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| To: | AASB members | Date: | 18 November 2011 |
| From: | Lisa Panetta & Angus Thomson | Agenda Item: | 9.1 |
| Subject: | Consolidation – Investment Entities | File: | -- |

Action

Agree on the main points to be included in the AASB's submission to the IASB ED/2011/4 *Investment Entities*.

Attachments

Agenda paper 9.2 – comments received on AASB ED 220 *Investment Entities*

Agenda paper 9.3 – AASB Media Release *Investment Entities proposals could have far-reaching impacts* dated 4 October 2011

Agenda paper 9.4 – AASB ED 220 *Investment Entities* (incorporating IASB ED/2010/4)

Background

At its September 2011 meeting, the Board considered the IASB's ED/2011/4 *Investment Entities* that was issued on 25 August 2011 for comment by 5 January 2012, and agreed to incorporate it in an AASB ED with a brief Preface that:

- * in broad terms, notes the range of entities that might fall within the scope of the IASB's proposals and outline those types of entities that might be affected by ED/2011/4, including entities that could be impacted because they would not meet the proposed criteria for 'investment entities'; and
- * includes a question for Australian constituents to identify the types of entities they consider might be affected and the costs and benefits, whether from a user or preparer perspective, they may experience depending on whether those types of entities meet the 'investment entities' criteria.

The Board noted its decision in July 2011 that the Chairman should raise questions about the proposals in the IASB ED in a media release.

ED 220 is open for comment by 30 November 2011. To-date two written responses have been received. Any further constituent responses will be sent to you or tabled, depending on when they are received.

Targeted Outreach

The Board agreed that staff should conduct telephone and face-to-face meetings with constituents in the period leading up to the end of the comment period.

Staff have conducted discussions with a range of constituents, including general insurers, life insurers, bankers, fund managers, superannuation entities, regulators and auditors.

The following are the main themes that emerged from the discussions. Those who spoke with us were largely expressing personal views that may or may not reflect the views of the organisations that employ them or with which they are affiliated.

Overall support for the proposals

In general terms, those supporting the proposals consider that there are many circumstances in which users would be better off with FVTPL accounting for subsidiaries rather than consolidating those subsidiaries because:

- * some entities and their users are purely focused on investment returns;
- * it can better reflect the parent's risk exposure, such as where risk is confined to the investment risk and the parent is protected from exposure to risks relating to the underlying liabilities of the subsidiary;
- * it can better reflect a 'through the eyes of management' approach in many cases;
- * the proposals could give rise to greater consistency in reporting on direct and indirect investments, such as where one entity invests directly in say international shares and another has a majority interest in a fund that invests in international shares (because consolidation gives rise to a non-controlling interest);
- * control in some investment settings (such as with layers of fund management entities) is temporary, inadvertent or passive – that is, in the event the parent does not agree with a subsidiary's management approach, the practice is for parents to sell down their interests rather than exercising a capacity to control;
- * consolidations can be more costly than identifying fair values for subsidiaries, especially where the investment is (already) managed on a fair value basis; and
- * fair values can be determined more quickly than consolidations, especially where the investment is (already) constantly managed on a fair value basis, and that means financial statements can be made available on a more timely basis and can be more useful to users.

Overall opposition to the proposals

In general terms, those opposing the proposals are concerned that:

- * it is not clear how entities would determine if there is 'collectively significant ownership' by unrelated investors – this seems to be a potential rival concept to 'control' and 'significant influence';¹
- * they will give rise to different accounting outcomes in similar situations because the criteria are not principle-based – for example:

1 Paragraph BC16 of ED/2011/4 comments: "The boards noted that a typical investment entity would have significant external investment and concluded that investors unrelated to the entity or its affiliates should collectively have significant ownership in the investment entity."

- + managed investment schemes (MISs) with investments in ‘real’ assets (toll roads etc.) would not seem to qualify (because they develop and manage), yet the MISs could alternatively have units in other entities with real assets and meet the criteria;
- + some securitisations may hold similar assets but have different ownership structures that mean they do, or do not, meet the criteria; and
- + superannuation plans can be unitised or use account balances and crediting rates, and only the former would seem to meet the criteria;
- * they serve no useful purpose because they cannot be applied at higher levels of a (non-investment entity) group;
- * without consolidation, information is lost about leverage and other risks – these may be able to be made up through additional disclosures, but the existing proposed disclosures would not suffice – more information would be needed about leverage in subsidiaries and past asset write-downs to assess the management’s track record on the efficient use of capital;
- * they will give rise to structuring opportunities to achieve particular accounting outcomes; and
- * they will deprive some users of useful information because some entities that presently apply FVTPL to associates and interests in joint ventures will be forced to apply equity accounting.

Suggested alternatives to the proposals

- * There should be greater limits on the entities that are classified as ‘investment entities’ to avoid structuring – for example, limiting them to those entities that have a track record of passive investment in subsidiaries.
- * Use the existing ‘list’ of entities in IAS 28 *Investments in Associates and Joint Ventures* to determine those entities that are investment entities. That list is “venture capital organisations, mutual funds, unit trusts and similar entities including investment-linked insurance funds” [IAS 28, paragraph 18].
- * Add to the entities that qualify as investment entities the existing ‘list’ of entities in IAS 28 allowed to use FVTPL.
- * It should be optional whether an investment entity prepares a consolidation or uses FVTPL.
- * FVTPL accounting should be required only where it would remove an accounting mismatch.
- * FVTPL accounting should be permitted only where it would remove an accounting mismatch – similar to the option to designate at FVTPL in paragraph 4.5 of AASB 9 *Financial Instruments* (IFRS 9).
- * There should be modifications to the proposed ‘unrelated investors criterion’ [see paragraph 2(d) of ED/2011/4] to cater for entities in the start-up phase, such as those that start with only one investor but later expand their investor base – otherwise they will start with one form of accounting and have to transition to another. A related view is that governments should not have to meet the criterion in paragraph 2(d) as single investors on behalf of taxpayers.
- * the same requirements as apply in North America should apply in the IFRSs, including requiring FVTPL accounting to flow up into higher levels in the group.

Entities that currently don’t need to apply equity accounting

Under existing IFRSs, venture capital organisations, mutual funds, unit trusts and similar entities including investment-linked insurance funds that use a fair value through profit or loss (FVTPL)

approach to entities they significantly influence need not apply equity accounting to those investees [IAS 28, paragraph 18].

ED/2011/4 proposes replacing that scope out with a reference to ‘investment entities’.

Some constituents are deeply concerned that equity accounting will need to be applied to interests in other entities that they believe should be at FVTPL. In particular, insurers are likely to be significantly affected. AASB 1023 *General Insurance Contracts* and AASB 1038 *Life Insurance Contracts* currently require insurers to apply FVTPL accounting to associates and interests in joint ventures. Some insurers believe that the proposals would give rise to material and misleading accounting mismatches between assets and insurance liabilities.

Some of those who support the general thrust of the exception from consolidation for investment entities are so concerned about the impacts of the proposed changes to the scope out in IAS 28 that, overall, they would prefer the proposals do not go ahead.

Other issues

- * Although it is proposed that transition be prospective, entities would still need to work out the equity accounted amounts from transition date if they lose the exemption from equity accounting – it could be difficult to determine the original cost because they might have been using FVTPL accounting for decades;
- * ED/2011/4 proposes prospective transition and, if the project proceeds, it would be an amendment to IFRS 10, which has retrospective transitional arrangements;
- * It is not clear how superannuation entities would identify ‘collectively significant’ unrelated investors because all the investors could be considered unrelated or they could all be considered to be related.
- * There are potential inter-actions with IFRIC 12 *Service Concession Arrangements* and those concession arrangements with financial assets could be investment entities, but those with intangible assets would seem not to be investment entities.
- * The proposals are different from US GAAP (which generally has a wider scope for investment entities) and will not necessarily improve the prospects for IFRS – US GAAP convergence.
- * If the FVTPL accounting were allowed to flow up into the group, it could solve the mismatches created by the existing accounting for investments in own shares.
- * There might be many debates about an entity’s primary purpose and different constituencies might have different perspectives, for example, insurers selling largely investment-linked products might think they are primarily investors while customers and regulators might think of them as (insurance) risk bearers because of the existence of insurance riders in those products.

Overall comment

While some constituents were generally in favour of the ED/2011/4 proposals, none were completely satisfied with them. That is, even those constituents who are generally in favour of some type of relief from consolidation have one or more significant concerns about the proposals.