENTITIES

Memorandum of comment submitted in January 2012 by ICAEW, in response to the IASB's ED/2011/4 published in August 2011.

Contents **Paragraph**

INTRODUCTION

1. ICAEW welcomes the opportunity to comment on ED/2011/4 *Investment Entities* published by the International Accounting Standards Board (IASB) on 25 August, a copy of which is available from this link.

WHO WE ARE

2. ICAEW is a world-leading professional accountancy body. We operate under a Royal Charter which obliges us to work in the public interest. ICAEW's regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the UK Financial Reporting Council. We provide leadership and practical support to over 136,000 member chartered accountants in more than 160 countries, working with governments, regulators and industry in order to ensure that the highest standards are maintained.

3. ICAEW members operate across a wide range of areas in business, practice and the public sector. They provide financial expertise and guidance based on the highest professional, technical and ethical standards. They are trained to provide clarity and apply rigour, and so help create long-term sustainable economic value.

4. The Financial Reporting Faculty is recognised internationally as a leading authority on financial reporting. The Faculty's Financial Reporting Committee is responsible for formulating ICAEW policy on financial reporting issues, and makes submissions to standard setters and other external bodies. The faculty also provides an extensive range of services to its members, providing practical assistance in dealing with common financial reporting problems.

MAJOR POINTS

Overall assessment

5. We welcome the publication of the exposure draft and are supportive of the board's proposals to introduce an exemption from the requirements of IFRS 10 *Consolidated Financial Statements* that would require investment entities to measure their investments in controlled entities at fair value through profit or loss rather than consolidate them. However, we have some concerns about some of the other proposals in the exposure draft.

We strongly agree that an exception from the consolidation principles of IFRS 10 should be provided for investment entities

6. Allowing an investment entity to measure its investments in entities that it controls at fair value through profit or loss rather than consolidating them provides users of the financial statements with more relevant and useful information. Therefore we strongly agree that an exemption from the consolidation principles of IFRS 10 should be provided for investment entities.

7. From a theoretical perspective, some may argue that how an investment is measured should be based on the nature of the investment rather than on the nature of the investor ie, that in all instances those investments held for capital appreciation, investment income or both should be measured at fair value through profit or loss while those investments acquired for wider business purposes should be consolidated. We have some sympathy for this viewpoint. However, we feel that introducing an exemption at a transaction level rather than an entity level would present structuring opportunities. We therefore pragmatically agree that it is necessary to limit the exemption to investment entities.

8. We would recommend that the board undertakes a post implementation review once the exemption has been effective for one or two years in order to assess how it is working in practice.

We believe that the definition of an investment entity should be reconsidered

9. The proposals include detailed criteria that must be met before an entity is considered an investment entity. While we agree that clear criteria are needed, we recommend that a more principles-based approach is adopted with the exemption from consolidation being made available to investments held by venture capital organisations, mutual funds, unit trusts and similar entities including investment-linked insurance funds (to borrow the wording from paragraph 1 of the current version of IAS 28). While we believe that the board should retain some of the proposed qualification criteria, we believe that some simplifications would be beneficial.

10. If the board retains the detailed criteria in the exposure draft, we recommend that they consider creating an additional exemption for investment-linked insurance funds. See paragraphs 20-22 below for more details.

For the exemption to be useful in practice, it is essential that it is available in the consolidated accounts of a non-investment entity parent

11. In our view the exceptions available to the investment entity should 'roll up' into its parent's own consolidated financial statements regardless of whether that parent is an investment entity or not. If fair values provide users with the most useful information about investments held for capital appreciation, investment income or both at an investment company level, it seems incongruous to suggest that they do not provide the most useful information in the context of a group whose parent company is not an investment entity. The proposals in this area are also inconsistent with the requirements for associates and joint ventures, where investments can be carried at fair value through profit or loss in both the investment company's own financial statements and their parent's consolidated financial statements.

12. From a practical level, these particular proposals would make the remainder of the exposure draft ineffective in situations where groups have non-investment parts of their businesses and would have to therefore consolidate at group level investments measured at fair value through profit or loss. Not only will the more valuable, user-friendly fair value information be lost in the group accounts but any cost savings anticipated as a consequence of entities not being required to consolidate their investments will also be eliminated.

We disagree with the proposed removal of the exemption that is currently available to certain entities under IAS 28

13. While we agree that investment entities should be required to measure associates and joint ventures at fair value through profit or loss - as this reflects their business model and is consistent with the proposed treatment for controlled entities - we see no reason to remove the option to measure such investments at fair value through profit or loss from entities that currently apply the IAS 28 exemption.

14. The current exemption is widely used, for example, by insurance companies for whom fair value is the most relevant measure for these types of investments. Since the exemption in IAS 28 works well, we believe it provides an instructive basis for the exemption for controlled entities.

15. Removing this option would make the financial statements of insurers and other entities who apply it less relevant and decision useful to users. We do not believe that the board has provided sufficient explanation as to why this element of IAS 28 should be amended. Moreover, we would not want prolonged debate on this issue to hold up the finalisation of the consolidation exemption. We therefore suggest that the board retains this option, perhaps returning to it in the future as part of a wider reaching project on equity accounting.

RESPONSES TO SPECIFIC QUESTIONS

Question 1

Do you agree that there is a class of entities, commonly thought of as an investment entity in nature, that should not consolidate controlled entities and instead measure them at fair value through profit or loss? Why or why not?

16. We agree that investment entities are different from trading entities as their business model is to hold investments for capital appreciation, investment income or both. The users of the financial statements of investment entities also have different needs. Consolidating investments in controlled entities does not provide the information that is needed by these users; more useful information to allow users to assess the performance of the investments in the context of their business model is provided by measuring such investments at fair value through profit or loss. Therefore we agree with the board's proposals.

17. From a theoretical perspective, some may argue that how an investment is measured should be based on the nature of the investment rather than on the nature of the investor ie, that in all instances those investments held for capital appreciation, investment income or both should be measured at fair value through profit or loss while those investments acquired for wider business purposes should be consolidated. We have some sympathy for this viewpoint. However, we feel that introducing an exemption at a transaction level rather than an entity level would present structuring opportunities. We therefore pragmatically agree that it is necessary to limit the exemption to investment entities.

18. We would therefore recommend that the board undertakes a post implementation review once the exemption has been effective for one or two years in order to assess how it is working in practice.

Question 2

Do you agree that the criteria in this exposure draft are appropriate to identify entities that should be required to measure their investments in controlled entities at fair value through profit or loss? If not, what alternative criteria would you propose, and why are those criteria more appropriate?

19. We are not convinced by the board's decision to 'use US GAAP as the basis for developing criteria' for determining whether an entity meets the definition of an investment entity or not. This has resulted in detailed criteria being included in the proposals. While we agree that clear criteria are needed, we would recommend that a more principles-based approach is adopted. with the exemption from consolidation being made available to investments held by venture capital organisations, mutual funds, unit trusts and similar entities including investment-linked insurance funds (to borrow the wording from paragraph 1 of the current version of IAS 28). We believe that the criteria as drafted are too restrictive. While we believe that the board should retain some of them, we believe that some simplifications would be beneficial.

20. Turning now to each of the six criteria outlined in the proposals:

a) *Nature of the investment activity*

We do not believe that the exemption should only apply where the entity's 'only substantive activities' are investing in 'multiple investments'.

Firstly, we disagree with the 'only substantive activities' clause. Retaining such a clause would potentially prevent companies with a fund management element of their organisation from applying the exemption. For these companies, their investment management business is an extension of their underlying investment activities and as such is synonymous with their regular investment activities. It is often the case that the investment entity co-invests alongside the funds that the investment entity manages on behalf of third parties. While one solution would be to specifically allow investment entities to provide such services, we would prefer that all references to 'only substantive activities' are removed.

Secondly, we question whether 'multiple investments' are necessary for an entity to be an investment entity. If an investment entity is holding an investment for capital appreciation, investment income or both that investment should be measured at fair value through profit or loss regardless of whether the investor holds a single investment or many thousands of individual investments.

Paragraph B6 includes examples of relationships or activities that demonstrate that an entity is investing other than for capital appreciation, investment income or both. We agree that many of these items suggest just that. However, we believe that transactions that are carried out on an arm's length basis should not prevent an entity being exempted from consolidation.

b) *Business purpose*

We believe that this is the most important criterion. However, we feel that more emphasis should be given to the need for either an exit strategy for the investment (ie, how the entity plans to realise capital appreciation of its investments) or a strategy for generating long-term investment income (ie, holding to optimise capital appreciation and dividend income). We recommend that the board refers to this requirement not only in the application guidance but also in the body of the final standard.

c) *Unit ownership*

While we have no significant issues *per se* with this criterion, we do not see it as critical to whether a controlled investment should be consolidated or measured at fair value through profit or loss. We therefore suggest that the board delete it or be clearer as to why it is relevant.

d) *Pooling of funds*

The exposure draft proposes to require an investment entity to have unrelated investors who collectively hold significant ownership interests in the entity. As explained further in our response to question 4 below, we do not feel that there is any need for there to be multiple investors. What is critical is that those investors are unrelated to the fund manager.

e) *Fair value measurement*

Where investments are held for capital appreciation, investment income or both it follows that they are likely to be managed, and their performance evaluated, on a fair value basis. However, not all investments will be managed on a fair value basis. For example syndicated debt is unlikely to be managed in this way. While we note that the proposals state that 'substantially all' of the investments must be managed on a fair value basis for the exemption to apply, we are concerned that even a relatively small investment that is managed on a basis other than fair value may be considered enough to taint the whole fund. Therefore while overall we agree that this is a sensible criterion, we feel more clarity is needed around the issue of tainting.

f) *Providing financial information to its investors*

Criterion (e) above requires performance to be evaluated internally and externally on a fair value basis. Therefore, if that criterion is met then this criterion is likely to be met too. We do not understand why it has been listed as a separate criterion and therefore prefer the language used in paragraph B17 which combines the two when it talks about investments being managed and evaluated 'internally and externally' on a fair value basis.

The second sentence under this criterion is critical ie, that ‘the entity can be, but does not need to be, a legal entity’. This sentence opens up the possibility that an individual legal entity could measure the investments of, for example, one business unit at fair value through profit or loss while those of another are consolidated. We encourage the board to provide more clarity in this area.

21. If the board retains the detailed criteria in the exposure draft, we recommend that they consider creating an additional exemption for investment-linked insurance funds.

22. We believe an insurance company should be allowed to measure investments in certain investment funds at fair value through profit or loss regardless of what other investments it holds and, indeed, regardless of the proportion of the fund held. Information about the business strategy of the investment and the way is managed may be lost or misinterpreted by users of the financial statements if consolidation of controlled investment funds is required. The open-ended nature and liquidity characteristics of many investment funds mean that measuring investments in them at fair value through profit and loss provides users with the most useful and relevant financial information. It also reflects how such investments are managed and how their performance is evaluated. In addition, insurers cannot control the percentage of the fund they hold – as external investors are able to purchase and dispose of their holdings without restriction and therefore dilute or concentrate the insurers’ holding – and therefore they may consolidate the fund in some periods but not in others.

23. To avoid structuring opportunities, it may be necessary to introduce additional criteria that must be met before the exemption from consolidation can be applied to open-ended investment funds. We suggest that these criteria should be that the investments are managed on fair value basis, that the holder’s investment in the investee is not leveraged, that the investee itself is not leveraged, that external parties may increase or decrease their holdings in the investment at any time without restriction or penalty and that the investee is open to a wide range of investors and prices are publicly available.

Question 3

Should an entity still be eligible to qualify as an investment entity if it provides (or holds an investment in an entity that provides) services that relate to:

(a) its own investment activities?

(b) the investment activities of entities other than the reporting entity?

Why or why not?

24. As noted in paragraph 19(a) above, we disagree with the ‘only substantive activities’ criterion. Therefore, we believe that an entity which provides (or holds an investment in an entity that provides) services that relate to its own investment activities should be eligible to qualify as an investment entity. We also believe that an entity which provides (or holds an investment in an entity that provides) services that relate to the investment activities of entities other than the reporting entity should be eligible to qualify as an investment entity.

Question 4

Should an entity with a single investor unrelated to the fund manager be eligible to qualify as an investment entity? Why or why not? If yes, please describe any structures/examples that in your view should meet this criterion and how you would propose to address the concerns raised by the board in paragraph BC16.

25. We do not see why user needs change just because there is a single investor. As noted above and in the exposure draft itself, where investments are held for capital appreciation, investment income or both, more useful information is provided by measuring such investments at fair value through profit or loss. This is true regardless of how many investors there are. Therefore, we believe the exemption from consolidating controlled entities should be available where the definition of an investment entity is met even if there is only one investor.

26. We understand that the board introduced this criterion to try to limit abuse and appreciate their concerns. However, we feel that what is critical is not whether there is a single investor but whether that investor is unrelated to the fund manager. It is in situations where the investor and the fund manager are related that abuse may occur.

27. Consequently, we have no concerns, for example, with a sovereign wealth fund with a single investor qualifying as an investment entity provided that the investor is not related to the fund manager.

28. Careful consideration needs to be given to what is meant by 'related' in this context. For example, it is common for insurance companies to set up and manage investment businesses where the majority of units are held by the insurance company's own life assurance business. As drafted, the exposure draft would not allow the investment business to apply the exemptions it offers as they are related to their biggest investor (ie, the life assurance business). But in this case the reality is that the life assurance business is not investing its own funds but those of its policyholders, who themselves are not related to the fund manager. We feel that in these circumstances the investment business should be allowed to 'look through' the life assurance business to the underlying policy-holders and measure its investments at fair value through profit or loss, as this clearly better reflects the nature of the investment activities of the fund.

Question 5

Do you agree that investment entities that hold investment properties should be required to apply the fair value model in IAS 40, and do you agree that the measurement guidance otherwise proposed in the exposure draft need apply only to financial assets, as defined in IFRS 9 and IAS 39 *Financial Instruments: Recognition and Measurement*? Why or why not?

29. We agree that investment entities that hold investment properties should be required to measure those properties using the fair value model in IAS 40. Doing so would increase consistency, not only across an investment entity's overall portfolio but also across entities. We understand that many investment entities already chose to fair value investment properties. While the impact of this change is therefore likely to be minimal it is nonetheless welcomed.

30. We agree that the guidance proposed should otherwise be only applied to financial assets.

Question 6

Do you agree that the parent of an investment entity that is not itself an investment entity should be required to consolidate all of its controlled entities including those it holds through subsidiaries that are investment entities? If not, why not and how would you propose to address the board's concerns?

31. We strongly disagree with this proposal.

32. In our view the exceptions available to the investment entity should 'roll up' into its parent's own consolidated financial statements regardless of whether or not that parent is an investment entity ie, investments should continue to be carried at fair value through profit or loss rather than consolidated. If fair values provide users with the most useful information about investments held for capital appreciation, investment income or both at an investment company level, it seems incongruous to suggest that they do not also provide the most useful information in the context of the consolidated accounts of a non-investment group, which will itself be holding the investments for capital appreciation, investment income or both. Measuring the investments at fair value in the consolidated financial statements not only improves the visibility of the investments held by the investment entity but also better reflects the business model of this type of entity.

33. The proposals in this area are also inconsistent with the proposals in the exposure draft for investments in associates and joint ventures. Where an entity would be required to measure such investments at fair value through profit or loss at an investment entity level, the investments will be required to be measured in this way in the group accounts. There is no requirement for the equity method to be applied at group level. We believe a similar approach should be applied to investments in controlled entities measured at fair value through profit or loss ie, they should not be consolidated at group level.

34. From a practical level, these particular proposals would make the remainder of the exposure draft ineffective in situations where groups will have non-investment parts of their businesses and would have to therefore consolidate at group level investments which they are required to measure at fair value through profit or loss. Not only will the more valuable, user-friendly fair value information be lost in the group accounts – which may be the accounts most widely available to users - but any cost savings anticipated as a consequence of entities not being required to consolidate their investments will also be eliminated.

35. We note that the US FASB disagrees with the board on this point. We are supportive of the FASB's view that the exemption available to the investment entity should 'roll up' into its parent's own consolidated financial statements regardless of whether that parent is an investment entity or not. We do not consider that in this instance there is any sound conceptual basis which justifies creating and maintaining a GAAP difference.

36. We note the board's concerns about possible abuses of investment company status if the exemption from consolidation is retained in the investment company's parent's consolidated financial statements. However, we believe that these legitimate concerns are best addressed by a robust and appropriate set of criteria for the application of fair value accounting at a subsidiary level and by restricting or disclosing transactions between the investment entity and other members of its consolidated group.

Question 7

Do you agree that it is appropriate to use this disclosure objective for investment entities rather than including additional specific disclosure requirements? Do you agree with the proposed application guidance on information that could satisfy the disclosure objective? If not, why not and what would you propose instead?

37. We agree with the concept of having a disclosure objective for investment entities rather than a detailed list of specific disclosures. However, we feel that the disclosure objective included in paragraph 9 of the exposure draft could be clearer and better articulated. As it stands we do not believe it is clear what it is trying to achieve. We suggest expanding the objective to specifically require information on what the entity has invested in, what those investments cost, what they are currently worth, what the entity's exit strategy or strategy for generating long-term investment income is and an assessment of the risks the investments entail.

38. We are not supportive of proposed application guidance. We feel that many preparers will be confused by guidance that 'may satisfy' the disclosure objective. Some may feel obliged to include everything just to be on the safe side whereas others may see it as entirely optional and keep disclosure to a bare minimum. The former is likely to create excessive detail at a time when many regulators in the UK and beyond are trying to cut clutter in the financial statements. The latter may mean investors are ill informed. An enhanced disclosure objective – along the lines we suggest above - would mean that this application guidance would not be necessary.

39. Much of the information suggested by the proposed application guidance will already be disclosed by investment entities, either as part of the business review in the narrative part of their financial statements or because other standards (such as IFRS 7,12 and 13) require them to do so.

40. We note that paragraph B20 states that 'an investment entity does not need to apply the disclosure requirements… if other IFRSs require disclosures of the same information'. The board should determine which disclosures are already required by other standards and avoid repetition of requirements that already exist elsewhere; it should not be left to preparers of financial statements to work this out for themselves.

Question 8

Do you agree with applying the proposals prospectively and the related proposed transition requirements? If not, why not? What transition requirements would you propose and why?

41. Generally speaking, we are supportive of retrospective application of new standards unless doing so is impractical or the costs outweigh the benefits. In many cases retrospective application may be relatively straightforward as the investment entity will have been managing its investments on a fair value basis anyway and should therefore have the relevant information to hand that it will need to restate comparative periods.

42. Therefore, we would allow - but not mandate - retrospective application. If management have this information readily available and it is of more interest to users of the financial statements, there seems no reason to force them to apply the new standard prospectively. For the same reasons, we encourage the board to allow investment entities to voluntarily apply the new standard early.

43. We agree with the proposed transition arrangements.

Question 9

Do you agree that IAS 28 should be amended so that the mandatory measurement exemption would apply only to investment entities as defined in the exposure draft? If not, why not? As an alternative, would you agree with an amendment to IAS 28 that would make the measurement exemption mandatory for investment entities as defined in the exposure draft and voluntary for other venture capital organisations, mutual funds, unit trusts and similar entities, including investment-linked insurance funds? Why or why not?

44. We agree that investment entities should be required to measure associates and joint ventures at fair value through profit or loss, as this reflects their business model and is consistent with the proposed treatment for controlled entities. However, we see no reason to remove the option to measure such investments at fair value through profit or loss from entities that currently apply the IAS 28 exemption. In our view, the option to fair value through profit or loss under IAS 28 should be retained.

45. The current exemption is widely used, for example, by insurance companies for whom fair value is the most relevant measure for these types of investments. We understand that this works well in practice as, typically, these investments represent a subset of the insurers' portfolio of investments held to back liabilities and capital which are managed on a fair value basis. Removing this option would make insurers' financial statements less relevant or decision useful to users. We do not believe that the board has provided sufficient explanation as to why this element of IAS 28 should be amended. Moreover, we would not want prolonged debate on this issue to hold up the finalisation of the consolidation exemption. We therefore suggest that the board retains this option, perhaps returning to it in the future as part of a wider reaching project on equity accounting.

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